GERMANY

Logic and Illogic of German Transfer Pricing Law – Part II

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

This is the second of two articles discussing the legal basis of German transfer pricing law – the first was published last month in *Tax Planning International transfer pricing*, Vol.3, No. 8, August 2002. Last month, the authors looked at withdrawals from and contributions to sole proprietorships and partnerships, while this month they examine withdrawals from and contributions to corporations, constructive dividends, and Section 1 AStG, and provide a tabular summary on page 27.

I. Withdrawals from and Contributions to Corporations

A. In General

The courts have affirmed the applicability of the principles discussed in our first article to corporations as regards contributions, but held that withdrawals from a corporation are impossible as a legal matter.

Section 8 (1) KStG (Corporation Tax Act) states that the definition of corporate income and the rules for determining such income are governed by the provisions of the Income Tax Act (EStG), as supplemented or modified by the Corporation Tax Act. This incorporates by reference the definition of income contained in Section 4 (1) EStG, with its rules requiring subtraction of contributions and add-back of withdrawals.[1]

One should, however, note the differences between a sole proprietor and a corporation. Whereas a sole proprietor is a single individual with different spheres, *i.e.*, one or more business spheres and a private sphere, a corporation is an entity legally distinct from its shareholders that lacks any private sphere under the prevailing German view (principal of separation of shareholder and corporation).[2] A contribution by a sole proprietor to his business involves no change in the ownership of the contributed asset, and contributions by partners involve only a qualified change by reason of the look-through approach to partnership-partner relationships. In both cases, the asset is contributed by the same person who later derives the income flowing therefrom.[3]

By contrast, contributions by shareholders to their corporation cause a change in ownership. Under the principle of separation, corporate income is not attributable to the owners of the corporation. Hence, the "teleological extension" to corporations of the rule that contributions must be subtracted in calculating taxable income is by no means a foregone conclusion.[4] However, it is a conclusion that the courts have drawn.[5]

On the other hand, the courts have refused to apply the withdrawal concept to corporations. Calling attention to section 8 (3) of the Corporation Tax Act (KStG), they have stated that this provision is the more specific rule and hence takes precedence over Section 4 (1) EStG with regard to withdrawals.[6] Section 8 KStG reads as follows:

> "For purposes of determining [taxable corporate] income, it is irrelevant whether the income has been distributed. Even constructive dividends[7] ... shall not reduce [taxable] income."

B. Open and Constructive Contributions to Corporations

1. In general

Contributions to corporations may be open, that is, in return for corporate shares, much like contributions to partnerships.[8] It is also possible for shareholders to make contributions to corporations without receiving new shares. In such situations, the parties (corporation and shareholders) may account for the transaction as a direct contribution to capital reserves under Section 272 (2) no. 4 HGB (Commercial Code), or treat the amounts in question as revenue in the income statement.[9] The term "constructive contribution" is sometimes reserved for cases where a transaction is accounted for as revenue on the income statement.[10] However, as used with regard to corporations in the Income Tax Act, it refers to all transactions whereby the shareholder receives no consideration in the form of shares for a contribution to his corporation.[11]

2. Open contributions to corporations

Open contributions in return for shares are taxable events under the barter sale principles discussed under Section III D, last month. Where the property being contributed is not held as business property, realisation of gain depends on the rules set forth above.[12] Where the contributed property is business property, the contributing shareholder realises gain to the extent of the excess of fair market value over book value. In both cases, the corporation takes the contributed property onto its books at fair market value. The amount of an open contribution does not need to be subtracted from the corporation's profit where this is determined via the income statement, because open contributions are recorded as direct increases in capital without affecting the income statement.[13]

3. Constructive contributions to a corporation

Constructive contributions are not taxable as sales for want of consideration flowing to the shareholder. If the

  TPTP ISSN 1472-0841

contribution is non-business property, it is nevertheless treated as a sale under Section 23 (1) sent. 5 no. 2 EStG, leading to the realisation of gain if the transaction takes place inside the speculation holding period.[14] Fair market value is the deemed sales price.[15] If the shareholder realises gain on the deemed sale, the receiving corporation shows the asset at going concern value.[16] Similar rules apply under Section 23 (1) sent. 5 no. 2 EStG for constructive contributions of corporate stock to corporations within the 1 year speculation holding. If the contributed shares are part of a stake of 1 percent or more, constructive contribution to a corporation is treated as a deemed sale without regard to any holding period.[17] The corporation shows the stock at going concern value on its books.[18]

The rationale for treating constructive contributions of non-business property to corporations as deemed sales is the same as that behind the rules for constructive contributions of non-business property to partnerships or sole proprietorships.[19]

Constructive contributions to corporations of individual assets[20] constituting business property in the hands of the contributing shareholder are covered by Section 6 (6) sent. 2 EStG.[21] The assets being contributed may be held in a sole proprietorship, a partnership, or a corporation. The statute provides that the shareholder's basis in his shares in the receiving corporation is increased by the going concern value of the assets contributed.[22] This results in realisation of gain by the contributing shareholder to the extent going concern value exceeds book value. The receiving corporation values the contributed property at going concern value under Section 6 (1) no. 5 EStG.[23]

Schmidt/Glanegger suggest that contributions of an asset by a business to a corporation have two components:

- *Withdrawal* of the asset from the contributing business, triggering valuation at going concern value with realisation of gain where this exceeds book value; followed by
- *Increase* of share basis by the amount of going concern value.

Under this analysis, revaluation of the contributed asset at going concern value follows from the general principles of withdrawals in Section 4 (1) EStG in conjunction with the valuation rule of Section 6 (1) no. 4 EStG (valuation of withdrawals at going concern value). Under this view, Section 6 (6) sent. 2 EStG would be superfluous. The *raison d'être* of Section 6 (6) sent. 2 EStG is to be found in the case law that "teleologically reduces" the definition of withdrawals to exclude transfers between businesses of the same taxpayer.[24] Even though a shareholder and his corporation are discrete persons (principle of separation), the relationship is still so close to as to make it unclear whether a withdrawal has occurred. Hence the need for the provision.[25]

C. Downstream Usages and Services

1. Upstream vs. downstream transfers

A constructive dividend occurs when a corporation renders services or loans assets to its shareholder for less than arm's length consideration (upstream transfer).[26]

The results are quite different, however, when a shareholder renders services or loans assets to its subsidiary free of charge or for less than fair market compensation (downstream transfer).

Example

The X Painting GmbH is the sole shareholder of the Y Construction GmbH. X and Y are both domestic corporations. Painters of the painting corporation paint the business premises of the construction corporation. The fair market value of the work is 200. The related costs (labour, travel, materials) are 100. Y pays nothing for the work performed.[27]

Tax consequences

The painting service is not a discrete asset that the recipient construction corporation can capitalise on its balance sheet. Hence, the performance of the painting work by X for Y does not result in a contribution by X to Y. Had an asset been contributed, the profits of Y would be reduced by the amount of the contribution under the rule of Section 4 (1) EStG. Instead of deducting the amount of the contribution as a business expense, X would add this amount to the basis of its shares in Y.[28] Since no contribution occurs, Y's profit is increased by the amount of the expenses it has saved (200).[29] Subject to Section 3c (1) EStG, X GmbH can deduct its costs (100) as current expenses related to its shareholding in Y GmbH.

2. Downstream transfers: corporation vs. personal business

With regard to sole proprietorships and partnerships, we have seen that the courts have treated upstream non-arm's length transfers of usages and services (from business/partnership to sole proprietor/partner) as withdrawals and downstream transfers (from sole proprietor/partner to business/ partnership) as quasi-contributions.[30] Where benefits of this sort move from one business to another of the same owners, the approach has been to treat the benefit as having been withdrawn from one business and – in effect – contributed to the other. However, we have also seen that usages and services – whether contributed or withdrawn, whether transferred up- or downstream – are valued at their actual cost in the context of personal businesses.[31]

The different solution given for the example given in Section I C 1 above follows from a 1987 decision by a Combined Chamber of the Federal Tax Court.[32] The case before the court in 1987 involved an interest-free loan downstream loan, as did the Federal Tax Court judgement of October 17, 2001, from which the following example is taken:[33]

Example

X AG, the sole parent of Y GmbH, grants Y an interest-free demand loan in an amount of DM 90 million.[34] Y has loss carry forwards of DM 20 million. Y entrusts the loan proceeds to X for investment in the name and for the account of Y. Y earns interest of DM 20 million from the loan, which it offsets against its loss carry forwards on its tax return. It is then merged into another subsidiary of X. Under the merger law of the time, the loss carry forwards would not have survived the merger.

