GERMANY

## V. Conclusion

There are a wide variety of rules which affect different tax jurisdictions, the amount of documentation, enforcement and also general perceptions of transfer pricing. Multinationals should avoid using boilerplate style documents across all group companies and should ensure that they are amended to suit particular circumstances.

Multinationals should analyse the value of transactions taking place between related companies across all the jurisdictions where they have entities. If minimising costs is important then a risk management exercise should be carried out to see where their exposure to an adjustment is greatest. In countries where a large amount of trade is undertaken an independent study will be necessary.

Although many corporations have in-house legal and transfer pricing capabilities, it is important that their systems should be reviewed independently.

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# Key Transfer Pricing Statute Void Under E.U. Law?

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Ruling on a motion to stay collection of tax, the German Federal Tax Court (FTC) has affirmed the existence of "serious doubts" as to the compatibility of Germany's codification of the transfer pricing arm's length principle with the anti-discrimination provisions of Art. 52 ff. (new article 43 ff. – freedom of establishment) and Art. 73b ff. (new Art. 56 ff. – free movement of capital) of the E.C. Treaty. The ruling, dated June 21, 2001,[1] accordingly grants the taxpayer a stay of collection pending a judgement on the merits. German procedural law gives taxpayers a right to a stay where "serious doubts" exist as to the legality of the assessed tax.

## I. Text of Section 1 AStG

At issue is Section 1 AStG (International Transactions Tax Act or *Außensteuergesetz*), subsection 1 of which reads as follows:

> "Where the income derived by a taxpayer from business relationships with a related person is reduced by reason of the taxpayer's agreement, in the context of relationships involving foreign jurisdictions, to terms and conditions that are at variance with those on which unrelated third parties would have agreed under the same or similar circumstances, then – without prejudice to other provisions – the income allocable to the taxpayer shall be that which would have resulted under the terms and conditions as agreed between unrelated third parties."

## II. Court's Reasoning

Since the statute only applies to transactions with foreign jurisdictions, it disadvantages such transactions compared with comparable dealings in a purely domestic context. This arguably discourages transactions with related parties in other E.U. countries and may hence conflict with the cited provisions of the E.C. Treaty.

While the lower court had affirmed possible discriminatory effect, it declared this to be permissible as long as taxes on income have not been harmonised within the E.U. Member states with high tax levels such as Germany were entitled, in the lower court's opinion, to protect their tax base with measures like Section 1 AStG, which rest on the international consensus reflected in Article 9 of the OECD model convention on income taxation.

The FTC stated that such considerations were not sufficient to negate "serious doubts" as to the legality of the statute. It was not persuaded by the argument based on Article 9 of the OECD model tax treaty because European law overrides both the domestic law of member states and their bilateral tax treaties. The high court noted the corresponding adjustment (decreased income) enjoyed by a related party in another E.U. Member state where the income of a domestic taxpayer is increased by an adjustment under the challenged statute. It stated, however, that the European Court of Justice (ECJ) had hitherto permitted offsetting benefits to justify a discriminatory law only where the detriment and the benefit were "coherent" in that they related to the same taxpayer (national of member state). The FTC doubted whether a corresponding benefit enjoyed by a related party was sufficient.

## III. Transfer Pricing Significance of Section 1 AStG

### A. Overview of Transfer Price Adjustment Doctrines

Section 1 AStG is but one of several legal grounds on which prices can be adjusted under German tax law.

Adjustments are also possible on the following grounds:

- constructive dividends (Section 8 (3) KStG)
- constructive withdrawals (Section 4 (1) sent. 1 EStG)
- constructive contributions (Section 4 (4) EStG)

The relationship of the alternative doctrines to Section 1 AStG is unclear in certain respects. A complete discussion is beyond the scope of this article, which is intended to call attention to a number of key aspects.

### B. Constructive Dividends and Section 1 AStG

The doctrine of constructive dividends has an explicit statutory basis in Section 8 (3) KStG (Corporation Tax Act). As such, it can only apply to a transaction between a corporation and a shareholder that does not constitute a declared dividend, but is nevertheless in the nature of a distribution of income. Many transfer pricing adjustments fall into this category because they involve dealings between domestic German subsidiaries and their foreign parents or affiliates.

Situations in which a German subsidiary pays higher than arm's length consideration to a foreign parent or affiliate have consistently been decided in Germany under the constructive dividend provision of the Corporation Tax Act, not under Section 1 AStG. This has been justified with reference to the "without prejudice to other provisions" clause of Section 1 AStG.

