German Transfer Pricing New Deal

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The German Federal Tax Court (FTC) judgement of October 17, 2001 represents the most important decision to date on German transfer pricing law.[1] The new judgement decides an appeal of a December 1998 decision by the Düsseldorf Tax Court[2] that attracted attention primarily because of the lower court's rejection of the use of so-called secret comparables in transfer pricing litigation.[3]

In May 2001, an interlocutory ruling by the FTC in the same matter signalled the high court's unwillingness to uphold the transfer pricing documentation regulations that had been proposed by the German tax authorities.[4]

I. Statement of the Case

The case arose out of attempts by the tax authorities to adjust the income of the German marketing subsidiary of an Italian fashion apparel manufacturer. The Tax Court held that the taxpayer had overpaid its parent for goods purchased, hence that these prices should be reduced to increase the taxpayer's gross profit margin on resale from 18 percent to 24 percent for the period in dispute (1980 – 1990). The tax authorities contended, however, that the gross margin should have been 28 percent from 1980 to 1987 and 26 percent from 1988 to 1990. They appealed the case to the FTC, whereas the taxpayer accepted the lower court's finding that a 24 percent gross profit margin was appropriate. The FTC has now remanded the case to the lower court for further deliberations.

II. Legislative Response to "Tax Chaos"?

The judgement of October 17, 2001 is a victory for the tax authorities in the sense that the high court overturns the lower court's judgement pursuant to their appeal. The taxpayer's cross-appeal on a narrow technical issue is rejected. The authors of this article believe that the judgement is a victory for the tax authorities in a larger sense as well. However, a number of articles have already appeared affirming the contrary.[5] The judgement is complex and warrants close analysis.

It is clear that the FTC sees the judgement as a new leading case in the transfer pricing field. While the judgement makes important statements on many transfer pricing issues, Bert Kaminski and Günther Strunk correctly point out in a major German-language article (*Internationale Wirtschaftsbriefe* number 2/2002) that many issues are not explored thoroughly and many questions are left unanswered. The case now goes back to the lower court. Kaminski/Strunk conclude their article on a derisory note, commenting that it will likely take until 2010 – a total of 30 years – to resolve the transfer pricing consequences of transactions dating back to 1980. The authors call this a "telling picture of the tax chaos that prevails unabated in Germany".

The tax authorities are considering a legislative response to the judgement of October 17, 2001. Kaminski/Strunk anticipate transfer pricing legislation before the year is out, probably to take effect on January 1, 2003. Such legislation may codify taxpayer transfer pricing documentation requirements and create sanctions for violations. The exact details are unknown.

Germany's lawmakers must enact legislation that is consistent with European law. The same chamber of the FTC that wrote the judgement of October 17, 2001 ruled in June 2001 that there was "serious doubt" as to the compatibility of Germany's codification of the transfer pricing arm's length principle with the antidiscrimination provisions of the EC Treaty.[6] Transfer pricing documentation requirements that apply to cross-border transactions, but not domestic transactions, may violate EU law.

The judgement of October 17, 2001 is the starting point for considering future legislative changes. This article focuses on the judgement's core issues – taxpayer transfer pricing compliance obligations, the consequences of violation of such obligations, the allocation of the burden of proof, and the role of estimation – before discussing the court's peripheral statements on other significant transfer pricing matters.

III. Compliance Obligations

A. Obligations Rejected by the Court: Documentation

The October 2001 judgement reaffirms the position taken in the court's much-publicised ruling of May 10, 2001 that there is no basis in German tax law for requiring taxpayers to keep special records or create special documentation for transfer pricing purposes.[7] Extensive documentation requirements were the heart of the proposed transfer pricing regulations that the tax authorities released in August 2000.[8] These regulations are known to have been considerably revised by the Federal Ministry of Finance following the ruling of May 10, 2001 and are now thought to be on hold pending a decision regarding new legislation.

The court furthermore states that current law does not oblige the taxpayer to show that its transfer prices are compatible with the arm's length standard. However, this statement should not be taken at face value, as is explained under section IV below.

The court does not comment on the extent to which domestic taxpayers may be required under Section 90 (2) AO to produce price calculation documents held by the corporate parent or other related parties. This silence is odd in light of the lengthy remarks on the subject contained in the May 2001 ruling.[9] Presumably, the court has not changed its opinion, which was essentially that there are no such *upstream* obligations, but that there very likely are *downstream* obligations because parents can use their powers under corporate law to obtain documents held by their subsidiaries. Hence, the German subsidiaries of foreign groups have no obligation to produce calculation documents held by their parent or affiliate companies, but German parents are probably required to do so with respect to their foreign subsidiaries.[10] Perhaps this implication, which places German-based groups at a considerable comparative disadvantage, explains the court's silence on the topic in its October 2001 judgement.

B. Obligations Affirmed by the Court

The May 2001 ruling and October 2001 judgement have not eliminated all transfer pricing compliance obligations, however. In both decisions, the court cites taxpayer compliance obligations of three sorts:

- obligation to produce books, records, papers, and other documents with transfer pricing relevance that taxpayers possess in fact (Section 97 (1), Section 200 AO);[11]
- obligation to procure such documents within certain limits (Section 90 (2) AO – see section IIIA above regarding documents held by related parties); and
- obligation to respond to interrogatories from the tax authorities (Section 90 (2), 93, 200 AO – duties to provide information in general, in the audit context, and with respect to foreign transactions).

C. Obligation to Provide Information

The October 2001 judgement goes beyond the May 2001 ruling by holding that the taxpayer violated its duties to provide information by failing to respond to virtually any of the transfer pricing interrogatories directed to it by the tax auditors. In particular, the taxpayer failed to explain "how the parties arrived at the transfer prices actually agreed on, what risks and functions the taxpayer's predecessor in interest assumed, and what influence the [taxpayer's parent company] exercised in bringing about the prices actually agreed on".[12]

D. Constructive Dividend Consequences of Failure to Provide Information

The court states that the taxpayer's failure to provide the required transfer pricing information "supports ... [the conclusion] that the agreed prices were occasioned by the shareholder relationship".[13]

Background information on German transfer pricing law and corporate tax law is required in order to make sense of this statement. The German Foreign Transactions Tax Act (*Außensteuergesetz* - AStG) contains a general provision (Section 1 AStG) by which non-arm's length transactions between domestic and foreign related parties can be adjusted to the arm's length price. However, the prevailing view is that Section 1 AStG is pre-empted by the constructive dividend rules of corporate tax law in situations potentially covered by these rules. The October 2001 judgement tacitly rests on the prevailing view. Hence, this judgement asks not whether the prices paid by the German marketing subsidiary to its foreign parent should be adjusted under Section 1 AStG,[14] but rather, whether they constituted constructive dividends under Section 8 (3) KStG.

