

## Overview of updated transfer pricing administrative guidance from the German tax authorities

Update of 2005 guidance leaves questions remaining that could lead to disputes between taxpayers and tax authorities.

Germany's federal Ministry of Finance (MOF) released long-awaited transfer pricing administrative guidance ("Administrative Principles 2020" (*Verwaltungsgrundsätze 2020*)) on 3 December 2020 through a circular that makes some welcome updates to the previous guidance from 2005 ("Administrative Principles Procedure 2005"); however, the new guidance partly lacks a legal basis under the current law and the guidance leaves some questions unanswered that could lead to potential disputes between taxpayers and the tax authorities. The new guidance also provides for some procedural changes that shift the burden of proof regarding transfer pricing matters to the taxpayer in certain situations and grant additional rights to the tax authorities. This article highlights some relevant aspects of the new guidance and how they could affect tax audits.

### I. Introduction

In addition to the tax law and decree laws that are binding on taxpayers, the tax courts, and the tax authorities, the MOF has published a series of items of administrative guidance that aim to ensure a comparable level of scrutiny regarding the examination of transfer prices across Germany, but which are binding only on the tax authorities. As noted above, on 3 December 2020, the MOF released the Administrative Principles 2020, which focus on taxpayers' duty to cooperate with the tax authorities ("duty to cooperate"), the burden of proof in transfer pricing matters, foreign language issues, and the tax authorities' right to estimate the tax base. As from their publication in the federal tax gazette, which occurred in December 2020, the Administrative Principles 2020 are applicable for all German tax audit assessment periods that remain open.

In response to 2017 amendments to the general transfer pricing documentation requirements in section 90 (3) of the German General Tax Code (GTC) to conform with the recommendations under [BEPS action 13](#), the MOF amended the decree law on the transfer pricing documentation requirements (*Gewinnabgrenzungsaufzeichnungsverordnung*) on 12 July 2017, effective for fiscal years beginning after 31 December 2016. However, the Administrative Principles Procedures 2005 (dated 12 April 2005) regarding the legal requirements for transfer pricing documentation under section 90 (3) of the GTC had not been updated, and were applicable until the publication of the Administrative Principles 2020 (and remain applicable to the extent that they do not conflict with the Administrative Principles 2020).

The Administrative Principles 2020 deal less than what might have been expected with the new transfer pricing documentation approach implemented in Germany in 2017, and they modify the burden of proof in transfer pricing matters in a way that may disadvantage taxpayers and pave the way for increased use of estimates by the tax authorities to assess taxable income during a tax audit.

### II. Summary of the main aspects of the new guidance

The key provisions of the Administrative Principles 2020, and conclusions that could be drawn based on these provisions, can be summarized as follows:

- The scope of the general duty to cooperate is explicitly limited by the principle of proportionality, but also is clearly extended in other respects;
- Generally, the choice of language (e.g., "spoiler of evidence," "non-arm's length arrangement") could be interpreted to imply a certain tendency of suspicion by the tax authorities with respect to taxpayers;
- There are additional obligations for taxpayers to submit documents and data, such as expert opinions, e-mails, messenger service messages, etc.;
- A "best method rule" is introduced, i.e., the taxpayer is obliged to document the

reasoning behind the choice and appropriateness of the transfer pricing method applied;

- The tax authorities are granted the right to select an alternative transfer pricing method, i.e., they may select the transfer pricing method that they consider to be the most appropriate (“alternative method”);
- The scope of what is considered required documentation is broadened to include, among other things, a requirement to submit the group’s accounts;
- The tax authorities are granted the right to adjust a taxpayer’s income in the event that it is “more probable” that the transfer prices determined by the tax authorities correspond to the arm’s length standard;
- The submission of “usable” records by the taxpayer does not preclude the tax authorities from estimating transfer prices (under section 162 (1) and (2) of the GTC);
- The details of the taxpayer’s specific duty to cooperate may be discussed in advance with the tax authorities responsible for the field tax audit; and
- Direct reference is made to the topic of criminal tax proceedings.

### **III. Duty to cooperate**

A variety of matters covered within the Administrative Principles 2020 broadly relate to the duty to cooperate, including an increased duty with respect to cross-border transactions to ensure access to relevant information, special obligations under the GTC (including those relating to transfer pricing documentation in a foreign language and other transfer pricing documentation measures), and the tax authorities’ power to estimate the taxpayer’s tax base in a situation where they consider that the taxpayer has breached the duty to cooperate.

#### 1. General provisions

The Administrative Principles 2020 state (in paragraph 5) that the scope of the duty to cooperate depends on the circumstances of each individual case and is limited by the “principle of proportionality.” Although this clear statement on the limitation of the duty to cooperate is welcome, further specifics are not provided and, therefore, the wording provides only limited protection for the taxpayer that could apply in the case of particularly excessive information requests.