GERMANY

The Federal Tax Court affirmed the tax effect of the above transaction, which the tax authorities sought to attack primarily under the general anti-avoidance provision in the German tax code.[35]

The 1987 case was referred to a Combined Chamber of the FTC by the 1st Chamber of the court. The referring court argued that the interest earned by a corporation that received an interest free loan from its corporate parent should be treated as a contribution of the interest by the parent to its subsidiary. Under the rule of Section 4 (1) EStG, the contribution would reduce the subsidiary's taxable income. The parent's basis in its shares in the subsidiary should increase commensurately, thus causing it to realise income in like amount.[36] However, the Combined Chamber of the FTC rejected this approach, holding that the mere use of an asset (*e.g.,* cash) was not contribuable.[37]

3. Related expenses

The 1987 ruling addresses the issue of the parent's refinancing costs and affirms that they are deductible expenses related to the parent's stake in its subsidiary.[38] This applies as well to the expenses associated with other forms of downstream non-arm's length transfers of usages and services.

Note that it is not possible to attribute expense incurred by the parent to its subsidiary. The attribution of expense incurred privately by a sole proprietor to his business and expense incurred privately by a partner to his partnership is possible only because the expense is incurred by the same person to whom the income from the business activity is attributable for income tax purposes.[39] Corporations, however, have legal identity distinct from that of their shareholders (principal of separation).

The 2001 changes in German corporation tax law modify this result somewhat.[40] Since inter-corporate dividends are now tax exempt in all cases,[41] the rule of Section 3c (1) EStG applies to expenses related to such income. Section 3c (1) EStG prohibits a deduction for expenses directly related to tax exempt income. However, the courts have held that a direct relationship of expenses to dividend income exists only to the extent dividends are received in the same assessment period in which expense is incurred.[42] This rule in many cases permits a deduction of expenses incurred by a corporation with regard to its subsidiary even under the new corporation tax law.

Section 3c (2) EStG applies only to shareholders who are natural persons. This provision denies a deduction for half of the expense related to stakes in corporations. The provision requires no direct relationship between expenses and dividend income and therefore cannot be avoided by bunching dividend income in assessment periods where minimal related expense is incurred.

In rare instances, it may be possible to challenge deduction of related expenses at the shareholder level on the grounds that the shareholder lacks the required intent to earn a profit from the stake in his corporation.

4. Summary

Non-arm's length downstream transfers of usages and services to a corporation thus lead to the following results:

- The income of the transferring shareholder (parent corporation) is not adjusted;
- The income of the receiving corporation (subsidiary) is not adjusted;
- If a natural person, the transferring shareholder is denied a deduction of half of the expenses related to the non-arm's length portion of a downstream usage or service (Section 3c (2) EStG);
- If a corporation, the transferring shareholder is generally able to avoid the application of Section 3c (1) EStG and deduct most or all expenses related to the non-arm's length portion of a downstream usage or service.

5. Cross-border usages and services

A different result emerges, however, where the lender (parent corporation) is a German resident and the borrower (subsidiary) is resident in a foreign jurisdiction. In such situations, the arm's length amount of interest foregone by the lender is added back to its income under Section 1 AStG.[43] Section 1 AStG is discussed under Section ll below.

Since Section 1 AStG may conflict with E.C. law[44] and hence be inapplicable to non-arm's length downstream transfers of usages and services to EU corporations, the question arises as to whether German tax law is able to reach results different from those summarised in Section I C 4 above on grounds other than Section 1 AStG.

6. Alternative 1: valuation at cost

Biergans[45] argued in response to the 1987 ruling by a Combined Chamber of the FTC that the court should have solved the problem using the time-tested approach to usages and services in the context of sole proprietorships and partnerships. That is, the court should have affirmed that usages and services constituted contributable assets, but valued the contribution with respect to the related costs instead of fair market value.[46]

> *Example 1*
>
> A sole proprietor manages his sole proprietorship. This constitutes a contribution of a service. The contribution is valued with respect to the related costs (*e.g.*, the expense of commuting to work). The resulting contribution is negligible.
>
> *Example 2*
>
> A shareholder makes an interest-free loan to his corporation. The funds in question are a) sums inherited from the shareholder's aunt (shareholder = natural person) or b) after-tax profits of the shareholder's business (shareholder = individual, partnership, or corporation). Since there are no related costs, the contribution is valued at zero.[47]

The Combined Chamber of the FTC adopted this approach only with regard to contributions of legal rights to the use of assets:[48]

> *Example 3*
>
> Instead of making a demand loan, the parent company enters into a contract with its subsidiary giving it a contractual right to a 10 year interest free loan. Whereas the mere use of an asset cannot be capitalised, a protected legal right to use an asset is capitalisable and hence contributable.

However, the protected legal right is to be valued with regard to the associated costs, not its fair market value.

This small exception is of little significance because shareholders can structure transactions to reach the desired result (contribution or no contribution).

7. Alternative 2: withdrawals

Similar results can be reached by treating usages and services provided by a shareholder to its corporation as *withdrawals*. This possibility was not addressed by the 1987 Combined Chamber of the FTC. In the context of personal businesses, withdrawals are valued with respect to their related costs.[49]

As far as the authors of this article have been able to determine, only one author has ever suggested that an interest free loan by a shareholder to his corporation – or other forms of asset loans or services – can constitute a withdrawal. *Wassermeyer* took this position in an article written prior to the 1987 ruling.[50] In response to the prevailing opinion that constructive dividends (Section 8 (3) KStG) take precedence over Section 4 (1) EStG as regards withdrawals by corporations,[51] *Wassermeyer* noted that constructive dividends relate only to upstream transactions (corporation to shareholder). Thus, while a constructive dividend could be regarded as the exclusive corporate tax form of a withdrawal from a corporation by its shareholder, the doctrine of constructive dividends should not pre-empt withdrawals by the shareholder for contribution to a subsidiary (downstream transactions).

A transaction involving a transfer between two distinct taxable entities (shareholder and corporation) does not correspond to the traditional concept of a withdrawal as a movement between different spheres of the *same* taxpayer (*e.g.*, from his business to his private sphere or between different business spheres). Furthermore, transfers by a shareholder to his corporation are not clearly "extraneous" to the business of the shareholder. After all, a corporate parent holds the shares in its subsidiary as business property.[52]

On the other hand, if movements between different spheres of the same taxpayer can constitute withdrawals, why not movements from one taxpayer to another? Also, downstream transfers are "extraneous" to the *operational* business of the upstream corporation. First and foremost: the legal definition of withdrawals is not limited to assets that can be capitalised on the balance sheet, but rather explicitly includes usages and services, whereas the legal definition of contributions is limited to assets. Hence, there are grounds for treating usages and services conferred by a corporate parent on its subsidiary for less than arm's length consideration as withdrawals.

The legal consequence would to deny the parent a deduction for the costs associated with the usage or service conferred.

D. Corporate Permanent Establishments

The treatment of corporate foreign permanent establishments is essentially as outlined in Section ll J, of last month's article.

E. Constructive Dividends

1. Background

German tax law treats corporations as taxable entities distinct from their shareholders (principle of separation).[53] Shareholders may accordingly contract with their corporations in all respects for tax purposes.[54] Where the shareholders are individuals, a need arises to ensure that such charges are at arm's length to prevent circumvention of the trade tax.[55]

Prior to 1977, Germany had a classic corporation tax system under which tax was imposed both on corporate earnings and on shareholder dividends. In order to collect the tax owing at the corporate level, transactions between corporation and shareholder had to be scrutinised and corrected where necessary. In 2001, Germany instituted a modified two tier corporation and income tax system with a flat 25 percent corporation tax rate.[56] Resident individuals pay tax on half of the amount of dividends received. Dividends paid to another corporation are 100 percent exempt.[57] From 1977 to 2000 (and beyond, considering the phase-out provisions), Germany had an integrated system of corporate taxation, under which individuals enjoyed a full credit, against their income tax liability on dividends received, for corporation tax paid. The mechanics of the credit system made accurate determination of corporate income crucial. For all these domestic tax reasons, German tax attention has focused on accurate determination of corporate income.

