New German Transfer Pricing Documentation Rules

Dr. Rolf Heinrich *and* ***William Bader***
KPMG, Munich

In the spring of this year, Germany enacted its first transfer pricing documentation rules, thus joining the club of some 30 countries that have legislated or otherwise established such rules. On June 12, 2003, the German tax authorities released a substantially revised draft of regulations implementing the new laws.[1] This article analyses the new legislation, discusses the proposed regulations, finalisation of which is not expected until September 2003, and offers preliminary advice to taxpayers.

I. Background of Transfer Pricing Documentation Legislation

The new transfer pricing legislation is a legislative response to the defeat the tax authorities perceived themselves to have been dealt by the German Federal Tax Court's judgment of October 17, 2001.[2] The tax authorities found this judgment unacceptable in several respects:

- The judgment held that there was no basis in German tax law for requiring taxpayers to compile transfer pricing documentation. Since another court decision indicated that whatever relevant documentation in fact existed would have to be produced on audit,[3] the tax authorities feared that some taxpayers might adopt a policy of minimal documentation so as to make their transfer prices as difficult to audit as possible.[4]
- While holding that taxpayers were required to explain to the tax auditors how their transfer prices had been arrived at, the judgment appeared to deny an effective sanction for failure to comply with this obligation.[5] The tax authorities therefore feared that the judgment would encourage taxpayer audit stonewalling.
- The court also held that subsidiaries were generally not required to produce documents, for example on price calculation, that were held by their parent company because a subsidiary was unable as a legal matter to compel its parent to provide the documents and because uncontrolled parties dealing with each other at arm's length do not customarily condition their consent to do business on access to their counterparty's confidential business records.
- Though the court held that a rebuttable presumption could arise against the taxpayer in certain circumstances and lead to estimation of appropriate transfer prices, the court's reasoning seemed convoluted and narrow, hence hard to use offensively in future cases.[6]
- Finally, the judgment held that transfer prices could as a rule only be determined (estimated) within a certain range and that the taxpayer must generally be given the benefit of the most favourable value in the range. This suggested to the tax authorities that taxpayers could set inappropriate transfer prices with impunity, since any adjustment would merely return them to the most favourable position they could legitimately have taken.

The new transfer pricing documentation rules seek to reverse the negative aspects of the October 2001 decision and translate its positive aspects – rebuttable presumption and estimation – into an effective sanction for deficient documentation compliance.

II. Text of Documentation Statute

The transfer pricing documentation requirements are contained in new section 90 (3) AO (Tax Procedure Act), which reads as follows (sentences numbered for ease of reference):

> 1In matters involving dealings with a foreign nexus, the taxpayer is required to document the nature and the content of its business relationships with related persons within the meaning of section 1 (2) of the *Außensteuergesetz* [Foreign Transactions Tax Act]. 2The obligation to document also encompasses the economic and legal bases of agreement with the related person on prices and other business conditions that accord with the arm's length principle. 3Documentation pertaining to extraordinary transactions must be prepared contemporaneously. 4The documentation requirements apply *mutatis mutandis* to taxpayers who, for purposes of domestic taxation, must allocate profits between their domestic enterprise and its foreign permanent establishment or who must determine the profits of the domestic permanent establishment of their foreign enterprise. 5To ensure consistent application [of the foregoing], the Federal Ministry of Finance is authorised to determine the nature, content, and scope of the required documentation in statutory regulations adopted with the consent of the Bundesrat [Federal Council]. 6As a rule, the tax authorities shall only request the production of documentation for purposes of a tax field audit.

7[Document] production shall be governed by section 97 [of the Tax Procedure Act] except that subsection 2 of this provision shall not apply. 8[Document] production shall take place within 60 days of the respective request. 9The [document] production deadline may be extended in justified individual instances.

III. Entry into Force

The documentation requirements apply retroactively to January 1, 2003. Strictly speaking, they apply beginning with the taxpayer's first fiscal year to start after December 31, 2002. For a taxpayer with a fiscal year from July 1 to June 30, they would apply as of July 1, 2003. However, the penalties for non-compliance with the documentation requirements (see sections VI - VIII below) do not take effect until 2004 (first fiscal year to commence after December 31, 2003) or until six months after the effective date of the regulations authorised by new section 90 (3) sentence 5 AO, whichever is later.[7]

The rules on entry into force mean that documentation must be prepared for fiscal years from 2003 onwards, not that documentation must be available by the start of fiscal 2003 on all prior years.

The tax authorities currently expect to submit their proposed regulations[8] to the Bundesrat for ratification after the summer break, that is, in approximately September 2003. The regulations may undergo significant changes by then in response to industry criticisms. The regulations will nevertheless be retroactive to June 30, 2003, which would appear to permit the penalties to take effect as early as January 1, 2004. This seems questionable, however, since the intention of the law is arguably to give taxpayers a sanction-free period of at least six months after entry into force of the regulations to implement the new documentation requirements. The issue is likely to be moot as a practical matter, however.[9]

IV. Small Business Exemption

The proposed regulations include, and the final regulations will undoubtedly contain, an exemption from the new transfer pricing documentation regulations for small businesses.[10] Businesses that earn or pay less than Euro 5 million per year for goods sold to or purchased from related parties and less than Euro 500,000 per year for services and other transactions (loans, leases, licence agreements, etc.) qualify for the exemption. However, related domestic enterprises and the domestic permanent establishments of related persons will be aggregated in determining whether the small business exemption thresholds are exceeded.[11]

The exemption for small businesses under section 8 of the proposed regulations is not complete in that they must still respond to interrogatories regarding their transfer prices and produce any documents they in fact possess. The preliminary March 2003 draft regulations suggested that the tax authorities could demand full documentation from small businesses if they so chose. The new wording makes clear that small businesses need generate no documents specifically for transfer pricing purposes.

V. Comments on the Documentation Statute

A. Basis in Substantive Tax Law?

The new transfer pricing documentation provisions constitute procedural law requiring taxpayers to document the conformity of their related party international transactions to the arm's length standard. The question therefore arises as to the significance of compliance with the arm's length standard under substantive tax law.[12]

The simple answer is that there is only one substantive German tax provision that makes explicit mention of the arm's length standard – section 1 AStG (International Transactions Tax Law). This provision was intended to transpose the Associated Enterprises article of Germany's bilateral tax treaties[13] into domestic law. For reasons beyond the scope of this article, section 1 AStG has so far played a relatively minor role in German transfer pricing law.[14] Moreover, section 1 AStG is considered to violate European Union law by the majority German opinion.[15]

While a change made to section 1 (4) AStG by the same law that created the transfer pricing documentation rules expands the scope of section 1 AStG by broadening the definition of "business relationships" (see section V.G below), the new reach of the statute is unclear.

Most German transfer pricing litigation has been based on the doctrine of constructive dividends under section 8 (3) KStG (Corporation Tax Law).[16] The prevailing, if not universally accepted, view is that the constructive dividend doctrine pre-empts section 1 AStG where the elements of both are fulfilled.[17] Section 8 (3) KStG makes no mention of the arm's length standard, and the relation of the arm's length standard to constructive dividends is controversial. One of the unstated premises of the Federal Tax Court decision of October 17, 2001[18] is that the arm's length standard underlies the constructive dividend doctrine. It is therefore likely that violation of the arm's length standard is relevant both in the context of constructive dividends and in the partially overlapping context of situations covered by section 1 AStG.

Constructive contributions and constructive withdrawals are also doctrines with transfer pricing relevance. The arm's length standard is irrelevant to these doctrines, however.[19] Prior to the change in section 1 (4) AStG, the prevailing view was that practically all forms of constructive contributions and constructive withdrawals pre-empted section 1 AStG. The extent to which this will be true under the amended version of section 1 (4) AStG remains to be seen. See the discussion of the term "business relationship" in section V.G below.

Further discussion of the relationship of the procedural arm's length standard for documentation purposes to substantive tax law must be deferred. Suffice it to say that the procedural transfer pricing documentation rules have a sufficient grounding in substantive tax law with regard to situations governed by section 1 AStG (in past experience, roughly three percent of all cases)[20] and in all likelihood with respect to situations involving cross-border constructive dividends as well

  TPTP ISSN 1472-0841

(85 percent of all adjustments). To what extent this is the case for situations involving constructive contributions and withdrawals is unclear.

The tax authorities have announced plans to anchor the arm's length standard in income tax law, thus extending it to all related party transactions, domestic and foreign, subject to an exemption for small businesses.[21] After such a change, the mesh between the new documentation rules and the substantive tax law would presumably be perfect. See also section V.D below.

See section VIII.B below for a discussion of the relation of the primary penalty for non-compliance to substantive tax law.