The precise meaning of this clause is unclear, however. Basically, there are two alternatives:

- The clause means that, where a transaction potentially constitutes a constructive dividend, Section 1 AStG is inapplicable, whether or not a constructive dividend is determined to exist in the specific instance and whether or not the amount of any constructive dividend found to have been paid is equal to or greater than the income adjustment that would have resulted under Section 1 AStG (constructive dividend and Section 1 AStG as mutually exclusive doctrines).
- The clause means that Section 1 AStG is applied in addition to the constructive dividend doctrine where the adjustment under this doctrine falls short of that under Section 1 AStG (constructive dividend and Section 1 AStG cumulatively applicable).

While the issue is still open, the prevailing view and the view indicated by the Federal Tax Court judgement of 17 October 2001[2] is that constructive dividends take precedence over Section 1 AStG, hence that the two doctrines are mutually exclusive.[3] Since constructive dividends take precedence over Section 1 AStG, the possible invalidity of Section 1 AStG under European law would have no effect on constructive dividend situations, to which Section 1 AStG was inapplicable to begin with.

Since most transfer price adjustments involving the German subsidiaries of foreign-based corporate groups can be treated as constructive dividends, the validity or invalidity of Section 1 AStG will not significantly affect such relationships.

### C. Constructive Contributions

The doctrine of constructive contributions can apply in both the corporate and non-corporate realms. The constructive contribution doctrine is likewise independent of Section 1 AStG and would continue to exist even if Section 1 AStG violated European law. The classic constructive contribution situation is sale of goods by a German corporation to its foreign subsidiary at prices under fair market value. The amount of the constructive contribution is added back to the income of the contributing party.

Constructive contributions are valued with respect to their going concern value under Section 6 (1) no. 5 EStG. The going concern value of an asset cannot exceed its replacement cost and hence contains no profit mark-up. For this reason, an adjustment to income by reason of a constructive contribution from a German parent to its foreign subsidiary may well fall short of an adjustment by reason of Section 1 AStG, which always includes a profit mark-up.[4]

If the constructive contribution doctrine and Section 1 AStG are mutually exclusive and could thus not apply to the same situation to begin with, the possible invalidity of Section 1 AStG under European law has no impact on such situations. However, the relationship between Section 1 AStG and constructive contributions is unclear. In the corporate realm, the 1983 transfer pricing guidelines take the position that the constructive contribution doctrine takes precedence over Section 1 AStG, even though a higher adjustment would often result under Section 1 AStG.[5]

Many, though not all, transfer price adjustments between German-based corporate groups and their foreign subsidiaries can be subsumed under the constructive contribution doctrine.

### D. Services

Services rendered under fair market value by a domestic parent to its foreign subsidiary cannot be treated as constructive contributions because the services do not constitute a contributable asset. Hence, Section 1 AStG is the only basis for adjusting the income of a domestic parent by reason such transactions. The same applies where a domestic parent loans funds or assets to its foreign subsidiary. The tax treatment of such transactions would therefore be greatly impacted by the invalidity of Section 1 AStG.[6]

Section 1 AStG is thus important to transfer price adjustments involving outbound transactions between German-based corporate groups and their foreign subsidiaries that cannot be treated as constructive contributions. The greatest impact of the potential invalidity of Section 1 AStG is probably in this area.

### E. Non-corporate Realm

It is unclear whether Section 1 AStG can apply to the non-corporate realm in the first place. A 1997 ruling by the FTC held that there was serious doubt whether Section 1 AStG takes precedence over the rules of the income tax code with respect to constructive withdrawals.[7] No final resolution of this issue has as yet emerged.

The case involved assets transferred by a domestic sole proprietorship to its foreign owner. If subject to Section 6 (1) no. 4 EStG, the withdrawal would be valued at going concern value, *i.e.,* at no more than the replacement cost of the asset in question. The domestic business would report income only to the extent of the excess of going concern value over book value. If Section 1 AStG applied, the "transfer value" of the assets would be determined with respect to the arm's length price and hence include a profit mark-up.

At issue in the non-corporate area is thus not so much whether an adjustment is possible as the extent thereof. However, the same situations discussed in section III.D above with respect to corporations (services and loans) can arise in the non-corporate realm as well.[8]

Transactions between an unincorporated business and its owners (including transfers between discrete businesses under common ownership) should be distinguished, however, from transactions between the domestic and the foreign permanent establishments of the same business.

