GERMANY

Logic and Illogic of German Transfer Pricing Law – Part I

Alexander Vögele and **William Bader**
KPMG, Frankfurt

This is the first of two articles discussing the legal basis of German transfer pricing law. This month, the authors look at withdrawals from and contributions to sole proprietorships and partnerships. In next month's article, they will examine withdrawals from and contributions to corporations, constructive dividends, and Section I AStG, as well as providing a tabular summary with conclusions.

I. Legal Foundation of German Transfer Pricing Law

One might begin an essay on the legal basis German transfer pricing law by saying that, in theory, there isn't any. The exaggeration involved in such a statement would be slight. While Germany does have a statute on the books – section 1 of the International Transactions Tax Act or AStG[1] – that authorises adjustments to income where related parties have not dealt with one another at arm's length, this statute has so far led a "wallflower existence"[2] largely irrelevant to the resolution of international income allocation questions.

Instead, Germany has preferred to address transfer pricing problems using ancient legal doctrines developed over decades in a domestic context.[3] There are three such doctrines:

- constructive contributions[4]
- constructive withdrawals[5]
- constructive dividends[6]

The relationship of the above doctrines to Section 1 AStG is "astonishingly unclear".[7] The percentage of cases decided under the above doctrines as opposed to Section 1 AStG is estimated by *Wassermeyer* as shown in Table 1:[8]

Table 1

Constructive dividends	85%
Constructive withdrawals	5%
Constructive contributions	7%
Sec. 1 AStG	3%

This article explores the three "ancient doctrines" in comparison with each other and with Section 1 AStG. The analysis reveals surprising anomalies that result from inconsistent application of the arm's length standard. Inconsistent application of the arm's length standard is in turn the reason why Section 1 AStG, Germany's codification of the arm's length principle, may conflict with EU law and hence be unenforceable.[9]

II. Withdrawals From and Contributions To Sole Proprietorships

A. Section 4 (1) EStG (Income Tax Act)

The German Income Tax Act defines seven categories of taxable income.[10] The list is exhaustive, hence income not subsumable under one of the seven categories is not subject to income tax. For three income categories – income from agriculture and forestry, income from independent personal services, and income from commercial business activity – taxable income is defined as the profit from the respective activity.

The term "profit" is in turn defined in Section 4 (1) EStG, the first sentence of which reads as follows:

> "Profit is the difference between business property[11] at the close of the fiscal year and business property at the close of the preceding fiscal year, increased by the value of withdrawals and decreased by the value of contributions."

In the above definition, "business property" refers to net business property, in other words, to the difference between assets and liabilities at a given point in time, as illustrated in Table 2:[12]

Table 2

	Assets
	minus Liabilities
=	Business property

The term "business property" could thus also be replaced by "net assets" or "equity". Profit is the increase in equity between two cut-off dates after adjustment for withdrawals and contributions. Withdrawals and contributions are likewise defined in Section 4 (1) EStG:

> "Withdrawals are all assets (cash withdrawals, goods, products, usages,[13] and services) that the taxpayer has withdrawn from the business in the course of the fiscal year for himself, for his household, or for other purposes extraneous to the business.... Contributions are all assets (cash payments and other assets) that the taxpayer has placed in the business in the course of the fiscal year."[14]

B. Withdrawals and Contributions by Sole Proprietors

Section 4 EStG refers to a sole proprietor, not to a business conducted in partnership, let alone

corporate form. Withdrawals and contributions by sole proprietors are factual events that involve no contractual or company law relationship and no change in asset ownership. The terms denote movements between different spheres of the same individual.[15] Of prime importance are movements of assets between the taxpayer's business and private spheres.[16]

The basic statutory concept is simple: the difference between net assets at two cut-off dates is an accurate measure of profit only if non-business transactions affecting net assets are eliminated. For instance, if the taxpayer uses money inherited from his parents to buy a new business machine, this increases net assets, but should not impact profit. The injection of cash is a contribution. By the same token, if the taxpayer takes Euro 20,000 out of his business bank account to pay for his daughter's wedding, this reduces business assets, but cannot be permitted to reduce profit.

Example:

Taxpayer T owns an automobile repair shop. In 2001 he buys a new machine using Euro 60,000 inherited from his aunt. Throughout the year, he uses spare parts purchased for the business to build dragstrip race cars, which he drives in amateur racing events as a hobby. The total cost to the business of the spare parts used for private purposes in 2001 is Euro 20,000. The calculation of T's 2001 business profit might be as shown in Table 3:

Table 3

		Euro
Assets at 31 Dec. 2001	3,000,000	
Liabilities at 31 Dec. 2001	–2,800,000	
Net assets at 31 Dec. 2001		200,000
Net assets at 31 Dec. 2000		100,000
Differential amount (tentative profit)		100,000
Plus withdrawals in 2001		+20,000
Minus contributions in 2001		–60,000
Profit for 2001		60,000

C. Valuation of Withdrawals

Note that the withdrawals in the above example have been valued at their cost to the business, not at their arm's length price – the price the business would have charged its customers for the spare parts. This is in accordance with the valuation rule of Section 6 (1) no. 4 EStG, which provides for valuation of withdrawals at their so-called *going concern value.*[17]

Going concern value is defined as the amount that a prospective buyer of the entire business would allow for a particular asset, assuming an intention to continue the business.[18] The going concern value of cash is its nominal value. The going concern value of current assets (inventory) is generally their replacement cost, here, the price the business would have to pay to replace the spare parts in question. The going concern value of current assets not needed in the business is determined by the price the asset would bring if sold at the *same market level* (less selling costs).[19] If the car parts in question were no longer needed by the business, for instance because of a decision to repair only trucks in the future, their going concern value would be the price that another car repair shop would pay to acquire the parts, not the price on sale to a vehicle owner.

The valuation of withdrawals at going concern value means that they are adjusted to going concern value on the business's books a logical second before being withdrawn.[20]

Assuming constant prices, the withdrawal will not cause the business to realise any gain because the going concern value will equal the book value of the spare parts. Prices for current assets will generally be constant where the interval between asset purchase and asset withdrawal is short. While gain or loss on the withdrawal is conceivable if the current replacement cost is above or below book value (historic cost), the withdrawal never triggers a profit mark-up because the assets are valued at the trading level of the enterprise, not that of the enterprise's customers. The addback rule of Section 4 (1) EStG thus in general prevents the withdrawal from reducing business profit, but does not put the business in the position it would have occupied had it sold the withdrawn current asset to a customer.

The going concern value of depreciable or amortisable fixed assets is likewise determined with reference to their replacement cost, adjusted for the age of the asset. The going concern value of non-depreciable fixed assets, such as land, or non-fungible fixed assets, such as most forms of intellectual property is, however, in no case less than their fair market value if sold by the business (less selling costs). Hence, withdrawals of fixed assets sometimes result in an adjustment similar to that which would result if the withdrawal were valued at its arm's length price.