Constructive dividends are defined by German case law[15] as transactions that:

- reduce a corporation's net assets *or* prevent an increase in its net assets;
- are occasioned by the shareholder relationship;[16]
- negatively impact taxable income; and
- do not constitute declared dividends.[17]

Hence, when the court states that the taxpayer's failure to answer the interrogatories directed to it justifies the conclusion that the prices were occasioned by the shareholder relationship, it is affirming that the second required element of a constructive dividend may be inferred from the taxpayer's compliance violation.

However, the court then goes on to say, pointedly yet somewhat obscurely, that one cannot infer from the violation of compliance obligations that the prices were "inappropriate", that is outside of "the range of appropriate arm's length prices".[18] This can only be mean that transfer prices have a negative impact on income (third required element of a constructive dividend) only to the extent they are outside of the arm's length range.[19]

Where does this leave the taxpayer and the tax authorities? The answer seems to be: with the ball still in the tax authorities' court.

E. Litigation Consequences of Compliance Violations

The court states emphatically that, in addition to showing that a price is occasioned by the shareholder relationship, an adjustment to income by reason of a constructive dividend requires a finding "that the price actually agreed is not within the range of appropriate arm's length prices". Furthermore, "the general principles on the allocation of evidentiary risks" apply with respect to such a finding. This is to say that the tax authorities bear the burdens of production and persuasion (burden of proof) on this issue.[20]

Hence, the taxpayer's violation of its duties to provide information still leaves the tax authorities with a major hurdle to overcome before the taxpayer's prices can be adjusted.[21] The taxpayer can with impunity reply "no comment" when asked how it arrived at its transfer prices as long as the tax authorities cannot show that these transfer prices are outside of the arm's length range. While the taxpayer violates its statutory obligation to provide information, this alone is of no consequence, in the court's view. One suspects that the situation would have been the same even if the court had affirmed an obligation on the taxpayer's part to document its transfer prices. The transfer prices of taxpayers who violated such an obligation could likewise

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be presumed to be occasioned by the shareholder relationship. But where does this presumption get the tax authorities? Nowhere, it seems, or at least not far enough.

An essential implication of the FTC judgement of October 17, 2001 is thus that, under current law, the violation of statutory compliance responsibilities in the transfer pricing context is largely irrelevant,[22] because German tax procedure law does not effectively sanction such violations.[23]

F. Theoretical Stance on Compliance Violations

The October 2001 judgement also contains theoretical comments that should not be ignored on the consequences of compliance violations. The judgement's sixth headnote reads as follows:

> When compliance obligations are violated, a distinction must be drawn depending on whether the obligation relates to a required element (*Tatbestandsvoraussetzung*) or the legal consequence (*Rechtsfolge*) of a taxable event. If it relates to a required element, the compliance obligation results in a reduction of the standard of proof for the determination of the element in question. If it relates to a legal consequence, it generally justifies estimation of the basis of taxation.[24]

The court sees typical transfer pricing compliance obligations as relating to a single required element of a constructive dividend, namely to the element of shareholder influence.[25] The court perceives at most a weak and hence negligible relation to the element of negative impact on income.[26] The court gives no examples of compliance obligations that relate to the "legal consequence" of a taxable event. One may conjecture that only concealment of taxable income would fall into this category.

In an essay commenting on the October 2001 judgement, Professor Franz Wassermeyer, the chief justice of the chamber of the FTC that handed down the decision, writes that violation of compliance obligations gives rise to a *rebuttable presumption* that the taxpayer's transfer prices were occasioned by the shareholder relationship, hence lowering the standard of proof for the tax authorities on this issue.[27]

IV. Burden of Proof

A. Burden of Proof in General

German courts have consistently held that the tax authorities bear the burden of proof (burdens of production and persuasion) for all elements of a constructive dividend.[28] The pivotal elements of a constructive dividend are shareholder influence and negative impact on income (prices outside of the arm's length range).[29]

As has been shown, the court is willing to permit the first, but not the second of these pivotal elements to be inferred from taxpayer violation of compliance obligations. As explained by the same authors in more detail in a prior article,[30] German tax law generally requires "proof with virtual certainty" (*mit an Sicherheit grenzender Wahrscheinlichkeit*) of all required elements of a taxable event. This is seldom, if ever, possible in transfer pricing litigation. Hence, some authors have suggested that the tax authorities can virtually never win a transfer pricing dispute under the law as presently written.[31] The inability of the tax authorities to resolve the case giving rise to the FTC's October 2001 judgement within a span of two decades after the earliest tax year at issue lends credence to this position.

B. Shift of Burden Through Rebuttable Presumption

The judgement of October 17, 2001 contains the following remarkable passage with regard to the FTC's 1993 *Aquavit* judgement:[32]

> [The court] understands the decision it reached with regard to the allocation of evidentiary risks in [*Aquavit*] as signifying that, when a [domestic] marketing company distributes the products of a [foreign] related-party manufacturing company and generates nothing but losses of considerable proportions for three years in a row, this gives rise to a rebuttable presumption that the agreed transfer prices are inappropriate *and* occasioned by the shareholder relationship.[33] The ... rebuttable presumption means that the tax-payer must come forward with evidence (*darlegen*) and prove (*nachweisen*) why the transfer price actually agreed is nonetheless appropriate.... If the evidence [offered in rebuttal] is insufficient ... estimation is permitted within the limits of the presumption, that is, constructive dividends may be assessed by way of estimation in the amount of the difference between the reported loss and an appropriate overall profit and allocated to the years [in question]. The estimation may also relate to the purchase prices of the first three years without necessarily resulting in a profit for these years (emphasis added).[34]

Thus, the same court that affirms that the tax authorities must prove – with virtual certainty – that the taxpayer's transfer prices are influenced by the shareholder relationship and outside of the arm's length range will rebuttably presume both requirements to be met where a domestic marketing subsidiary has generated start-up losses for three years in a row and has not earned an "appropriate overall profit" over its entire operational period. Where the presumption arises, the burden of production and persuasion shift to the taxpayer on the issues of shareholder influence and arm's length range.