B. Transactional Approach

The documentation requirements must be understood transactionally. They apply to each relevant transaction individually. The proposed regulations thus provide that documentation must in principle be prepared for each transaction separately.[22] The issue of compliance of documentation with the law must in our opinion likewise be approached in principle on a transaction-by-transaction basis. Documentation may arguably be in compliance with respect to one transaction, set or interrelated transactions, or group of aggregated transactions, but not with regard to another discrete transaction, set, or group.[23]

The requirement of documenting each individual transaction, as opposed to major transaction flows only, has been criticised as overly burdensome.[24] While a *de minimis* rule for negligible transactions may have been sensible, the penalties for overlooking a transaction should be commensurate to the significance of the transaction overlooked.

C. Tax Authority Stance in a Nutshell

The documentation requirements as envisaged by the tax authorities are discussed under section X below and throughout this article. In essence, the tax authorities expect taxpayers to identify and catalogue their business dealings with foreign related parties, document in an organised fashion the aspects of the relationship that are potentially relevant from a transfer pricing perspective (*e.g.*, the nature and scope of each transaction, the applicable terms and conditions, functions and risks, benefits and burdens, beginning and end, anticipated and actual results), and apply a single transfer pricing method to each transaction or set of aggregated transactions so as to demonstrate that the transaction was conducted at arm's length. Third party data (*internal* data on dealings between related parties and uncontrolled third parties as well as *external* data on dealings of uncontrolled third parties amongst themselves) is required in this connection.

The tax authorities do not expect taxpayers to commission a formal transfer pricing opinion by outside tax counsel on relevant transactions. Taxpayers are instead expected in effect to prepare transfer pricing studies on their own, using outside help at their discretion.

The tax authorities hope that the new requirements will:

1. have a strong self-policing effect on taxpayers,
2. enable tax auditors to audit transfer prices more efficiently,
3. provide auditors with sorely needed insight into the economics of the taxpayer's business, and
4. enable the tax authorities to challenge inappropriate transfer prices with less effort and greater chances of success.

D. Foreign Nexus

The documentation requirements only apply to "matters involving dealings with a foreign nexus".[25] While the exact meaning of this tortuous phrase is unclear, it in essence refers to cross-border exchanges of goods and services involving Germany and another tax jurisdiction. The proposed regulations are strangely silent on the "foreign nexus" requirement of the statute and indeed written as if this requirement did not exist. The tax authorities have announced plans to extend the transfer pricing documentation requirements to domestic transactions in the near future to avoid potential conflict with E.U. law (see section V.E and section IX below).[26] The new regulations have apparently been drafted with this in mind.

E. European Union Law

Because the documentation requirements only apply to transactions with foreign jurisdictions, a number of authors have argued that they contravene E.U. law and are void as applied to transactions between Germany and another E.U. country.[27] This issue is discussed in more detail under section IX below. The tax authorities believe that any temporary conflict with E.U. law will be cured by extending the arm's length standard to domestic transactions as a matter of *substantive* tax law.[28] The document rules will then likewise be extended to domestic relationships, so that they no longer discriminate against cross-border transactions.

F. Related Persons

The statue applies essentially to transactions with related parties in foreign jurisdictions. As defined in section 1 (2) AStG, a domestic taxpayer is related to a third party:

1. if either controls the other or holds an interest of 25 percent or more in the other;
2. if a third person controls both or holds an interest of 25 percent or more in both;
3. if the taxpayer or the third party is able to exert influence extraneous to the business relationship on the other, or
4. if either has an interest in increasing the other's income.

G. Business Relationships

Taxpayers are only required to document their "business relationships" with related persons. The term "business relationship" is probably to be construed in accordance with the definition in section 1 (4) AStG (Foreign Transactions Tax Act), which was revised by the 2003 Tax Preference Reduction Act to

provide that all contractual relationships constitute business relationships except when based on a shareholder or partnership agreement.

It is clear that cash contributions of capital explicitly pursuant to articles of partnership or incorporation do not constitute business relationships by this standard. Just about everything else is unclear, however, and it is possible to take the position that the following transactions do not involve business relationships and hence need not be documented under the new law:[29]

- transactions under a cost-sharing agreement that is based on a quasi-partnership pool concept:[30]
- in-kind withdrawals from and contributions to a partnership without adjustment of the partner's interest in the partnership;[31]
- in-kind contributions to a corporation and conceivably even constructive dividends paid by a corporation;[32]
- "factual" (as opposed to contractual) rearrangements of functions and risks inside a controlled group.

A full discussion of these issues is beyond the scope of this article. New section 1 (4) AStG may require a transaction to be explicitly set forth in articles of partnership or incorporation in order that it not constitute a business relationship. The best chance for non-application of the new documentation statute exists with respect to pool-based cost-sharing arrangements. It is noted, however, that the proposed regulations explicitly include cost-sharing arrangements in the scope of the documentation requirement.[33] The authors of this article consider it likely that the new documentation requirements will apply to pool arrangements and all other transactions listed above.

H. Permanent Establishments

Under section 90 (3) sentence 4 AO, the documentation requirements apply *mutatis mutandis* to profit allocation between the head office and the permanent establishments of the same enterprise in different jurisdictions. Hence, it is not possible to argue that the documentation rules are inapplicable to the various permanent establishments of the same enterprise for want of business relationships between discrete legal persons.

Application of the documentation rules to permanent establishments is problematic in several respects, however.[34] Essentially, the uncertainties regarding the allocation of profits between permanent establishments impact the record keeping that is supposed to document this allocation. While Article 7 (2) of the OECD Model Convention on income taxation adopts a "separate enterprise" approach to determining the profits of a permanent establishment, there are numerous exceptions under German law (*e.g.*, non-recognition of loans between PEs). While it is clear that the international flow of goods and services between permanent establishments of the same enterprise and the resulting allocation of profits must be documented and justified in some manner, the proposed regulations offer no meaningful guidance on this issue.[35]

I. Timing Issues

Documentation must be produced within 60 days of request, but will "as a rule" only be requested in the context of a tax audit. It seems likely that this rule will be strictly adhered to, hence that documentation requests outside of tax audits will be limited to unusual cases such as criminal tax fraud investigations. Since taxpayers can gauge their approximate audit schedule, and since the audit period generally does not include the year in progress and often not the preceding year, the time for document preparation is obviously longer than 60 days as a practical matter.

Example

X-GmbH is a calendar year taxpayer. In the past, it has been audited every four years with its last tax audit covering the years 1997–2000. The next audit is therefore expected to begin in mid-2006 and cover the years 2001–2004. Only the years 2003 and 2004 are covered by the new documentation requirements. Hence, X-GmbH should expect to have to present documentation for 2003/04 within 60 days of a request that it will probably not receive before July 2006, *i.e.*, the anticipated date of receipt of notice of commencement of the next audit.[36]

Uncertainty enters the calculation, however, because companies have no legal right to insist on adherence to past audit scheduling practices. Continuing the above example, an audit could also be announced in mid-2004 for the period 2000–2003, in which case X-GmbH would have to present its 2003 documentation much earlier than the above example assumes.[37] However, it seems reasonable to infer from the position taken by the proposed regulations on contemporaneous documentation (see section V.K below),[38] that taxpayers will at a bare minimum have six months from the end of a fiscal year to prepare documentation for that year.

Even if audit scheduling were completely predictable, it would still not be feasible or advisable to wait until a new audit begins to start work on the documentation. It is impossible to put together documentation for a period of up to five years in a matter of weeks. Even if it were possible, document preparation should still be more or less contemporaneous, even though contemporaneous documentation is only required for "extraordinary" transactions (see section V.K below). It is easier to prepare convincing documentation while memories and the document base are fresh. Even a year later, the personnel in charge of planning certain operations may have been transferred or left the group entirely. The thinking behind a given business decision quickly fades from the minds of those involved, as do the reasons why losses were sustained. As time passes, the paperwork that is left behind becomes inscrutable even for its authors.

The German transfer pricing system takes a prospective approach (*ex ante* approach) to whether prices are at arm's length. Thus, only the circumstances existing at the time prices were set are relevant. Subsequent developments may require adjustment of the original arrangement in order for it to remain at arm's length, but

  TPTP ISSN 1472-0841

many arrangements that turn out badly for a participant can still be defended if the relevant arguments are marshalled before they are forgotten.

The bottom line is that a system of ongoing document generation will involve less work and achieve a better result in the long run than a "last-minute" system based on a guess as to commencement of the next audit.