In contrast to the Administrative Principles Procedures 2005, the Administrative Principles 2020 contain a reference (in paragraph 4) to the relationship between criminal proceedings and taxation proceedings (section 393 of the GTC), without providing further specifics. Since the MOF circular setting forth the principles is addressed (in particular) to the tax authorities, the question may arise as to whether this reference is intended to increase the scrutiny of tax auditors regarding criminal tax offenses and, thus, to possibly accelerate the trend of increasing criminal prosecution of potentially inappropriate transfer pricing arrangements that has been observed in recent years.

#### 2. Increased duty to cooperate with respect to cross-border transactions

The Administrative Principles 2020 (paragraph 9 and following) contain provisions relating to fact-finding, including statements on obtaining evidence located in foreign countries. The parties involved are obligated to ensure that evidence is accessible and that precautionary measures are taken to ensure that the parties can comply with the increased duty to cooperate that applies when dealing with matters abroad (pursuant to section 90 (2) of the GTC; the duty is increased since the German authorities and courts do not have the same ability to obtain information abroad that they do domestically). Under the guidance (paragraph 13), evidence includes expert opinions and statements on transfer prices, to the extent that they were used for price setting or the determination of income. Evidence also includes emails, messenger service messages, and other electronic communications, to the extent that they represent commercial documents that are tax relevant.

It is understandable that the MOF would wish to adapt the Administrative Principles Procedures 2005 to modern means of communication. However, the Administrative Principles 2020 provide no specifications regarding how information requests relating to the parties’ overall electronic communications would comply with the principle of proportionality. In view of the fact that tax auditors increasingly are requesting substantial information on email communications, the guidance could be interpreted as an implicit call for further measures regarding stricter tax audit investigations.

On a similar note, the Administrative Principles 2020 (paragraph 14) require that the parties involved in foreign transactions undertake precautionary measures to ensure that evidence

is retained for the appropriate period and can be provided to the authorities to fulfill the increased duty to cooperate. The guidance indicates that clauses relating to information should be included when an (intercompany, cross-border) agreement is concluded, to ensure that the German contracting party has access to the information located abroad and is able to present it to the tax authorities upon request. In addressing the necessary documents in more specific terms, the guidance refers to the “prudent business manager” approach and provides corresponding examples regarding the kind of information to which a German entity should ensure access:

- Sales prices abroad, in the case of application of the resale price method;
- The basis for calculating costs incurred in connection with services provided, in the case of application of the cost plus methodology;
- Evidence of the contributions of all parties involved, in the case of cost contribution arrangements;
- Revenues of licensees, in the case of revenue-based royalties; and
- Information on total profit, in the case of application of the profit split method.

In line with the Administrative Principles Procedures 2005 (section 3.3.2.b)), the MOF presumes in the Administrative Principles 2020 (paragraph 15) that in the case of a direct or indirect majority shareholding, the party involved/taxpayer has the legal ability to obtain information and evidence. The same applies in the case of a “personal union,” i.e., where the same individual acts as a managing director of both the German entity and the foreign entity.

Consistent with current case law and with the Administrative Principles Procedure 2005 (section 3.3.2.e)), any foreign restrictions on providing information to the authorities do not release a party from its duty to cooperate under section 90 (2) of the GTC. In the event of a possible conflict of obligations, the tax authorities should consider the foreign restrictions when applying the estimation rules under section 162 (1) of the GTC.

Aside from the procedural changes, the most significant changes in the new guidance in comparison to the Administrative Principles Procedures 2005 are those with possible tax-technical consequences. In the Administrative Principles 2020 (paragraph 23), it is stated that in the event of a breach of the duty to cooperate by the taxpayer, “that facts may be assumed to be to the disadvantage of the taxpayer” to the extent that there is “a certain degree of probability” (emphasis added) for the fact pattern assumed. The use of such an imprecise term is questionable—especially in light of the significant impact that an income adjustment may have on the fundamental rights of taxpayers.

### 3. Documentation obligations under section 90 (3) of the GTC

#### *3.1 General provisions*

The Administrative Principles 2020 provide (in paragraph 34 and following) that records required under section 90 (3), sentence 3 of the GTC (i.e., the “master file”) may be submitted in a foreign language if an application is submitted to and approved by the competent tax authority. The application to submit the transfer pricing documentation in another language (commonly English) should be submitted before the documentation is prepared, and may be submitted no later than immediately after receiving the request for submission of documentation from the tax authority. Transfer pricing documentation is considered “unusable” if the documentation is provided in a foreign language without the consent of the tax authorities and the taxpayer does not translate the documentation despite being requested to do so. In practice, it should be increasingly possible to address the language issue by using intelligent translation software.

