

Changes in transfer pricing rules – Current status March 2021

In February 2020, we provided an overview of the most significant tax law changes enacted and expected for transfer pricing. We update this overview below:

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I. Codified Law

1. The **EU Directive on reporting obligations for cross-border tax arrangements** was implemented into German law with effect from July 1, 2020 (Sections 138d-138k AO). Section 138e (2) no. 4a) - c) AO is of particular interest for transfer pricing and restructurings. Certain transfer pricing situations and restructurings are reportable regardless of whether their main objective is to achieve a tax benefit or not (main benefit test). Accordingly, the following are to be reported:
 - an arrangement which involves the use of unilateral safe harbor rules (No. 4a),
 - an arrangement involving the transfer of hard-to-value intangibles (No. 4b) and
 - an arrangement involving an intragroup cross-border transfer of functions and/or risks and/or assets, if the projected EBIT is less than 50 % of the projected annual EBIT of such transferor or if the transfer had not been made. (No. 4c).

Nevertheless, other transfer pricing arrangements may also be reportable.

Although the Directive (EU) 2020/876 allowed member states to extend the deadlines for initial notification by six months to avoid burdening companies during the Covid-19-Pandemic even more, Germany did not extend the deadlines. Therefore, a reporting deadline of 30 days applies to all reportable arrangements from July 1, 2020 (new cases). Old cases had to be reported by August 31, 2020.

2. On November 28, 2020, the law implementing the **Multilateral Instrument (MLI)** ("Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting") entered into force. 14 German DTAs are to be amended by the MLI, namely the DTAs with Austria, Croatia, the Czech Republic, France, Greece, Hungary, Italy, Japan, Luxembourg, Malta, Romania, Slovakia, Spain and Turkey. Full implementation will take place in two stages,
 - first, through the Implementation Act of November 28, 2020 and
 - second, through a DTA Application Act.

Germany intends to clarify amendments to DTAs based on the MLI via bilateral consultation. The DTA Application Act shall adopt these in parliament.

In addition to the implementation of the MLI, consultations have begun with other DTA states to amend the respective DTA according to the ideas of the BEPS project. Germany and the United Kingdom have already adopted an additional protocol to the DTA, which implements Art. 6, 7, 13, 16 MLI. Among other regulations, this introduces an anti-fragmentation rule. It is intended to allow for an overall view of the business activities of related companies in a country. Thus, it should not be possible to avoid a permanent establishment by splitting up functions into preparatory and auxiliary activities.

The Additional Protocol requires the completion of the legislative process in Germany (Act of Approval) and, according to Art. 8 of the Additional Protocol,

shall enter into force on the date of the exchange of the instruments of ratification.

3. The scope of **country-by-country reporting** was expanded in the Annual Tax Act 2020. Before, a country-by-country report shall include companies only that are included in consolidated financial statements. Now, the legislator "clarified" that all business units must be included in the country-by-country report (Section 138a (2) no. 1 AO). This extension is intended to harmonize the German regulations with EU-requirements and OECD-recommendations. The new regulation is applicable to all open cases as of December 29, 2020.
4. **Changes to the Controlled Foreign Corporation rules (CFC-rules)** by implementing the EU Anti-Tax Avoidance Directive ("ATAD I - Directive"). The draft bill of an ATAD implementation Act of March 24, 2020, included in particular at the following changes:
 - A foreign intermediate company shall be domestically controlled if more than half of the shares, voting rights, capital or profit entitlement are attributable to the shareholder alone or jointly with related parties.
 - Losses of the intermediate company shall only be able to be carried forward, not carried back.
 - The threshold above which foreign passive income is considered low-taxed shall remain at 25 %.
 - The negative regulation technique ("All income is passive unless it exceptionally falls under active income") shall remain. However, the term of active income not subject to CFC-rules shall be partially revisited.