The taxpayer is free to rebut the presumption. The court suggests that the taxpayer may demonstrate that its poor earnings performance is the result of management errors or other unforeseeable circumstances and that, as soon as such were recognised, corrective action was taken. One might add that it would assist the taxpayer in such efforts to be able to produce forecasts of projected earnings or other documents showing why it was reasonable to accept the agreed transfer prices based on expectations at the time (prospective, not retrospective viewpoint).[35] A taxpayer might also show that its transfer price structure is part of a long-term strategy to acquire market share, hence that it will only earn an overall profit over a longer than normal period of time.[36] Hence, at least for this one situation (domestic marketing subsidiary with start-up losses and poor

overall performance), the court's holding has the effect of placing pressure on the taxpayer to assemble "voluntarily" a good part of the transfer pricing documentation which it is not required to compile under current German tax law.

Where the burdens of production and persuasion shift to the taxpayer, the question arises as to the standard of proof that the taxpayer must meet to rebut the presumption. Is the shoe now completely on the other foot? In other words, must the taxpayer now show "with virtual certainty" that its transfer prices were not influenced by the shareholder relationship and are within the arm's length range? The October 2001 judgement is silent on this point. Logically, the evidence needed to rebut the presumption should be no stronger than that needed to give rise to it. And who could claim that three years of consecutive losses prove "with virtual certainty" that the transfer prices of the company in question are not at arm's length?

C. Aquavit Presumption in the Narrow Sense

The details of application of the "Aquavit presumption" remain unclear even after the October 2001 judgement. Numerous questions besides the standard of proof applicable to the taxpayer's rebuttal are not addressed. For instance, the court mentions the possibility that the presumption may be raised by less than three years of losses in some cases. While the court defines the minimum "appropriate overall profit" in terms of "appropriate interest earned on injected equity (including compounded interest and risk compensation factor)," it is unclear what sort of results this could lead to in practice.[37] Even less clear is the period over which an "appropriate profit" should be earned. Kaminski/Strunk[38] note that German courts have bent over backwards to avoid finding that individuals renting residential property, on whom German income tax law has traditionally showered tax benefits, lacked the intent to earn an overall profit. To this end, the courts have accepted profit projections stretching over generations – up to 100 years!

Of interest are also the court's statements to the effect that taxpayers unable to rebut an Aquavit presumption will be allocated an "appropriate profit" even if another transfer pricing method (e.g. the comparable uncontrolled price method or resale price method) indicates that a lower adjustment is warranted or none at all. The result yielded by the new "appropriate profit method" thus appears to override all other methods where these methods yield results less favourable to the treasury.

The space available does not permit exploration of these issues. Instead, attention is called to a considerably more important question, namely the extent to which the methodology underlying the new Aquavit presumption may be applied in other contexts.

D. Aquavit Presumption in a Larger Sense?

It is noted by way of preface that this section presents the authors' interpretation of comments by the FTC in its October 2001 judgement and by the court's chief justice, Professor Dr. Franz Wassermeyer, in his above-cited essay.[39]

Wassermeyer indicates that presumptions can arise against the taxpayer in circumstances not related to the specific situation covered by *Aquavit*. This highly theoretical essay presents an exciting re-definition of the arm's length standard as an instrument for allocation of the burden of proof in constructive dividend situations.[40] Where the structure chosen by the taxpayer does not accord with the arm's length standard, a rebuttable presumption of payment of constructive dividends arises against it. While the taxpayer may rebut the presumption, it bears the burdens of production and persuasion in attempting to do so. The tax authorities bear the burdens of production and persuasion (burden of proof) only with respect to the initial showing of non-compliance with the arm's length standard. Once they have made this showing, the burden of proof shifts to the taxpayer. Constructive dividends are assessed where the taxpayer fails to meet this burden and rebut the presumption. Estimation is permitted if necessary in the assessment process.

Wassermeyer not only places the judgement of October 17, 2001 in this theoretical framework, but seeks to re-interpret decades of constructive dividend case law in light of these principles as well.[41]

The re-interpretation of the arm's length standard as a device for allocating the burden of proof has far-reaching implications. The purpose of recourse to this standard, at least in the initial stage of litigation, is no longer to determine "with virtual certainty" the price (or range of prices) on which independent parties dealing with each other at arm's length in precisely the same situation would have agreed. Rather, recourse is had to a highly objectified arm's length standard as a sort of initial check on the plausibility of the transfer prices applied.[42] Where the taxpayer "fails" this initial plausibility check, a rebuttable presumption arises against it that its prices are occasioned by the shareholder relationship and have negatively impacted its earnings. These are the two essential conditions for assessing a constructive dividend.[43] The burdens of production and persuasion shift to the taxpayer. These burdens are difficult to meet. Indeed, in Wassermeyer's view, the entire body of constructive dividend case law is to be read in terms of the taxpayers' failure to rebut presumptions raised against them.[44]

Wassermeyer writes (emphasis added):

> *The threshold for raising a rebuttable presumption is not very high....* The FTC states that a domestic distribution subsidiary that has generated large losses for three years in a row from the only product in which it trades has acted at variance with normal third party practice. 'At variance with normal third party practice' (*fremdunüblich*) does not mean that no other domestic distribution subsidiary is conceivable that has not incurred similar losses three years in a row. It is sufficient that a clear majority of comparable enterprises generate different results.[45]

It thus appears likely that the FTC would permit a rebuttable presumption to be raised against a taxpayer where the tax authorities could show that a taxpayer's transfer prices appear high or low (as the case may be)

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by comparison to a majority of firms comparable to the taxpayer to a certain degree, though not in every conceivable respect. The tax authorities could make such a showing using two types of data, either in conjunction or in isolation:

- data from publicly available databases[46]
- anonymous data from databases compiled by the tax authorities using information available to them alone, e.g. from tax audits.[47]

It cannot be emphasised enough that the application of the arm's length standard at this stage of the litigation (Stage 1) is *solely for purposes of allocating the burden of proof*. To shift the burden of proof to the taxpayer, the tax authorities need show merely that the taxpayer's prices are at variance with normal third party prices or that the taxpayer meets the requirements for an Aquavit presumption in the narrow sense (distribution subsidiary with three years of start-up losses etc.). Other situations are conceivable as well that indicate with a comparable degree of probability that the taxpayer's transfer prices are inappropriate.

