GERMANY

Global Trading

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1. INTRODUCTION

Germany's transfer pricing environment has changed dramatically during the last three to four years. Although with its original 1983 transfer pricing regulations[3] Germany was one of the first OECD countries to deal with transfer pricing in some detail, it was not before 2003 that the tax authorities were able to introduce transfer pricing documentation requirements in tax law. This legislation is generally considered a direct consequence of an earlier landmark Federal Tax Court ruling in October 2001[4] which made it clear that, in essence, at time of the ruling German tax law did not provide for transfer pricing documentation requirements.[5]

The new rules introduced in 2003[6] provide transfer pricing documentation requirements for fiscal years commencing on or after 1 January 2003. For fiscal years beginning on or after 1 January 2004, non-compliance with the documentation rules may trigger transfer pricing sanctions.[7] These sanctions include penalties of up to 10% of the adjusted amount and a reversal of the burden of proof to the taxpayer. Documentation rules and sanctions are not limited to German taxpayers, but also apply to German permanent establishments (PEs) of foreign taxpayers. On 12 April 2005, the Federal Ministry of Finance (BMF) issued extensive administrative principles on transfer pricing documentation, describing the interpretation of the tax authorities with regard to the documentation requirements.[8]

Against such a historical background, it should not be surprising that the legislative change is also reflected by a change in the taxpayers' behaviour as well as in that of the tax authorities. German-based international financial institutions, as large multinational enterprises, increasingly recognize the need to address transfer pricing and transfer pricing documentation in a coordinated and globally consistent fashion, while tax auditors increasingly focus on transfer pricing in almost all tax audits. At the same time the level of technical and economic sophistication of taxpayers and auditors alike is moving rapidly towards common international standards. A greater emphasis on profit-related transfer pricing methods and the use of financial benchmarking for net margins is the most prominent example of this development.

On the other hand, banks may be considered to have been a vanguard of profit-oriented methods in Germany in the past. Typically, global trading served as one of the very few standard examples for the application of profit splits or residual profit splits in German transfer pricing literature.[9] Traditionally the prerequisites for the application of a profit split method used to be:

- a very high level of operational integration of the various participants in one and the same transaction;
- an inability to allocate costs or revenues to individual transactions in an appropriate (i.e. arm's length) manner; or
- an existence of more than one non-routine intangible employed in such a transaction by more than one owner.

Perhaps it took a sufficiently complex and apparently difficult to understand business model as that of the global trading of financial institutions to justify a deviation from the extreme preference for standard methods at that time. In some cases, high-level representatives of the tax authorities even seemed to be automatically endorsing the applicability of the profit split method for any investment banking activity, implicitly identifying global trading to the latter.

2. EXPERIENCE WITH APPLICATION OF DESCRIPTION IN THE OECD DRAFT

Currently, no explicit regulation of global trading of financial instruments is found in German tax law, but the tax authorities are supposed to work on industry-specific transfer pricing regulations (including the financial services sector). Before the enforcement of the new transfer pricing documentation requirements, the tax authorities had a strong preference for the traditional transaction-

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3. Administrative Principles for the Examination of Income Allocation in the Case of Internationally Related Enterprises (23 February 1983).
4. See Federal Tax Court decision of 17 October 2001, IR 103/00, Bundessteuerblatt II 2004, at 171.
5. Kroppen, Rasch and Roeder, "German Federal Tax Court Issues Landmark Transfer Pricing Decision", *Tax Notes International* (10 December 2001), at 1111.
6. Cf. Sec. 90, Para. 3 of the General Tax Code (AO) and the documentation Decree-Law *Gewinnabgrenzungsaufzeichnungsverordnung* (GAufZ).
7. Sec. 162, Para. 3 and 4 General Tax Code (AO) and Art. 97, Sec. 22 of the introductory act of General Tax Code (EGAO).
8. Administrative Principles for the Examination of Income Allocation between Related Parties with Cross-Border Business Relations in Respect of the Duty of Determination, the Duty of Cooperation, Adjustments, Mutual Agreement Procedures and EU Arbitration Procedures (12 April 2005) (Administrative Principles – Procedures). For a discussion, see Kroppen and Rasch, "New German Draft Ordinance on Transfer Pricing Documentation", *Tax Notes International* (10 January 2005), at 197; Eigelshoven and Nientimp, "German Versus OECD Transfer Pricing Principles – a Recipe for Double Taxation?", *Tax Notes International* (22 August 2005), at 725.
9. See Portner, "Zwischenstaatliche Gewinnabgrenzung – Profit Split in Sonderbereichen", *Internationales Steuerrecht* (1995), at 549; Selling, "Global Trading", *Internationales Steuerrecht* (1998), at 417; Wassermeyer and Baumhoff, *Verrechnungspreise verbundener Unternehmen* (Cologne: 2001), No. 551.