The proposed new regulation should have been applicable for the first time to interim income arising in a fiscal year beginning after December 31, 2020. Most recently, the implementation of the ATAD I - Directive failed as part of the Annual Tax Act 2020.

5. The ATAD I - Directive amendment concerning additional regulations on hybrid financing and hybrid mismatches ("**ATAD II - Directive**") entered into force on June 27, 2017. It was to be implemented by December 31, 2019 (for reverse hybrid mismatches, by December 31, 2021). A draft bill implementing the directive was published on March 24, 2020. It provided a very extensive disallowance of the business expense if the (interest) income is taxed at a lower rate or not at all at the recipient level. The ATAD II - Directive is still not implemented in Germany.
6. On July 15, 2020, the EU Commission published a draft directive on improving **administrative cooperation** in the field of taxation (DAC 7). The aim is to introduce a reporting obligation for operators of online platforms. This is intended to prevent tax fraud through non-declaration of income generated via the platforms. In addition, a clear legal framework for joint tax audits within the meaning of the EUAHiG is to be introduced and administrative cooperation expanded.

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The draft aims to be implemented by the member states by December 31, 2022, and to be applied from January 1, 2023. Provisions on joint shall be implemented by December 31, 2023, and applied as of January 1, 2024, as stated by the draft.

7. The ECJ had declared the previous **anti-treaty-shopping** rule (Section 50d (3) EStG) to be incompliant with EU law both in its wording of 2007 and 2012. The legislator is obliged to draft the provisions in accordance with EU law. A government draft now provides a reform of Section 50d (3) EStG. In positive terms, a corporation, association of persons or an estate is only entitled to relief from withholding tax on the basis of a DTA insofar as persons participate in it/benefit from it who would also be entitled to such relief in the event of direct receipt (personal entitlement to relief) or insofar as the source of income has a material connection with the economic activity of the corporation, association of persons or an estate (substantive entitlement to relief). If at least one of these conditions does not apply, the deduction entitlement shall nevertheless remain in effect if
 - the corporation, association of persons or estate proves that none of its main purposes is to obtain a tax advantage, or
 - substantial and regular trading of the corporation's main class of shares on the stock exchange (stock exchange clause).

The provision would be applicable to all open cases as of the effective date of the Act. If income was already accrued before the new regulation comes into force, a more-beneficiary-principle applies. The version of Section 50d (3) EStG valid at the time of the accrual shall be relevant in these cases if it allows for the taxpayer's relief.

8. The government draft of a Deduction-Tax-Relief-Modernization Act provides for a revised Section 50c EStG. This combines the regulations on **withholding tax relief** (Sections 50a, 50d EStG). Some changes are foreseen in the process. For example, there will no longer be retroactive exemption certificates; in the future, these will be valid for a maximum of three years from the date of issue. In addition, according to the draft, tax returns are required even if no tax is to be withheld due to exemption certificate. Furthermore the seeds for a fully digitized application processing by the BZSt are sowed.
9. The government's draft of a Deduction-Tax-Relief-Modernization Act contains large parts of the provisions already included in the draft bill of March 24, 2020 on the implementation of the EU ATAD I - Directive. In particular, **Section 1 AStG** shall be amended as follows:

The following key points of the draft bill are noteworthy:

- Introduction of the OECD's principle to apply the most appropriate transfer pricing method;
- Incorporation of the DEMPE-concept for the taxation of income from intangible assets;

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- Intermediated or passed on loans are generally considered low-function and low-risk services;
- Mandatory transfer package valuation for transfer of functions without escape clauses;
- Revision of price-adjustment-clauses for intangible assets with shortening of the observation period to seven years;

The draft bill of March 24, 2020 provided a special regime for intercompany financing including a reversal of burden of proof for interest deduction. This has been abandoned.

The first draft envisaged first time application for FY 2021; the government draft of a Deduction-Tax-Relief-Modernization Act does not contain a dedicated application provision.

