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German Income Tax Audits

Survey on the experiences of inbound investors

As countries seek to increase tax revenue in the wake of the global financial crisis, enforcement measures, including tax audits, have received renewed and increased attention. This is also the case in Germany where tax audits have historically always played a significant role in the overall taxation and tax revenue collection process.

Within this study, Deloitte Germany aims to provide an overview on the current status of tax audit experiences and perceived trends for multinational groups with German investments. This survey focuses on income taxation (including transfer pricing); indirect taxes were not in the scope of our research.

Approach

Deloitte Germany has conducted a web-based survey on the income tax audit experiences of German inbound investors. During June and July 2010, 234 respondents from at least 18 countries answered 35 questions on their experiences with German income tax audits in the following areas:

- Technical aspects (years covered, duration, etc.)
- Most important issues raised
- Perception of the process
- Results (i.e. tax payments and/or tax refunds)
- Response to the results

Most respondents were publicly quoted groups with annual sales of more than €1bn globally and €50m to €500m in Germany; most were headquartered in the U.S., the U.K. and Japan. The German operations were mainly in the form of corporations. Most German operations are classified as "large" and, thus, subject to continuous and comprehensive German tax audits.

Key findings

The survey reveals that inbound investors generally have many open tax years and they undergo lengthy German tax audits, which results in considerable tax uncertainty. On average, the German operations were audited through 2004. Current tax audits on average cover years through 2006.

Transfer pricing is by far the most important issue in past and current tax audits, and the survey suggests that the significance of transfer pricing will continue to grow. Transfer pricing adjustments mainly arise from a failure to comply with the arm's length principle. Close behind transfer pricing issues in importance are accruals and the deductibility of business expenses, even though the survey shows that tax audits in these areas do not necessarily generate high additional taxes. Other frequent tax audit areas include asset valuations, financing, reorganizations, tax losses, tax groups and withholding taxes. Future tax audit topics are likely to include valua-

tions, the relocation of functions, substance, anti-abuse, business purpose and the compatibility of bookkeeping with statutory requirements.

German tax audits tend to be costly for both inbound and outbound investors. On average, the last completed income tax audit resulted in (normalized) additional taxes of 49% of the relevant group's average German income tax expense per year. However, the cash impact of tax audits can in certain cases be significantly more severe. Respondents who ranked tax group issues among their top three issues on average paid 97% of the annual average income tax (rather than 49%). While a group's overall tax planning approach impacts the likelihood of German tax adjustments, the survey does not suggest that it is economically effective to be "very conservative." The shareholder and legal structure can affect the outcome of a German tax audit, with private equity investors suffering the highest adjustments, and partnership structures appearing to be more exposed than corporate structures.

Taxpayers should try to actively manage their tax exposure to minimize (e.g. via tax planning) the amount of additional tax and reduce interest charges. Inbound taxpayers should note that while the group's overall tax planning approach impacts the likelihood of being subject to tax audit adjustments, the survey does not support a conclusion that it is economically efficient to be "very conservative".

Certain investor groups need to better prepare for German tax audits. The German operations of private equity-owned groups suffered the highest German tax audit charges, which should be addressed by more proactive management, documentation and a detailed tax review of the identified risk areas.

Proper preparation for the next tax audit is key when tax functions want to address risks associated with German tax audits. Ensuring that sufficient documentation is readily available, and that there are clear responsibilities for dealing with the audit within the taxpayer's organization all play a significant role in mitigating audit-related exposures, and they help to reduce the burden of dealing with a tax audit on an ad hoc-basis. Deloitte experts can assist your organization in adequately addressing German tax audit-related risks.

Contact us

If you have any questions or wish to discuss any of the topics covered in the survey in more detail, please do not hesitate to contact the following tax partners:

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