J. Language of Documentation

The statute is silent on the language in which the documentation must be prepared. The proposed regulations provide that documentation must be in the German language unless the tax authorities grant the taxpayer's request for exceptions to this rule. Contracts and similar documents may, however, be produced in the original language, subject to the right of the tax authorities to require translations under section 87 AO.[39]

K. Contemporaneous Documentation

Contemporaneous documentation is only required for extraordinary transactions. The proposed regulations state that documentation will be considered contemporaneous if prepared within six months of the close of the fiscal year in which the transaction occurred. Extraordinary transactions are vaguely defined as singular and significant events such as reorganisations, changes in business strategy, changes in the group allocation of functions and risks, and the conclusion or modification of long-term contracts (*e.g.*, licence, lease, rental, or purchase agreements) that significantly impact earnings.[40]

L. Statute vs. Regulations

The scope and many other details of the required documentation cannot be determined from the statutory language. To remedy this deficiency, section 90 (3) sentence 5 AO authorises the Federal Ministry of Finance to promulgate regulations. Proposed regulations were issued on June 12, 2003 with an invitation to comment by June 27, 2003.

While the regulations to be issued are statutorily authorised and thus will bind taxpayers and the courts as well as the tax authorities, regulations which overstep the bounds of the underlying statute would nevertheless be invalid. In view of the broad authority to regulate granted by the statute, the courts may be expected to uphold the regulations issued by the tax authorities as long as the regulations have a plausible basis in the letter of the law.

M. Factual vs. Analytic Documentation

Some commentators have taken the position that the statute requires factual documentation, but not analytic or comparative documentation.[41] In this view, taxpayers would have to document the relevant facts regarding their transfer prices, but would not have to make a showing that the transfer prices thus arrived at were actually at arm's length, except to the extent arm's length comparisons were in fact relied on in setting transfer prices.

Factual documentation includes the terms on which business was actually conducted, related profit forecasts and budgets, internal transfer pricing guidelines and policies, information on the allocation of functions, risks, and assets inside the group, information on business plans, business models, and group structure, and information on any changes in the above. Analytic documentation comprises above all third party data, such as database analysis of the profitability or margins of similar enterprises or information on royalty or licence fees charged by others. Analytic documentation would also include application of a transfer pricing method to the facts at hand to show that group companies had dealt with each other at arm's length.

The proposed regulations (see section X below) require substantial comparative and analytic documentation and clearly reject any limitation to factual documentation. Sufficient basis for requiring comparative and analytic documentation is probably found in section 90 (3) sentence 2 AO.

N. Nature and Content vs. Scope

It has been suggested that the new documentation rules do not require taxpayers to document the scope of their international related party dealings because the statutory language refers only to nature (type, form) and content.[42] Under this view one would have to document the nature and terms (*e.g.*, sale of a particular good at a certain price on certain terms of payment and delivery, etc.) of a particular related party transaction, but not disclose the volume thereof, that is the total amounts received and paid in a particular type of transaction (*e.g.*, whether transactions of the documented sort occurred 10 times or 10,000 times in a certain period). The proposed regulations provide, however, that the scope and performance of transactions must be documented.[43] The authors of this article believe that there is little chance that the required documentation will not have to include the scope of the relevant transactions as the scope is an important factor in determining whether a transaction is at arm's length (section 90 (3) sentence 2 AO). For instance, the purchaser of 10,000 widgets can demand a better price that the purchaser of 10 widgets.

O. Incorporation of Section 97 AO

Sentence 7 of the statute incorporates by reference section 97 AO, *excluding* subsection 2 thereof.[44] Section 97 AO authorises the tax authorities to require taxpayers and other persons to produce books, records, and other documents for inspection. In requesting documents the tax authorities must state whether they are being sought with respect to the taxes of the person requested to produce them or for the taxation of some other person. Production of the documents may take place in the offices of the tax authorities or on the premises of the person producing the documents if this person consents or if the documents are unsuited for production in the offices of the tax authorities. In an audit context, document production on the taxpayer's premises will be the rule.[45] Documents stored on electronic media must be converted to readable form and printed out on request.[46]

P. Unstated Limitations; Electronic Audit

The new documentation requirements constitute in German terminology duties of co-operation (*Mitwirkungspflichten*) imposed on the taxpayer to aid the tax authorities in their administration of the tax laws. Under

general principles, the scope of all duties of co-operation is determined by the circumstances of the individual case.[47] In particular, all co-operation required of the taxpayer must be appropriate, necessary, feasible, and not unreasonably burdensome.[48]

Some commentators[49] argue that it would be unreasonably burdensome to require the taxpayer to prepare separate documentation on transfer pricing information that is already contained in data electronically stored and accessible to the tax authorities pursuant to their rights of access to electronic data under section 146, 147 AO.[50]

The authors of this article do not share this view. The so-called "electronic audit" rules essentially require the taxpayer to maintain data in electronically searchable form until expiration of the document retention period if the data was originally generated or later stored electronically. They do not require that any specific data be electronically generated or stored in the first place and hence guarantee neither the availability of the transfer pricing data required under the new documentation rules nor its organisation as a separate body of data subject to production on demand. There is thus little overlap between the electronic audit rules and the new transfer price documentation rules.

It is also argued in the alternative that, where data is compiled and organised in accordance with the transfer pricing documentation rules, the tax authorities are prohibited from searching for any other data with transfer pricing relevance that might be present on the taxpayer's data systems.[51] We again do not share this position because the electronic audit rules are intended to permit the tax authorities to search for relevant data in addition to that which the taxpayer has to submit in fulfilment of other obligations. The transfer pricing documentation rules thus complement the electronic audit rules and vice versa.

The proposed regulations explicitly extend the electronic audit rules to transfer pricing documentation that is prepared with the aid of a data processing system.[52] This means that the tax authorities may subject such data to computer analysis using the taxpayer's own computer systems.

VI. Text of Penalties for Non-Compliance

The penalties for non-compliance with section 90 (3) AO are found in new section 162 (3) and (4) AO and read as follows:

> (3) 1Where a taxpayer breaches its obligations under section 90 (3) [AO] by failing to produce documentation or by producing documentation that is substantially useless, or where it is determined that the taxpayer has not contemporaneously prepared the documentation described in section 90 (3) sentence 3 [AO], a rebuttable presumption shall arise that the taxpayer's income subject to domestic taxation, the determination of which is facilitated by the documentation required under section 90 (3) [AO], exceeds the income declared by the taxpayer. 2If estimation by the tax authorities is indicated in such cases and it is only possible to determine the relevant income within a certain range, in particular only on the basis of price margins, the range may be fully exploited to the taxpayer's detriment.
>
> (4) 1Where a taxpayer fails to produce the documentation described in section 90 (3) [AO] or the documentation produced is substantially useless, a tax surcharge of Euro 5,000 shall be assessed. 2The surcharge shall amount to at least 5 percent and at most 10 percent of the incremental amount of income arising pursuant to an adjustment by reason of application of subsection 3 if the resulting surcharge exceeds Euro 5,000. 3In case of late production of useful documentation, the surcharge shall amount to not more than Euro 1,000,000, but at least Euro 100 per day of lateness. 4To the extent the tax authorities are granted discretion with respect to the amount of the surcharge, the factors to consider shall include without limitation the benefits derived by the taxpayer and, in case of late production, the extent of the lateness, in addition to the surcharge's purpose of compelling preparation and timely production of documentation by the taxpayer. 5Assessment of a surcharge shall be waived if the failure to fulfil the obligations under section 90 (3) [AO] appears excusable or the degree of fault is only slight. 6Fault on the part of a legal representative or a performance assistant[53] is the equivalent of the taxpayer's own fault. 7The surcharge shall be assessed as a rule after conclusion of the tax field audit.

VII. Entry into Force of Penalties

The entry into force of the penalties for non-compliance is dealt with in section III above.

VIII. Comments on the Penalties for Non-Compliance

A. Procedural and Monetary Penalties

The penalties for non-compliance are of two sorts: procedural and monetary. The procedural penalties (section 162 (3) AO) shift the evidentiary burden on transfer pricing issues to the taxpayer and thus make it easier for the tax authorities to adjust the taxpayer's income. They also permit an adjustment to income based on the point in the arm's length range of transfer prices that is least favourable to the taxpayer. The monetary penalties (section 162 (4) AO) add a tax surcharge of five percent to 10 percent onto any adjustment made *by reason of* the procedural penalties. Taxpayers whose documentation is satisfactory, but not timely, face a maximum monetary penalty of Euro 1 million, but will apparently not be subject to the procedural penalties.

B. Procedural Penalties – Rebuttable Presumption

The primary penalty for non-compliance is procedural and consists in a *rebuttable presumption* that the taxpayer's transfer prices were not at arm's length and resulted in an understatement of income (or overstatement of loss – new section 162 (3) AO). Such a presumption arises in at least three situations:

1. The taxpayer produces no documentation;

  TPTP ISSN 1472-0841

2. The taxpayer produces "substantially useless" (*i.e.*, unsatisfactory) documenta-tion; or
3. The taxpayer does not prepare its documentation on extraordinary transactions contemporaneously.