Corporations are also the primary form of international business association. The income of a corporation may be falsified as a result of non-arm's length dealings with corporate affiliates. This erodes the tax base where the related parties are located in other jurisdictions. However, the doctrine of constructive dividends, which has an explicit statutory basis in Section 8 (3) KStG, nevertheless developed first and foremost in a domestic context as a means to control abuse by German individuals as owners of domestic corporations. Thus, standard corporation tax commentaries discuss at length the plethora of cases involving shareholder salaries, pensions, loans, and the like, yet have little to say about transfer prices,[58] even though the vast majority of transfer pricing cases are decided under Section 8 (3) KStG.[59]

2. Basic concept of constructive dividends

Under German corporate law, the shareholders of a corporation have an inchoate right to distribution of its profits. This means that, while the profits are destined for distribution to them, they acquire a legally enforceable right to distribution only pursuant to a duly adopted shareholder resolution. The distribution of profits other than pursuant to a shareholder resolution is in theory prohibited. However, it is not in practice sanctioned by corporate law.[60]

3. Tests for constructive dividends

In determining whether a benefit conferred by a corporation on its shareholder (or a related party) was occasioned by the shareholder relationship, the courts have employed several tests.

1) Where the transaction involved a controlling shareholder (or a related party), transactions have been treated as constructive dividends where not the subject of a clear and unequivocal, legally binding agreement entered into in advance of the transaction and performed in fact in accordance with its terms.

GERMANY

GERMANY

Example

A subsidiary pays its foreign group parent annual fees for management services. On audit, the subsidiary is unable to explain what services it was entitled to or received and how the fee was calculated.

Alternative: The subsidiary produces a detailed management service agreement. However, the fees actually paid bear no relation to the fees payable under the agreement.

Type 1 constructive dividends involve situations giving the corporation discretion to make payments on a purported contractual basis or pay dividends, as appears most advantageous. By insisting on formal requirements for recognition of the contractual basis, the courts have sought to compel shareholders and corporations to commit themselves in advance to a verifiable contractual arrangement. Where the formal requirements are not met, the payments have been treated as constructive dividends in full.[61] Whether the payments are at arm's length is irrelevant.

2) Arrangements between shareholders and corporations have been treated as constructive distributions to controlling and non-controlling shareholders alike where the courts doubted the seriousness of the parties' intentions, *e.g.*, because the arrangement was unusual, or where there had been a conspicuous failure to perform the agreement.

Type 2 constructive dividends include a wide range of disparate cases that are hard to summarise and systematise. The courts have spoken of arrangements that were "unusual" or "not seriously intended" by the parties. Payments in this category are sometimes treated as constructive dividends in full, sometimes in part.

3) The most important type of constructive dividend for transfer pricing purposes involves arrangements by which the corporation confers a benefit on a shareholder that is not explicable in terms of arm's length motivation. Here, the courts have historically asked whether a diligent and conscientious business manager would have conferred the benefit on a non-shareholder (or unrelated party). Where the answer to this question is negative because the benefit (*e.g.*, payment) in question is excessive, the *excessive portion* of the benefit constitutes a constructive dividend and is added back to corporate income.

Type 3 constructive dividends occur when a corporation makes an interest-free or low interest loan to its shareholder; where it pays its shareholder excessive amounts for goods or services received; and where it provides goods or services to its shareholder for less that arm's length consideration.

The "diligent and conscientious business manager" test employed with regard to Type 3 constructive dividends[62] focuses attention on the corporation as opposed to shareholder. A transaction that favours the corporation is thus always one to which a reasonable manager *of the corporation* would have agreed. The fact that the other party would not have agreed is irrelevant. In some cases, the Federal Tax Court has held that a transaction was occasioned by the shareholder relationship if *either* party would not have agreed to it under arm's length conditions.[63] These cases have so far been limited to remuneration arrangements between a corporation and its shareholder-general manager. However, the same theory might be used to treat unsecured loans between affiliated corporations as constructive dividends. The court justified its approach, which elicited harsh criticism, with regard to the need to bring the constructive dividend doctrine into line with the international arm's length standard.[64]

4. General definition of constructive dividends

Based on Section 8 (3) KStG, German case law[65] has defined constructive dividends as transactions that:

- reduce a corporation's net assets *or* prevent an increase in its net assets;
- are occasioned by the shareholder relationship;
- negatively impact taxable income; and
- do not constitute declared dividends.

In essence, a constructive dividend is a transaction occasioned by the shareholder relationship that negatively impacts corporate income either by reducing the corporation's net assets or by preventing an increase in its net assets.[66] The general definition is crafted with regard to the definition of profit in Section 4 (1) EStG[67] and corresponds best to Type 3 constructive dividends. It is irrelevant to Type 1 constructive dividends under the prevailing view. (See Footnote 61.)

In Type 1 constructive dividends, a transaction is rebuttably presumed to be occasioned by the shareholder relationship because formal requirements are not met. In older cases, the failure to observe the formal requirements was treated as raising an irrebutable presumption.

Type 2 and Type 3 constructive dividends are also approached by the more recent case law as involving rebuttable presumptions against the shareholder that the transaction that reduced income or prevented an increase in income was occasioned by the shareholder relationship. In Type 3 situations, it is clear that the presumption relates only to so much of the transaction as was not at arm's length.

5. Private sphere vs. shareholder sphere

The legal consequence of a constructive dividend is thus similar to that of a withdrawal, in that both result in an add-back to income. Furthermore, there is an important parallel between the private sphere of a sole proprietor or partner in a partnership and the shareholder sphere of a corporation. Just as sole proprietors and partners have a private sphere and business sphere, corporations have a shareholder sphere and a business sphere. *Wassermeyer* writes, "the shareholder sphere is to corporation tax law that which the private sphere is to [personal] income tax law".[68] The legal consequence of the receipt of corporate profits by a shareholder is identical to that of receipt of business profits by an individual for private purposes. In neither case is the amount that leaves the business sphere permitted to diminish taxable business profits.

6. Upstream, downstream, and cross-stream transfers

The general rule is: upstream and cross-stream transfers inside a corporate group result in constructive divi-

  TPTP ISSN 1472-0841

dends. Downstream transfers not supported by consideration are constructive contributions.[69]

Example 1: upstream

Subsidiary pays parent 200 for goods purchased. The arm's length price is 100. The overpayment of 100 is an upstream constructive dividend from subsidiary to parent.

Example 2: cross-stream

X GmbH and Y SARL are both 100 percent subsidiaries of Z AG. X and Z are both German corporations; Y is a foreign corporation. X pays Y 200 for goods purchased. The arm's length price is 100. The overpayment of 100 is a constructive dividend from X to Z and a constructive contribution by Z to Y. X's profit is increased by 100; Z receives a dividend of 100, which is tax exempt under current German corporate law. Z's basis in Y is increased by 100. Y's profit is decreased by 100 (from a German perspective).

Example 3: downstream

Z GmbH is the 100 percent subsidiary of Y AG. The parent pays its subsidiary 200 for goods purchased. The arm's length price is 100. The overpayment of 100 is a constructive contribution from Y to Z.

7. Valuation of constructive dividends

While withdrawals are valued at going concern value, the courts have held that constructive dividends must be valued at fair value.[70] Valuation at fair value means valuation at the price the enterprise would have obtained on a sale to a customer. This differs significantly from valuation at going concern value, which is determined with reference to the price the enterprise would have paid on a purchase from a supplier.[71]

Example

X GmbH manufactures apparel. Every month, it produces clothes at a cost of 100. It sells one third of its monthly output to one of its two shareholders at a price of 100, one third to its second shareholder at a price of 125, and the rest to an unrelated wholesaler at a price of 150. Questioned about its price structure on audit, X GmbH offers no explanation for the differences.

Tax consequences

X GmbH pays a monthly constructive dividend of 50 to shareholder number 1 and 25 to shareholder number 2. While the corporation's selling prices to its two shareholders are at or above its own production cost (going concern value of the goods), the constructive dividend is measured by the price the corporation could have obtained on sale to an unrelated party. In the example, the sales to the unrelated wholesaler provide an easy gauge of this price (internal comparable price comparison).