10. The government draft of a Deduction-Tax-Relief-Modernization Act is also intended to create a **procedural basis for advanced pricing agreements (APA)** (Section 89a AO). The draft prescribes large parts of the previous administrative practice. Fees for advanced pricing agreements (APAs) are scheduled to increase. Pursuant to Section 89a (7) AO-E, the fee for each application for the initiation of an APA amounts to 30,000 Euro and for each extension application amounts to 15,000 Euro. If the application is not a transfer pricing case, the fee for each application shall be one-fourth thereof. If the request relates to a matter in which a joint audit was performed and resulted in an agreement of facts and an agreement on tax treatment of such facts, the fee shall be reduced by 75 %. If the sum of the business transactions covered by the preliminary approval procedure is not expected to exceed the amounts of Section 6 (2) Sentence 1 of the GAufzV the fee shall amount to 10,000 Euro for each APA application and 7,500 Euro for each extension application. The regulation shall be applicable to all APA applications received by the BZSt after Act's effective date.
11. On April 22, 2020, the **draft bill of a Corporate Liability Act** was published. Within the bill's meaning, "Corporation" shall mean all legal entities and partnerships whose purpose is directed towards an economic business operation. So-called "corporate crimes" shall be punishable in addition to current possibilities provided by the Ordnungswidrigkeitengesetz (Administrative Offences Act). These sanctions could amount up to 10 Mio. Euro, for companies with a group revenue of more than 100 Mio. Euro up to 10% of the annual revenue of the corporation. Compliance programs can mitigate penalties. The act shall enter into force two years after the first day of the calendar quarter following the Act's promulgation.
12. The introduction of mandatory publication of income tax information for certain companies and branches (**public country-by-country reporting**) can now be expected. The Council of Ministers has approved an EU Presidency (Portuguese) proposal to amend the EU Accounting Directive 2013/34/EU. The obligation to publish country-by-country reports shall fall on multinational groups with consolidated revenues of more than 750 million Euro. Groups, whose ultimate parent entity is a partnership with personally liable individuals,

rather than a co-operation, shall be exempted. The Council of Ministers has authorized the EU Presidency to negotiate with the European Parliament a corresponding amendment to the EU Accounting Directive. Approval of obligatory publication of country-by-country reports by the Parliament can be expected.

II. Case Law

1. The **German Federal Fiscal Court's case law on intercompany financing** continues to develop. The direction set in 2019 by the decision of February 27 (Case No. I R 73/16) was confirmed by further decisions published in 2020. Accordingly, a lack of loan security is in general one of the non-arm's length conditions within the meaning of Section 1 (1) AStG. Implicit group support shall merely describe the legal and economic framework of the corporate relationship and expresses the customary practice of not securing credit claims within a group as it is done among third parties. However, implicit group support itself could not be regarded as a loan security. Art. 9 (1) of the OECD Model Tax Convention (or the corresponding correction provision of the respective DTA) not only permits price adjustments, but also allows neutralizing the profit-reducing (partial) writing-off of a loan receivable. Finally, this practice shall be in line with EU law. Constitutional complaints against the judgment of February 27, 2019 (Case No. I R 73/16), the judgment of August 14, 2019 (Case No. I R 34/18) and the judgment of December 18, 2019 (Case No. I R 72/17) are currently pending before the Federal Constitutional Court (Case No. 2 BvR 1161/19, 2 BvR 1079/20, 2 BvR 2002/20).
2. In its judgement of November 27, 2019 (Case No. I R 40/19), the German Federal Fiscal Court commented on the **relationship between deemed dividend and Section 1 (1) AStG**. According to the judgement, there is no order of precedence. Insofar as the legal consequences of the two laws do not differ, the legal practitioner may choose which of them to apply as a matter of priority. This confirmed the long-standing practice of tax audits. It should be noted that the decision relates to the disputed years 2003 and 2004. It remains to be seen to what extent the judgement will affect FYs 2008 onwards, after Section 1 AStG was revised in the course of the JStG 2008.