Apparently, no presumption will arise in the event the taxpayer produces satisfactory documentation, but after expiration of the deadline (late documentation – see section VIII.D below). Timely production of documentation that is imperfect or incomplete, but not substantially useless, likewise triggers no presumption.

The rebuttable presumption may be criticised for confounding presumption with legal consequence. The fact that a transfer price charged by a German taxpayer is below the arm's length price or that a transfer price paid is above the arm's length price only has tax relevance if the substantive tax law attaches consequences to this fact. The effect of the rebuttable presumption can only be to (rebuttably) establish the presence of a required element (violation of the arm's length standard) of a provision of *substantive tax law.*

This is in our opinion clear from section 162 (3) sentence 1, which states that the rebuttable presumption only relates to income "the determination of which is facilitated by the documentation required under section 90 (3) AO". The determination of income to which the arm's length standard is irrelevant as a matter of substantive tax law is not "facilitated" by the required transfer pricing documentation. Hence, the rebuttable presumption arises primarily with respect to adjustments to income under section 1 AStG and section 8 (3) KStG. See the discussion of these statutes in section V.A above.

One should also bear in mind that any presumption must logically also be transactional, that is, relate to a specific transaction, group of similar transactions, or set of interrelated transactions, not to the totality of the taxpayer's related party dealings. Compare with section V.B above.

C. Procedural Penalties : Unsatisfactory Documentation

1. Text of statute

No penalties are triggered as long as the documentation is timely and not "substantially useless" (*im Wesentlichen unverwertbar*). This standard is fairly generous to the taxpayer and rules out procedural sanctions by reason of minor imperfections or gaps in its documentation (incomplete documentation).

2. Proposed regulations

The tax authorities devote an entire section of their proposed regulations to the question of when documentation is "substantially useless" (unsatisfactory). This section reads as follows:

> Section 6 – Usefulness of Documentation
>
> (1) Documentation is useful if, based thereon and within a reasonable period of time, an outside expert can identify the relevant transactions engaged in by the taxpayer in the context of its business relationships with related parties and verify whether the taxpayer has complied with the arm's length principle with regard thereto. Documentation that does not permit such verification within a reasonable period of time shall be rejected as substantially useless within the meaning of section 162 (3) and (4) [AO].
>
> (2) The situations in which documentation is substantially useless include without limitation the following:
>
> a) when it is unclear, not understandable,[54] or incomplete in material respects;
>
> b) when it is self-contradictory, or
>
> c) when the taxpayer has selected an obviously inappropriate transfer pricing method and its documentation is useless or insufficient for application of an appropriate method.

At another point, the proposed regulations provide that the taxpayer's documentation must evidence its "earnest attempt" or "good-faith effort" to structure its business relationships with related parties in accordance with the arm's length principle.[55] In applying this standard, it is possible to imagine a court weighing various deficiencies before deciding whether a good-faith effort has been made on the whole.

3. Comments

The standards contained in the proposed regulations focus by and large on specific aspects of the documentation instead of asking whether any significant amount of useful information can be gleaned from it, as the statutory language might suggest. For instance, the determination that the documentation is lacking in a material respect (*e.g.*, failure to document sales of Type 5 Widgets) does not mean it is substantially worthless if in fact other important aspects are as they should be (exemplary documentation of sales of Widget Types 1 to 4 = 80 percent of all sales). Similarly, one major self-contradiction (*e.g.*, regarding Type 5 Widgets) need not taint the entire documentation.

A *transactional approach* must therefore be taken to applying the "substantially useless" standard. Documentation can be useful with regard to certain transactions or types of transactions but substantially useless with regard to others. A rebuttable presumption should then arise only with regard to the latter transactions. Whether the tax authorities intend to apply the statute in this manner is unclear.

While the above standards, both statutory and regulatory, are of little use in determining precisely how many corners the taxpayer can cut and still not face sanctions, they do make plain that sanctions can be avoided with relative certainty by presenting documentation that is clear, logical, substantially complete, free of self-contradiction, and not fundamentally flawed in its choice of a transfer pricing method.

The proposed regulations are to be criticised for offering no guidance on the choice of an appropriate transfer pricing method. It is scarcely possible to advise a client to use a profit-based method for fear that it might be rejected as "obviously inappropriate".[56]

D. Procedural Penalties: Consequences of Lateness

Section 162 (3) AO makes no mention of lateness, and it is not immediately evident whether mere lateness triggers procedural penalties. Section 162 (3) AO speaks of a breach of obligations by failing to produce documentation. Literally, such a breach occurs when the

deadline for production expires without documentation being produced.[57] However, unofficial statements made by certain tax officials indicate that the tax authorities interpret the statute as imposing no procedural sanctions on taxpayers who submit satisfactory documentation after expiration of the production deadline. Instead, the sole sanction for late production of satisfactory documentation is the monetary penalty of section 162 (4) sentence 3 AO (see section VIII.J below). Hence, taxpayers who initially submit no documentation by the document production deadline, or who submit documentation that is timely, but unsatisfactory, will, it seems, be able to escape procedural penalties by submitting documentation after the deadline has expired.

Under this reading of the statute, the determination that a taxpayer has failed to produce satisfactory documentation would apparently not be made upon expiration of the document production deadline, but rather at some unspecified later time (*quasi* grace period). The proposed regulations offer no guidance on this issue, which will conceivably affect the documentation strategies of many multinationals.

It should be noted, however, that production of documentation is not late if the nominal 60 day deadline has been extended under section 90 (3) sentence 8 AO.

E. Procedural Penalties: Grace Period?

Since submission of late documentation can apparently avert procedural penalties, the question arises as to just how late documentation can be and still achieve this result (*quasi* grace period). Neither the statute nor the proposed regulations address this issue. Since the documentation is primarily intended to facilitate a tax field audit, the tax authorities may argue that documentation must be submitted in time for consideration in the audit process. Section 162 (4) sentence 7 AO lends some support to this position.

Another possible view is that documentation is "merely late" if it is still admissible in evidence at the time of its production under the generally applicable rules of evidence. This means that the latest conceivable time for production of documentation would be prior to the conclusion of litigation before the Tax Court, since additional pleadings of fact are generally inadmissible on appeal to the Federal Tax Court.

Closure could occur much sooner, however. If the tax authorities set an explicit final deadline under section 364b AO and this deadline is not kept, the Tax Court has discretion under section 76 (3) FGO (Tax Court Procedure Act) to refuse to admit the documentation in evidence. Furthermore, the Tax Court may also itself set an exclusionary deadline under section 79b FGO.

F. Procedural Penalties: Burden of Proof

A taxpayer faced by a rebuttable presumption has the burden of production and possibly the burden of proof on the issue of its transfer prices. Exactly how much evidence will be needed to rebut the presumption is hard to say, but rebuttal will probably be difficult as a practical matter and at least involve a prima facie showing by the taxpayer that its transfer prices were at arm's length.

Whether the rebuttable presumption shifts the burden of proof as well as the burden of production is a procedural fine point that may not have much practical significance. A distinction is commonly drawn between presumptions of fact and presumptions of law. A presumption of fact is based on a logical inference from general experience: "If A, then B", whereby the conclusion "B" must follow from the premise "A" with a high degree of probability or possibly with near certainty. The Federal Tax Court decision of October 17, 2001 rests on a presumption of fact involving less than near certainty.[58]

The rebuttable presumption created by new section 162 (3) AO is a presumption of law. Its basis is not logical, but statutory. The general rule on presumptions of law is that they can only be rebutted by proof of the opposite and hence shift the burden of proof to the party trying to rebut the presumption.[59]

G. Procedural Penalties: Estimation

Assuming the presumption is not rebutted, what happens next? The Federal Tax Court decision of October 17, 2001[60] stands, among other things, for the proposition that a range of reasonable transfer prices (an arm's length range) may be estimated if it is established in principle that transfer prices are not at arm's length and if no clearly correct transfer price is discernable. Under the October 2001 decision, the taxpayer is entitled to the benefit of the point in the estimation range that is most favourable to it. This holding is, however, reversed by section 162 (3) sentence 2 AO.

Example

X-GmbH, a German limited liability company, purchases widgets from Y-Corp., a related party based in the Philippines. The unit price is 105. When X definitively fails to produce any transfer pricing documentation on audit, the auditors inform X that its transfer prices are presumed to be too high. X is then given the opportunity to rebut the presumption. While X cannot demonstrate that 105 was undoubtedly the correct price, it is able to show an arm's length purchase price range from 90 to 110. The auditors agree that the arm's length range is appropriate, but refuse to accept the fact that the actual price was within this range as rebuttal of the presumption. Citing section 162 (3) sentence 2 AO, they re-calculate X's profits based on a purchase price of 90, the point in the arm's length range least favourable to X. After rejection of its administrative appeal, X takes the case to court.