The above example is a Type 3 dividend under the nomenclature of Section I E 3, above. Compare the results in the same situation involving the partners of a partnership.[72]

Constructive dividends paid by corporations to their shareholders are thus in essence valued at the price on which unrelated parties dealing with each other at arm's length would have agreed under the circumstances. The doctrine of constructive dividends thus accords with the arm's length standard found in tax treaties.[73]

8. Usages and services

A constructive dividend occurs when a corporation renders services or loans assets to its shareholder (corporate parent) for less than arm's length consideration (upstream benefit).[74]

Example

The X Painting Corporation is a 100 percent subsidiary of the Y Construction Corporation. Pursuant to a clear and unequivocal advance agreement, painters of X paint the business premises of Y. Y pays 150 for this service. The fair market value of the work is 200. The related costs (labour, travel, materials) are 100.[75]

Tax consequences

The painting work performed by X for its sole shareholder Y involves a constructive dividend from X to Y. The amount of the constructive dividend is determined with respect to the arm's length charge for the service involved, which is posited to be 200. The profits of X are increased by the difference between the arm's length charge and the actual payment. Y is treated as having received a dividend in like amount, which is, however, tax exempt under Germany's new corporation tax law.[76]

The constructive dividend is valued at its arm's length price. The profit of the corporation is increased by this amount and the shareholder in principle receives a dividend in like amount.[77]

The results are analogous if, instead of performing a service, the subsidiary loans an asset (*e.g.*, cash or a material or immaterial fixed asset) to its parent for less than arm's length consideration. The difference between any consideration paid to the subsidiary and the arm's length consideration constitutes a constructive dividend.

See Section I C above regarding the different consequences of an upstream non-arm's length transfer of usages or services.

9. Burden of proof

The courts have consistently held that the tax authorities bear the burden of proof on the facts necessary to establish a constructive dividend.[78] In allocating the burden of proof, the courts have generally not distinguished between expense-side and revenue-side constructive dividends:[79]

- The corporation purchases goods or services from its shareholder for more than fair market value (corporation seeking a higher deduction or carrying value, thus reducing its profit) – *expense-side constructive dividend*;
- The corporation undercharges its shareholder for goods or services supplied (tax authorities seeking to add the revenue shortfall back to corporate profit) – *revenue-side constructive dividend.*

GERMANY

The courts have also never explained the reasoning behind their allocation of the burden of proof. However, in its most recent and most detailed decision on constructive dividends in a transfer pricing context, the Federal Tax Court indicated that the burden of production and possibly the burden of proof as well could shift to the taxpayer where the tax authorities could make a preliminary showing of facts strongly indicative of a constructive dividend.[80]

The courts thus appear to follow a two-step approach. As an initial matter, the tax authorities bear the burden. However, following a showing on their part of facts strongly indicative of a constructive dividend, the burden of proof, or at least the burden of production, shifts to the taxpayer.

Where the tax authorities show that pricing between a shareholder and its corporation is not at arm's length, the courts rebuttably presume that the variation from the arm's length standard is occasioned by the shareholder relationship.[81] In this context, the arm's length standard is applied "objectively", meaning one asks what parties dealing with each other at arm's length would have done in theory or as a rule. The fact that, in isolated instances, actual parties dealing with each other at arm's length may not conform to the theoretical standard is not relevant. Where a rebuttable presumption arises, the taxpayer has an opportunity to rebut.

Finally, taxpayer violation of compliance obligations has prompted courts to lower the standard of proof that the tax authorities must meet. However, in the most recent recorded transfer pricing case, the court was in effect willing to draw only limited constructive dividend consequences on these grounds.[82]

10. Related parties

The comments on related parties in Section II M, last month, apply analogously in the corporate context.

II. Section 1 AStG

A. Basics of Section 1 AStG

Section 1 (1) AStG reads as follows:

> "If the income derived by a taxpayer from business relationships with a related party 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."

Note that Section 1 AStG can only apply in a cross-border context. The primary condition for operation of the statute is reduction of the income of a domestic taxpayer by reason of a non-arm's length agreement with a related party, in most cases a foreign related party. There is no requirement that the transaction be occasioned by the shareholder or ownership relationship.[83] Regarding the definition of "related party" see Section II F below.

In the German literature, attention has been called to the fact that Section 1 AStG refers to the conditions on which unrelated *parties* (plural) would have agreed.[84] From this it is inferred that it is proper in the context of Section 1 AStG to consider what both parties to the transaction would have done. By contrast, the "diligent and conscientious business manager" test employed with regard to withdrawals and constructive dividends focuses attention on the business as opposed to its owner or shareholder. See Section I E 4 above with regard to the possible implications of this distinction.

B. Apparent and Actual Scope of Section 1 AStG

While the statute was intended as a catch-all clause to prevent related parties from shifting income outside of Germany by means of non-arm's length transactions, it has in practice played a negligible role in transfer pricing litigation. There are essentially two reasons for this apparent anomaly:

- The clause "without prejudice to other provisions" *can be read* as subordinating Section 1 AStG to any other income adjustment doctrine, specifically to the rules governing contributions, withdrawals, and constructive dividends. Astonishingly, there is no case law resolving these issues.[85] Voices in the literature advocate application of Section 1 AStG instead of other doctrines where this leads to a larger adjustment to income.[86]
- The statute operates only where "business relationships" are involved. The courts have interpreted this requirement narrowly. For instance, a guarantee given without consideration by a group parent to a group member, albeit a contractual arrangement, ostensibly involves no "business relationship" where the group company would be unable to function without the guarantee for want of sufficient equity.[87]

Wassermeyer regards Section 1 AStG as a flawed statute deservedly relegated to legal obscurity. In a 1997 article, he states that the statute cannot operate wherever a contribution, a withdrawal, or a constructive dividend is involved, thus endorsing the view that these doctrines pre-empt Section 1 AStG.[88] *Wassermeyer* all but ridicules the legislature for creating a purportedly comprehensive transfer pricing statute that is never applicable because almost every situation in which it might apply involves a contribution, a withdrawal, or a constructive dividend.

Wassermeyer notes that Section 1 AStG could be confined to legal oblivion but for a judicial accident: the 1987 ruling of a Combined Chamber of the Federal Tax Court.[89] By holding that usages and services could not be contributed by a parent to its subsidiary, the court opened up a bailiwick for Section 1 AStG.[90]

Example

X AG, the German sole parent of Y SARL, a foreign limited liability company, grants Y SARL an interest-free demand loan in an amount of DM 90 million. Y SARL has loss carry forwards of DM 20 million that will soon expire unless used. Y SARL earns interest of DM 20 million from the loan, which it offsets against its loss carry forwards on its tax return. It then repays the loan.

  TPTP ISSN 1472-0841

German tax consequences

Under Section 1 AStG, the income of X AG is increased by the amount resulting from an arm's length interest rate for the duration of the loan.[91]

Thus, the scope of Section 1 AStG has so far been limited to assets loaned and services provided for less than arm's length consideration by German shareholders to their foreign corporations.

C. Relation of Section 1 AStG to Withdrawals

The relation of Section 1 AStG to withdrawals is at issue in a case pending before the Tax Court of Lower Saxony. In 1997, the Federal Tax Court decided an appeal of a denial of a motion to stay collection of tax pending a decision on the merits.[92] The FTC reversed the lower court and granted the stay, holding:

- That there was serious doubt whether Section 1 AStG could be applied to a situation involving a withdrawal (pre-emption of Section 1 AStG by withdrawals), and
- That there was serious doubt whether a situation involving a withdrawal could also involve a "business relationship" within the meaning of Section 1 AStG.[93]

No decision on the merits has yet emerged.

D. Relation of Section 1 AStG to E.C. Law

The relation of Section 1 AStG to E.C. law is at issue in a case pending before the Münster Tax Court. In 2001, the Federal Tax Court decided an appeal of a denial of a motion to stay collection of tax pending a decision on the merits.[94] The FTC reversed the lower court and granted the stay, holding that there was serious doubt whether Section 1 AStG conflicted with prohibitions on discrimination in the E.C. Treaty (freedom of establishment, free movement of capital: Art. 43 and 56 of the current E.C. Treaty). The essential objection to Section 1 AStG is that it taxes foreign transactions more harshly than identical domestic transactions. The interest-free loan examples in Section I C and II C above illustrate this point.