III. Administrative Directives

1. On December 13, 2020, the financial administration issued new Administrative Principles. The so-called **Administrative Principles 2020** partially replace the Administrative Principles 2005. The new Administrative Principles relate to the taxpayer's obligation to cooperate, to provide documents, to (proactively) ensure access to evidence and to document transfer pricing. Further, the Administrative Principles 2020 relate to requirements of transfer pricing adjustments and estimations. Overall, applying the new Administrative Principles aggravates the taxpayer's position dramatically. For example:
 - taxpayer's shall be obliged to provide legal opinions of tax advisors and tax lawyers as well as e-mails and chat protocols;

- transfer pricing adjustments shall be justified if prices determined by the tax authority appear to be "more likely".

The Administrative Principles are not legally binding for taxpayers, but will coin the tax authorities' application of the law in all open cases.

IV. International Developments / OECD-Developments

1. On February 11, 2020, the OECD published **Transfer Pricing Guidance on Financing Transactions**, which has been included in the OECD Transfer Pricing Guidelines as a new Chapter X and as a supplement to Chapter I. This includes opinions on issues such as the appropriate remuneration of financing and treasury services, loans, cash-pool structures, letters of guarantee and comfort, and captive insurers. In contrast to the German Federal Fiscal Court's case law, the OECD acknowledges the need to take into account the overall group rating when determining interest rates for intergroup loans.
2. On December 2018, 2020, the **OECD** published a **Guidance on the transfer pricing implications of the COVID-19 pandemic**. It is supposed to support taxpayers and tax authorities. Key points of the guide are: Issues in comparability analyses, dealing with losses and COVID-19 specific costs, government assistance programs, and APAs.
3. On October 14, 2020, the OECD published two **Discussion Drafts on Tax Challenges Arising from Digitalization**. The reform consists of two "pillars".

Pillar 1 contains three measures:

- Participation of market jurisdiction in the group's residual profit (Amount A)
- Remuneration for distributors performing baseline marketing and distribution activities in market jurisdictions on TNMM (Amount B)
- Improving tax certainty by implementing effective dispute prevention and resolution mechanisms.

The OECD's main focus is on Amount A. It uses formulary allocation of the residual profit of Automated Digital Services (ADS) and Consumer Facing Businesses (CFB). The OECD provides a general definition as well as positive and negative lists in order to define ADS and CFB. One should not forget that B2B transactions may also constitute ADS. Pillars 1 and 2 are intended to apply to companies with sales of at least 750 Mio. Euro. This revenue threshold corresponds to the minimum revenue for country-by-country reporting. In addition, Pillar 1 shall only apply to companies with a minimum cross-border revenue.

With Pillar 2, the OECD is essentially pursuing the goal of drawing a floor in international tax competition by introducing a global minimum tax. Specifically, the OECD proposes four regulations:

- Income Inclusion Rule (IIR)
- Undertaxed Payment Rule (UTPR)
- Switch-Over Rule (SOR)

- Subject-to-Tax Rule (STTR)

The IIR and the UTPR are collectively referred to as "GloBE Rules". The IIR is comparable to CFC-rules, but does not require an asset or liability catalog. The OECD has opted for the so-called top-down approach, i.e. the state of the Ultimate Parent Entity (UPE) should be allowed to "re-tax". If it does not re-tax, the state of the next entity along the chain of ownership may tax the company. Under the UTPR, a "top-up tax" is levied on business expenses which corresponding business income is taxed at a low rate (Base Eroding Payments). This is similar to the German and Austrian license barriers. The SOR and the STTR are already known from existing DTAs.

In order to define "taxation at a low rate", an Effective Tax Rate (ETR) of 10-12 % is discussed. This shall apply per country so that higher taxation in one country does not prevent the application CFC-ruled.

All in all, the discussion of Pillar 2 is significantly more advanced than Pillar 1, especially in technical details. As of today both pillars are to be adopted only as an overall package. The OECD aims for an agreement among all participating countries by mid-2021.