While the tax authorities must make their showing of variance from normal third party practice "with virtual certainty," the requirements for such a showing are "not very high" (Wassermeyer). In other words, the tax authorities need not show "with virtual certainty" that the taxpayer's transfer prices are outside of the arm's length range. Rather, they need only show something akin to good cause to suppose that the prices may be outside of this range. This is not sufficient to decide the case. It is, however, sufficient to shift the burden of proof to the taxpayer. A key sentence in Wassermeyer's essay thus reads: "One should not confuse the opportunity to rebut with the arm's length standard to be applied".[48] Arguments to the effect that the enterprises cited by the tax authorities in the initial stage of the litigation (stage in which the burden of proof is assigned) are in fact not truly comparable are admissible in the rebuttal stage. However, in this stage, the taxpayer – not the tax authorities – has the burden of proof.

Naturally, a threadbare or perfunctory showing by the tax authorities of variance from normal third party practice will not be enough to shift the burden of proof. Future court decisions will decide whether the interpretation set forth above is accurate and, if so, exactly how convincing the tax authorities' initial showing must be to shift the burden of proof to the taxpayer. At this juncture, one can only quote Wassermeyer once again: "The threshold for raising a rebuttable presumption is not very high".

E. Burden of Proof and Documentation

Where the burden of proof has shifted to the taxpayer, one may say as a general matter that documentation of the sort outlined in the August 2000 draft transfer pricing regulations[49] will be required in order to rebut the presumption. By creating a significant risk that the taxpayer may have to bear the burden of proof on the appropriateness of its transfer prices, the October 2001 judgement reinstates *de facto* the transfer pricing documentation requirements that it nullifies *de jure*.[50]

V. Estimation and Arm's Length Range

A. No-Fault Estimation of Constructive Dividend

The FTC states repeatedly that, where the taxpayer has failed to rebut a presumption that it has paid constructive dividends, the amount of such constructive dividends can be determined by estimation if necessary under Section 162 (1) AO.[51] As is explained in greater length in the authors' article in *International Tax Review* September 2001 page 45, the essence of the estimation process is the reduction of the standard of proof from "with virtual certainty" to the highest lesser standard that can be met on the basis of the available facts. Hence, in cases where the taxpayer has failed to rebut a presumption raised against it, an income adjustment (assessment of constructive dividends) occurs based on less than "virtually certain" accuracy. In other words, once the litigation has reached the estimation stage, the high standard of proof generally required in German tax litigation will not shield the taxpayer from an income adjustment, even if the taxpayer has not violated any compliance obligations.

Wassermeyer stresses this point in his essay:

> The FTC bases the estimation on Section 162 (1) AO and not on Section 162 (2) AO. The true reason for estimation is thus not the violation of compliance obligations, but rather the impossibility of determining the precise amount of the constructive dividend.[52]

B. Arm's Length Range

The court states that estimations of transfer prices lead to an arm's length range, not to the one and only correct price. The court holds that, within this range, the value most favourable to the taxpayer must be applied when determining the amount of a constructive dividend.[53] Presumably, the same applies when applying the arm's length standard to allocate the burden of proof as an initial matter.[54]

Kroppen/Rasch/Roeder report considerable concern on the part of tax authorities over this aspect of the October 2001 judgement. The tax authorities fear that taxpayers will be able to set inappropriate transfer prices at no risk because, in the event of an adjustment, they will automatically be placed in an optimal position.[55]

This may be true in theory, but not in practice. Compare a taxpayer with a carefully constructed and documented transfer pricing system to a taxpayer like that involved in the FTC's October 2001 judgement, whose prices were dictated by its parent. Assume that 10 years have passed and that the second taxpayer is able to produce absolutely nothing in support of its transfer prices. An arm's length range determined on this basis will be less accurate, and hence may well be less favourable to the taxpayer, than one constructed on the basis of careful documentation. Hence, the most favourable value in a prospectively documented arm's length range may be more advantageous to the taxpayer than the most favourable value in a range determined retrospectively on the basis of scanty information. The expense of transfer pricing litigation should also not be underestimated.

C. Estimation in the FTC Judgement

The FTC states that, where estimation is permissible, the Tax Court is free to substitute its own estimate for that of the tax authorities. In so doing, it need not find the tax authorities' estimate to be in error. Rather, the Tax Court, as the finder of fact, need only reasonably believe that its own estimate yields results with a higher probability of accuracy. Estimates by the tax authorities are subject to full legal and factual judicial review. The standard of review is not abuse of discretion.

The FTC treats the case before it as one in which the lower court substituted its own estimate for that advanced by the tax authorities. The FTC finds that the lower court was justified in resorting to an estimate, but committed errors of law and logic in making its estimate. While the Tax Court's estimate is a finding of fact that binds the FTC, the FTC is permitted to review and overturn it for errors of law and logic.

The FTC's comments on the lower court's reasoning are interesting, but beyond the scope of this article. Two points are noted, however. First, it is unclear from the lower court's decision that either the lower court or the tax authorities thought they were estimating transfer prices. Second, it is unclear from the FTC's judgement why the FTC thinks the lower court was justified in estimating transfer prices.[56]

VI. Secret Comparables

The FTC's holding with regard to secret comparables is murky and leaves the crucial issues for decision by later courts, thus perpetuating the uncertainty in this area. The court states that the tax authorities might have violated Section 30 AO (obligation to preserve confidentiality of tax records) had they provided the court with the tax records of firms allegedly comparable to the taxpayer, but not party to the litigation. Violations of Section 30 AO are subject to criminal penalties and fall under the jurisdiction of the general courts, not the tax courts.