D. Valuation of Contributions

The receiving business generally capitalises contributions at their going concern value from its perspective.[21] The going concern value of the cash involved in the example under Section 2.B. is the nominal value of the cash. In the case of contributions in kind, the going concern value for the receiving business is determined under the general definition.[22]

E. Logic of the Valuation Rules

Private capital gains are largely exempt from income taxation under German income tax law. A taxable "private" capital gain occurs on sale or other alienation of an asset not held in a business only where the sale takes place within a "speculation" holding period of ten years for land and one year for all other assets.[23] By contrast, the income derived from the sale of a business asset is always taxable. If assets could be transferred at book value from the business to the private sphere, virtually all business assets could be sold "privately" free of tax by removing them from the business shortly before sale.

The valuation of withdrawals at going concern value by and large defeats such tax avoidance strategies by small business owners. While valuation at going concern value is not identical to valuation at the arm's length price, it is a close approximation for land and

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most fixed assets, which are the only assets likely to contain significant appreciation (hidden reserves). As for current assets (inventory), taxpayers are able to consume these to a certain extent for personal purposes without paying any profit mark-up.[24] The law concedes this slight tax break in return for the simplification achieved by valuing withdrawals at cost in most cases.

Valuation of withdrawals at going concern value thus makes sense in the context of sole proprietorships, for which the statute was crafted.[25]

F. The *Veranlassungsprinzip*: An Arm's Length Test

Section 4 (1) and (4) EStG are the source of a German tax concept known as the *Veranlassungs-prinzip* or "principal of occasionality". The principal of occasionality is the means by which withdrawals, which are added back to profits, are distinguished from business expenditures, which reduce profits.[26] Section 4 (4) EStG defines business expenses as expenditures that are occasioned by the business. A distinction must be drawn for tax purposes between business expenses, on the one hand, and expenditures that are occasioned by non-business considerations, such as the private consumption of the owner of the business, on the other.

German courts have approached the problem of separating withdrawals from business expense by asking whether a diligent and conscientious business manager[27] would have conferred the benefit in question on an unrelated third party. Where the answer to this question is negative, a benefit conferred on the sole proprietor or a related party is occasioned by the ownership relationship, not by the business.

Example

The sole proprietor of a film rental company travels to the Cannes film festival with his wife. They arrive a week before the film festival begins and stay a week after it ends. All costs are treated as business expenses.[28] Part of the relevant expenses are occasioned by the business, part constitute private consumption.

The same problems can in theory result from transactions between different businesses of the same sole proprietor:

Example

A sole proprietor has a painting business and a photocopying business. The painters paint the premises of the photocopying business. A payment twice the going rate is transferred from the bank account of the photocopying business to that of the painting business.

G. Interim Result

Withdrawals occur when a sole proprietor transfers assets from his business sphere to his private sphere. Withdrawn assets are removed from the list of business assets and liabilities, thus initially decreasing the positive difference (or increasing the negative difference) between assets and liabilities. Withdrawals are added back to the differential amount (tentative profit) in calculating taxable business profit.

More broadly, withdrawals may also be defined, in keeping with the principal of occasionality, as the removal of an asset from the business by the owner for non-business reasons.

Contributions are assets that a sole proprietor has moved from his private sphere to his business sphere. Contributed assets are entered on the list of business assets and liabilities, thus initially increasing the positive difference (or reduce the negative difference) between assets and liabilities. Contributions are subtracted from the differential amount (tentative profit) in calculating taxable business profit.

Contributions are injections of non-business assets into the business by the owner.

Withdrawals and contributions are valued at their going concern value to the business. Since the going concern value of current assets cannot exceed their replacement cost, sole proprietors can withdraw current assets (goods) from their businesses without paying a profit mark-up on the withdrawal.[29]

H. Balance Sheet and Income Statement

As a technical matter, profit is today seldom determined using the method prescribed by Section 4 (1) EStG.[30] Rather, virtually all commercial businesses are required to keep accounts in accordance with the principles of double entry bookkeeping and German GAAP.[31] This includes preparation of an income statement, of which the balance sheet is a product. While the technique is different, the principle of Section 4 (1) EStG must still be respected. That is, contributions must be accounted for so as to have no impact on profit. Withdrawals impact profit only to the extent going concern value exceeds or falls short of book value at the time of withdrawal.

Section 5 (6) EStG provides that the tax principles behind withdrawals and contributions are controlling for tax accounting purposes in the event of any conflict with German GAAP.[32] Hence, whether a transaction constitutes a withdrawal or a contribution for commercial accounting purposes is irrelevant for tax accounting purposes. For tax accounting purposes, the principle of occasionality[33] overrides commercial accounting principles.

I. Narrow and Broad Definitions of "Business"

Whereas movements between the taxpayer's business and private spheres constitute withdrawals or contributions, it has not been clear whether movements inside or between business spheres should be treated in the same manner.

Example

A sole proprietor owns a textile manufacturing business and a cement plant. The textile business operates from two locations, one of which is proximate to the cement plant. In order to expand the cement plant, textile operations are consolidated at the other site. The cement plant then expands onto the land formerly used in the textile business. The sole proprietor bought the land 20 years ago for DM 100,000. Its fair market value is now DM 1,000,000.

If the re-dedication of the land is treated as a withdrawal from the textile business and a contribution to the cement business, the taxpayer will have to pay tax

GERMANY

on the unrealised appreciation. Here, going concern value is probably equal to fair market value.[34]

The professional literature has elucidated two concepts of the term "business":[35] a narrow concept and a broad concept.[36] Under the narrow concept, the same sole proprietor can have different businesses. Transfers of an asset from one business to another are for a purpose "extraneous" to the business that relinquishes the asset and hence constitute withdrawals.[37] From the perspective of the receiving business, a contribution takes place. Under the broad business concept, all business operations owned by the same taxpayer constitute a single business. Since the transfer in the above example involves no change of ownership, no withdrawal takes place under the broad concept.

Without ever clearly endorsing the broad concept of a business, the German courts developed a "teleologically reduced" concept of withdrawals[38] and declined to treat transactions such as that described in the above example as withdrawals triggering gain as long as eventual taxation of the unrealised appreciation inherent in the transferred asset was assured.[39] Under this line of cases, the piece of land in the above example would in effect be withdrawn from the textile business and contributed to the cement business at book value (carryover basis). The courts in essence overrode the valuation rules of Section 6 (1) nos. 4 and 5 EStG and valued withdrawal/contribution transactions inside the German tax sphere at book value instead of going concern value.[40]

The reasoning of the courts is criticised in the literature. *Heinicke* points out that German tax law contains no general rule that the unrealised appreciation or "hidden reserves" inherent in taxable assets are realised when they exit the German tax sphere.[41] Hence, it is improper to treat the same event as a taxable withdrawal or not depending on whether Germany's right to tax the hidden reserves is preserved.