Consistent with the Administrative Principles Procedures 2005, the documentation must provide evidence of the taxpayer’s “serious efforts” to set its transfer prices in accordance with the arm’s length principle. The new administrative principles (paragraph 36) broaden the concept of “serious efforts” to include all documentation (documentation of the facts and circumstances, and economic analysis).

The Administrative Principles 2020 include additional language that is stricter than that of the 2005 guidance and that appears unfavorable to taxpayers. Under the new guidance on the estimation of the tax base (paragraph 80): “If the taxpayer thereby violates their record-keeping obligations ..., it is rebuttably presumed ... that the income from [cross-border, intercompany] business relations has been reduced by a non-arm’s length arrangement” (formerly, only “non-arm’s length price setting” was presumed). As noted above, in principle,

a review of the Administrative Principles 2020 may create the impression that the wording of these principles is influenced by a choice of wording that may reflect a general suspicion against taxpayers that their transfer pricing is part of aggressive tax structures and that the parties involved are not prepared to provide the necessary transparency for the tax authorities.

### *3.2 Documentation of the facts and circumstances*

The 2020 Administrative Principles provide examples of the information that may be relevant in documenting the pertinent facts and circumstances, depending on the type of business relationship. The examples are function-based and, significantly, cover only business activities with traditional business models. More modern aspects, such as digitalization, service-oriented business models, and industry-specific features are not covered. Similarly, the new administrative principles (unfortunately) do not address issues such as the presentation of the value chain or value contribution analyses required by law. From a transfer pricing analysis perspective, both the functional and the risk analysis, as well as the value chain analysis, provide an essential foundation for the economic analysis. Accordingly, it is puzzling as to why the MOF has not provided more specific guidance with respect to the documentation of the factual background.

### *3.3 Economic analysis*

The section of the Administrative Principles 2020 that relates to the economic analysis introduces some new elements. As noted above, the principles (paragraph 45) introduce a "best method rule," i.e., the taxpayer is required to record in each case why the transfer pricing method applied is considered to be the most appropriate method. It is welcome that the Administrative Principles 2020 clearly state that taxpayers are not obliged to demonstrate the appropriateness of their transfer prices by more than one method. However, the manner in which the best method has to be identified remains unclear. In addition, the best method rule is not supported by the current language of the relevant law, which clearly prescribes a priority for the comparable uncontrolled price method, the resale price method, and the cost plus method. The German government has since issued a legislative bill that would provide for the legal basis that currently is lacking, if enacted.

Regardless of the best method rule, the guidance (paragraph 46) grants the tax authorities the right to select a method deviating from the method applied by the taxpayer that they consider is the "correct" transfer pricing method, i.e., the "most appropriate" transfer pricing method ("alternative method") in the tax authorities' view. However, the tax authorities must demonstrate that that it is "more probable" that the results of the alternative method are correct (probability is discussed further below in the section on estimation of the tax base). The tax authorities are thus given the opportunity to question transfer pricing methods in principle and, based on the facts of the case, to select a transfer pricing method from their perspective. If the guidance were limited to permitting the tax authorities to use alternative (transfer pricing) methods for corroboration purposes, this would be in line with the current law and case law, but the guidance goes beyond this in granting broad power to the tax authorities.

It would seem that if the taxpayer derives the transfer price from the available data with due diligence in accordance with the principles of a prudent business manager, it would be unreasonable for the tax authorities to challenge the pricing in principle, on the basis of an alternative method. The key issue in the delineation of the transfer pricing method used by the taxpayer and the alternative method determined by the tax authorities is how the term "probable" is put into operational terms. "Probability" is a concept from decision theory, where the objective is to resolve decision-based problems in the face of uncertain expectations. If one were to follow this technical approach, it would seem to mean that in the future, the German tax authorities would have to demonstrate—using analytical procedures, sensitivity analyses or other procedures—the probability that the alternative method used would produce a result that is closer to arm's length than the transfer pricing method originally used by the taxpayer.

When applying the hypothetical arm's length test, the Administrative Principles 2020 require the performance of "sensitivity analyses," in addition to the documentation of the appropriateness of the assumptions and parameters on which the valuation is based (see paragraph 47). The analyses should provide information on how the determined value of the asset valued changes if alternative assumptions and parameters are selected for the model. There are legal questions as to whether the last requirement mentioned (relating to alternative assumptions and parameters) is within the scope of the statutory law on

documentation obligations.