There is in our opinion a good chance that the court will uphold the assessment and rule that, by failing to comply with the documentation rules, a taxpayer forfeits its entitlement to the benefit of the margin for error inherent in the arm's length range. In the above example, the showing required from the taxpayer to rebut the presumption might be *either* that 105 is the only objectively correct price *or* that the estimation range (arm's length range) runs from e.g. 105 to 125, in other words that X's purchase prices are at the extreme low end of the range.[61]

Basing an adjustment to income on the point in the estimation range that is least favourable to the taxpayer represents a harsh sanction for non-compliance with the documentation rules.

  TPTP ISSN 1472-0841

H. Monetary Penalties: Basics

The new legislation potential imposes monetary penalties in the following situations:

1. The taxpayer produces no documentation;
2. The taxpayer produces unsatisfactory documentation;
3. The taxpayer produces satisfactory documentation, but after expiration of the deadline (late documentation);

There is apparently no monetary penalty for failure to document contemporaneously where required.

I. Monetary Percentage Penalty

The most significant monetary penalty is a tax surcharge of five percent to 10 percent of the amount of any adjustment resulting from the application of the procedural penalties discussed above. The adjustment amount on which the penalty is imposed must arise "by reason of application of subsection 3" of section 162 AO, otherwise there is no percentage penalty. An adjustment is in our opinion only "by reason of application of subsection 3" if it is based on a rebuttable presumption under section 162 (3) AO that the taxpayer fails to rebut. Accordingly, the percentage penalty is avoided:

1. when no procedural penalties arise under section 162 (3) AO because satisfactory documentation is timely furnished to the tax authorities; and
2. when procedural penalties in the form of a rebuttable presumption arise under section 162 (3) AO, but the taxpayer successfully rebuts this presumption.

As discussed, late production of satisfactory documentation would not trigger procedural penalties under the reading of section 162 (3) AO which has been unofficially endorsed by certain tax officials.[62] Since the percentage penalty is contingent upon an adjustment to income by reason of the procedural penalties, it is inapplicable where no procedural penalties arise in the first place and hence would not apply to cases of late submission of satisfactory documentation.

J. Monetary Penalties for Lateness

Section 162 (4) sentence 2 and 3 AO read:

> 2The surcharge shall amount to at least 5 percent and at most 10 percent of the incremental amount of income arising pursuant to an adjustment by reason of application of subsection 3 if the resulting surcharge exceeds Euro 5,000. 3In case of late production of useful documentation, the surcharge shall amount to not more than Euro 1,000,000, but at least Euro 100 per day of lateness.

There are two possible readings of sentence 3. Under the first reading, it imposes a cap of Euro 1 million on the percentage surcharge created by sentence 2. Under the second reading, it creates a special monetary penalty for lateness of up to Euro 1 million independent of the percentage penalty in sentence 2. The second reading is the position unofficially taken by certain tax officials.

The *first reading* leads to the conclusion that mere lateness must trigger procedural penalties (rebuttable presumption). The percentage monetary penalty is clearly contingent upon and hence supplementary to the procedural penalties. If the words "the surcharge" in sentence 3 refer back to the same words in sentence 2, then sentence 3 caps the surcharge of sentence 2. Note that it could not conceivably cap the minimum surcharge of Euro 100 per day of lateness because it would take more than 27 years for this surcharge to grow to Euro 1 million. Under this reading, sentence 3 operates as a cap on the percentage penalty (and as a modest minimum penalty of Euro 100 per day of lateness).

Under the *second reading* of section 162 (4) sentence 3 AO, the tax authorities are authorised to assess a surcharge of up to Euro 1 million where satisfactory documentation is submitted after expiration of the production deadline. In this view, sentence 3 creates a penalty specifically for lateness. Lateness is penalised neither by procedural penalties nor by the monetary percentage penalty nor by the minimal penalty of Euro 5,000 discussed in section VIII.K below, but rather solely by the penalties defined in sentence 3. Subject to its upper and lower limits, the amount of the lateness penalty is up to the discretion of the tax authorities, to be exercised with regard to the factors referred to in section 162 (4) sentence 4 AO.

The second reading leads to an anomalous result where no adjustment to income would occur under section 162 (3) AO, *e.g.* because the taxpayer could rebut any presumption that arose. In such situations, taxpayers who produce late documentation face a surcharge of up to Euro 1 million, while those who produce no documentation at all need pay nothing. As a practical matter, however, only taxpayers who fear procedural and monetary penalties substantially in excess of the lateness penalty will submit late documentation.

The public statements made by the tax authorities so far indicate that they follow the second reading of sentence 3. It therefore appears that, by submitting satisfactory documentation after the deadline, taxpayers will in essence be consenting to a lateness penalty of up to Euro 1 million in exchange for avoiding the risk of procedural penalties leading to an adjustment to income and a concomitant monetary percentage penalty. The amount of the lateness penalty will vary between its upper and lower limits depending on the relevant circumstances, one of which might be the likely amount of the percentage penalty avoided.

K. Other Monetary Penalties

A minimum flat rate penalty of Euro 5,000 applies under section 162 (4) sentence 1 AO for failure to produce the required documentation or production of unsatisfactory documentation. This penalty is also apparently not applicable in cases of late production of satisfactory documentation.

L. Penalty Summary

The most important penalties are procedural. A rebuttable presumption of understatement of income by reason of improper transfer prices forces the taxpayer to come forward with evidence to rebut, whereby it may have the burden of proof. Failure to rebut in turn opens the door to determination of an arm's length range of transfer prices and adjustment of

income using the point in the range least favourable to the taxpayer. The ability to exploit the arm's length range to the taxpayer's detriment results in an income adjustment that is on the extreme high end of what is reasonable. A monetary penalty of five percent to 10 percent of the adjustment to income resulting from the procedural penalties poses a substantial added risk (percentage penalty).

However, according to unofficial statements by tax officials, procedural penalties can be ruled out by submitting satisfactory documentation after expiration of the nominal production deadline. The exact length of the *quasi* grace period is unclear. Those who avail themselves of the grace period are subject to a monetary lateness penalty of not more than Euro 1 million.

IX. Conflict with E.U. Law?

A. Arguments Pro and Con

As noted above,[63] certain authors have contended that the new German documentation requirements violate E.U. law, specifically the clauses of the Treaty of Rome guaranteeing freedom of establishment and free movement of capital, goods, and services.[64] The argument runs that the administrative burden of documenting foreign related party transactions constitutes illicit discrimination in favour of domestic related party transactions, with respect to which no documentation is required. This arguably discourages German-based groups from establishing subsidiaries or permanent establishments elsewhere in the E.U. and discourages non-German E.U. groups from commencing German operations.

The basic argument that the documentation rules are consistent with E.U. law is that domestic transactions are not comparable to transactions involving foreign jurisdictions because the ability of the domestic tax authorities to investigate foreign transactions is limited.[65] Hence, different procedural rules are warranted when transactions involving foreign jurisdictions are involved. The German tax code has in fact long had a provision – section 90 (2) AO – that imposes heightened duties of co-operation on taxpayers with respect to foreign transactions. The transfer pricing documentation rules of section 90 (3) AO are in this view but an extension of the same principle.

While the similarity between section 90 (2) AO and section 90 (3) AO is granted by those who believe the documentation rules violate E.U. law, they draw from this the conclusion that section 90 (2) AO likewise violates E.U. law. And the come-back to the argument that investigative possibilities in foreign jurisdictions are limited is that, inside the E.U., the member states are obliged to render judicial assistance to one another in tax matters under the E.U. Judicial Assistance Convention, thus putting foreign E.U. jurisdictions on a par with the domestic jurisdiction as far as investigative capacity goes. Whether this is true as a factual matter is disputed.[66]

In yet another view, only substantive tax laws, that is, laws that impose taxes, can violate the freedom of establishment clause of the Treaty of Rome. Since the transfer pricing documentation rules of section 90 (3) and section 162 (3) AO impose no taxes and instead operate on a purely procedural level, they arguably conform to E.U. law. The monetary penalties of section 162 (4) AO do impose extra taxes and hence contravene E.U. law, in this view.[67]

B. Comments and Guidance

Given the recent trend of decisions by the European Court of Justice,[68] the authors of this article believe that there is a strong chance that the new transfer pricing documentation rules violate E.U. law. We nevertheless believe that taxpayers are ill-advised to refuse to comply in the expectation that the ECJ will ultimately void the laws in question. Our reasoning is as follows:

- Transfer pricing documentation should be prepared irrespective of statutory obligation in order to protect against challenges by the tax authorities and, more particularly, to ward off attempts by the tax authorities to make offensive use of the Federal Tax Court judgment of October 17, 2001.[69]
- Even if the new documentation laws are void inside the E.U., they will – probably – still apply to transactions between Germany and other countries.[70] Since a documentation system is advisable on general grounds (see above) and will be needed with respect to non-E.U. countries in any event, inclusion of E.U. transactions in the system will in many cases not entail much additional effort.
- Contravention of E.U. law is speculative and likely to remain speculative for some years. Hence, a policy of disobedience will expose companies to substantial risks and likely provoke litigation, which is sure to entail expense.
- High German tax officials have stated that they will extend the transfer pricing documentation rules and the arm's length standard as a matter of *substantive* tax law to domestic transactions to bring them into line with E.U. law.[71] It is possible that this will occur soon, that is without waiting for a ruling by the ECJ on point.
- It is also conceivable that agreement will be reached at the E.U. level on E.U.-wide transfer pricing documentation rules.[72]

Needless to say, taxpayers should review the issues with the aid of tax counsel before making any decision.