Had the tax authorities provided such records to the court, the taxpayer would, in the FTC's view, have been entitled to inspect such records. This part of the court's holding is at variance with a 1984 decision by an 8th Chamber of the FTC.[57] Since providing such records to the taxpayer would probably have violated Section 30 AO, the FTC affirmed that the lower court had acted properly by declining to request such records.

However, the FTC also held in conclusion that the lower court committed an error of law by refusing to consider the information assembled by the tax authorities in anonymous form. Under certain conditions, the tax courts may give weight to such data, the FTC said.

What those conditions are and whether they can be satisfied as a practical matter is still an open question. The FTC contented itself with the enigmatic remark that "minimum requirements as to the quality of the compiled data" must be met and the Tax Court must determine such to be the case.[58] If the tax courts ever actually decide against a taxpayer on the basis of anonymous data, this is sure to trigger an appeal to the Federal Constitutional Court on due process grounds.[59]

Hence, the FTC's October 2001 judgement sheds scant light on the issue of secret comparables.

VII. Summary

The highlights of the Federal Tax Court judgement of October 17, 2001 are summarised in conclusion:

- Adjustments to the transfer prices of a domestic corporation by reason of constructive dividends presuppose that the corporation's transfer prices:
  - are determined by shareholder influence, as opposed to arm's length considerations, and
  - have negatively impacted corporate earnings.
- A transfer price has negative impact on a corporation's earnings where it is outside (on the negative side) of the range of prices on which independent parties dealing at arm's length would have agreed (arm's length range).
- The tax authorities in principle bear the burden of proof on the above issues – essentially:
  - shareholder influence, and
  - deviation from the arm's length price.
- There appear, however, to be three ways in which the tax authorities can raise a rebuttable presumption that both elements of a constructive dividend are proven:
  - by using publicly available databases to show that the taxpayer's transfer prices are outside of the normal arm's length range;
  - by using databases available only to tax authorities (secret comparables) to make the same showing, provided certain conditions are met; or
  - by demonstrating that the taxpayer's start-up losses extended beyond a reasonable period of generally not more than three years and/or by showing that a reasonable overall profit has not been earned in a longer unspecified period. Databases may be used here as well to show the start-up loss periods for comparable uncontrolled companies and/or to show the period over which such companies achieved an overall profit.
- The hurdle to raising a rebuttable presumption in the above sense is apparently not high. In this stage (Stage 1), the arm's length standard operates as an instrument for allocating the burden of proof.
- The taxpayer may rebut the presumptions where they arise, but to do so must come forward with convincing evidence. In this process (Stage 2), the taxpayer has the burdens of production and persuasion (burden of proof).
- Where the taxpayer fails to refute the presumptions raised against it, a transfer price adjustment is justified in principle (*dem Grunde nach*). The amount of the adjustment is determined in a logically distinct additional step (Stage 3), in which the sort of database analysis used in Stage 1 and/or Stage 2 may again be applied to determine the amount of the adjustment. The legal basis for estimation is generally found in Section 162 (1) of the Tax Procedure Act (*Abgabenordnung* – AO), which permits the tax authorities to assess tax on an estimated basis where an exact determination of the tax owing is not possible, as

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is normally the case in the transfer pricing context. Taxpayer fault is not a prerequisite to applying Section 162 (1) AO.

- The court emphasises that there is generally a range of acceptable arm's length prices and states that any price within this range must be accepted in the taxpayer's favour. This would appear to apply for purposes of raising rebuttable presumptions (Stage 1), for purposes of the taxpayer's attempted rebuttal (Stage 2), and in estimating the amount of a transfer price adjustment (Stage 3).

The following statements by the court are of secondary importance in light of the above:

- Taxpayers are under no obligation to assemble transfer pricing documentation. However, they are required to provide information as to how their transfer prices were arrived at (obligation to provide information, not to create documentation as such).
- Failure to explain the determinative factors behind transfer prices justifies the assumption by the tax authorities that shareholder influence, not arm's length considerations, was determinative.
- This is, however, not in itself enough to support a transfer price adjustment. In addition, the tax authorities must show that the taxpayer's transfer prices are outside of the arm's length range of comparable prices. Hence, taxpayer violations of compliance responsibilities would in themselves appear to be of limited importance. Violations may, however, make it impossible for the taxpayer to rebut a presumption raised against it. They may also prevent the taxpayer from benefiting from the most favourable value in the arm's length range.

The judgement is strangely silent on one important issue dealt with at length by the court in its interlocutory ruling of May 2001:

- The court does not comment on the extent to which domestic corporations are required by Section 90 (2) AO to produce documents with transfer pricing relevance that are held by foreign related parties. In its May 2001 ruling, the court held domestic subsidiaries are generally not required to produce documents held by their parent company or affiliates. The court's reasoning strongly implied, however, that domestic parent companies would have such an obligation with respect to documents held by foreign group companies.

In order to be able to rebut a presumption raised against them under the above principles, taxpayers have an interest in assembling the sort of documentation outlined in the tax authorities' proposed transfer pricing documentation guidelines of August 2000. By shifting the burden of proof to the taxpayer in a potentially wide variety of circumstances, the judgement of October 17, 2001 imposes *de facto* compliance obligations on taxpayers in the same breath with which it rejects the statutory basis for *de jure* obligations.

The above article first appeared in abridged form in International Tax Review, February 2002.

1 FTC judgement of 17 October 2001 - I R 103/00 (DB 2001, 2474).

2 Judgement of 8 December 1998 - 6 K 3661/93; Datev document no. 0551165; excerpts printed in IStR 1999, 311; see *KPMG German News* no. 2/1999 p. 13 = article no. 177.

3 See articles in *International Tax Review* by A. Vögele – July/August 1999, p. 9 – and by T. Borstell and M. Prick – April 1999, p. 9.

4 FTC ruling of 10 May 2001 - I S 3/01 (DStR 2001, 985). For a discussion of this ruling, see Vögele/Bader *International Tax Review* Sept. 2001 p. 45.

5 E.g., Kroppen/Rasch/Roeder 2001 *World Tax Daily* 237-11; Lahodny-Karner/Furherr SWI 2002, 14. More balanced Kaminski/Strunk *Internationale Wirtschaftsbriefe* no. 2/2002, Fach 8 Gruppe 2 p.1831.