Since German transfer pricing law does not rest on Section 1 AStG, it will not collapse should the European Court of Justice one day rule the statute void under E.C. law. On the other hand, the invalidity of Section 1 AStG would open up numerous opportunities to shift income abroad with impunity by means of downstream services and loans of assets provided for less than arm's length consideration. Even if such transactions could be treated as withdrawals,[95] the resulting adjustment to income would fall short of that under Section 1 AStG.

The invalidity of Section 1 AStG would also remove the possibility of applying Section 1 AStG instead of the doctrines of contributions, withdrawals, and constructive dividends where the requirements were cumulatively fulfilled and the adjustment under the competing doctrine fell short of that under Section 1 AStG.

E. Related Parties

Section 1 AStG contains a legal definition of the persons with respect to whom non-arm's length transactions result in an adjustment to income. The details are beyond the scope of this article. Suffice it to say that the concept of related party for purposes of a constructive dividend or a withdrawal is potentially wider than that under Section 1 AStG. As a practical matter, there is substantial overlap.

F. Burden of Proof

The prevailing view is that the tax authorities bear the burden of proof for the facts necessary to justify an adjustment of income under Section 1 AStG.[96]

III. Summary

1) The doctrine of constructive dividends provides the legal basis for international transfer pricing adjustments under German tax law in the great majority of cases. Constructive dividends are a domestic tax concept not specific to the transfer pricing context. There are three reasons for the dominance of this domestic tax doctrine in the transfer pricing realm:

(i) The doctrine applies both where a corporation has been overcharged by its parent (or a related party) for goods and services received and where a corporation has undercharged its parent or a related party for goods and services supplied. Hence, the doctrine covers the typical transfer pricing adjustment situations.

(ii) Most international groups are organised in corporate form.

(iii) The general German transfer pricing statute, Section 1 AStG, has so far taken a back seat to constructive dividends. Where courts have been able to treat a transaction as a constructive dividend, they have generally not bothered to ask whether the same transaction also falls under Section 1 AStG, much less whether a greater adjustment to income would have been possible under Section 1 AStG.[97]

2) One reason for the lack of concern with the theoretical relationship of constructive dividends to Section 1 AStG is that both approaches yield similar numerical results. Like adjustments under Section 1 AStG, constructive dividends are valued in accordance with the arm's length principle. The adjustment resulting from an undercharge by the subsidiary to the parent includes a profit mark-up for the subsidiary. Overcharges to the subsidiary result in adjustments based on an arm's length charge.[98]

3) Constructive dividends are the corporate tax counterpart of withdrawals in the non-corporate realm. Just as withdrawals by the owner of a personal business are added back to business profits, so constructive dividends are added back to corporate profits.

4) Withdrawals are valued at going concern value. Where fixed assets are withdrawn, going concern value is generally equal to fair market value. But when current assets (goods, inventory) are withdrawn, going concern value cannot exceed the replacement cost of the assets to the business from which they were withdrawn. In these cases, the adjustment includes no profit mark-up and hence falls short of the adjustment on a constructive dividend paid by a corporation to its shareholder. The going concern value of usages (loans of cash or assets) and services is the actual related cost

GERMANY

GERMANY

to the business. By contrast, loans of cash or assets by a corporation to its shareholder at less than fair value result in an adjustment based on the price the corporation would have charged a unrelated party. Adjustments under Section 1 AStG are essentially equal to those by virtue of a constructive dividend.

5) Since the constructive dividend doctrine cannot apply in a non-corporate context, the question arises whether Section 1 AStG can apply to cross-border withdrawals from partnerships or sole proprietorships. This issue is still open. There are three reasons why Section 1 AStG may not apply:

(i) Withdrawals may take precedence over Section 1 AStG as a basic matter.

(ii) Withdrawals may not involve a "business relationship," one of the required elements of Section 1 AStG.

(iii) Section 1 AStG may be void as regards dealings with parties in EU countries because it conflicts with the E.C. Treaty.

6) Unlike withdrawals, the doctrine of constructive contributions applies in both the non-corporate and corporate areas. Where a payment treated as expense by the payor and presumably as revenue by the payee in fact represents a constructive contribution, the payment is added back to the payor's profit. The payment increases the capital accounts of sole proprietors and partners and the basis of the stake held by a corporate shareholder. The recipient may not treat the payment as revenue for tax purposes.

7) The rules on contributions are complex. However, they govern all downstream transfers occasioned by the ownership relationship, including those within a corporate group. Thus, downstream transfers of intangibles are analysed as constructive contributions just like any other asset.

8) It would be logical to conceive of contributions from one business[99] to another business as withdrawals from the first business and contributions to the second business, whereby both the withdrawal and the contribution are valued at going concern value under the general rules,[100] meaning that the withdrawal can lead to realisation of gain for the contributing business. However, the applicable law is not so simple, primarily because the courts and tax authorities have historically permitted the owners of personal businesses (sole proprietorships and partnerships) to move assets between businesses at a carryover basis without realising gain. Furthermore, the courts have held the doctrine of withdrawals inapplicable to corporations.[101]

9) The law thus currently permits assets to be shifted among personal businesses owned by the same person or persons without realisation of gain (carryover basis), provided the assets stay in the German tax sphere. Even open contributions to partnerships may be accomplished at a carryover basis. Subject to certain restrictions, these rules apply for corporate partners as well.

10) Where assets exit the German tax sphere by reason of a transfer between two personal businesses owned by the same persons or persons, the statutory carryover basis rules do not apply. Hence, the transaction constitutes a withdrawal from one business and a contribution to the other.[102] Withdrawal and contribution are valued at going concern value. The business from which the asset is withdrawn realises gain where going concern value exceeds book value.

11) The different treatment of cross-border withdrawals and contributions as opposed to domestic withdrawals and contributions resembles the different treatment of non-arm's length downstream transfers of usages and services to a corporation. In both cases, gain is potentially realised on the international transaction, but not the domestic transaction. Hence, if Section 1 AStG conflicts with E.C. law because of its harsher treatment of cross-border downstream transfers of usages and services (see numbers 16 and 17 below), Germany's rules respecting cross-border withdrawals must likewise violate EC law.

12) Germany's permanent establishment regulations prescribe fair market value as the standard for measuring transfers of assets to foreign permanent establishments. Transfers to foreign permanent establishments are transfers within the same business. Transfers to a *different* foreign business should then, *a fortiori*, also be valued at arm's length. This conflicts with the result under number 11 above. Moreover, the legal basis of the permanent establishment regulations is unclear. Germany has no tax rule whereby realisation of gain is triggered merely because an asset leaves the German tax sphere.

13) The deferred income approach of the permanent establishment regulations nevertheless leads to appropriate results in most cases. Application of this approach to cross-border withdrawals should be considered.

14) By contrast, contributions to corporations of single assets held as business property are always taxable events.[103] If the contribution is open, *i.e.*, in return for new shares, it is treated as a barter sale. Realisation of gain occurs based on fair market value. If the contribution is constructive, *i.e.*, not for new shares, the asset is re-valued at going concern value a logical second prior to transfer, resulting in gain or loss. The basis of the transferring business in its shares in the receiving corporation increases commensurately. The receiving corporation takes the asset at going concern value (form its perspective).

15) The relationship of Section 1 AStG to constructive contributions is just as unclear as its relationship to withdrawals. For the three reasons given under number 5 above, Section 1 AStG may not apply to constructive contributions. So far, the courts and the tax authorities have proceeded on the assumption that it does not. Where current assets are contributed, application of Section 1 AStG would generally result in a higher adjustment to income.

16) By ruling in 1987 that services and the mere use of an asset cannot be contributed to a business, the Federal Tax Court accidentally staked out a territory in which Section 1 AStG could operate undisturbed by competition from constructive dividends and contributions. As long as the contributing business was a corporation, the dogma proscribing withdrawals from corporations also prevented competition from withdrawals. Henceforth, Section 1 AStG applied to down-

  TPTP ISSN 1472-0841

stream non-arm's length corporate cross-border usages and services. Comparable domestic transactions result in no adjustment to income whatsoever. The recent FTC decision involving a DM 90 million domestic intra-group interest-free loan is the perfect illustration of the difference.[104]

17) Because of such discrepancies, Section 1 AStG may violate E.C. law and be void as applied to foreign EU parties.