X. Proposed Regulations: Further Aspects

A. Regulations in General

Selected aspects of the proposed regulations released on June 12, 2003 are discussed below. Reference is also made to the proposed regulations throughout this article where it seemed preferable to discuss the positions taken in the regulations in juxtaposition with the statutory language. The tax authorities have explicit statutory authority to regulate this area of the law.[73] The resulting statutory regulations will carry considerably more weight and be harder to challenge in court than mere administrative regulations. See section V.L above for a discussion of the relationship of the statute to the pending regulations.

  TPTP ISSN 1472-0841

The proposed regulations require the consent of the German Bundesrat (Federal Council) to take effect. The opposition parties control the Bundesrat. While they agree in principle on the need for transfer pricing documentation rules, they may still insist on changes to the regulations. In releasing the proposed regulations, the tax authorities invited comment by June 27, 2003. According to statements by tax officials, they intend to consider these comments in the coming months and submit the regulations to the Bundesrat for ratification in September 2003. Whether and to what extent the current proposals will undergo modification is uncertain. The draft of June 12, 2003 is considerably more detailed than the preliminary draft that unintentionally became public in March 2003.

B. Proposed Regulations – Selected Issues

1. Foreign nexus

As previously noted, the proposed regulations make no effort to define the foreign nexus that is a required element of the documentation obligation under the statute. Exchanges of goods and services with related parties in foreign jurisdictions establish the required nexus to the extent such exchange is based on a "business relationship". See section V.G above for a discussion of this concept.

2. Factual and analytic documentation

The proposed regulations require taxpayers to document the facts relevant to international transactions (factual documentation) and show the extent to which these transactions were at arm's length (analytic documentation). Facts and analysis together constitute the documentation required by the regulations. Factual documentation includes information on the nature, scope, and performance of relevant transactions including legal and economic aspects of the relationship.[74] See also section V.M above.

3. Related party information

The proposed regulations state that a taxpayer cannot avoid or limit its transfer price documentation obligations by arguing that it lacks access to necessary information controlled by related parties. The proposed regulations thus seek to overturn the Federal Tax Court decision of October 17, 2001 in this respect.[75]

4. Comparative data

The proposed regulations list considerable information that must be collected *to the extent* a showing is required that the taxpayer's business dealings are in accordance with normal third party practice (*fremdüblich*).[76] This provision appears to dodge the issue of *when* such comparative documentation is required in the first place. The words "to the extent" might be regarded as shorthand for all situations involving the required foreign nexus, related parties, and business relationships, in which case the information on normal third party practice is required for all transactions covered by the documentation rules. Or the words may be taken to mean that information on third party practice is required sometimes, but not always, without it being clear how to distinguish one case from the other.

Where information on third party practice is required, it includes a description of the market conditions and competition situation. Comparative data must be compiled and recorded to the extent the taxpayer or a related party has such data at the time the relevant business relationship was entered into and to the extent the taxpayer can obtain such data "with reasonable effort" from sources readily available to it. Public database analysis comes to mind in this context, but is not specifically referred to by the proposed regulations. Data is sought on comparable transactions between uncontrolled third parties and on comparable transactions between the taxpayer or a related party and an uncontrolled third party. Examples include prices, cost allocation, profit mark-ups, gross margins, net margins, and profit splits.[77]

5. Planning data

The proposed regulations require the production of internal planning data such as forecasts (presumably profit and budget forecasts) as a check against the plausibility of the agreed transfer prices.[78]

6. Transfer pricing method

The taxpayer must use "an appropriate transfer pricing method" to arrive at its transfer prices. There is no requirement to apply more than one transfer pricing method.[79] The reasoning behind the selection of the chosen method must be explained.[80] Group transfer pricing guidelines may be included in the documentation if they accord with the arm's length principle. The preliminary March 2003 draft regulations went further in this respect and suggested that properly drafted transfer pricing guidelines would be sufficient by themselves.[81]

Since all aspects of the documentation must be understood transactionally,[82] a taxpayer might in our opinion use different transfer pricing methods for different transactions, groups of similar transactions, or sets of related transactions.

7. Aggregation of transactions

Documentation is in principle required on each relevant transaction. Transactions may, however, be aggregated if they are of the same or an equivalent type, provided the aggregation rules are defined in advance and make logical sense.[83] Aggregation is also permitted for sets of interrelated transactions appropriately assessed as a whole.[84]

8. Changed circumstances

Where circumstances change in the context of ongoing transactions, the taxpayer must document the changes so as to permit the tax authorities to determine whether uncontrolled parties would have modified their agreement in response to the changed circumstances. Documentation is required in particular for losses that an uncontrolled party would not have accepted and price adjustments to the taxpayer's detriment.[85]

9. Contemporaneous documentation

Contemporaneous documentation is required for extraordinary transactions. Documentation is contemporaneous if its preparation is closely proximate in time to the transaction. Documentation is, however,

deemed to be contemporaneous if prepared within six months of the close of the fiscal year in which the transaction occurred.[86]

10. Extraordinary transactions

Extraordinary transactions include without limitation asset transfers related to restructuring, material changes in functions and risk allocation, transactions subsequent to a change in business strategy that has transfer pricing significance, and entering into or amending long-term contracts of particular importance that "significantly" impact earnings from business relationships with related parties.[87]

11. Information required in all cases

Section 4 of the proposed regulations is a catalogue of information that must be presented on demand in all cases:

- Apparently (the passage is confusingly worded), a description of the ownership structure by virtue of which the taxpayer is "related" to persons with whom it does business directly or indirectly. Changes in this ownership structure must also be documented.[88]
- A description of circumstances other than ownership structure which can cause the taxpayer to be "related" to another person under section 1 (2) AStG.[89]
- A description of the group's organisational and operative structure, including permanent establishments and interests in partnerships. Changes in this structure must also be documented.[90]
- A description of the taxpayer's business operations.[91] Presumably any changes therein must also be documented.
- A description of business relationships with related persons including an overview of the nature and scope thereof. The contractual basis of such business relationships must be explained. Any changes must be documented.[92]
- The taxpayer must provide a list of material intangible assets that it owns or uses in business dealings with related parties.[93]
- The respective functions performed and risks assumed by the taxpayer and related parties must be detailed and any changes therein recorded. Information is also required as to
  - the material assets used in business dealings with related persons,
  - the contractual arrangements that exist with such persons, and
  - significant aspects of the market and competition situation to the extent such information has a bearing on business relationships with related parties.[94]
- The value added chain must be delineated as it relates to the taxpayer and the related persons with whom it deals.[95]
- The chosen transfer pricing method and the manner of its application must be described; the suitability of this method must be justified; and the calculations in connection with application of this method must be documented.[96]

12. Information required in certain cases

Section 5 of the proposed regulations states that the taxpayer must document circumstances specific to itself to the extent it wishes to rely thereon for any purpose. In addition, the taxpayer is supposed to document special circumstances with potential transfer pricing significance. The list includes without limitation:

- Information on business strategies (*e.g.*, marketing strategies, choice of sales channels, management strategies) and other special circumstances such as intentional set-offs to the extent they have influenced the taxpayer's transfer prices.
- A statement of reasons why third party prices and other financial data on which the taxpayer relies are in fact comparable, including documentation of any adjusting calculations made to obtain comparability.
- For cost-sharing arrangements, documentation on the other participants, the cost allocation formula, and the benefit anticipated from the cost-sharing arrangement.
- Information on transfer pricing assurances received from and agreements entered into with foreign tax authorities (*e.g.*, advance pricing agreements); information on mutual agreement procedures or arbitration proceedings requested or completed in other jurisdictions that have bearing on the taxpayer's business relationships.
- Documentation on any price adjustments made by the taxpayer, above all when they result from transfer pricing adjustments or advance rulings by foreign tax authorities with respect to related persons.
- Documentation on the reasons for losses suffered and steps taken by the taxpayer or related persons to terminate such losses where the taxpayer has posted a negative result in more than three consecutive fiscal years from business relationships with related persons.