6 See *International Tax Review* September 2001, p. 64.

7 FTC judgement of 17 Oct. 2001 loc. cit. (Fn. 1 sec. III.A.2(d)(bb).

8 See articles by A. Vögele and W. Bader in *International Tax Review* January and February 2001, pp. 38 and 17 respectively.

9 See Vögele/Bader *ITR* 2001 Sept. 2001 p. 45.

10 Ibid.

11 This obligation is underscored by a recent Tax Court case (Münster Tax Court judgement of 22 Aug. 2000 - 6 K 2712/00 - EFG 2001, 4); see *KPMG German News* no. 2/2001 p. 15.

12 FTC judgement of 17 Oct. 2001 loc. cit. (Fn. 1 sec. III.A.2(d)(bb). This finding is not contained in the ruling of 10 May 2001 (loc. cit. Fn. 4), which is surprising in that the ostensible issue in this ruling was whether the taxpayer had violated any compliance obligations and should be denied a stay of execution of the tax assessments pending against it for this reason. In the May 2001 ruling, the court found no compliance violations and hence granted the stay. In its October 2001 judgement, the court says the compliance obligations were violated after all, indicating that its May 2001 ruling was incorrect.

13 FTC judgement of 17 Oct. 2001 loc. cit. (Fn. 1) sec. III.A.2(d)(bb).

14 Were the court to have based the decision on § 1 AStG, it would have had to confront its own ruling of 21 June 2001 - I B 141/00 (DB 2001. 1648) that there is "serious doubt" as to the compatibility of § 1 AStG with the anti-discrimination provisions of the EC Treaty (see *International Tax Review* September 2001, p. 64).

15 The line of cases applying this definition reaches back to 1989 (FTC judgements of 1 Feb. and 22 Feb. 1989, BStBl II 1989 p. 522 and p. 631). The constructive dividend doctrine itself is much older.

16 The German expression is "*veranlaßt durch das Gesellschaftsverhältnis*". Elsewhere in this article, the noun form "*Veranlassung*" is translated as "influence" because the literal translations "occasionalism" or "occasionality" are meaningless in English. The concept of *Veranlassung* is the subject of a long-standing controversy that addresses the question whether an expenditure is "occasioned by the business" (cf. § 4 (3) EStG) and therefore deductible as a business expense or "occasioned by the shareholder relationship" (cf. § 8 (3) KStG) and therefore not deductible. Expenditures that are in the nature of distributions of income are treated as occasioned by the shareholder relationship. The essay by *Wassermeyer* cited below (Fn. 27)

comments at length on the meaning of the terms "occasioned by the business" and "occasioned by the shareholder relationship" and concludes, somewhat paradoxically, that constructive dividends are as a rule occasioned both by the shareholder relationship and by the business ("*In der Mehrzahl der Fälle ist die vGA zugleich Betriebsausgabe*"). See *Wassermeyer* ibid. (Fn. 27) at p. 2466/1.

17 The FTC judgement of 17 Oct. 2001 (loc. cit. Fn. 1) reiterates this definition verbatim at the outset of its sec. III.A.1.

18 FTC judgement of 17 Oct. 2001 (loc. cit. Fn. 1) sec. III.A.2(d)(bb).

19 The court does not make this statement with the clarity one would have desired. Nor is it clear that the court is correct in its approach. Past case law has tended to regard a payment as occasioned by the shareholder relationship if it was in the nature of a distribution of income, as opposed to a business expense. The fact that a payment was excessive has heretofore been taken as an indication that it was occasioned by the shareholder relationship. The required negative impact on income generally follows automatically from the first requirement (reduction of or frustrated increase in net assets) because Germany defines taxable income under § 4 (1) EStG as the excess of net assets at the end of an assessment period over net assets at the start of this period, after add-back of withdrawals and subtraction of contributions. A constructive contribution is thus in essence a corporate business transaction (i) occasioned by the shareholder relationship that (ii) negatively impacts taxable income by reducing the excess of closing net assets over starting net assets compared with what it would otherwise have been. However, it is also established that, where a corporation's payments to its shareholder are in principle "normal" (e.g. it is "normal" to pay for goods supplied), payment of an excessive price leads to a constructive dividend only in the amount of the excess, not in the full amount of the payment. See FTC judgements of 05 Oct. 1994 - I R 50/94 (DStR 1995, 718, 719 with further references); 12 Oct. 1995 - I R 27/95 (DStR 1996, 177); and 20 Jan. 1999 - I R 32/98 (BStBl II 1999, 369) dealing with assets purchased from shareholders and salaries paid to shareholders serving as general managers. However, these cases may be read as holding that the payments were occasioned by the shareholder relationship only to the extent of the excess over the arm's length payment. It is something new to hold that the payments reduced income only in the amount of the excess. Prior case law appears to treat the payments as reducing income in full, as they indeed literally do. All business expenses reduce income. But not all are occasioned by the shareholder relationship. The October 2001 judgement thus appears to effect a shift in the prior definition of constructive dividends by investing the third requirement (negative impact on income) with new meaning. Barring special circumstances (such as situations involving failure to observe certain formal requirements in arrangements with controlling shareholders or payments that are by their nature unusual (cf. FTC judgements of 13 Dec. 1989 - I R 99/87 [BStBl II 1990, 454]; 02 Dec. 1992 - I R 54/91 [BStBl II 1993, 311]; and 17 May 1995 I R 147/93 [BStBl II 1995, 419] – shareholder salary (i) subject to "ability to pay" clause or (ii) 100 percent profit-linked or (iii) consisting solely of pension rights), the October 2001 judgement appears to stand for the proposition that income is negatively impacted only to the extent the price paid exceeds (or falls short of) the arm's length price (as the case may be).

20 FTC judgement of 17 Oct. 2001 loc. cit. (Fn. 1) sec. III.A.2(d)(bb).

21 The court states that the obligations to provide information "related *only* to influence of a reduction ... in net assets by the shareholder relationship as a required element ... of a constructive dividend. This violation of compliance obligations therefore results *only* in a reduction of the obligations of the tax authorities and the Tax Court to investigate this ... required element ..., that is to say that in the case at hand one may infer from the compliance violation *only* that the [taxpayer's] predecessor in interest exercised no influence of its own in setting prices and in as much bowed to the dictates of its parent company" (loc. cit. Fn. 1 sec. III.A.2(d)(bb) – emphasis added).