Be this as it may, the result reached by the courts is presently codified in Section 6 (5) sent. 1 EStG, which mandates valuation at a carryover basis in such situations without affecting the definition of withdrawals and contributions as a theoretical matter.[42] It is important to note, however, that withdrawal and contribution still occur in the above example. Only the valuation has been changed. Hence, the amount of the withdrawal (book value) is added back to the profits of the textile business and subtracted from the profits of the cement business. The allocation of profit between the two businesses has significance above all for trade tax purposes. Under the prevailing view, a natural person can have different businesses for trade tax purposes.

The "teleologically modified" valuation of withdrawals means that they can only trigger gain in two primary situations:

- Movements between the sole proprietor's business sphere and his private sphere, and
- Movements inside the business sphere into a foreign jurisdiction with which Germany has concluded a tax treaty under which Germany avoids double taxation by the exemption method.[43]

J. Foreign Permanent Establishments

1. Permanent establishments vs. discrete businesses

A distinction must be drawn between transfers between discrete businesses of the same taxpayer and transfers between different permanent establishments of the same business. The example given under Section 2.I. above involves discrete businesses owned by the same sole proprietor. The following example involves two permanent establishments of the same business.

Example

A sole proprietor owns a cement business with two cement plants located on opposite sides of the Rhine river, one in Kehl and the other in Strasbourg. In Year 02, a cement mixing machine is transferred from the Kehl plant in Germany to the Strasbourg plant in France. The machine was purchased in Year 01 for 100 and has a useful life of six years. Its book value at the time of the transfer is 90. Due to price increases, the age-adjusted replacement cost is 140.

Tax consequences

Transfer of the machine to the taxpayer's French PE is not a taxable event. However, the unrealised appreciation inherent in the machine at the time of transfer is still properly applicable to the German PE. Hence, the German PE should set up a collateral account outside of its books with regard to the transaction. The collateral account records the unrealised appreciation of 50. The collateral account balance is transferred to revenue over the remaining useful life of the machine, *i.e.*, at a rate of 10 per year. The assumption behind this accounting treatment is that the value inherent in the machine is realised over its useful life.[44] Part of this value, *i.e.*, the unrealised appreciation at the time of transfer, is properly applicable to the German PE. But revenue may not be recognised until it is realised. There is no legal basis for treating the transaction as a sale or withdrawal and causing the German PE to recognise the unrealised appreciation at the time of the transfer.

2. Outbound transfer as taxable event?

Transfers between permanent establishments are sometimes discussed as if they represented withdrawals at least where assets leave the German tax sphere.[45] In the above example, Germany's tax treaty with France precludes German taxation of the business profits of the French permanent establishment. Hence, the assets leave the German tax sphere when they are transferred to the French permanent establishment. However, as noted above,[46] German tax law contains no general rule triggering taxation of unrealised appreciation (hidden reserves) when assets exit the German tax sphere.[47] Outbound transfers are not withdrawals. Section 4 (1) EStG covers only transfers between different businesses, not between two permanent establishments of the same business.[48]

However, Germany's current regulations on the taxation of permanent establishments tacitly assume that outbound transfers constitute taxable events, either as withdrawals or by virtue of leaving the German tax sphere (*Entstrickung*).[49]

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Nevertheless, in most situations, the regulations defer recognition of gain on outbound transfers on "equitable" grounds.[50] The result reached under the regulations is thus the same as the solution given to the example in Section 2.J.1 above. But the regulations prescribe immediate recognition of gain if a French sole proprietor moves a machine from his German to his French permanent establishment.[51] This treatment lacks a legal base. Even if it was founded in law, it may conflict with the anti-discrimination provisions of the E.C. Treaty.[52]

3. Valuation standard

Also noteworthy is the insistence of the permanent establishment regulations on deferral of gain based on the difference between the *arm's length price* of the transferred asset and its book value at the time of the transfer.[53] If outbound transfers to tax treaty countries constituted withdrawals, the withdrawal would have to be valued at going concern value under Section 6 (1) number 4 EStG.[54] For current assets, this frequently equals the book value of the transferred assets.[55] Only for fixed assets is the going concern value generally equal to the fair market value, which is in turn equivalent to the arm's length price.[56]

4. Income allocation vs. income realisation

Viewed as income allocation rules, as opposed to income recognition rules,[57] the provisions of Germany's permanent establishment regulations on outbound transfers reach valid results in most, but not all cases. Viewed as income recognition rules, the provisions are doubly invalid: they both assume a taxable event (withdrawal) where none exists and apply the wrong valuation standard (arm's length price instead of going concern value) to the non-existent taxable event.

Kramer affirms most of the results reached by the permanent establishment regulations regarding outbound transfers on the grounds that allocation of income between permanent establishments is necessary for purposes of domestic tax law[58] and the application of tax treaties.[59] Since the tax code and treaty law necessitate such allocation, but contain no provisions governing its details, the courts are in *Kramer's* view justified in propounding reasonable rules to fill a gap in the tax laws (*Lückenfüllung*).[60] However, there is no justification for overriding the basic principle that income cannot be taxed until realised. Hence, deferred taxation is mandatory in all cases under the tax laws.

The application of the above principles to situations involving exchanges of services or loans of assets between permanent establishments is beyond the scope of this article.

K. Usages and Services

1. General

The legal definition of withdrawals includes usages (loans of assets)[61] and services, whereas the definition of contributions does not.[62] A "usage" is withdrawn where a sole proprietor or a related party uses a business asset for purposes extraneous to the business, *e.g.*, for private benefit. Services are withdrawn in analogous circumstances. The prevailing view is that usages and services may be withdrawn from a business, but not contributed to it.[63]

2. Withdrawals of usages and services

Example1: Usage

A sole proprietor uses a business vehicle 40 percent for private purposes.

Example 2: Service

The factory groundskeeper spends 30 percent of his time tending the taxpayer's private garden.

German courts have treated situations like the above as withdrawals to be valued in accordance with the related costs borne by the business.[64] In Example 1, 40 percent of vehicle depreciation and operating costs would be added back to profit. In Example 2, 30 percent of the groundskeeper's wages and accrued benefits would be added back.[65] While this result was originally reached on the theory that the related costs represented the going concern value of the withdrawn usages and services, the reasoning later changed. It now rests on the premise that usages and services are not assets and hence can have no going concern value.

Since the legal definition of withdrawals nevertheless includes usages and services, the courts are obliged fill the gap in the law by finding a suitable standard of measurement. Actual cost to the business is considered the correct standard.[66] Accordingly, no measurable withdrawal occurs when an asset is used for purposes extraneous to the business without identifiable related cost.[67]

While a chamber of the Federal Tax Court has suggested that it may be more proper to value withdrawals of usages at fair market value,[68] there is no indication that the courts are about to change their position on this issue.

Hence, withdrawals of usages and services result in neutralisation of any related expense at the level of the business, but do not trigger a realisation of profit based on the arm's length price.

3. Contributions of usages and services

In 1987, a combined chamber of the Federal Tax Court held that usages and services could not be contributed by a shareholder to his corporation because they were not capitalisable assets.[69] While the decision related to a corporation (see the section "Withdrawals from and contributions to corporations", next month), the holding is considered applicable to sole proprietorships and partnerships as well.