13. Adequacy of documentation

The adequacy of documentation is addressed by section 6 of the proposed regulations. See section VIII.C above.

14. Form and retention of documentation

Documentation may be in writing or in electronic form. It must be retained for 10 years or until no longer of relevance for any taxes on which the statute of limitations for the assessment of tax has not yet run.[97]

15. Procedural matters

The proposed regulations repeat the statutory injunction that documentation shall as a rule only be requested in connection with tax audits. A request for documentation must specify the areas of the taxpayer's business and the business relationships which are to be audited and should also state the nature and scope of the documentation sought. A request for documentation may be part of the official notice of audit commencement. Documentation must generally be in the German language. The tax authorities may grant exceptions. Also, contracts and similar instruments may be produced in the original language subject to trans-

 07/03 TPTP ISSN 1472-0841

lation on demand. Where documentation and the underlying data have been prepared using a data processing system, the electronic audit rules of section 147 (6) AO apply.[98]

C. Changes vs. Initial Draft Regulations

The proposed regulations released on June 12, 2003 are in general more detailed and better organised than the initial draft of March 2003. A number of significant provisions found in the initial draft are, however, no longer present in the proposed regulations. These include the following:

- Section 1 (2) of the initial draft required taxpayers to plan and document their transfer price thinking *prior* to entering into transactions with related parties. This conflicted with the principle that documentation need in general not be contemporaneous and that even contemporaneous documentation need not necessarily be prepared in advance.[99]
- Section 1 (3) of the initial draft contained a sweeping requirement to track later developments related to documented transactions. This requirement is moderated in section 2 (3) of the proposed regulations.
- Section 6 (4) of the initial draft contained more detailed requirements relating to transfer pricing analysis than are found in the corresponding section 4 (4) of the proposed regulations. Among the omissions is a statement that "mere profit comparisons" are as a rule inadequate for showing that prices are at arm's length. Since section 1 (3) sentence 3 of the proposed regulations continues to list profit splits as relevant third party information, one may conjecture that the tax authorities are no longer adamantly opposed to profit-based transfer pricing methods.[99]
- Section 8 of the initial draft stated that transfer pricing documentation may be stored abroad. No such statement is present in the corresponding section 7 of the proposed regulations. However, one may infer from section 7 sentence 5, which states that it is the taxpayer's responsibility to ensure timely document production, that storage abroad remains permissible, but will not be accepted as grounds for extending the 60 day document production deadline.

XI. Closing Remarks

The new German transfer pricing documentation requirements confront multinationals with many decisions regarding their German transactions. This article provides an overview of the new requirements and their entry into force. It analyses the controversial possibility that the new statutes may contravene E.U. law in whole or part and describes the proposed regulations that the tax authorities issued in June 2003. Various disputed issues regarding the scope of the new laws are discussed, as are the sanctions for non-compliance.

The contours of the new transfer pricing documentation rules are clear, even if the implementing regulations have yet to be finalised. Compliance will involve significant effort for taxpayers that have not previously prepared systematic transfer pricing documentation. There were advantages to preparing such documentation even before the new legislation took effect. Basically, a taxpayer with sound documentation is less likely to face a challenge to its transfer prices from the tax authorities and better able to defend itself if challenged. The new laws merely add another reason to document, albeit a compelling one: the need to avoid sanctions. With proper planning, achieving this goal should not be difficult.

Dr. Rolf Heinrich *is senior tax manager with KPMG Global Transfer Pricing Services in Munich, Germany. He may be contacted at +49-(0)89-9282-1591 or by e-mail at RolfHeinrich@kpmg.com.* ***William Bader*** *is a freelance writer for KPMG Germany and may be contacted at Wbader @kpmg.com.*

1 Proposed Regulations of June 12, 2003 on the Nature, Content, and Scope of Documentation under section 90 (3) AO (Tax Procedure Act). They supersede a preliminary draft that unintentionally became public in March 2003. The proposed regulations do not affect Germany's basic 1983 transfer pricing regulations, the Administrative Regulations (AR) of 23 Feb. 1983 – BStBl I 1983, 218.

2 Federal Tax Court (*Bundesfinanzhof*) judgment of October 17, 2001 I R (103/00, DB 2001, 2474 = IStR 2001, 745). Regarding this judgment, see Vögele/Bader, *Tax Planning International transfer pricing*, Vol.3, No.3, March 2002, p. 7.

3 Münster Tax Court judgment of August 22, 2000 (6 K 2712/00 – EFG 2001, 4); implicitly affirmed by Federal Tax Court judgment of October 17, 2001 (Note 2).

4 Hahn/Suhrbier-Hahn IStR 2003, 84 section 2 even report on recommendations to destroy potentially relevant documents in advance of audit. Destruction of relevant documents would potentially violate document retention obligations under section 147 (1) no. 5 AO (Tax Procedure Act).

5 This aspect of the decision has attracted considerable criticism. See Vögele/Bader, (Note 2) section III.E; Hruschka, IStR 2002, 753, 756; Seer, FR 2002, 380 section III.

6 See Vögele/Bader (Note 2) for a discussion of reasons why the judgment of 17 October 2001 is more favourable to the tax authorities than they apparently realise.

7 Section 22 EGAO.

8 Note 1

9 See Note 37 below.

10 Proposed Regulations section 8.

11 Proposed Regulations section 8 (3). The rules for aggregation of separate enterprises are borrowed from section 13 – 19 of the German Audit Rules (*Betriebsprüfungsordnung*).

12 Cf. the doubts of Kroppen/Rasch, (*Worldwide Tax Daily* (WTD) 2003, 46-6 of March 10, 2003) "whether the arm's length test may be enacted by changing the procedural law".

13 Cf. Article 9 of the OECD Model Tax Convention on Income and on Capital.

14 See Vögele/Bader, *Tax Planning International transfer pricing*, Vol.3, No.9, September 2002 p. 14 for further discussion of this issue.

15 See Vögele/Bader, *Tax Planning International transfer pricing*, Vol.3, No.6, June 2002, p. 15; Wassermeyer in Wassermeyer/Baumhoff, *Verrechnungspreise international verbundener Unternehmen* (Verlag Dr. Otto Schmidt, 2001) marginal nos. 96 and 816.1; same opinion Scheuerle, IStR 2002, 798; Köplin/Sedmund, IStR 2000, 307 and 2002, 120; Borstell/Brüninghaus/Dworaczek, IStR 2001, 757; Herlinghaus, FR 2001, 240; Dautzenberg/Gocksch, BB 2000, 904.

16 See Vögele/Bader, *Tax Planning International transfer pricing*, Vol.3, No.8, August 2002, p. 3.

17 Cf. section 1.1.3. of the 1983 Transfer Pricing Regulations (Note 1).

18 Cf. Note 2 above.

19 See Vögele/Bader, *Tax Planning International transfer pricing*, Vol.3, No.8, August 2002, p. 3 and Vol.3, No.9, September 2002, p. 14.

20 See Vögele/Bader, *Tax Planning International transfer pricing*, Vol.3, No.8, August 2002, p. 3.

21 See remarks of Ministerialrat Wolff documented in IWB no. 10 of May 28, 2003, pp. 433 ff.

22 Proposed Regulations section 2 (2) sentence 1.

23 Regarding aggregation, see section X.B "Aggregation of Transactions" below.

24 Kroppen/Rasch, *Worldwide Tax Daily* (WTD) 2003, 46-6 of 10 March 2003.

25 In German: *Sachverhalte, die Vorgänge mit Auslandsbezug betreffen.*

26 See IWB (Note 21) above.

27 Frotscher, (*Worldwide Tax Daily* of April 23, 2003 – 2003 WTD 78-3); Schnitger, BB 2002, 332 and IStR 2003, 73. Of opposing view Seer, FR 2002, 380; Crezelius, IStR 2002, 433; Hruschka, IStR 2002, 753; Hahn/Suhrbier-Hahn, IStR 2003, 84. Hahn/Suhrbier-Hahn do, however, believe that the monetary penalties under section 162 (4) AO violate EU law.

28 See IWB (Note 21) above.

29 See e.g. Schnorberger, DB 2003, 1241, 1242/2.

30 Section 5 of the pertinent German administrative regulations (BStBl II 1999, 1122) requires documentation on general arm's length grounds that are independent of section 90 (3) AO.

31 For a discussion of the issues involved, see Vögele/Bader, *Tax Planning International transfer pricing*, Vol.3, No.8, August 2002 and Vol.3, No.9, September 2002, pages 3 and 14 respectively.

