On 3 December 2020, the German Federal Ministry of Finance [BMF] published new Administrative Guidelines 2020 (“AG 2020”). The AG 2020 mainly refer to the cooperation duties pursuant to Section 90 of the German Tax Code [AO] as well as estimation of tax bases and penalties pursuant to Section 162 AO as part of the audit of income allocation between international affiliates. These replace the corresponding sections of the Administrative Guidelines - Procedures from 12 April 2005. Apart from the above-mentioned procedural aspects, the new AG 2020 however also include substantial statements, particularly with regard to documentation requirements for cross-border transactions between related parties.

1. Reasons for revision

The sections of the Administrative Guidelines – Procedures, which have now been replaced, were drawn up on the basis of Section 90 (3) AO from 2003 and the German Profit Allocation Documentation Regulation [GAufzV] from 2004. These legal frameworks have been amended since. Tax audit practice has also progressed, so that revision became necessary. The amendment of legal frameworks however referred largely to implementation of the documentation approach developed by the OECD, while the new AG 2020 primarily focus on procedural aspects. This reflects the increasingly tightened practice of the tax administration that has been observed over the years.

2. Key features relevant in practice

Scope of increased cooperation duties in cross-border matters

Pursuant to Section 90 (2) AO, taxpayers are required to secure the necessary evidence to clarify the circumstances relating to cross-border matters. The scope of this necessary evidence is now to be significantly expanded in BMF guidance, both with respect to the content of evidence and the conditions under which taxpayers are required to secure the necessary evidence.

For transfer pricing audits, taxpayers should expect the tax authorities to request emails, electronic text messages and other electronic media in addition to the...
submission of books and records, business papers, professional opinions and statements and numerous other documents and data of international related parties. This represents a significant tightening of the tax administration guidance.

Particularly alarming, however, is the requirement of the tax authorities to secure the necessary evidence for data and documents that could be required at a later stage in the course of validation of the appropriateness of transfer pricing during the tax audit. Although taxpayers are not required to use more than one transfer pricing method for validation, they would nevertheless have to procure the necessary evidence in advance for all possible transfer pricing methods that may potentially be used during a tax audit. The BMF notes that taxpayers can already make contractual agreements prior to a transaction to submit, for example, the selling prices of an affiliated sales company to third parties, calculation documents of a foreign service company and proof of contributions made as part of a cost contribution arrangement, without examining further whether such arrangements are arm’s length.

**Estimation**

The new AG 2020 include significant tightening regarding the permissible range of estimation by the tax authority. It is also apparent that the tax authorities are attempting to expand the cooperation duties specifically defined for transfer pricing in Section 90 (3) AO in conjunction with GAufzV and the resulting estimation power by means of Section 90 (2) AO in order to thereby facilitate more extensive income adjustments using estimation pursuant to Section 162 (2) AO. Whereas it was previously assumed that the classification of the transfer pricing documentation as unusable was essentially the result of a failure to submit it, the transfer pricing documentation is now also to be considered unusable in the event of differences between the actual facts and the presentation in the transfer pricing documentation. This could be the case, for example, if a supposedly routine company is presented as a residual-earning entity or if the submitted third-party data does not match the functional and risk profile. There is a concern that the tax authorities could potentially apply this regulation to cases where they have a different interpretation of the functional and risk profile compared to the taxpayer’s view. The regulation could therefore provide the tax authorities with wide scope for estimation with adverse consequences for taxpayers, as a deviating interpretation by the tax authorities could already be sufficient to reject the transfer pricing documentation as a whole.

Taxpayers should also be aware that the penalties pursuant to Section 162 (4) sentences 1 to 3 AO are now to be assessed for each transaction and for each individual assessment year separately. Using the example of a late filing penalty, the maximum amount could thus increase from one million euros to several times that amount due to the number of transaction groups and tax audit years. Taxpayers should therefore be even more careful about submitting their transfer pricing documentation on time than they were in the past.

The new AG 2020 also clarify at this point that the submission of a usable transfer pricing documentation does not preclude the tax authority’s right to make estimates pursuant to Section 162 (1) and (2) AO. In this regard, the administrative guidelines already contain a range of obligations to provide evidence (e.g. submission of emails) in the context of the above-mentioned scope of increased cooperation duties in cross-border matters.

**Content of the TP documentation**

With a view to the transfer pricing documentation as such, it is now to be demonstrated within the framework of arm’s length analysis why the chosen transfer pricing method is considered the best method. Previously, taxpayers only had to explain why the applied method was considered suitable. This shows a certain convergence with other jurisdictions where the “best method” approach has already been used for some time.

This rather economic approach generally takes up certain criteria of the Draft ATAD Implementation Act of 24 March 2020, in which the sections on transfer pricing have most recently – in an unofficial draft from November 2020 – been significantly abridged. Now, many of the provisions relating to transfer pricing originally provided for in the ATAD Implementation Act are contained in the government’s draft bill for a Withholding Tax Relief Modernisation Act of 20 January 2021.

Further changes in the area of arm’s length analysis concern situations, for example, in which companies determine transfer prices based on budget estimates. In such cases, arm’s length data is to be used in future whenever possible. In addition, according to the tax authorities, sensitivity analysis is to be conducted for valuations, so that it can be determined how the individual valuation parameters impact the determined value.
3. Conclusion

The AG 2020 were published on 30 December 2020 in the Federal Tax Gazette (Part I 2020, p. 1325) and are applicable to all tax assessment periods still outstanding. As administrative guidance, they set out the legal opinion of the tax authorities on the relevant rules and are therefore not directly binding for taxpayers. However, they do in fact also have a considerable effect on taxpayers through their application in tax audit practice.

Viewed in summary, the AG 2020 contain several purported clarifications which at closer inspection reveal themselves as a tightening of the previous interpretation of the statutory duties to cooperate by the tax authorities. This particularly concerns the details on the unusability of the transfer pricing documentation, on the cooperation duties pursuant to Section 90 (2) AO, but also on estimation pursuant to Section 162 (3) and (4) AO. In addition, rules are set out that may not be covered by current law. This also includes, for example, a focus on the economic approach taken in the OECD Transfer Pricing Guidelines 2017, which so far have not yet been enshrined in law and are available only as a government bill.

The type of implementation, in which only parts of the previous administrative guidelines are replaced, leaves room for interpretation as to which guidance is to be applied for which issues and at which point the new guidance is to be regarded as supplementary to the older regulations. Since, according to recent information, the 1983 Administrative Guidelines and also the guidance on mutual agreement procedures are currently being revised, consolidated conclusive BMF guidance would have been desirable.

Taxpayers can only be advised to place even more value than before on the preparation of and cooperation in transfer pricing audits, on the one hand, and on protecting their rights, on the other. In doing so, close attention should be paid to the procedural options the tax authorities really have at their disposal. Especially considering the increasingly observable attempts at hasty estimation, it is likely that the above-mentioned issues will be clarified by the tax courts sooner rather than later. With regard to issues of applicable transfer pricing methods and estimates, the German Federal Tax Court (BFH) already has the opportunity to contribute to clarification in the appeal proceedings (file ref. I R 4/17) on the judgment of the Münster Tax Court (judgment of 7 December 2016, file ref. 13 K 4037/13 K, F).

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Your direct contact persons at KPMG AG Wirtschaftsprüfungsgesellschaft are always at your disposal to answer any question you may have.