Previously, contributions of usages and third party services[70] by sole proprietors (and partners in partnerships – see Section 3.C. below) were commonly accepted.

Example1: Usage

A sole proprietor uses a private vehicle 40 percent for business purposes.

Example 2: Service

A sole proprietor's private gardener spends 30 percent of his time tending the plant grounds.

Even after the 1987 ruling by the FTC's combined chamber, such transactions continue to be treated analogously to the reverse examples involving withdrawals given in Section 2.K.2 above. However, instead of treating the usage or service as contributed to the

GERMANY

business and valuing the contribution in terms of the associated cost, the cost is itself deemed to be a business expense allocable to the business. This achieves the same result under different nomenclature.[71]

4. Inter-business transactions

The discussion has so far focussed on contributions and withdrawals of usages and services between the taxpayer's private and business spheres. Transactions are also possible between businesses:

Example

Sole proprietor X has a painting business and a construction business. Painters of the painting business paint the premises of the construction business. The sum of 200 is transferred from the bank account of the construction business to that of the painting business. The construction business treats the amount as a business expense, the painting business as business revenue. However, the fair market value of the work performed is only 100.

This transaction does not fall under the rule of Section 6 (5) sent. 1 EStG, which applies only to transfers of assets. For income tax purposes, it makes no difference (in a domestic context) what profit the individual businesses report, since the positive or negative income of both businesses is attributed to X. However, for trade tax purposes the businesses are treated separately. The proper treatment in the posited example is unclear. As a practical matter, adjustments seldom occur. As a theoretical matter, the sum of 100 has been withdrawn from the construction business and contributed to the painting business. Hence, the unadjusted profit of the construction business should be increased by 100 and that of the painting business reduced in like amount.

L. Burden of Proof

The allocation of the burden of proof has seldom decided cases involving alleged withdrawals and contributions. The general rule of allocation of the burden of proof in German tax law is that the tax authorities bear the burden on facts that, if proven, would increase taxes owing, and the taxpayer bears the burden on facts that would decrease taxes owing.[72]

Where the deductibility of alleged business expenses was at issue, the courts have therefore assigned the burden of proof to the taxpayer on the theory that he must prove the facts that establish that expenditure was occasioned by the business.[73]

Conversely, the tax authorities would bear the burden of proof as to the going concern value of assets withdrawn from the business:

Example 1

Taxpayer T owns an automobile repair shop. Throughout the year, he uses spare parts purchased for the business to build a dragstrip race car, which he occasionally drives in amateur racing events. T treats the spare parts used for his private race car as withdrawals and values them at 100. On audit, the tax authorities claim the proper going concern value is 200.[74]

Assuming the book value of the spare parts to be 100, the tax authorities would have the burden of proof under the general rule. The taxpayer is not seeking a deduction on the transaction. Rather, the tax authorities are alleging that the transaction triggers gain. Since, as a practical matter, the exact book value of the spare parts will be unknown if a periodic inventory system is used, the general rule is difficult to apply. If the book value were somehow known to be 125, the taxpayer would have the burden as to the facts showing going concern value to be under book value and the tax authorities the burden of proof for showing it was above book value. Thus, the burden of proof on the same issue (going concern value at the time of withdrawal) would be split between the parties, which is a curious result.

The general rule places the burden on the taxpayer with regard to the valuation of contributions, since these reduce taxable income.

Example 2

Taxpayer T takes 100 out of his sole proprietorship and contributes a piece of land to it, which he values at 100. The tax authorities claim the land is only worth 50.

Valuation of the cash withdrawal (addback to income) is clear. Valuation of the in-kind contribution is more difficult. Since contributions reduce taxable business income, the general rule would place the burden of proof on the taxpayer.

Where taxpayers have violated compliance obligations (obligation to co-operate in the fact-finding process), the German courts have occasionally been willing to lower the standard of proof that the tax authorities must meet and decide cases against the taxpayer based on plausible assumptions, as opposed to proven facts.[75]

M. Related Parties

Withdrawals are also possible where the business confers a benefit on a person related to its owner. Whether a benefit conferred on a third party is occasioned by the business or occasioned by the owner's relationship to the recipient is a factual question. There is neither a defined group of persons, such as close family members, with regard to whom benefits conferred are deemed to be withdrawals, nor are there any persons with respect to whom benefits conferred can never constitute withdrawals.

III. Withdrawals From and Contributions to Partnerships

A. Similarities to Sole Proprietorships

The above-described principles of contributions and withdrawals apply to the relationship between a partner and his partnership as well as that between a sole proprietor and his business. Partnerships represent separate entities for trade tax purposes, but are transparent for personal and corporate income tax purposes (look-through entity). Partnership income is determined at the partnership level. Individuals who are partners declare their distributive shares of partnership profit and loss after trade tax on their personal

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income tax returns. Corporate partners do the same on their corporation tax returns.

Just as the sole proprietor is the owner of his business, partners own undivided interests in partnership property. In fact, partnerships were for decades viewed in Germany less as entities than as aggregates. Following this view, now superseded, partners took pro rata shares of partnership assets and liabilities onto their own balance sheets (so-called "bundled balance sheet approach"[76]). This affinity between sole proprietorships and partnerships made it easy to extend the principles of contributions and withdrawals to partnerships.

There are also two major differences between sole proprietorships and partnerships. Both flow from the fact that partnerships have an existence separate from that of their partners.

B. Contractual Dealings Between Partner and Partnership

The first difference is that contractual relations are possible between a partnership and its partners, whereas none are possible between a sole proprietorship and its owner. However, German tax law denies tax recognition to payments made by a partnership to its partners for services performed for the partnership as well as for sums loaned and assets leased to it by a partner.[77] This rule is essentially intended to prevent partners from reducing the partnership's trade tax base by such means. However, the same transactions in the reverse direction are recognised for tax purposes, as are sales in both directions.[78]

Example

X and Y (both natural persons) are equal partners in the X & Y General Partnership. X contracts to provide architectural services to the partnership for an annual fee of 100 and Y leases it a building for annual rent of 100. The partnership records the payments as business expenses and earns a net profit for the year of zero. However, the payments to X and Y are added back to partnership revenue. The resulting net profit of 200 is subject to trade tax of 40 (20 percent).[79] The remaining profit of 160 is attributable half each to X and Y, who pay income taxes on these sums at their respective personal rates. Without the addback rule, they would have zero partnership income for the year, but personal service income or rental income of 100 respectively.[80] If the relationships were reversed and the partnership provided services and rented property to its partners, the resulting expense and income would be accepted for tax purposes if at arm's length.

Note that the addback rule places partners in the same situation as sole proprietors as regards trade tax. Because they cannot contract with themselves, sole proprietors are legally incapable of saving trade tax by charging their sole proprietorships for personal services and assets provided.

Where partnerships undercharge their partners for goods, services, or usages, the transaction may involve a withdrawal by the partner from the partnership.[81] Since the withdrawal is obscured by combination with a contractual exchange of consideration, the term *constructive withdrawal* is appropriate.[82] While a sole proprietor may also conceal a withdrawal as a practical matter, he cannot contract with himself and hence cannot use a contractual performance to mask a withdrawal.