IV. Tabular Summary

A summary of results in tabular form is provided as an appendix to this article on page 27. The summary sacrifices some precision in the interest of clarity. It ignores contributions of assets held as non-business property ("private" property) prior to contribution. The term "personal businesses" refers to sole proprietorships and partnerships. Foreign jurisdictions are assumed to be tax treaty countries with regard to which Germany uses the exemption method to avoid double taxation.

V. Concluding Remarks

Germany's law on transfer pricing adjustments reminds one of a charming medieval city, full of quaint twisting roads, alleys, and passageways – but confusing to outsiders. For historical reasons, Germany has essentially two laws of transfer pricing: an "ancient" one developed out of the domestic doctrines of withdrawals, contributions, and constructive dividends, and a "modern" one, Section 1 AStG.

The courts have relegated Section 1 AStG to obscurity. The fault allegedly lies with the legislature.[105] However, the courts' reluctance to clarify the relationship of Section 1 AStG to the competing doctrines is clearly not a legislative failing. The application of Section 1 AStG "without prejudice to other provisions" can be construed to mean that other provisions take precedence only where they go farther. When a lawyer writes in a contract that his client may claim stipulated damages "without prejudice to other remedies," he intends to expand, not restrict, his client's rights.

Furthermore, strict interpretation of the "business relationship" element required under Section 1 AStG also seems odd in light of the legislature's intention to create a comprehensive statute. The courts could have viewed all relationships not openly and explicitly resting on applicable company law and – accounted for as such – as "business relationships" within the sense of the statute.

One is also struck by the inconsistent standards used to measure adjustments to income under the doctrines of withdrawals, contributions, constructive dividends, and Section 1 AStG. Going concern value, fair market value, and arm's length value thus intertwine and lead to different results. Above all, there is a marked tendency to treat purely domestic transactions more leniently than cross-border transactions, particularly as concerns personal businesses.

Then there is the special status of corporate downstream services and loans of assets at less than arm's length consideration. No adjustment at all occurs domestically,[106] but cross-border transfers lead to application of the arm's length principle.

Finally, one notes Germany's permanent establishment regulations and the lack of clear authority to treat passage of assets out of the German tax sphere as taxable events. While the permanent establishment regulations may be valid as income allocation rules, they in certain cases allocate income that has not yet been realised.

Considering this situation, Germany's alternatives going forward are as follows:

- *Strategy 1*: Maintain the present system, but *expand Section 1 AStG* so that it applies wherever it yields a greater adjustment to income than a competing doctrine and covers all transactions not resting on an explicit company law basis and accounted for accordingly;
- *Strategy 2*: Maintain the present system, but *construe Section 1 AStG narrowly* so that it is inapplicable to constructive dividends, contributions, and with-drawals, thus allowing these domestic doctrines to govern cross-border transactions as well and leaving only corporate downstream non-arm's length transfers of usages and services to be covered by *Section* 1 AStG; accept the risk that *Section* 1 AStG will be declared void as to these transactions under EC law;[107]
- *Strategy 3*: Make the arm's length standard the uniform and sole measure of withdrawals, contributions, and constructive dividends for domestic as well as cross-border purposes. Extend the arm's length standard to domestic corporate usages and services as well.[108]

Strategy 1 runs the risk of conflict with E.C. law. Germany may be compelled to refund much of the tax it collects under this strategy. Strategy 2 permits non-arm's length valuations of withdrawals and contributions in certain circumstances. If Section 1 AStG conflicts with E.C. law, tax collected by imposing the arm's length standard on cross-border corporate downstream non-arm's length transfers of usages and services may have to be refunded. Strategy 3 complies with E.C. law, but has a draconian impact on the previously liberal rules governing domestic contributions and withdrawals.

The dilemma inherent in the above alternatives has two sources. On the one hand, Germany has tried to handle transfer pricing issues using domestic tax doctrines – contribution, withdrawal, constructive dividend – developed over decades to address the tax problems of small-scale domestic enterprises. One may question whether the differences between the globe-spanning operations of multinational corporations in the 21st Century and the essentially local and highly personal dealings of small entrepreneurs and family businesses in the early to mid 20th Century are not so great as to doom this effort to failure.

However, any attempt to create a modern transfer pricing law based on the arm's length standard and applying only to cross-border transactions must come to terms with the second source of the dilemma: European Community law. If a procedural[109] and substantive[110] double standard for domestic and

GERMANY

cross-border transactions is indeed precluded by EC law, then a certain degree of disarray in transfer pricing law is probably inevitable for the foreseeable future – not just in Germany, but throughout the European Union.

1 See Section II A, last month.

2 So the holding in the FTC "sailing yacht" judgement of December 14, 1996 (I R 54/95 – DStR 1997, 707). See however the FTC's recent "equestrian sport" judgement of November 7, 2001 (I R 14/01 – DStR 2002, 667) with respect to non-resident corporate entities.

3 Except for trade tax purposes.

4 Cf. *Otto* (Footnote 15, last month) Section C.I.3 (a) of FTC ruling of October 26, 1987 (GrS 2/86 – Footnote 64, last month) and Section C.I.1 of FTC ruling of June 9, 1997 (GrS 1/94 – BStBl II 1998, 307).

5 See Section C.I.3 (a) of FTC ruling of October 26, 1987 (GrS 2/86 – Footnote 64, last month) and Section C.I.1 of FTC ruling of June 9, 1997 (GrS 1/94 – BStBl II 1998, 307), both citations from *Hoffmann* GmbHR 1999, 452, 455, his Fn. 21.

6 See Section C.I.3 (a) of FTC ruling of October 26, 1987 (GrS 2/86 – Footnote 64, last month); H/H/R Wrede marginal no. 35 on Section 8 KStG; Dötsch/Eversberg/Jost/Witt marginal no. 36 of commentary preceding Section 8 KStG. The latter consider withdrawals as necessarily involving movements from a taxable to a non-taxable sphere of the *same* taxpayer. Withdrawals are thus impossible for corporations because corporations have no private or other non-taxable sphere. An exception applies to corporate entities with non-profit and for-profit activities.

7 In German, *verdeckte Gewinnausschüttungen*, literally "concealed distributions of profit"; often abbreviated in German as "vGA".

8 See Section III D, last month.

9 *Hoffmann* DStR 1994, 1208, 1209/2 speaks in this connection of a "quasi-option" enjoyed by the parties. *Hoffmann* is commenting on the famous Schneider bankruptcy case in the mid-1990s in which the controlling shareholder of a bank holding some DM 400 million of the bankrupt debtor's bad loans contributed a like sum to the bank. The bank (Bank I) treated the contribution as extraordinary income and thus was able to show a profit for the year despite the DM 400 million loan write-off. The controlling shareholder, another bank (Bank II), increased the book value of its shareholding in its subsidiary by the amount of the contribution, hence avoiding any loss by reason of the transaction. Bank II's previous carrying value of its shares in Bank I was allegedly below fair value. *Hoffmann* speaks of "hidden realisation of hidden reserves" in this connection. It is unclear whether a "quasi-option" exists *de jure* under commercial accounting law to treat contributions not in return for shares as income or as direct increases to capital. But such an option exists *de facto*, as the Schneider bankruptcy shows.

10 Cf. Büchele, DB 1997, 2337, 2343/1.

11 Cf. Section 6 (6) sent. 2, 17 (1) sent. 2, and 23 (1) sent. 5 no. 2 EStG.

12 See last month, Section II E, Footnote 26, and Section III D.

13 Subtraction would still be necessary under the "increase in equity" formula of Section 4 (1) EStG, but this is merely a technical matter (see II A, II H, last month).

14 See Section II E, last month.

15 Section 23 (3) sent. 2 EStG.

16 Cf. *Schmidt/Glanegger* keyword "*verdeckte Einlagen*" in ABC, marginal no. 440 on Section 6 EStG. The rules of Section 6 (1) no. 5 EStG would normally require the corporation to show contributed assets at not more than the contributor's cost of acquisition if the assets were produced or purchased within three years of contribution. Regarding contributed stock, see Footnote 18, below.

