Transfer Pricing Circular[1]

(BStBl 1983 p. 218)

The Federal Minister of Finance

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Ministers of Finance (Senators of Finance) of the German Länder

Ref.: Principles for the Examination of Income Allocation in the Case of Internationally Associated Enterprises (Administration Principles)

Ref.: discussions with the highest tax authorities of the German *Länder*

a) meeting with the tax officials ASt III/82, point 4 of the agenda
b) meeting with the heads of department (tax) on 10/11 January 1983, point 11 of the agenda

With reference to the results of the discussions held with the representatives of the highest tax authorities of the German *Länder*, the following shall apply to the question as to which principles should govern the review of international income allocation on the basis of the arm's length standard in the provisions of domestic law and of double taxation conventions:

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[1] This translation is provided merely for information purposes. Only the German language version is authoritative for the application of the law.

1. The Legal Basis for Income Allocation

1.1. *Allocation Rules of Domestic Tax Law*

1.1.1. If a taxpayer has business relations with related persons (cf. m.no. 1.3) then it should be examined whether his income is fully accounted for, i.e. whether it is correctly allocated internationally (income allocation) pursuant to the arm's length principle (cf. m.no. 2.1.). The

governing rules (allocation rules) therefore are

a) constructive dividends (section 8 (3) KstG) (m.no. 1.3.1.1.),

b) constructive equity contributions (m.no. 1.3.1.2.), and

c) the adjustment of income in the case of business relations with foreign countries (section 1 AStG) (m.no. 1.3.2).

1.1.2. The general rules on the attribution of business assets and income as well as those on the determination of the tax basis (e.g. sections 39-42 AO) take precedence over the allocation rules.

1.1.3. The allocation rules under their legal prerequisites are independent of one another and may apply concurrently. If the conditions of a constructive dividend, or a constructive equity contribution or of section 1 AStG are met at the same time, then the amount of the adjustment should be treated according to the income tax principles regarding constructive dividends, or constructive equity contributions.

1.1.4. This circular contains general principles for the examination of the international income allocation. In applying this circular, all circumstances of the individual case should be considered; they include e.g. special circumstances due to the structure of markets or of supply, the structure of the enterprise, government measures and customs of trade. The general principles for tax audits (e.g. on disclosures and examination of the facts also in favour of the taxpayer) as well as rules for their rationalisation remain unaffected.

1.1.5. The highest tax authorities of the German Federation and of the German *Länder* will issue instructions in order to

a) pay due regard to the results of international understandings regarding the arm's length principle in certain areas, or

b) safeguard the principle of reciprocity for the protection of enterprises resident in the Federal Republic of Germany.

1.2. *Allocation Clauses of Double Taxation Conventions (DTCs)*

1.2.1. The DTCs contain clauses regarding income allocation which conform with the arm's length principle (cf. in particular paragraph 1 of Article 9 of the OECD Model Convention). They do not directly establish any tax liability (BFH-decision of 12 March 1980, BStBl II p. 531). They do however permit the international, uniform application of the arm's length standard. The allocation rules of German domestic tax law (in particular section 1 AStG) also remain applicable in those cases of related interests which are not mentioned in the allocation clauses of the DTCs. It does not comply with the sense and purpose of the DTCs if income adjustments which are required under the facts would be prevented in certain cases.

1.2.2. The allocation clauses of the DTCs enable the German and foreign tax authorities to allocate income on the common legal basis of the convention. According to German treaty interpretation, mutual agreement or consultation procedures may be initiated for this purpose. For the aspects of taxpayers' protection which have to be considered in this context see BFH-decision of 26 May 1982, BStBl II p. 583.

1.2.3. On the basis of a mutual agreement or consultation procedure:

a) income which has been taxed in the Federal Republic of Germany may also be reduced to allocate income in both countries uniformly;

b) it may be determined that the uniform allocation shall be carried out irrespective of the binding effect of a German tax assessment notice,

if double taxation cannot be prevented in any other manner (cf. Article 25 of the OECD Model Convention in conjunction with section 2 AO, as well as BFH-decision of 1 February 1967, BStBl III p. 495).
In this context the German tax authorities take into account the principle of reciprocity.