The standard discussed in Section 2.F. above is used to distinguish constructive withdrawals from business expenses. One asks whether a diligent and conscientious business manager would have conferred the benefit on the partner. If the answer is negative, the benefit is rebuttably presumed to be occasioned by the partnership relationship instead of by the business. Essentially, an arm's length standard is applied to distinguish business expenses from constructive withdrawals.

Example

X is partner in the X & Y oHG. X purchases goods from the partnership for 200. The replacement cost of the goods at the time of purchase is 300. The arm's length sales price is 400. Since replacement cost determines the going concern value of current assets (inventory), the withdrawal amounts to 100. This sum is added back to the partnership profits.

Where constructive withdrawals of assets are found to have occurred, they are valued at going concern value. As explained in Section 2.C. above, going concern value is not equivalent to the arm's length price in certain circumstances. For partnerships as for sole proprietorships, an arm's length test is used to identify withdrawals, but not to determine their tax consequences.[83]

C. Usages and Services

While fees for services rendered and property leased by a partner to his partnership are disregarded for tax purposes,[84] the partnership may render services and lease property to its partners. Where the partnership loans assets or provides services to its partner without payment, the related costs incurred by the partnership are treated as withdrawn and hence added back to its profits. However, no mark-up occurs to compensate for lost profit.[85] This is analogous to the treatment of usages provided and services rendered to a sole proprietor by his business.[86]

Where a partnership makes low interest or zero interest loans to a partner for non-business reasons, this can result in a withdrawal of the loan principal from the partnership by the partner. The partnership's refinancing costs then cease to be business expenses of the partnership.[87]

The same consequences should apply where a partnership provides a service or loans an asset for less than fair consideration to a partner or a related partnership for business as opposed to private use:

Example

X and Y are partners in the X & Y Painting Partnership and in the X & Y Construction Partnership. Painters of the painting partnership paint the business premises of the construction partnership. The related costs should be treated as

withdrawn from the painting partnership by X and Y. The same cost should be deductible by the construction partnership.[88]

Related partnerships may contract to perform services and lease assets to each other. The case law in this area is complex, but sometimes accepts the results of such contracts even where the conditions are not at arm's length.[89] A discussion of the case law in point is beyond the scope of this article.

D. Contributions to Partnerships

Contributions by partners to partnerships may occur in return for interests in the partnership. Such contributions may be either in money or in kind and are referred to as *open contributions*. Open contributions in kind thus involve an exchange of property for partnership interests and are treated a barter sale if the partner held the contributed asset as *private* property.[90] Barring exemption under the rules discussed under Section 2.E. above, taxable gain is realised to the extent of excess of fair market value over the contributing partner's basis in the asset.[91] The partnership then takes the asset onto its books at going concern value.

Open contribution of property previously held in another business owned by the same partner does not trigger tax, however, as long as the property in question remains subject to German tax. Like transfers of assets between separate sole proprietorships of the same individual,[92] open contributions of business property to partnerships also take place at book value as long as ultimate taxation is assured. This is generally the case where the asset remains business property of a German business. The carryover basis rules are currently codified in Section 6 (5) sent. 3 EStG.[93] If Germany's ultimate right of taxation is not preserved, the transaction is treated as a barter sale.

Contribution of an asset from one domestic business to another in exchange for partnership rights does not trigger gain because the transaction is valued at book value instead of fair market value. The transaction nevertheless involves withdrawal of the asset in question from the first business as well as contribution to the second.

Example

Taxpayer X, a natural person, owns a sole proprietorship and is also partner in the X & Y oHG (a general partnership). X transfers a machine previously used in his sole proprietorship to the partnership in return for an increased interest in the partnership. The book value of the machine is 100; its going concern value (replacement cost of a new machine adjusted for the age of the machine) is 150.[94] The transfer does not trigger gain at the level of the sole proprietor-ship, from which the asset is withdrawn as book value. The partnership takes a carryover basis of 100 in the asset. If the transaction has impacted the profits of the two businesses, *e.g.,* because the transferring business charged the asset off to expense and the receiving business treated it as revenue, an amount of 100 must be added back to the profit of the transferring business and subtracted from the profit of the receiving business.

It is also possible for a partner to contribute property to a partnership without receiving an increased interest in the partnership or other consideration in return. Such contributions are referred to as *constructive contributions.*[95] Because no consideration in the form of a partnership interest is received by the partner, such transactions cannot be treated as barter sales.

Constructive contributions of land held as non-business property are retroactively deemed to be a sale if the land is subsequently sold within a specified holding period.[96]

Where the asset is already business property of the contributing partner, the transfer involves withdrawal from one business sphere and contribution to another. Under the rules of Section 6 (1) numbers 5 and 6, both withdrawal and contribution would normally be valued at going concern value. However, the carryover basis valuation rules of Section 6 (5) sent. 3 EStG apply to constructive contributions as well as open contributions. The tax consequences are thus the same as under the above example. Again, the carryover basis is contingent on preservation of Germany's right to tax the transferred assets. If this condition is not met, the normal rule of valuation at going concern value applies. A withdrawal and a contribution occur and must be accounted for in both cases. Only the amounts depend on the applicable valuation rule: carryover basis or going concern value.

E. Policy Behind Non-recognition of Gain

The above-discussed non-recognition rules for contributions to partnerships have a long and complicated tradition in German case law. Ultimately, they are motivated by a perceived need to confer preferential tax treatment on personal businesses (sole proprietorships and partnerships). The current codified non-recognition rules were enacted following a storm of protest in response to restrictions imposed in 1999. Personal businesses are often family businesses and are thought to need restructuring flexibility, both with respect to normal operations and in order to manage inter-generational transition. The current codified rules even permit certain transfers of assets at book value between different partners of the same partnership,[97] provided the transfer is without consideration.

F. Withdrawals from Partnerships

A withdrawal from a partnership occurs where the partnership confers a benefit on its partners by reason of the partnership relationship. This is rebuttably presumed to occur where a diligent and conscientious business manager would not have conferred the same benefit on an unrelated party.

Example

X & Y oHG, a general partnership, manufactures apparel. Every month, it produces clothes at cost of 100. It sells one third of its monthly output to one of its two partners at a price of 100, one third to its second partner at a price of 125, and the rest to an unrelated wholesaler at a price of 150. Ques-

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tioned about its price structure on audit, X GmbH offers no explanation for the differences.