based methods in transfer pricing; other, profit-based, methods where often rejected and officially regarded as inappropriate.[10] The only reference to a profit split in transfer pricing regulations was note 2.4.6. of the Administrative Principles of 1983, which stated that in special circumstances the profit could be split between related parties if a third party had also agreed to such an allocation. In practice, with reasonable economic justification profit splits have been implemented within the transfer pricing system of multinationals in Germany and have also been accepted by the tax authorities.

The new Administrative Principles – Procedure of 2005 are somewhat clearer on profit splits, as they now explicitly allow the profit split method in cases where more than one entrepreneur is involved in a transaction.[11] The tax authorities even mention global trading as an example to apply a profit split, and also refer to Secs. 3.1 and 3.5 of the OECD Transfer Pricing Guidelines (OECD Guidelines). From a German transfer pricing perspective, the application of a profit split is not limited to the global trading of financial instruments. A profit split could in principle apply to all other business models with more than one entrepreneur involved in initiating, conducting and completing a transaction, but where the individual contributions of a party could not be identified.

As published rulings in German tax law, administrative principles or tax court rulings on global trading are not available, the general arm's length principle and transfer pricing regulations or PE profit allocation rules apply. With the absence of specific German rules, the OECD papers are often used as guidance in day-to-day tax work. In competent authority or arbitration procedures and APA negotiations, the tax authorities regularly take the OECD papers into consideration as well. As the tax authorities put aside their former reluctance with regard to profit-based methods, the acceptance of profit splits in global trading situations is expected to increase further in the future. The mentioning of global trading (without further guidance) as an example of a business model justifying a profit split in the 2005 Administrative Principles – Procedures should be regarded as very helpful in this context and confirms the OECD approach and the opinions published in German tax literature.[12]

For tax purposes, the OECD Discussion Draft Part III[13] distinguishes between three types of global trading, namely separate-enterprise trading, centralized product management and integrated trading. Generally speaking, all of these types of trading can be found within financial institutions in Germany. In practice, often models other than these three pure or standard models are used; business models, as well as the function and risk allocation between involved entities, usually deviate from the pure or standard types and may even be more complex. The German banking environment is comprehensive, with various global national and international institutions operating in Germany. The variety of banking business ranges from small, highly specialized banks acting in specialized markets, to the globally active banks doing business in virtually all markets. Banks present in Germany are active in the full range of banking business and, in view of global trading, perform all functions discussed in the OECD draft. Within financial institutions in Germany involved in global trading, one finds different business models, trading organizations and risk management models. Generally, sales and trading functions, as well as for example structuring and risk management, are common within German banks. Furthermore, all middle- and back-office functions can be found in German entities or branches as well.

The financial products for which the three pure or standard models are used are much the same in Germany as in other major international banking locations. The integrated trading model is often used for foreign exchange (F/X) business in the major currencies and certain derivatives, while the centralized product management and separate-enterprise trading model are often used for more localized products (e.g. European equities). However, the business model also strongly depends on the overall strategy of the relevant bank, and particularly specialized institutions often have customized trading organizations.

3. FUNCTIONAL ANALYSIS AND BENCHMARKING

One of the basic transfer pricing documentation requirements in Germany is a functional and risk analysis with a description of the value chain of the taxpayer's business. Such an analysis would be the basis for any transfer pricing analysis of a bank's global trading business. There exist only general rules for the functional analysis, which should contain a description of the type, content and scope of related cross-border transactions, as well as indicating the economic and legal conditions of such transactions.[14] In particular, the functional analysis should enable the reader to understand the determination of the transfer prices employed by the taxpayer.