17 Section 17 (1) sent. 2 EStG.

18 The rules of Section 6 (1) no. 5 EStG require the corporation to show stock received by contribution at not more than the contributor's cost of acquisition. However, this does not apply where the contribution is treated as a deemed sale. Cf. *Schmidt/Glanegger* keyword "*verdeckte Einlagen*" in ABC, marginal no. 440 on Section 6 EStG.

19 Cf. Section II E, Footnote 26, and Section III D, last month.

20 As opposed to branches of activity, partnership interests, or majority stakes in corporations, which may be contributed openly (*i.e.*, in return for new shares) without realisation of profit under Section 20 UmwStG (Tax Reorganisation Act). Cf. also Section 6 (3) EStG which permits tax-neutral transfers of branches of activity and interests in partnerships provided no consideration changes hands. According to *Schmidt/Glanegger* (marginal no. 551 on Section 6 EStG), Section 6 (3) EStG does not apply to constructive contributions to corporations.

21 There is controversy as to the scope of this provision. Whereas *Hoffmann* (Footnote 15 at p. 456) believes it covers contributions of non-business property as well as business property, *Schmidt/Glanegger* (marginal no. 551 on Section 6 EStG) argue that the statute is limited to contributions of business property, be it the business property of a sole proprietorship, a partnership, or that of another corporation. The present article follows the view of *Schmidt/Glanegger.*

22 See Section II C, last month, regarding the meaning of going concern value.

23 *Hoffmann* (Footnote 15, last month, at p. 456 ff.) correctly notes that the statute is not explicit as to the perspective from which going concern value is to be determined. The authors of this article believe that the increase in share basis of the contributing shareholder is determined by the going concern value of the property for his business (cf. Section 6 (1) no. 5 EStG), whereas the going concern value of receiving corporation determines the value at which it takes the asset onto its books.

24 See Section II I, last month.

25 Cf. *Hoffmann* (Footnote 15, last month) at p. 453.

26 See Section I E 8 below.

27 Cf. examples in Section III C, last month, and I E 8 below.

28 Cf. Section 6 (6) sent. 2 EStG and Section I B 3, above.

29 Cf. *Dötsch/Cattelaens/Gottsteins/Stegmüller/Zenthöfer* (Footnote 175) marginal nos. 408, 414. The examples given by Dötsch et. al. relate to natural persons as shareholders.

30 See Section ll K 3 last paragraph. last month. Rather than treating the expense as contributed, the expense is directly allocated to the business benefited thereby.

31 See Section ll K and lll 3, last month.

32 Cf. Footnote 64, last month.

33 FTC judgement of October 17, 2001 (I R 97/00), not to be confused with the transfer pricing decision of even date (I R 103/00 – IStR 2001, 745). The following example simplifies the facts of the case (I R 97/00).

34 In 1999, Section 6 (1) no. 3 EStG was amended to require liabilities not maturing within 12 months to be discounted for tax accounting purposes to their present value, assuming an interest rate (discount rate) of 5.5 percent. This affects interest free loans to domestic commercial taxpayers in that the difference between the nominal and discounted value of the loan is treated as income in the year of the loan. However, the annual increases in the discounted value of the loan are interest expense. Over the term of the loan, net income is zero.

35 Section 42 AO (Tax Procedure Act).

36 The 1st Chamber of the FTC offered no clear reason why the upstream corporation should recognise gain on the transaction. Section 6 (6) sent. 2 EStG was not in effect at the time. Nor did the court propose to treat the interest-free loan as a withdrawal of a usage from the upstream corporation (cf. Section I C 7 below). Essentially, the 1st Chamber argued that the treatment of the upstream corporation must mirror that of the downstream corporation.

37 The approach desired by the 1st Chamber of the FTC was rejected primarily because of its consequences for personal businesses. If an individual leases an asset (e.g. land) to others, the resulting income is taxable even though the asset (land) is held as private property. If the same individual were committed to "contribute" the use of the asset to his sole proprietorship, *e.g.*, the use of a piece of land for 10 years, the sole proprietorship would capitalise and depreciate the asset. Assuming the arm's length rent for the land to be 100 per year, and ignoring discounting, the contributed use of the land might be capitalised at 1000 and depreciated at 100 per year. By such means, the taxpayer would have transformed his taxable rental income into a deductible business expense. Note that the business would not be able to depreciate the land if the asset itself were contributed. See *Biergans* DStR 1989, 367, 370, Example 2.

38 The court refers in general to the costs incurred by a shareholder in order to permit use of an asset by his corporation (GrS 2/86 – Footnote 64, last month – under Section C.I.3.d). In the case of an interest-free loan, these are the refinancing costs. See Section I A above.

39 See Section ll K 3 last paragraph.

40 The new corporation tax law is phased in beginning on January 1, 2001.

41 Section 8b (1) KStG.

42 FTC judgement of 29 May 1996 (I R 167/94 – BFHE 1996, 415).

43 Foreign Transactions Tax Act. Cf. FTC judgement of October 17, 2001 (I R 97/00) under Section II.4.

44 See Section II D below.

45 *Biergans* DStR 1989, 367.

46 The problems posed by the situation discussed in Footnote 37 arise only where the contribution is valued at fair market value.

47 This approach solves the problem discussed in Footnote 37.

48 GrS 2/86 (Footnote 64, last month) under Section C.I.1(c); not clearly expressed.

49 See Sections ll K, lll C, last month.

50 *Wassermeyer,* DB 1987, 1113, 1115. *Wassermeyer* was at the time a justice sitting on the 1st Chamber of the FTC, the chamber that referred the case to the combined chamber. *Wassermeyer* is now the chief justice of the 1st Chamber of the FTC.

51 See Section l A above.

52 Cf. legal definition of withdrawals in Section ll B, last month.

53 See Section l A above.

54 By contrast, a sole proprietor is incapable of contracting with himself for any purpose. While partnerships may contract with their partners under civil law, for tax effect is denied to contracts by which partners provide services or lease assets to their partnerships.

55 See example in Section lll B, last month.

56 Legislation is pending that would raise the corporation tax rate to 26.5 percent for the year 2003 only to help fund the Eastern German recovery from the disastrous August 2002 floods. While passage of this legislation currently appears certain, the opposition parties have vowed to repeal it if they are voted into office in the national elections on September 22, 2002.

57 Under the new corporate tax system, a trade tax incentive still remains to drain off profits in the form of shareholder salaries, pensions, etc. See calculations by *Hey,* GmbHR 2001, 1.

58 This criticism is raised by *Wassermeyer* in the first paragraph of his article in IStR 2001, 633.

59 See estimates by *Wassermeyer* in Section 1, last month.

60 The corporate law and commercial accounting consequences of constructive dividends represent a complex subject beyond the scope of this article. Whatever the consequences in theory, corporate law and commercial accounting rules are no obstacle in practice to the payment of constructive dividends.

61 Recent case law, including the leading transfer pricing decision of October 17, 2002 (I R 103/00 – IStR 2001, 745) suggests that it may be more appropriate to limit the adjustment to the excessive portion of the payment in most, if not all, instances of Type 1 constructive dividends. Note that the interest-free loan decision discussed above (Footnote 33) also dates from October 17, 2001, but represents a distinct case.

62 And withdrawals.

63 FTC judgements of May 17, 1995 (I R 147/93 – BStBl II 1996, 204) and November 13, 1996 (I R 53/95 – DStR 1997, 697).

64 See last paragraph of Section ll A below. *Wassermeyer* (DStR 1996, 733, 734) plays down the importance of these cases and reads them as applying only to Type 2 dividends. The fact that the other party would not have agreed is seen as indicative of a lack of serious intent to carry through with the transaction. See also *Wassermeyer,* StbJB 1997/98, 79, 87, 88.

65 The line of cases applying this definition reaches back to 1989 (FTC judgements of February 1 and February

GERMANY

22, 1989, BStBl II 1989 p. 522 and p. 631). The constructive dividend doctrine itself is much older.

66 Cf. *Wassermeyer,* GmbHR 1998, 157, 159/2 and legal definition of income in Section 4 (1) EStG, as explained in Section II A, last month.

67 See Section II A, last month.

68 *Wassermeyer,* StVj 1993, 208, 214/1.

69 The following examples assume that the excessive payments were occasioned by the shareholder relationship. The fact of the overpayment to a related party would raise a rebuttable presumption that this was the case.