### F. Transactions Between Permanent Establishments

The relevance of Section 1 AStG to the allocation of income between permanent establishments of the same enterprise is debatable. Such allocation arguably arises out of the inherent necessity of allocating income between different jurisdictions for purposes of limiting the scope of taxation in accordance with national law and tax treaties.

Under this approach, Section 1 AStG is irrelevant to transactions between the permanent establishments of a corporate entity or between multiple permanent establishments of the same unincorporated business.

### G. Summary

Section 1 AStG is not as important to German transfer pricing law as it may seem. Under the majority view, Section 1 AStG is inapplicable in corporate constructive dividend and constructive contribution situations. The respective doctrines, described above, permit transfer pricing adjustments in these situations.[9] Since non-arm's length pricing by foreign-based groups with regard to their domestic subsidiaries generally poses a constructive dividend situation, to which Section 1 AStG is inapplicable to begin with under the prevailing view, the invalidity of the statute under European law would not have great significance for such taxpayers.

The situation of German-based corporate groups is different, however. Adjustments of certain transactions with foreign subsidiaries are only possible under Section 1 AStG.[10] Hence, a tax planning loophole has potentially opened in Germany's transfer pricing laws with respect to German-based groups and their E.U. subsidiaries.

In the non-corporate realm, the situation is complicated by theoretical issues concerning the relationship of Section 1 AStG to the doctrines of constructive withdrawals and constructive contributions. It seems likely, however, that Section 1 AStG is pre-empted by these doctrines in the non-corporate realm, just as it is probably pre-empted by the doctrines of constructive dividends and constructive contributions in the corporate area. As in the case of corporations, there are situations where an adjustment to income arguably depends on Section 1 AStG because the transaction will not fit under the constructive contribution doctrine.[11]

The impact on transactions between the permanent establishments of the same business is probably minimal, since Section 1 AStG is not the basis on which income allocation between permanent establishments rests to begin with.

## IV. Status of the Litigation

The FTC did not refer the case to the ECJ. The case therefore returned to the Münster Tax Court for decision on the merits. The lower court may suspend proceedings and request a preliminary decision from the ECJ. If the case is not referred to the ECJ by the lower court, the uncertainty surrounding the compatibility of Section 1 AStG with European law will be prolonged. Even if the case were referred to the ECJ tomorrow, a preliminary decision by this court might take a year or more.

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1 FTC ruling of 21 June 2001 (I B 141/00 – DB 2001, 1648).

2 FTC judgement of 17 October 2001 (I R 103/00 – DB 2001, 2474). See article in *KPMG German News* no. 1/2002 p. 2, = article no. 239, particularly sec. 4.4 thereof.

3 This is the position taken by the tax authorities in their 1983 transfer pricing guidelines (see sec. 1.3.1 of the Administrative Regulations – AR – of 23 February 1983 – BStBl I 1983, 216). See also *Vögele/Kotschenreuther et. al.* Handbuch der Verrechnungspreise (1st ed. 1997 sec. A 157). *Borstell/Brüninghaus/Dworaczek* (IStR 2001, 757 at. p. 760/2) see indications in the June 2001 FTC ruling (Fn. 1) that the two doctrines should be applied cumulatively, hence that the doctrine yielding the largest adjustment to income should apply in a specific case.

4 Cf. *Borstell/Brüninghaus/Dworaczek* (Fn. 3), who explore in their article the situations in which an income adjustment under Section 1 AStG in theory exceeds that of an adjustment under an applicable alternative doctrine.

5 See sec. 1.3.1.2 AR (Fn. 3). The AR do not comment on the valuation of constructive contributions, i.e. the amount of the resulting adjustment to income.

6 Majority view. An adjustment to income by reason of a constructive withdrawal is, however, conceivable.

7 BFH ruling of 17 Dec. 1997 (I B 96/97 - BStBl. II 1998, 321).

8 See, however, Fn. 6 above.

9 The adjustment in the case of constructive dividends is in principle equal to that under Section 1 AStG. As *Borstell/Brüninghaus/Dworaczek* (Fn. 3) show, the adjustment in constructive contribution situations falls short of that under Section 1 AStG where assets move out of Germany at less than fair market value (outbound transactions), but is the same where assets enter Germany at greater than fair market value (inbound transactions).

10 See sec. 4.4 above. See also, however, Fn. 6 above.

11 See, however, Fn. 6 above.