Despite the absence of more precise guidance in the German regulations, it is generally advisable for a taxpayer to take into account the model description used by the OECD in the text of the draft. Practical experience suggests that the majority of cases can in fact be described by using a combination of the different activities and risks referred to in the draft. In addition, because the functional and risk analyses will be addressed to at least two different tax authorities, a high degree of recognition of OECD guidance will generally be helpful in discussions with local tax auditors. This will serve to minimize any appearance of

10. See press release of the Federal Ministry of Finance, *Internationales Steuerrecht* (1995), at 384.
11. Note 3.4.10.3. c) Administrative Principles – Procedures.
12. See Portner, "Zwischenstaatliche Gewinnabgrenzung – Profit Split in Sonderbereichen", *Internationales Steuerrecht* (1995), at 549-551; Selling, "Global Trading", *Internationales Steuerrecht* (1998), at 417-423; Menzel, "Global Banking/Global Trading. Das Verrechnungspreissystem der Dresdner Bank AG". *Verrechnungspreissysteme multinationaler Unternehmen*, edited by Raupach. (Herne-Berlin: NWB-Verlag, 1999) at 175-191; Häuselmann, "Grenzüberschreitender Wertpapierhandel unter Einschaltung von Auslandsniederlassungen und Tochtergesellschaften", *Internationales Steuerrecht* (2003), at 139-144.
13. OECD Discussion Draft on the Attribution of Profits to Permanent Establishments (PEs: Part III (Enterprises Carrying on Global Trading of Financial Instruments)).
14. 3.4.11.1 Administrative Principles – Procedures.

arbitrariness in the taxpayer's documentation and transfer pricing approach.

However, it will likely be useful to also take into account certain specific aspects of the new Administrative Principles – Procedure in light of the selection of transfer pricing methods relative to the entrepreneurial characteristics of a taxpayer. The regulations identify three types of companies for the application of the transfer pricing method.[15]

The first group of companies performs only *routine functions*, for example as limited-risk distributors or contract manufacturers. Pure service providers (e.g. in the back office) are also likely to be classified as performing such low-risk routine functions. The tax authorities assume that this type of company will derive a rather steady profit from its activities. For this group of companies, the transactional net margin method (TNMM) is fully applicable if no CUP, cost-plus or resale price method can be used. A proper benchmarking for those functions is essential to determine the arm's length remuneration.

The second group of companies consists of so-called *entrepreneurs* or *strategy leaders*. These companies own substantial non-routine intangibles and their profits are determined by these specific intangibles. Therefore, no reliably comparable companies are available for the application of the TNMM or the traditional, transaction-based methods. The entrepreneur typically receives the residual income from the transaction. If more than one entrepreneur is involved and no CUPs are available, a profit split could apply.

The third group of companies is the so-called *middle companies*. It seems that in other industries, a fully fledged distributor or a manufacturer licensing its intellectual property will fall into this category. The TNMM is not applicable to such companies, according to the tax authorities, because allegedly no comparable data are available. If no other method could be used, the arm's length price must be determined based on the company's budget data. Otherwise, the taxpayer might be exposed to transfer pricing sanctions.

Another aspect that must be taken into account is the allocation of equity to the banking PE involved in the global trading business. Here at least the basic principles of the OECD Working Hypothesis (WH) seem to appear most clearly in German transfer pricing regulations for PEs. In September 2004, the tax authorities released regulations on the allocation of equity to banking PEs.[16] From a regulatory perspective, German branches of international banks do not necessarily need to show own regulatory equity depending on the location of the bank's head office. However, as there are rules regarding the minimum capital requirement for operations in Germany, the September 2004 regulations basically stipulate that to determine an adequate (i.e. arm's length) equity capital dotation of a banking PE, the non-tax regulatory rules that apply to legal entities conducting banking business should be applied to the branch for tax purposes, as well. Hence, the tax authorities are primarily treating a PE like a separate and distinct enterprise, claiming that for tax purposes the capital adequacy requirements should be applied in the same manner to PEs as to separate legal entities.

The use of the general capital adequacy rule for PEs also leads to a stronger emphasis of risk for tax purposes. As the standard regulatory rules take into account different risk classes for assets that lead to different capital requirements, the future trend is already towards asset-specific risk weightings based on a wider use of individual credit ratings and the bank's proprietary risk management models. In the wake of this development, the standards that are applied to the allocation of banking assets for global trading, but also including other banking business, are increasing as well. For example a number of banks are now investigating or implementing internal transfer pricing guidelines using balanced scorecard approaches to determine an arm's length allocation of such assets.