1.2.4. The German tax authorities may also initiate mutual agreement procedures for the joint allocation of income if there is no DTC, if a DTC does not include an allocation clause, or if an existing allocation clause does not cover the relevant income allocation.

1.2.5. The taxpayer shall be granted the opportunity to inform the other persons affected by a proposed adjustment in due time so that they can discuss with the relevant tax authorities the effects which the proposed adjustment will have on their tax liability. The tax offices will issue such confirmations as required abroad.

1.2.6. If a foreign tax authority informs the foreign related person of a proposed adjustment, then, even before the mutual agreement procedure is implemented, the domestic related person is, upon application, to be given the opportunity of discussing with the domestic tax authority the effects which the proposed adjustment will have on its tax liability. If the tax authority needs to undertake a tax audit before taking a position then the tax audit may be started as early as circumstances permit. The enterprise has to submit all documents which are necessary for the evaluation, and in particular those regarding the measures proposed by the foreign tax authorities.

1.3. *Prerequisites for Income Allocation with Respect to Related Persons*

1.3.1. **Constructive Dividends and Constructive Equity Contributions**

1.3.1.1. A constructive dividend occurs if, independently of any profit distributions made pursuant to corporate law, a corporation confers a benefit on a shareholder or a person related thereto and the benefit is conferred as a result of the shareholding relationship. The amount of the participation is usually not relevant. For further details cf. Part 31 KStR.

1.3.1.2. A constructive equity contribution occurs if a benefit capable of being treated as a contribution to capital is conferred on a corporation by a shareholder or a person related thereto and the benefit is conferred as a result of the shareholding relationship. For further details cf. Part 36a KStR. If a benefit may not be treated as a constructive equity contribution, for example, because it is not capable of being treated as a contribution to capital, then in appropriate cases an adjustment is to be made pursuant to section 1 AStG.

1.3.2. **Adjustment of Income within the Meaning of section 1 AStG**

1.3.2.1. An adjustment may be made in all cases of income reduction where there are foreign business relations and those involved are related
through a substantial participation (m.no. 1.3.2.2.),

- through a controlling influence (m.no. 1.3.2.4.),
- through particular means of influence (m.no. 1.3.2.6.), or
- through identity of interests (m.no. 1.3.2.7.).

Business relations of partnerships, associations and similar entities as such with related corporations shall also be assessed under section 1 AStG in a given case.

1.3.2.2. The relationship through substantial participation is possible not only through participation in corporations but also through participation in partnerships and through participation in a sole proprietorship. It may also take the form of a silent partnership or a loan arrangement which is

similar to a participation.

1.3.2.3. For purposes of calculating the extent of the participation in a case where a person indirectly participates in a company, the participations held by an intermediate company are to be taken into account in the proportion of the participation held directly or indirectly by that person in the intermediate company and the aggregate of the participations in that immediate company.

1.3.2.4. The relationship through a controlling influence may be based on legal or factual circumstances or a combination of both. Individuals may also be under the controlling influence of others. The relationship is already established through the mere possibility of exercising a controlling influence.

1.3.2.5. The relationship through a controlling influence may be based in particular on

1. rights similar to participations;
2. enterprise agreements within the meaning of sections 291 and 292 AktG, integration within the meaning of section 319 AktG, the grouping of several enterprises under a single management within the meaning of section 18 AktG, reciprocal participations within the meaning of section 19 AktG;
3. direct or indirect participation by the same persons in the management or control of two enterprises; or
4. the subordination of two enterprises to the controlling influence of a third enterprise.

1.3.2.6. A relationship through particular means of influence requires that the influence of the person or the taxpayer extends to the business relationship concerned. The relationship is already established by the mere possibility of such influence. The possibility of exercising influence through others, e.g. through related companies (section 1 (2) no. 1 and 2 AStG) suffices.

1.3.2.7. The relationship through identity of interests exists if e.g. the business or personal interests of the person or taxpayer himself refer to the income which is being considered for adjustment.