22 Two negative consequences are nevertheless conceivable, though not certain. Compliance violations may render it more difficult for the taxpayer to rebut an Aquavit presumption – see sec.IVD below. Furthermore, taxpayers who commit such violations may forfeit the benefit of the most favourable value in the arm's length range (see sec. VB below).

23 The decision by the 1st Chamber of the FTC may be criticised in this respect. After ignoring possible violations of duties to provide information in its May 2001 ruling (loc. cit. Fn. 4), the court suddenly discovers such to have occurred in its October 2001 judgement (loc. cit. Fn. 1), only to render them inconsequential, if not completely irrelevant. The court could, however, just as easily have held that, at least in the case of crass violation of compliance responsibilities such as was involved in the matter before the court, *both* shareholder influence *and* prices outside of the arm's length range (negative impact on income) may be inferred from the violation. Had the court so ruled, compliance violations would operate like an Aquavit presumption (see sec. IV below) and shift the burden of proof to the taxpayer. The court itself admits that the violation of duties of information might provide "an initial indication" (*ein erster Anhaltspunkt*) of prices outside of the arm's length range (loc. cit. sec. III.A.2(d)(bb). The court's refusal to go further is seemingly motivated by determination to render compliance responsibilities irrelevant under the current German statutory scheme. However, the court's determination to strike the "compliance obligation" weapon out of the hands of the tax authorities is equalled by its countervailing determination to shift the evidentiary balance of power in the favour of the tax authorities, as is shown in sec. IV below.

24 This authoritative-sounding pronouncement is, strangely enough, not to be found in the body of the judgement. There, one reads only that sec. 9.3.1 of Germany's current general transfer pricing regulations (the 1983 Administrative Regulations – AR) "does not sufficiently distinguish according to whether the insufficient compliance relates to the clarification of the required element (consequence: reduction of the standard of proof for the element in question) or the legal consequence of the constructive dividend (consequence: estimation)". See FTC judgement of 17 Oct. 2001 loc. cit. (Fn. 1) sec. III.A.2(d)(bb).

25 See Fn. 21 and 23 above with associated text.

26 For critique of this stance, see Fn. 23 above.

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27 Wassermeyer "Verdeckte Gewinnausschüttung: Veranlassung, Fremdvergleich und Beweisrisikoverteilung" (freely translated: "Constructive Dividends: Business vs. Shareholder Purpose, Arm's Length Standard, and Allocation of Burden of Proof") DB 2001, 2465, 2465/1. See Fn. 16 above for a discussion of the German term "*Veranlassung*".

28 See FTC ruling of 10 May 2001 (loc. cit. Fn. 4 sec. II.3) with further references.

29 See sec. IIID above.

30 A. Vögele and W. Bader, *International Tax Review* September 2001 p. 45.

31 See e.g. Kroppen/Eigelshoven *IWB* Fach 8 Gruppe 1 p. 1745 at 1748 (27.06.1001) and Strunk/Kaminski *IWB* Fach 8 Gruppe 1 p. 1749 at 1758 (25.07.2001), both writing on the FTC ruling of 10 May 2001 (loc. cit. Fn. 4). Writing on the October 2001 judgement, Kroppen/Rasch/Roeder state that "it is not surprising that the German tax authorities are concerned about the documentation and burden of proof aspects of the Federal Tax Court's decision" and expect the tax authorities to seek new legislation as a result (Kroppen/Rasch/Roeder loc. cit. Fn. 5).

32 FTC judgement of 17 February 1993 - I R 3/92 (BFHE 170, 550 = BStBl II 1993, 457), dubbed the "Aquavit-decision" because it involved an alcoholic beverage by that name. In *Aquavit*, the court reasoned that a distributor dealing at arm's length would seek to earn a reasonable profit within a foreseeable period of time. Hence, under the *Aquavi*t approach, a domestic marketing subsidiary should earn a reasonable profit irrespective of other circumstances including the arm's length price of the products being distributed. An uncontrolled distributor – so the logic runs – would not agree to distribute a product at the arm's length price if it thought it could not earn a reasonable profit at that price. And it would discontinue products purchased at arm's length prices if, contrary to expectation, it lost money on them. (Naturally, situations are conceivable in which products are accepted, or must be marketed, as "package deals," whereby losses are accepted on certain products viewed in isolation in order to be able to earn a profit overall.) *Aquavit* exemplifies the so-called "hypothetical" arm's length price method because it operates with logical premises instead of applying a quantitative transactional transfer price method.

33 See Footnote 43 below.

34 FTC judgement of 17 Oct. 2001 loc. cit. (Fn. 1) sec. III.A.2(d)(ff).

35 Kaminski/Strunk (loc. cit. Fn. 5) state that the October 2001 judgement confirms the requirement that a domestic marketing subsidiary must prepare profit forecasts showing that it will earn an appropriate overall profit. The requirement to which they are referring is one of fact, not of law. The need for profit forecasts is *de facto* not *de jure*. Without such forecasts, taxpayers may find it difficult to rebut the presumption of shareholder-influenced non-arm's length transfer prices.

36 Kaminski/Strunk ibid. note the commercial aeroplane construction industry and the mobile telephone industry as examples of branches that operate under extremely long time frames. It took decades to establish the Airbus as a competitor of Boeing. Japanese corporations are also renowned for their willingness to accept many years of losses in pursuit of their long-term strategies. The October 2001 judgement does not rule out arguments by the taxpayer that its position is analogous. But it does saddle the taxpayer with the burdens of production and persuasion in making its case.

37 The income adjustment need not be determined using this method. Where the available data permits application of another method (e.g. one of the standard methods) and this other method leads to higher income, it takes precedence over the minimum method. The minimum method resembles strongly the estimation method of § 1 (3) AStG, which is presently regarded as a method of last resort.