4. On January 21, 2021, the **OECD** published an **updated guidance on tax treaties and the impact of the COVID-19 crisis**. Among other things, this guidance deals with the question whether a home office constitutes a permanent establishment. The OECD states that as long as the home office is caused by the pandemic, it does not constitute a permanent establishment. Accordingly, Germany has concluded consultation agreements with Austria, the Netherlands, France, Switzerland, Belgium and Poland. A mutual agreement has been concluded with Luxembourg in this regard.
5. Reference is made again to the enactment of an **additional protocol to the DTA between Germany and the United Kingdom**. This has already been discussed in Part I. Point 2. In addition, an Additional Protocol to the DTA between Germany and Ireland was signed on January 19, 2021. It includes provisions of the MLI and requires an Approval Act besides a ratification.

Hot Topics

	Subject	Content	Application
I. Codified Law			
1.	EU-Directive on mandatory exchange of information in the field of taxation in relation to cross-border tax arrangements	Introducing reporting obligations on cross-border tax arrangements	In force, application in Germany since July 1, 2020; applicable to arrangements after June 24, 2018.
2.	DTA	Selective amendments to existing DTAs due to the Multilateral Instrument	Notification pending
3.	AO	Expansion of the scope of country-by-country reports, more companies shall be included in the report	In force since December 29, 2020; concerns all open cases
4.	AStG	Draft bill on the amendment of Sections 7 ff. AStG implementing the "ATAD I - Directive"	Draft consultation in 2021
5.	EStG	Introduction of Section 4k EStG with regulations for hybrid mismatches implementing the "ATAD II -Directive"	Further consultation 2021
6.	EU-Draft Directive on improving administrative cooperation in the field of taxation	Introduction of a new reporting obligation for digital platform operators (DAC 7)	Further consultation 2021
7.	EStG	Draft bill for the reform of Section 50d (3) EStG	Further consultation 2021
8.	EStG	Draft bill of a Deduction-Tax-Relief-Modernization Act for a revised Section 50c EStG	Further consultation 2021
9.	AStG	Draft bill for the partial revision of Section 1 AStG	Draft consultation in 2021
10	AO	Introduction of Section 89a AO with regulations on the procedure for APAs	Draft consultation in 2021
11.	VerSanG	Draft bill of an Corporate Liability Act	Draft consultation in 2021
12.	EU-Accounting Directive	Introduction of a Public Country-by-Country Reporting	Inactive / possible consultation in 2021

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	Subject	Content	Application
II. Case Law			
1.	AStG	Change in the case law on the effect of Art. 9 DTA related to Section 1 AStG as well as on implicit group support	For all open cases
2.	KStG/AStG	Relationship between deemed dividend and Section 1 (1) AStG	Application probably only for tax assessment periods prior to 2008
III. Administrative Directives			
1.	Administrative Principles 2020	Issuance of new Administrative Principles concerning the taxpayer's duty to cooperate under Section 90 AO and the tax authority's powers of estimation under Section 162 AO	In force
IV. International Developments / OECD-Developments			
1.	Chapter I, X OECD-Transfer Pricing Guidelines	Publication of the Transfer Pricing Guidance on Financing Transactions	In force
2.	OECD Guidance on the transfer pricing implications of the COVID-19 pandemic	Guidance on dealing with comparability analyses, dealing with losses and COVID-19 specific costs, government assistance programs and APAs.	In force
3.	BEPS Action 1	Shifting of taxation rules in favor of market jurisdictions (Pillar One) and introduction of a global minimum tax (Pillar Two)	Further consultation 2021
4.	Updated guidance on tax treaties and the impact of the COVID-19 crisis	As long as home office is caused by the pandemic, it does not constitute a permanent establishment.	Automatic renewals as long as the agreements are not terminated.
5.	DTA	Additional Protocols to the DTAs with Great Britain and Ireland	Approval Act and ratification expected in 2021

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