70 In German, the *gemeiner Wert* (Section 9 (1) BewG); cf. Abschn. 31 (10) KStR. Cf. Dötsch/Cattelaens/Gottsteins/Stegmüller/Zenthöfer *Körperschaftsteuer* (13th ed. 2002) marginal no. 503 = p. 162: valuation in terms of the price or compensation which a diligent and conscientious business manager would have charged on the transaction. See also *Frotscher* in Frotscher/Maas (EL 2/2002), appendix "vGA" to Section 8 KStG, marginal no. 271 with further references; *Blümich/Rengers* marginal no. 405.

71 *Schulze zur Wiesche* (Footnote 84); cf. Section II C, last month.

72 Section III F, last month.

73 Cf. Article 9 of the OECD model income tax treaty.

74 Cf. Section II B below.

75 Cf. Example in Section III C, last month.

76 Section 8b (1) KStG; applicable to constructive dividends paid from January 1, 2001 onwards by calendar year corporations and from the beginning of the 2001/02 fiscal year on non-calendar year corporations.

77 The dividend received by the shareholder is not the subject of this article. Numerous differences, *e.g.*, in timing, can occur between payment of a dividend by a corporation and receipt of the corresponding dividend by the shareholder. Furthermore, dividends, including constructive dividends, received by corporations are tax exempt under the German corporation tax law in effect from 2001 onwards (subject to transition provisions). Resident individuals include half of the amount of dividends received in income.

78 See most recently the FTC judgement of October 17, 2001 (I R 103/00 – IStR 2001, 745) 7th headnote and Section III.A.2(d)(bb) with further references.

79 The FTC judgement of October 23, 1985 (I R 230/82 – BFH/NV 1986, 490, 493/1) did draw such as distinction, but was not followed by later decisions.

80 FTC judgement of October 17, 2001 (Footnote 78) at Section III.A.2(d)(ff) last paragraph. See Vögele/Bader *TPI Transfer Pricing,* Vol.3, No.3, March 2002, 7.

81 See definition of constructive dividend in Section I E 4 above.

82 FTC judgement of October 17, 2001 (Footnote 78) see Vögele/Bader *TPI Transfer Pricing,* Vol.3, No.3, March 2002, 7.

83 See Section I E 4 above regarding in particular constructive dividends.

84 Cf. *Wassermeyer,* StbJB 1997/98, 79, 87, 88.

85 Cf. *Wassermeyer* (Footnote 7, last month).

86 Cf. e.g. Frotscher (Footnote 70) marginal nos. 29–31.

87 FTC judgement of November 29, 2000 (I R 85/99 – DStR 2001, 739).

88 *Wassermeyer,* IStR 1997, 657, 658/2; cf. *Wassermeyer/Baumhoff Verrechnungspreise international verbundener Unternehmen* (Verlag Dr. Otto Schmidt, 2001) p. 122 (marginal no. 8).

89 See Section I C above.

90 *Wassermeyer* (Footnote 88) p. 658/2.

91 Cf. example in Section I C 2 above. In certain cases, the court has refused to apply Section 1 AStG to interest free loans, prompting an amendment to the definition of "business relationship" (new Section 1 (4) AStG). See FTC judgement of December 5, 1990 (I R 94/88 – BStBl II 1991, 287) and May 30, 1990 (I R 97/88 – BStBl II 1990, 875).

92 FTC ruling of December 17, 1997 (I B 96/97 – BStBl II 1998, 321).

93 *Gocksch* (IStR 2002, 181) analyses this issue and concludes that withdrawals never involve a business relationship within the meaning of Section 1 AStG, hence that the statute can never apply to withdrawals.

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

95 See Section I C 7 above.

96 Cf. *Wassermeyer/Baumhoff* (Footnote 88) p. 555, marginal no. 823.

97 Most recent case in point, the FTC judgement of October 17, 2001 (Footnote 78).

98 The mechanics of the corporation tax credit system in force through 2001 could result in payment of additional corporation tax by reason of a dividend.

99 The following summary ignores contributions of assets previously held as non-business property.

100 Section 6 (1) nos. 4 and 5 EStG.

101 The logic of this holding is questionable. See Section I C 7 above.

102 Chain of argument: Since the assets leave the German tax sphere, Section 6 (5) does not apply. Hence, a withdrawal occurs and is valued under the standard rule of Section 6 (1) no. 4 at going concern value.

103 This statement refers to contributions of individual assets and ignores possibilities under the Tax Reorganisation Act for tax-neutral contribution of branches of activity, partnership interests, and majority stakes in other corporations.

104 See example in Section I C 2 above.

105 *Wassermeyer/Baumhoff* (Footnote 88) p. 122 marginal no. 8.

106 See Section I C 4 and I C 5 above.

107 Advocated by *Wassermeyer* in IStR 2001, 633, 637/2.

108 Advocated by *Wassermeyer* in StbJB 1998/99, 157, 169-172. In a 1997 article (IStR 1997, 657, 658/2) *Wassermeyer* voiced the same suggestion, but only with respect to cross-border transactions.

109 Pertaining *e.g.*, to such issues as documentation, burden of proof, and possibly non-compliance penalties.

110 Defining the criteria for adjusting income from cross-border related party transactions.

  TPTP ISSN 1472-0841

Appendix: Tabular summary

Doctrine	Domestic?	Cross-border?	Test for application	Adjustment standard	Void under EC law?
Withdrawal: applies under prevailing view only to personal businesses, not to corporations	Yes	Yes	Reasonable businessman ≈ arm's length	Book value: for withdrawals for purposes of contribution to domestic personal businesses of same taxpayer[a] Fair market value: withdrawals for purposes of open contribution to a corporation or to a foreign personal businesses of same taxpayer Going concern value: other domestic withdrawals and withdrawals for purposes of constructive contribution to a corporation or to a foreign personal business of same taxpayer: ≈ arm's length for fixed assets; ≈ replacement cost for current assets; = related cost for usages and services Arm's length price: for cross-border transfers under permanent establishment regulations?? Corporations: withdrawals not possible under prevailing view; see "Contributions: consequences for contributing business"	Possibly, as regards denial of carryover basis for cross-border withdrawals
Contribution: consequences for the <u>contributing</u> business	Yes	Yes	Reasonable businessman ≈ arm's length	Receiving business is a personal business: see "Withdrawals" above Receiving business is a corporation: Fair market value: open contribution to a corporation ≈ arm's length Going concern value: constructive contribution to a corporation: ≈ arm's length for fixed assets; ≈ replacement cost for current assets No adjustment: domestic downstream non-arm's-length transfers of usages and services to a corporation; if cross-border, potential adjustment under sec. 1 AStG	Possibly, as regards denial of carryover basis for cross-border contributions to personal businesses
Contribution: consequences for the <u>receiving</u> business	Yes	Yes	Reasonable businessman ≈ arm's length	Receiving business is a personal business: valuation of asset received in general mirrors valuation of asset transferred: Carryover basis for transfers at book value Going concern value for transfers at going concern value[b] No adjustment: domestic downstream non-arm's-length transfers of usages and services to a corporation; if cross-border, potential adjustment under sec. 1 AStG	No
Constructive dividend: concealed distribution of profits by a corporation to its shareholder	Yes	Yes	Reasonable businessman ≈ arm's length	Valuation fair market value including a profit markup ≈ arm's length Usages and services: likewise valued at fair market value ≈ arm's length	No
Section 1 AStG	No	Yes	Arm's length	Arm's length Application in situations likewise constituting a withdrawal, contribution, or constructive dividend is unclear Application to constructive dividend situations would generally not result in a greater adjustment to income Application to withdrawal and contribution situations would sometimes result in a greater adjustment to income Application to downstream cross-border transfer of usages and services to a corporation is established (sec. 1 AStG fills "no adjustment" gap in above doctrines in cross-border situations)	Possibly

a Restrictions apply where corporations are involved, e.g. as partner in a partnership.

b In theory, the going concern value from the perspective of receiving business should apply where the going concern value from the perspective of the transferring business governs valuation at the level of the transferor. In cases involving the contribution of claims held by shareholders against their corporations, the courts have valued the contribution both at the level of the transferor and at that of the transferee with respect to the transferor's going concern value, i.e. that portion of the claim that is recoverable.