Tax consequences

The partnership's prices cannot be adjusted under the doctrine of withdrawals. The prices charged are all at or above going concern value, *i.e.*, replacement cost. If the partnership is located in Germany and its partners are in other jurisdictions, an adjustment is potentially possible under Section 1 AStG (Foreign Transactions Tax Act).[98]

G. Partnerships and Permanent Establishments

The comments under Section 2.J. above apply to partnerships with few changes. The permanent establishments of a partnership are treated as pro rata permanent establishments of its various partners, and the income attributable to those permanent establishments is treated pro rata as income of the partners for German personal or corporate income tax purposes.[99]

Example

A partnership with two partners, Partner G resident in Germany and Partner F resident in France, owns a cement business with two cement plants located on opposite sides of the Rhine river, one in Kehl and the other in Strasbourg. In Year 02 a cement mixing machine is transferred from the Kehl plant in Germany to the Strasbourg plant in France. The machine was purchased in Year 01 for 100 and has a useful life of six years. Its book value at the time of the transfer is 90. Due to price increases, the age-adjusted replacement cost is 140.

The tax consequences of the transfer of the asset from the partnership's German permanent establishment to its French permanent establishment should be the same as those outlined in Section 2.J.1 above. However, Sections 2.6.3 and 2.6.4 of the German permanent establishment regulations[100] indicate that the transfer results in immediate pro rata realisation of gain for the French partner, whereas the German partner is able to defer his gain.

H. Burden of proof

The comments on the burden of proof for sole proprietorships[101] apply to partnerships in principle. However, partnerships are able to purchase assets,[102] though not services,[103] from their partners for tax purposes. Such transactions are not possible between a sole proprietor and his business.

Example[104]

Partner P sells a piece of land to his partnership for 100. The tax authorities claim the land is only worth 50.

The issue is whether the partnership can capitalise the land at 100 or 50. Since the higher value reduces profit, the partnership should bear the burden of proof under the general rule.

I. Related Parties

The comments on related parties in Section 2.M. above apply analogously in the partnership context.

Part II of this article, covering withdrawals from and contributions to corporations and Section 1 AStG, and providing a tabular summary and conclusions, will appear in Tax Planning International Transfer Pricing, Vol.3, No.9 in September 2002.

1 Außensteuergesetz.

2 *Wassermeyer* IStR 1997, 657: opening sentence. Prof. Dr. Franz Wassermeyer is the Chief Justice of the 1st chamber of the Federal Tax Court (*Bundesfinanzhof*), Germany's highest tax court. Under the current allocation of responsibilities amongst the court's eleven chambers, the 1st Chamber hears cases on corporation tax law, among other things, and is hence the most important chamber as regards transfer pricing decisions.

3 Cf. Section 1.1.1, 1.1.3 of Germany's general transfer pricing regulations, the so-called Administrative Principles of 23 February 1983 (BStBl I 1983, 218). The 1983 regulations, which are still in force, provide that adjustments to income based on constructive dividends and constructive contributions shall take precedence over those based on Section 1 AStG. The 1983 regulations make no mention of withdrawals or constructive withdrawals.

4 In German, *verdeckte Einlagen*; literally, "hidden/concealed contributions".

5 In German, *verdeckte Entnahmen*.

6 In German, *verdeckte Gewinnausschüttungen*; literally, "hidden/concealed distributions of profit".

7 *Wassermeyer* (Fn. 2), opening paragraph.

8 *Wassermeyer* IStR 2001, 633, opening paragraph. *Wassermeyer* attributes a 90 percent share to constructive dividends and constructive withdrawals in the aggregate; the breakdown which follows is based on the authors' own estimate. See also *Wassermeyer/Baumhoff Verrechnungspreise international verbundener Unternehmen* (Verlag Dr. Otto Schmidt, 2001) p. 122 (marginal no. 8).

9 See Section on "Section 1 AStG – Relation to E.C. Law", next month, and *Vögele/Bader, TPI Transfer Pricing*, Vol.3, No.6, June 2002 p. 15.

10 Section 2 (1) EStG.

11 In German, *Betriebsvermögen*.

12 *Schmidt/Heinicke* (21st ed. 2002) marginal no. 42 on Section 4 EStG. All references in this article to Schmidt's commentary on the Income Tax Act are to the 21st edition.

13 *Nutzungen*; e.g. the use of a business vehicle for private purposes.

14 Section 4 (1) EStG sentences 2 and 5.

15 See *Otto* DB 1979, 30, 131, and 183; *Hoffmann* GmbHR 1999, 452, 453.

16 Cf. *Schliephake, Steuerliche Gewinnabgrenzung internationaler Personengesellschaften* (Erik Schmidt Verlag, 1990) p. 160. German income tax law has developed a series of tests to determine when assets are "business property" and when they are "private property" (non-business property). Of relevance are both the degree to which an asset is used for business or private purposes and the proprietor's decision to place an asset in one sphere or another, as evidenced for instance its accounting treatment.

17 In German, *Teilwert*. The term is equivalent to that in Section 10 BewG (Valuation Act).

18 Section 6 (1) no. 1 sent. 3 EStG.

19 *Preisniveau der gleichen Marktstufe*; cf. Horschitz/Groß/Weidner *Bilanzsteuerrecht und Buchführung*, 3rd edition, p. 303.

20 According to *Schmidt/Heinicke*, marginal no. 53 on Section 4 EStG, the adjustment to profit is generally made by charging the withdrawn asset to expense at its book value and then increasing the profit by the asset's going concern value, whereby the latter step generally takes the form of an off-the books (off-balance-sheet) adjustment to profit. Whatever mechanism is used, the result must be to impact profit in the amount of the positive or negative difference between going concern value and book value at the time of the withdrawal.

21 Section 6 (1) no. 5 EStG. The exceptions to the general rule are ignored for present purposes.

22 The going concern value of a piece of land might, for instance, exceed its fair market value if the location of the land (e.g. adjacent to the current plant grounds) meant that the particular business in question would pay a premium to acquire it.

23 Section 22 no. 2 and 23 (1) no. 1 EStG. If shares in a corporation are held as private (non-business) property, the gain is taxable irrespective of any holding period if the shares being sold are part of a stake of 1 percent or more in the corporation (Section 17 EStG).

24 The VAT consequences of such transactions are beyond the scope of this article. Briefly, German tax law used to subject withdrawals to VAT as self-supplies. Current VAT law instead denies the sole proprietor an input tax credit on self-supplies. Both systems neutralise the VAT benefit otherwise inherent in withdrawals.

25 For years, the valuation of contributions at going concern value opened up certain tax planning opportunities where appreciated assets could be contributed to a business from the private sphere. The contribution of an asset from the private sphere is not a taxable event. The business took the asset onto its books at going concern value, which was frequently equal to fair market value. This permitted taxpayers to obtain a stepped up basis at no tax cost and to sell the asset without observing the holding period. However, until 2000, the required holding periods were only two years for land and six months for other assets. From 2000 onwards, Section 23 (1) sentence 5 EStG treats contributions of land to a business as a taxable event if the land is sold within ten years of the date the taxpayer acquired the land. Strategies of the sort described still appear possible for assets other than land, however. See *Schmidt/Heinicke* marginal no. 32 on Section 23 EStG.

26 The discussion so far is limited to sole proprietorships. As between legally distinct entities, the principle of occasionality also differentiates between assets received by a business as consideration in an arm's length transaction and assets taken as contributions. The former impact earnings; the latter do not.

