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URL: http://www.deloitte-tax-news.de/german-tax-legal-news/updated-transfer-pricing-principles-provide-new-mof-guidance-on-financing-structures.html

29.07.2021

German Tax and Legal News

Updated transfer pricing principles provide new MOF guidance on financing structures

Tax authorities require "control" and "risk" at the level of a foreign financing company to claim a German interest deduction.

The German Ministry of Finance (MOF) published a decree providing updated "Administrative Principles regarding Transfer Pricing" on 14 July 2021. The updates generally were made in response to recently enacted legislation (specifically, the law to implement the EU anti-tax avoidance directive ("ATAD implementation law") and the law on the modernization of withholding tax relief and certification of withholding tax) and the February 2020 guidance on financial transactions provided in chapter X of the OECD transfer pricing guidelines; however, the decree also provides some unexpected new guidance regarding intercompany loans by a foreign financing company to a German borrower. The new decree replaces several decrees that were issued in the past in relation to transfer pricing, in particular, the original decree from 1983 and the 2011 decree regarding the application of section 1 of the German Foreign Tax Act on impairments of intercompany loans, as well as certain portions of the "Administrative Procedural Principles" from 2005 (to the extent they were not already replaced by the updated "Administrative Principles 2020" released in December 2020). The new decree must be applied to all open cases.

The most noteworthy aspect of the new decree is that the tax authorities included certain provisions regarding intercompany financing structures in the decree that originally were included in the December 2019 initial draft of the ATAD implementation law but that were eliminated during the legislative process.

The new decree provides that the interest rate on a loan provided by a foreign financing company must be determined based on a risk-free market return, unless the foreign financing company has the ability and authority to control the investment of the funds and bear the financial risk. Although the decree is silent on how sufficient "ability" and "authority" of the foreign financing company is to be determined and documented, there seems to be an intent by the tax authorities to deny a finding of sufficiency in the case of financing companies that lack substance and properly qualified employees. In such a situation, for tax purposes, a German borrower would be allowed to deduct only a risk-free market return as an arm's length expense. The decree also states that the remuneration for the financing company in such a situation generally must be calculated based on the cost-plus method on the basis of directly attributable operating costs. The decree specifically disallows the inclusion of refinancing costs in the cost base.

The new decree includes an example where a non-German equity financed group company (owned by an ultimate parent located in Germany) provides an intercompany loan to a German resident borrower without the financing company taking over the control and risk related to the funds. The tax authorities describe their view that the remuneration for the activity of the lender must be calculated based on the directly allocable operating expenses, e.g., wage expenses. The refinancing costs in such a scenario are limited to a risk-free return. As a result, the tax authorities consider an interest rate that exceeds a risk-free return as not being in line with the arm's length principle.

The guidance regarding financing activities/structures provided in the MOF's new decree comes as a surprise to tax practitioners and leaves many questions unanswered. Even though it seems to be the intent of the tax authorities to apply the principles described above to financing companies without sufficient substance, it is unclear what exactly sufficient "ability and authority" in relation to control and risk means for purposes of the decree, and how the requirements imposed by the tax authorities could be met. In addition, it remains to be seen whether the approach of the tax authorities would be upheld by the federal tax court (further clarification is expected later in 2021).

The tax authorities refer to their guidance as a "clarification" of the arm's length principle and therefore intend to apply the guidance to all open cases with retroactive effect. This approach seems to be questionable in light of the original inclusion of similar provisions in the first draft of the ATAD implementation law back in December 2019, which seems to indicate that the provisions do not represent a mere clarification of an established principle.

Taxpayers, nevertheless, are strongly encouraged to assess the risk of the principles for financing arrangements described in the new decree being applied in their specific situation.

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