38 Kaminski/Strunk ibid. sec. III.A.

39 See Footnote 27, above.

40 Wassermeyer writes that "the arm's length standard represents an alternative instrument for imposing compliance obligations on the taxpayer by means of the allocation of evidentiary risks [burden of proof] and effecting classification for tax purposes in accordance with presumptions in the event they [the compliance obligations] are violated" (Wassermeyer loc. cit. Fn. 27 p. 2467/1). The "compliance obligations referred to are *de facto*, not *de jure*, and their "violation" could better be described as the taxpayer's failure to meet the burdens of production and persuasion that are shifted to it. On the same page, Wassermeyer characterises the arm's length standard as "a case of application of rebuttable presumptions based on behavioural generalisations" and states that the arm's length standard "builds upon rebuttable presumptions" (ibid. p. 2467/2).

41 Wassermeyer concedes that the reasoning of prior cases decided by the FTC was "imprecise" in that the court often had recourse to concepts such as the "objective burden of proof" or "*prima facie* proof" (ibid. p. 2467/1). The situations in which German courts have consistently treated payments as constructive dividends (deviation from the arm's length standard or the "reasonable businessman" standard, non-compliance with the special formal requirements established by the court for transactions with controlling shareholders, unusual arrangements between corporations and shareholders, and arrangements the parties do not seriously intend to perform) all constitute circumstances which, in Wassermeyer's view, raise a rebuttable presumption against the taxpayer. The assessment of constructive dividends is then the consequence not of the facts giving rise to the presumption, but of the taxpayer's failure to rebut. Again, Wassermeyer concedes that "the FTC has in the past not always clearly differentiated between the aforementioned categories" (ibid. p. 2467/2).

42 Wassermeyer ibid. stresses the objective nature of the arm's length standard in sec. VI of his essay (p. 2467 ff.).

43 It must be emphasised that both of the key elements of a constructive dividend are presumed under an Aquavit presumption. See text at Fn. 33 above. This contrasts markedly with the presumption triggered by compliance violations. In this case, the court was willing to presume only one of the two key elements (see text at Fn. 21 above).

44 Cf. Footnote 41, above.

45 Wassermeyer ibid. p. 2468/2.

46 The court approvingly cites database studies by Vögele/Crüger and Vögele/Juchems (IStR 2000, 516 and 713 respectively), though it is unclear to which of the three stages of the litigation it is referring in so doing: Stage I (allocation of the burden of proof,

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raising a rebuttable presumption); Stage II (taxpayers attempted rebuttal); or Stage 3 (estimation of constructive dividend where rebuttal is unsuccessful). Presumably, the court's statement pertains to all three litigation stages.

47 Regarding such data, see however sec. VI below.

48 Wassermeyer ibid. p. 2468/1.

49 See articles by Vögele/Bader in *International Tax Review* January and February 2001, pp. 38 and 17 respectively.

50 Wassermeyer writes that "the arm's length standard represents an alternative *instrument for imposing compliance obligations on the taxpayer* by means of the allocation of evidentiary risks [burden of proof] and effecting classification for tax purposes in accordance with presumptions in the event they [the compliance obligations] are violated" (Wassermeyer loc. cit. Fn. 27 p. 2467/1, emphasis added).

51 Cf. FTC judgement of 17 Oct. 2001 loc. cit. (Fn. 1) sec. III.A.1: "To the extent this arm's length price cannot be otherwise determined, it shall be estimated under § 162 (1) sent. 1 AO 1977".

52 Wassermeyer loc. cit. (Fn. 27) p. 2469/2.

53 FTC judgement of 17 Oct. 2001 loc. cit. (Fn. 1) sec. III.A.2(d)(ff). The court's reasoning is that there is no basis in German law for basing the adjustment to income on the average or arithmetic mean of the arm's length range.

54 See sec. IVB above.

55 Kroppen/Rasch/Roeder loc. cit. (Fn. 5).

56 The FTC (loc. cit. Fn. 1 sec. III.A.1) speaks of the taxpayer's failure to rebut the "evidentiary presumption" arising from the deviation of the taxpayer's prices from the arm's length price, but does not explain how the deviation from the arm's length price was established in the first place. Likewise, Wassermeyer refers in his essay (loc. cit. Fn. 27) to the "apparently high price" paid by the taxpayer to its parent (p. 2469/1), but does not explain how one arrived at the conclusion that the price was high. The facts of the case appear to fit those of an Aquavit presumption in the narrow sense (distribution subsidiary, start-up losses etc.), however.

57 FTC judgement of 18 Dec. 1984 - VIII R 195/82 (BStBl II 1986, 226). By characterising the 8th Chamber's comments on point as *obiter dicta*, the FTC avoided procedural complications that would have delayed its judgement and possibly lead to decision of the issue by a specially convened multi-chamber panel of the FTC.

58 FTC judgement of 17 Oct. 2001 loc. cit. (Fn. 1) sec. III.A.2(c)(cc).

59 Kaminski/Strunk (loc. cit. Fn. 5) note that while anonymous data from the tax authorities has been accepted by the courts in the past, e.g. for purposes of determining the value of real estate or the amount of rent for residential property in a certain area, such situations are far less complex than transfer pricing issues.

Italian Ruling on Head Office Expenses

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Globalisation poses a number of new challenges for transfer pricing regulators and specialists. The new paradigm is a boundaryless business world where taxable bases are to a certain extent vanishing and where perhaps even business people may find it difficult to understand the real impact of re-engineering certain processes.

Multinational organisations are by definition "restless". They constantly change the way they operate and the reason why this happens is basically the perceived need to streamline operations trying to evolve in a changing (internal and external) environment with the aim of better implementing their vision and mission. Apart from the obvious politics that every significant business reorganisation carries with it, changes in the organisation structure are sometimes difficult to understand and share even from the inside (i.e., also for some of the executives involved). This may hold particularly true whenever the envisioned strategy does not show an immediate economic return, for instance, in terms of short-run costs reduction, but rather shows today's reorganisation costs against potential future benefits.

In this context the so-called HubCo[1] structures are being more and more explored by multinationals as a way of reconciling/optimising the way business should be (better, it needs to be) with the following consistent level of taxation. HubCo structures trigger, by definition, a real centralisation of functions and risks with a central cost pool to be fairly allocated. The most obvious consequence of this is a growing trend of central costs with a resulting need to allocate those expenses to the local operations and an increased tension on the so-called management fees.

Talking about centralised services, many issues can arise in terms of possible tax exposure from:

- the qualification of the services – specific services rendered centrally on behalf of a number of subsidiaries or mere availability of undistinguished central services (on call services),

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