27 In German, *ein ordentlicher und gewissenhafter Geschäftsführer.*

28 Cf. FTC judgement of 7 July 1976 (I R 180/74 – BStBl II 1976, 753), which actually involved the shareholder-general manager of a corporation (GmbH). Cf. R 117 EStR (Income Tax Guidelines)

29 Regarding the VAT consequences see Fn. 24 above.

30 See *Schliephake* (Fn.16) p. 165.

31 Cf. Section 5 (1) EStG and Section 242, 6 (1), and 4 (2) HGB (German Commercial Code).

32 In principle, German tax accounting is linked to commercial accounting in that German GAAP determine what assets and liabilities are shown for tax accounting purposes and at what values (Section 5 (1) EStG). The principle of linkage is subject to numerous exceptions, of which this is one.

33 See Section 2.F. above.

34 The land is a fixed asset of the textile business, albeit one it no longer needs since operations have been consolidated elsewhere. A hypothetical purchaser of the textile business would be willing to pay fair market value for the land (less selling costs). The going concern value of fixed assets is often their fair market value since the business is generally not able to purchase or produce fixed assets for a lesser price.

35 In German, *Betrieb.*

36 See *Schliephake* (Fn.16) p. 168 ff.; *Schmidt/Heinicke* marginal no. 326 on Section 4 EStG; *Biergans, Einkommensteuer*, 6th ed. (1992) p. 576, 582 ff., each with further references.

37 See definition of withdrawal under Section 2.A. above.

38 So-called "*finaler Entnahmebegriff*" or "purpose-related" definition of withdrawals; cf. FTC GrS 1/73 (7 October 1974 – BStBl II 1975, 168). In this view, the purpose of the withdrawal doctrine is merely to guarantee taxation of assets upon ultimate sale or use (GrS 1/73 C.II.1(b)).

39 See Federal Tax Court (FTC) ruling of 7 October 1974 (GrS 1/73 – BStBl II 1975, 168); FTC judgement of 17 August 1972 (IV R 26/69 – BStBl II 1972, 903); R 14 (2) Sent. 2 EStR 1998. Concerning irrelevance of the trade tax, see FTC 14 June 1988 (VIII R 387/83 – BStBl II 1989, 187).

40 Cf. *Biergans* (Fn.36) p. 582, 583, his Fn. 67); *Schmidt/Heinicke* marginal no. 328 on Section 4 EStG..

41 *Schmidt/Heinicke* on Section 4 EStG, marginal nos. 50, 320, 328 and 360 (ABC keyword "*Steuerentstrickung*").

42 Previously, the tax authorities allowed the taxpayer the option of realising gain: R 14 (2) Sent. 2 EStR 1998.

43 Germany uses the exemption method in most of its tax treaties.

44 The difference between book value and fair market value at the time of the transfer is also entered in a "collateral account" of the foreign permanent establishment. The balance of this account is charged to expense symmetrically with the balance in the collateral account of the German PE. The overall enterprise thus realises no gain on the transfer.

45 Cf. *Schmidt/Heinicke* marginal no. 317 on Section 4 EStG; *Biergans* (Fn.36) p. 583.

46 See text at Fn.41.

47 *Schmidt/Heinicke* on Section 4 EStG, marginal nos. 50, 320 and 360 (ABC keyword "*Steuerentstrickung*"). Cf. *Schaumburg, Internationales Steuerrecht* (Verlag Dr. Otto Schmidt: 1998), pp. 1181 ff. (dealing with outbound asset transfers).

48 Cf. *Kramer* IStR 2000, 449, 450/2: outbound transfers to tax treaty states are neither sales nor withdrawals. The contrary view has support in the case law, however. In its ruling of 7 October 1974 (GrS 1/73 – BStBl II 1975, 168), the FTC said that withdrawals occurred where an asset moved to a different part of the

same business (*Betriebsteil*) if ultimate taxation was no longer assured (at C.II.1(a)). Cf. FTC, 30 May 1997 – BStBl II 1997, 760.

49 See Section 2.6 of the so-called Permanent Establishment Directive of 24 December 1999 – BStBl I 1999, 1076.

50 For details see *Wiesmann*, *KPMG German News* 1/2001, p. 2, pp 18 ff. Deferral is, however, denied in various circumstances. For instance, the accidental destruction of a transferred asset is supposed to result in immediate recognition of gain to the German head office. Furthermore, deferral of recognition of gain is denied in all cases for outbound transfers from the domestic permanent establishment of a non-resident to a foreign permanent establishment. Moreover, any balance left in the collateral account of the transferring PE is transferred to revenue automatically after 10 years.

51 Section 2.6.3 of the Permanent Establishment Directive (Fn.49).

52 Cf. *Kramer* (Fn.48) p. 450/1.

53 Permanent Establishment Directive (Fn.49) Section 2.6.1 for fixed assets, current assets, and intangible assets. The solution to the example given above assumes that replacement cost may here be equated with the arm's length price since the machine in question was a fixed asset.

54 See Section 2.C. above.

55 See example in Section 2.B. above.

56 See example in Section 2.I. above.

57 For a discussion of the difference see *Kramer* (Fn.48) and Wiesmann (Fn.50).

58 Examples: the trade tax on commercial business earnings attributable to a German permanent establishment (Section 2 (1) GewStG – Trade Tax Act); the scope of Germany's non-resident taxation, particularly the taxability of commercial business profits attributable to a German permanent establishment (Section 49 EStG (Income Tax Act), applicable to foreign corporations via Section 2 and 8 KStG – Corporation Tax Act); the credit allowable for foreign income taxes levied on foreign income, particularly foreign commercial business profits attributable to a foreign permanent establishment (Section 34c, 34d EStG – Income Tax Act, Section 26 KStG – Corporation Tax Act.

59 Cf. the business profits article (Art. 7) of the OECD Model Convention With Respect to Taxes on Income and on Capital, which Germany's tax treaties generally follow.

60 *Kramer* (Fn.48) p. 450/2.

61 In German, *Nutzungen*.

62 See Section 2.A. above.

63 Ruling of 26 October 1987 by a combined chamber of the FTC (GrS 2/86 – BStBl II 1988, 348) Section C.I.1.b.bb.

64 See *Biergans* (Fn.36) p. 601, from whom the two examples are taken.

65 The journal entry would be: Dr. Withdrawals / Cr. Expense (Koltermann, *Fallsammlung Bilanzsteuerrecht* 8th ed. 1992 p. 60).

66 Cf. FTC ruling of 26 October 1987 GrS 2/86 (Fn.63); FTC judgement of 24 May 1989 (I R 213/85 – BStBl II 1990, 8); FTC judgement of 14 January 1998 (X R 57/93 – DStR 1998, 887) under B.II.5 (c) and (d).

67 Cf. FTC judgement of 23 March 1995 (IV R 94/93 – BStBl II 1995, 637), concerning an alleged withdrawal of know-how from a partnership. It is more exact to say that, while a withdrawal occurs, it has zero value.