4. APPLICATION OF TRANSFER PRICING METHODS

Historically, standard transactional transfer pricing methods have been favoured by the tax authorities. As discussed above, developments in recent years have to a certain extent reversed this tendency in favour of profit-based methods. The new transfer pricing regulations on procedures refer to net margin approaches in a number of prominent instances. For example:

- the use of the TNMM is explicitly allowed to price routine functions under certain conditions;[17] and
- the example on the computation of inter-quartile ranges uses database search results for a net operating margin.[18]

The strong preference for standard methods in the past in some cases let to situations in which, for example, a CUP method was applied and accepted by the tax authorities even though under a strict application of OECD standards, the CUP data may not have been regarded as comparable. If such a set-up is attacked by foreign tax authorities or if a bank seeks to revise its approach and changes to another transfer pricing method, discussions with the German authorities in tax audits are to be anticipated.

Compared to other industries, the financial services industry perhaps offers the widest range of comparable data for the application of the CUP method. This is not only because of the widespread existence of quantitative market data and the existence of a body of detailed, relevant economic theory, but also because in recent years the financial sector has also experienced an increasing trend of cooperation among unrelated parties (thereby leading to the existence of third-party service fees or commission rates). However, the current trend appears to be directed towards a more regular use of profit-based methods (also including the TNMM). Thus, Germany is continuously moving towards international standards in the application of transfer pricing methods, and this should also be

15. See also Eigelshoven and Nientimp, "German Versus OECD Transfer Pricing Principles – a Recipe for Double Taxation?", *Tax Notes International* (22 August 2005), at 725, for a detailed discussion.

16. Principles on the Allocation of Dotation Capital of Internationally Active Banks (29 September 2004).

17. Tz. 3.4.10.3 b) Administrative Principles – Procedure.

18. Tz. 3.4.12.5 d) Administrative Principles – Procedure.

reflected in easier procedures during competent authority proceedings, arbitration proceedings and bilateral or multilateral APAs.

The OECD makes it clear at various places in the draft that the appropriate transfer pricing method will ultimately depend on the results of the economic analysis of a given bank's business model and business strategy that is to be documented. Nevertheless, the three basic types of global trading (i.e. separate-enterprise trading, centralized product management and integrated trading) in their pure form will typically encourage the use of different transfer pricing methods in view of the key entrepreneurial activities (usually trading and risk management).

Assuming a simplified but not uncommon set-up (i.e. with trading and risk management being the dominant entrepreneurial functions, and the remaining functions consisting of low-risk, routine service activities), in practice the transfer pricing methods applied to the trading and risk management functions are likely to vary depending on the respective type the bank has chosen for its global trading business. While under the separate-enterprise model and the centralized product management model, conceptually only one entrepreneurial economic agent is responsible for either all its books or for one exclusive book, a multi-entrepreneurial set-up in principle occurs only under the integrated trading model. Thus, under both the separate-enterprise model and the centralized product management model, the low-risk, routine service providers should receive their remuneration based on either standard transfer pricing methods (e.g. CUP or cost-plus) or the TNMM in the event that the standard methods not be applicable.

Such a transfer pricing system design should basically allocate the residual profit to one location. It is only under the integrated trading model that a need arises to attribute such residual profit to more than one location responsible for trading and risk management. Under such a scenario, the profit split method should be an acceptable transfer pricing method to apply. In fact, the new German regulations refer to global trading as an exemplary business model that would justify the use of the profit split method.[19] This would generally be in line with the OECD draft.[20] Even though the regulations do not make a distinction between the three types of global trading defined in the OECD draft, the application of the profit split method to the separate-entity model and to the centralized production model will normally not be acceptable if the application of standard methods were possible.

If a profit split approach is applied, the documentation of the arm's length nature of the pricing mechanism will refer to the arm's length nature of the allocation key used for the profit split. Both German literature and practical experience suggest that the most common allocation keys are still based, in principle, on the adjusted compensation of key global trading personnel. Such a key would also be in line with the suggestions of the OECD draft.[21] It is only recently that individual German authors have suggested alternative keys such as value at risk.[22] As far as the other types of global trading are concerned, in some cases a CUP method is applied to transactions between entrepreneurially active parts of an enterprise. In these instances, very often transactional market data from the non-tax regulatory monitoring systems of the bank may be usable.