As under the Administrative Principles Procedures 2005, the Administrative Principles 2020 (paragraph 49) provide that the relevant point in time for the arm's length comparison is generally the time of the conclusion of the contract, and not the time of performance. Thus, the arm's length test is based on the time of the agreement to the business transaction. In addition, the new guidance allows a quasi-outcome test, under which arm's length data that subsequently becomes available can be used, to the extent that the data relates to the time of the agreement to the business transaction.

In addition, the Administrative Principles 2020 (paragraph 51) require that the tax-relevant documents and balance sheets of all parties involved, including the individual financial statements that can be consolidated (group accounts) "must be submitted for the performance of the economic analysis." This seemingly disregards the principle of proportionality.

In the event of difficulties in fulfilling the documentation and record-keeping obligations covered above, the Administrative Principles 2020 (paragraph 65) offer the taxpayer an opportunity to discuss the requirements in advance with the tax authority responsible for the field tax audit.

#### 4. Estimation of the tax base under section 162 of the GTC

##### *4.1 General provisions*

The Administrative Principles 2020 (paragraph 67) quote from a decision of the federal tax court (BFH) that the "spoiler of evidence" should not derive any advantage from this behavior. The term "spoiler of evidence" refers to a party that violates the duty to cooperate by failing to proactively disclose tax-relevant facts to the tax authorities.

In principle, the tax authorities carry the burden of establishing the facts that give rise to or increase a tax liability (see paragraph 68). The question of the burden of proof arises if a fact relevant to the decision cannot be completely examined, despite the exhaustion of all accessible and reasonable possibilities of investigation. The question that repeatedly arises in practice is how the concept of "completeness" is to be applied. In the event that the tax authorities come to the conclusion that the taxpayer did not provide complete clarification of the facts, they could conclude that the taxpayer violated the duty to cooperate and provide evidence, with the result that the tax authorities' duty of investigation would be considered to be reduced accordingly. As a result, the tax authorities would have the right to estimate the taxable amount.

Under the new guidance (paragraph 70), the basis for an estimate is to be derived from the facts and circumstances that come closest to reality, by the exercise of judgment. The results of the estimate must be "conclusive, economically possible and reasonable." It is also stated that any inaccuracies due to the estimate are at the taxpayer's expense. These statements could be interpreted as granting an exceedingly broad power for estimates by the tax authorities, but another provision (paragraph 73) appears to try to limit such estimates. In line with the discussion above on the economic analysis, the arm's length price can be determined with the greatest possible probability of correctness by using a suitable ("alternative") transfer pricing method to verify the transfer price actually agreed upon, and as a basis for the estimate. In paragraph 73, the concept of "probability" is described as meaning that there must be a higher probability that the transfer price determined by the tax authorities corresponds to the arm's length price than the probability that the transfer price applied and documented by the taxpayer corresponds to the arm's length price. How this probability of correctness can be determined or proven remains unclear.

Paragraph 73 also provides that "usable" records are merely the starting point for the audit: "The submission of usable records therefore also does not exclude the power of estimation of the tax authority."

##### *4.2 Power of estimation*

Under the Administrative Principles 2020 (paragraph 75), an estimate is unlawful if it exceeds the scope of the estimate determined by the tax authorities' information regarding the case. If the tax authorities' estimate is deliberately and arbitrarily to the detriment of the taxpayer, this can lead to the invalidation of the assessment notice.

It is interesting that the new guidance states (paragraph 87) that an estimate can be reviewed and corrected in a mutual agreement or arbitration procedure following the tax audit. This indicates a potential remedy for an incorrect estimate.

#### **IV. Outlook and recommendations**

The provisions of the Administrative Principles 2020 were analyzed in detail above with regard to their legal basis, the potential effects on tax audits, and possible disputes between the tax authorities and taxpayers in the future.

In light of the increasing complexities of transfer pricing, it would seem that the aim of all parties involved should be to find a solution-oriented approach and to avoid further escalation of disputes. The new guidance does not appear to be in line with these objectives. This is surprising since both the OECD and the MOF have placed the topic of dispute avoidance (procedures) around the top of their tax agendas.

In light of the new guidance, in the event of a tax audit, taxpayers are recommended to discuss and agree in advance with the tax authorities on the duty to cooperate, the expectations of the tax authorities in this regard, and tax-technical issues (e.g., acceptance of the transfer pricing method). In the event that the estimation rules are applied, multinational groups may wish to have the estimate reviewed (and corrected, if necessary) in a mutual agreement procedure following the tax audit. Unfortunately, the new guidance also raises many procedural questions that likely will be settled only by the tax courts.

The Administrative Principles 2020 could be seen as taking “one step forward, two steps back,” i.e., it could be perceived that in some ways the new guidance is regressive, rather than progressive, for both taxpayers and the German tax authorities.

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