68 FTC judgement of 29 April 1999 (IV R 49-97 – DStR 1999, 1026), under Section 5 (a).

69 FTC ruling of 26 October 1987 GrS 2/86 (Fn.63).

70 A sole proprietor cannot contribute his own labour to his business.

71 See *Biergans* (Fn.36) p. 603. The journal is as before; Dr. Expense / Cr. Contributions (cf. *Kolterman*, Fn.65, p. 60).

72 Cf. FTC judgement of 5 November 1970 (V R 71/67 – BStBl II 1971, 220) under Section II.5.

73 Cf. FTC judgement of 24 June 1976 (IV R 101/75 – BStBl II 1976, 562).

74 See example in Section 2.B. above.

75 Cf. FTC judgement of 15 February 1989 (X R 16/86 – BStBl II 1989, 462). See, however, *Vögele/Bader, TPI Transfer Pricing*, Vol.3, No.3, March 2002 p. 7 for a discussion of the FTC's most recent ruling on taxpayer violation of compliance obligation.

76 In German, *Bilanzbündeltheorie.*

77 Section 15 (1) no. 2 EStG.

78 *Schmidt* marginal no. 625 on Section 15 EStG.

79 Assumed rate. Trade tax rates are set by municipal government and therefore vary.

80 The income earned by individuals from exercise of any of the liberal professions architectural services and from renting real estate is not subject to trade tax.

81 *Schmidt* marginal no. 627 on Section 15 EStG.

82 In German, *verdeckte Entnahme*. However, this term is not widely used, although constructive contribution (*verdeckte Einlage*) and constructive distribution of profits (*verdeckte Gewinnausschüttung*) have gained great currency. *Gocksch* (IStR 2002, 181, 182/2) uses the term to refer to transactions for inadequate consideration (*teilentgeltlich*) between a partnership and a partner or a related party. In his terminology, "open withdrawals" are, by contrast, transactions in which no consideration whatsoever is exchanged. According to *Gocksch*, open withdrawals unquestionably involve no business relationship. After analysing the issues, he concludes that constructive withdrawals likewise involve no business relationship and thus cannot fall under Section 1 AStG. See "Section 1 AStG – Relation of Section 1AStG to withdrawals", next month.

83 Cf. Schulze zur Wiesche DStZ 1986, 98.

84 Section 15 (1) no. 2 EStG.

85 *Schmidt* marginal no. 627 on Section 15 EStG.

86 See Section 2.K. above.

87 *Schmidt* marginal no. 631 on Section 15 EStG.

88 Cf. Example in Section 2.K.4 above and Example 1 in "Withdrawals from and contributions to corporations – Constructive dividends – Usages and services", next month.

89 Cf. *Schmidt* marginal no. 601 on Section 15 EStG.

90 FTC judgement of 19 October 1998 (VIII R 69/95 – BStBl 2000, 230); *Schmidt/Weber-Grellet* marginal no. 208 on Section 5 EStG; *Schmidt/Glanegger* marginal no. 440 keyword "*Gesellschaftsrechtliche Einlagen*" in ABC on Section 6 EStG. Some authors question the treatment of open contributions as barter sales. However, this is the prevailing view.

FRANCE

91 Cf. Federal Ministry of Finance directive of 19 October 1998 (IV C 2–S2718–4100 – BStBl I 2000, 462), Section II.1.(a). If the value of the contributed asset exceeds the value of the partnership interest received, the transaction is treated as part sale and part contribution.

92 See Section 2.I. above.

93 The carryover basis rule applies in theory to corporate partners as well as individuals. However, there are provisions that restrict the use that corporations can make of the rules (Section 6 (5) sent. 5 and 6 EStG).

94 The fair value (*gemeiner Wert* – Section 9 (1) BewG) of the machine from the perspective of the sole proprietorship is almost certainly less than 150, since the sole proprietorship could probably not realise this price net of selling costs if it disposed of the machine.

95 Cf. Federal Ministry of Finance directive of 19 October 1998 (Fn.91) Section II.1(b).

96 Section 23 (1) sent. 5 EStG; see Section 2.5 and Fn.25 above.

97 Section 6 (5) sent. 3 no. 3 EStG.

98 See the Section "Section 1AStG", next month. Compare the results in the same situation involving a corporation and its shareholders (example under "Withdrawals from and contributions to corporations – Constructive dividends – Valuation of constructive dividends", next month).

99 Cf. *Frotscher, Internationales Steuerrecht* (C.H. Beck Verlag, 2001), marginal no. 8.5, p. 161. According to Section 1.1.5.1 of the Permanent Establishment Directive (Fn.49), the pro rata attribution of permanent establishments to partners is limited to commercial business partnerships. Cf. FTC judgement of 26 February 1992 (I R 85-91 – BStBl II 1992, 937). The partnership is a taxable entity for trade tax purposes; the trade tax falls only on income attributable to domestic permanent establishments (Section 2 (1) GewStG – Trade Tax Act).

100 Fn.49

101 See Section 2.L. above.

102 *Schmidt*, marginal no. 661 on Section 15 EStG.

103 See Section 3.B. above.

104 Cf. Example 2 in Section 2.L. above.

France: End in Sight for Secret Comparables?

Antoine Glaize *and* ***Olivier Marichal***
Archibald International, Paris

International transfer pricing regulations are based on the arm's length principle: the financial conditions of the related transactions must be equivalent to those agreed between independent companies placed in a similar economic situation. According to this principle, the control of transfer pricing, whether it is exercised upstream by the groups to define their policy and prices or downstream by the tax authorities, is based on the ability to identify and to present to the other party the comparables justifying its own position.

The analysis of the comparability is the very essence of the discipline. It tends to be complex by nature and requires a careful examination of the characteristics of the situation in question. In other words, discussions can only take place through transparency and the capacity to analyse all the information relevant to the transaction.

However, certain tax authorities continue to put forward, as comparable, certain information which they specifically have regarding other companies. This is still the case with the French authorities which base, in certain circumstances, their tax adjustments in relation to transfer pricing – but sometimes also in other domains – on information that they do not disclose, or only partially disclose. In this article we will summarise the conditions in which the tax authorities use secret comparables and to what extent they are authorised to use them (section I), and how this practice could evolve under the influence of case law (section II).

I. Use Of Secret Comparables in France

In order to define the arm's length price for a transaction between related parties, it is necessary to determine the price that would have been agreed upon by two unrelated companies under similar economic conditions. It is thus necessary, in order to determine this price, to carry out an analysis of comparable transactions.

Moreover, this obligation is set out in the OECD transfer pricing Guidelines which favour the use of comparable data (either via a direct examination of prices, as it is the case with the Comparable Uncontrolled Price Method (CUP), or data relative to the gross margins realised on comparable transactions (Cost Plus Method or the Resale Price Method) or net margins realised on comparable transactions (Transactional Net Margin Method)).

The French legislation, in the same spirit, states that:

> " In the absence of specific elements upon which to base the adjustments […], taxable income is determined through comparison with

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