32 For a discussion of the issues involved, see Vögele/Bader, *Tax Planning International transfer pricing*, Vol.3, No.8, August 2002 and Vol.3, No.9, September 2002, pages 3 and 14 respectively.

33 Proposed Regulations (Note 1) section 1 (1) last sentence. The Proposed Regulations state as a general matter that business relationships not involving an exchange of consideration are included in the scope of the documentation requirement and mention employee secondment in addition to pool arrangements as examples of business relationships of this type.

34 Cf. Schnorberger, DB 2003, 1241, 1244.

35 Proposed Regulations section 9.

36 Proposed Regulations section 7 (3) sentence 4 states that a demand for production of documentation can be made included in the official notice of audit commencement.

37 In all cases, however, the taxpayer is likely to have considerably more than six months after ratification of the proposed regulations by the Bundesrat in which to fulfil its transfer pricing obligations. See section III above.

38 Proposed Regulations (Note 1) section 3 (1).

39 Proposed Regulations (Note 1) section 7 (3) sentence 6 - 8.

40 Proposed Regulations (Note 1) section 3.

41 Schnorberger, DB 2003, 1241, 1243 ff. Schnorberger refers in German to *Sachverhalts-dokumentation* as opposed to *Angemessenheitsdokumentation*. Cf. IWB (Note 21).

42 Schnorberger, DB 2003, 1241, 1242/1.

43 Proposed Regulations (Note 1) section 1 (2).

44 The excluded subsection 2 of section 97 AO provides that document production shall as a rule only be requested when the person required to produce documents has not responded to a request for information or has given a response that is either inadequate or of doubtful accuracy. In an audit context, section 97 (2)AO is overridden in any event by section 200 AO.

45 Cf. section 200 (2) AO.

46 Section 97 (3) AO in conjunction with section 147 (5) AO.

47 Brockmeyer in Klein, *Commentary on the Tax Procedure Act* (7th ed. 2000; C.H. Beck, Munich), marginal no. 3 on Section 90 AO; cf. Proposed Regulations (Note 1) section 2 (1).

48 Münster Tax Court decision of August 22, 2000 (6 K 2712/00 – EFG 2001, 4); Federal Tax Court decision of November 7, 2001 *Equestrian Sport* (I R 14/01 – DStR 2002, 667) under II.10.a – relating to Section 90 Abs. 2 AO; Tipke/Kruse, *Commentary on the Tax Procedure Act* marginal no. 6 on section 90 AO and marginal no. 9 on Section 200 AO; Ritter, FR 1985, 34, 38/1; cf. Crezelius, IStR 2002, 433, 437.

49 Cf. Schnorberger, DB 1241, 1243/1.

50 Regarding electronic data access by the German tax authorities see Vögele/Bader, *Tax Planning International transfer pricing*, Vol.2, No.9, September 2001 p. 3.

51 Cf. Schnorberger (Note 49).

52 Proposed Regulations section 7 (3) last sent.

53 The German term (*Erfüllungsgehilfe*) covers primarily employees and independent contractors hired by the taxpayer. Cf. section 278 BGB (German Civil Code).

54 The German term, *nicht nachvollziehbar*, is rich in nuances and focuses on situations in which it is hard or impossible to re-trace the taxpayer's train of thought and determine how the conclusions reached were arrived as a logical matter. "Not analysable" and "not verifiable" are alternative translations.

55 Proposed Regulations section 1 (1) sentence 2.

56 Proposed Regulations section 6 (2) (2). While Germany's basic transfer pricing regulations (the 1983 AR – Note 1 above) do recognise three standard transfer pricing methods (comparable uncontrolled price method, resale price method, and cost-plus method), they provide only very general guidance as to what method to use in a particular situation, when methods may be mixed and combined, and under what situations a non-standard method may be used. There are no explicit comments on profit-based methods (section 2.2, 2.4 AR 1983). In 1995, the German tax authorities issued a press release stating that profit-based

  TPTP ISSN 1472-0841

methods would be used only for purposes of estimation or as a check against other methods (IStR 1995, 384), but there have since been occasional indications that the opposition to profit-based methods might be dropped or softened.

57 Frotscher (*Worldwide Tax Daily* of April 23, 2003 – 2003 WTD 78-3) states without giving reasons that failure to produce documentation "within the required time frame" will trigger a rebuttable presumption against the taxpayer.

58 Federal Tax Court (*Bundesfinanzhof*) judgment of October 17, 2001 I R (103/00, DB 2001, 2474 = IStR 2001, 745). Regarding the presumption of fact on which this decision rests, see Vögele/Bader, *Tax Planning International transfer pricing*, Vol.3, No.3, March 2002, p. 7.

59 Cf. section 292 ZPO (Code of Civil Procedure); *Deutsches Rechtslexikon* 3rd ed. 2001 (C.H. Beck, Munich) keyword "*Vermutung*"; *Völlmeke* DStR 1996, 1070, 1071/2; *Weber-Grellet* "In dubio pro quo?" StuW 1981, 48 59/2. Frotscher (*Worldwide Tax Daily* of April 23, 2003 – 2003 WTD 78-3) likewise assumes that the burden of proof is shifted by the presumption arising under section 162 (3) AO, as do numerous leading German tax experts (see IWB Note 21).

60 See Note 2 and 58 above and related text.

61 For more detail on the estimation process, which is not itself modified by the new laws, see Vögele/Bader, *International Tax Review* September 2001 p. 45 and *Tax Planning International transfer pricing*, Vol.3, No.3, March 2002, p. 7.

62 See section VIII.D above.

63 See text Note 27 above.

64 See Schnitger, BB 2002, 332 and IStR 2003, 73. Of opposing view Seer, FR 2002, 380; Crezelius, IStR 2002, 433; Hruschka, IStR 2002, 753; Hahn/Suhrbier-Hahn, IStR 2003, 84. Hahn/Suhrbier-Hahn do, however, believe that the monetary penalties under section 162 (4) AO violate E.U. law.

65 See e.g. Crezelius (Note 64).

66 Affirming parity Schnitger, denying it Hruschka, both Note 64.

67 See Hahn/Suhrbier-Hahn, Note 64.

68 See e.g. the ECJ's decisions in *Lankhorst-Hohorst* (December 12, 2002 C-324/00), striking down Germany's thin capitalisation rules (earnings stripping rules), and in *Überseering* (November 5, 2002 – C-208/00), limiting Germany's place-of-management theory of choice of law with regard to companies.

69 Regarding this judgment, see Vögele/Bader, *Tax Planning International transfer pricing*, Vol.3, No.3, March 2002, p. 7.

70 It is noted that some tax advisers are seeking to extend the benefits of *Lankhorst-Hohorst* (Note 68) beyond the E.U. by means of the anti-discrimination and most-favourite-nation clauses in tax treaties and in some cases, e.g. as between Germany and the U.S., in bi-lateral friendship and commerce treaties. A recent decision by the German Federal Tax Court lends support to this approach (decision of January 29, 2003 – I R 6/99).

71 See IWB (Note 21).

72 See Frotscher (*Worldwide Tax Daily* of 23 April 2003 – 2003 WTD 78-3).

73 Section 90 (3) sentence 5 AO.

74 Proposed Regulations section 1 (1) sentence 1 and (2).

75 Proposed Regulations section 1 (1) sentence 3; cf. section I above.

76 Proposed Regulations section 1 (3) first sentence.

77 Proposed Regulations section 1 (3) sentence 2 and 3.

78 Proposed Regulations section 1 (3) sentence 4.

79 Proposed Regulations section 1 (4).

80 Proposed Regulations section 2 (1).

81 Preliminary Draft Regulations section 1 (2) last sentence.

82 See section V.B above.

83 *Nachvollziehbar*; cf. Note 54.

84 Proposed Regulations section 2 (2).

85 Proposed Regulations section 2 (3).

86 Proposed Regulations section 3 (1).

87 Proposed Regulations section 3 (2).

88 Proposed Regulations section 4 (1) (a).

89 Proposed Regulations section 4 (1) (b). The proposed regulations cite section 1 (3) AStG, but this is a typographical error in our opinion.

90 Proposed Regulations section 4 (1) (c).

91 Proposed Regulations section 4 (1) (d).

92 Proposed Regulations section 4 (2) (a).

93 Proposed Regulations section 4 (2) (b).

94 Proposed Regulations section 4 (3) (a).

95 Proposed Regulations section 4 (3) (b).

96 Proposed Regulations section 4 (4).

97 Proposed Regulations section 7 (2).

98 Proposed Regulations section 7 (3).

99 See section X.B above: "Contemporaneous Documentation".

100 But note Proposed Regulations section 6 (2) (c): rejection of documentation based on an "obviously inappropriate" method.