Another aspect that impedes the full application of the OECD's WH is the current status of 1999 German regulations on the treatment of PEs. These regulations stipulate that not all transactions between head offices and PEs may be at arm's length prices. Instead, the application of the arm's length principle and thus the WH is limited to core economic activities of a taxpayer. The most relevant limitation stemming from this is the treatment of routine support activities. To the extent that they were considered non-core or auxiliary activities, it could be argued under the German PE regulations that only a cost allocation should apply without any profit mark-up. Similarly, the use of tangible (e.g. centralized, physical information technology infrastructure) and intangible property (e.g. proprietary software systems for the pricing of financial instruments) by the various PEs involved may also only be remunerated at cost. In this respect, prevailing German regulations may limit the room for manoeuvre of an international banking organization when it comes to the design of its transfer pricing system.

In line with Secs. 123 ff. of the OECD draft, routine activities and functions should normally fall under the scope of standard methods like the CUP method or the cost-plus method if the necessary third-party data are available. However, as indicated above, the new German regulations also allow the use of the TNMM in the case of low-risk, routine activities. As a first precondition for the application of the TNMM, it must be verified that standard methods will not be applicable because of a lack of usable third-party data. Second, the regulations indicate that the activities to be benchmarked must be limited to routine transactions that can also be consolidated to one uniform activity or transaction. Finally, it must be documented that the comparable companies used in the benchmark are sufficiently comparable to the tested party. In the financial services industry these three conditions will be met in a large number of cases. Hence, there is some expectation that in line with the trend in other industries Germany will witness an increasing number of global-trading transfer pricing systems that will rely on net margins or the TNMM as the method of choice for routine support activities.

Another not uncommon approach to allocate the cost of routine support activities is to use a cost contribution arrangement in line with Chap. VIII of the OECD Guidelines. German transfer pricing regulations support a basis for the pooling of costs and their subsequent allocation without a profit mark-up for auxiliary activities undertaken for the mutual benefit of all pool members.[23] From a German perspective, a major benefit of such an approach for a mixed banking organization consisting of branches as

19. Tz. 3.4.10.3 c) Administrative Principles – Procedures.
20. Sec. 240 OECD Discussion Draft Part III.
21. Id., Sec. 170 ff.
22. Reinhardt, *Erfolgsabgrenzung im Global Trading* (Hamburg: Dr. Kovac 2003).
23. Sec. 1.1 Administrative Principles on Auditing Cost-Sharing Arrangements between Internationally Related Enterprises (30 December 1999).

well as of separate legal entities, is the fact that a cost contribution arrangement can interface between the partially different standards applied to pricing for these activities between the PE on the one hand, and the strict application of the arm's length test (including a profit element) for separate legal entities on the other This category includes not only general head-office functions or functions of a bank which could be considered as support or auxiliary activities compared to the core banking activities (e.g. human resources, audit, legal and tax departments), but also certain general or group-wide risk management or treasury functions as well as several information technology and infrastructure functions.

From a practical point of view it should also be noted that the use of a cost contribution arrangement will as well require to make documentation available to taxpayers that are charged costs under those arrangements, which is providing sufficient detail regarding the costs that are allocated. The same is true for any transfer pricing method that is cost based.

5. CONCLUSION

German transfer pricing rules have been significantly overhauled in recent years. In this process, it appears that Germany has moved closer to OECD standards than had been the case in the past. Indications of this include a greater openness towards non-standard profit-based methods (e.g. the TNMM) and increased reference to OECD Guidelines in the German regulations. However, it is unlikely that Germany will follow other OECD member countries that literally transformed OECD regulations into national law.

Nevertheless, in view of the OECD Discussion Draft Part III on global trading of financial instruments, taxpayers are well advised to follow closely the discussion at the OECD level and also basically rely on this discussion for their planning in cases of doubt where they do not explicitly oppose domestic legislation. This should be advantageous not only in the case that international negotiations between national tax authorities become necessary (e.g. arbitration procedures, competent authority procedures and APAs), but there is also a certain expectation that Germany may increasingly adopt the essentials of the OECD working hypothesis in the future.

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DOCUMENTATION

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