1.4. *The Legal Form of the Business Relations between Related Enterprises*

1.4.1. If an enterprise deducts as business expenses expenditure incurred for the benefit of a related person it has to be examined whether the expenditure have a business cause or whether they are legally founded in the shareholding relationship.
With respect to a controlling shareholder business expenses may usually be allowed only if the expenditure is based on clear and unequivocal agreements entered into in advance (BFH-decision of 3 November 1976, BStBl II 1977, p. 172 or exceptions cf. BFH-decision of 21 July 1982, BStBl II, p. 761). The same applies with respect to sister corporations. In the ordinary course of transfers of goods and services, the same formal requirements are applicable as in business transactions between third parties.
In the remaining cases it is sufficient that the expenditure is based on arm's length obligations.

1.4.2. If an enterprise, in its business relations with a related person, waived consideration which it would have claimed on an arm's length basis, the absence of agreements to this effect does not prevent an adjustment.

1.4.3. If an adjustment is made in one country in the case of the lack of clear and unequivocal agreements and, because of the absence of such agreements, a deduction is not possible in the other country then m.no. 1.2.3. applies with respect to the resulting double taxation.

1.4.4. On the question of evidence cf. m.no. 9.

1.5. *Business Relations with Related Persons in Low Tax Areas*

1.5.1. When examining the income allocation with respect to related persons in low tax areas, the relevant provisions (e.g. sections 39-42 AO) as well as the administrative directives issued thereunder must be observed. The special circumstances which have to be considered in the evaluation (cf. e.g. m.no. 2.1.3. 4th sentence, m.no. 2.1.8. 4th sentence) must be clarified by the taxpayer in accordance with section 16 AStG, section 90 (2) AO. In such cases m.no. 2.4.3. and 2.4.6. are in principle inapplicable.

1.5.2. The allocation rules also apply to business relations with interposed companies within the meaning of section 5 and with intermediate companies within the meaning of sections 7-14 AstG respectively.

2. General Principles for Income Allocation

2.1. *The Arm's Length Principle as Standard for the Income Allocation*

2.1.1. Business relations between related persons should be evaluated for tax purposes according to whether those involved have acted like third parties independent of each other (arm's length principle). The standard thereby are the relations of free competition. The underlying principle is the ordinary prudence exercised by a sound and conscientious business manager (cf. e.g. BFH-decision of 16 March 1967, BStBl III p. 626 and BFH-decision of 10 May 1967, BStBl III p. 498) vis-a-vis unrelated parties.

2.1.2. The income allocation is in principle to be based on the relevant business transaction with the related person. The economic substance of the actual relations is decisive (cf. BFH-decisions of 30 July 1965, BStBl III p. 613, of 26 February 1970 BStBl II p. 419, and of 15 January 1974 BStBl II p. 606, cf. also m.no. 3.1.3. example 3).

2.1.3. In allocating income, the functions of the individual related enterprises have to be considered. For this purpose particular importance is given to:

- the structure, organisation, division of responsibilities and allocation of risk within groups as well as the attribution of business assets;

which enterprises undertake individual functions (production, assembly, research and development, administration related services, sales, services); and

- in what capacity the enterprises undertake these functions (e.g. whether as dealer, agent, or as participant on an equal basis in, or representative of a pool). The economic substance of the actual activity is decisive (cf. m.no. 2.1.2.). No consideration may be allocated to enterprises performing no functions at all; in the case of enterprises performing insignificant functions, only economic performances actually rendered may be considered, e.g. in general by means of a cost-oriented consideration (cf. m.no. 2.2.4.).

2.1.4. The allocation is to be determined according to the consideration which would have been agreed by third parties for similar supplies of goods or services (hereinafter: "arm's length price") or according to the revenue or expenditure which would have accrued to or been incurred by the taxpayer had he been dealing at arm's length. The starting point here is that, in general commercial practice, the individual supply of goods and services between independent parties are, as a rule, the subject of separate business relations, i.e. they are agreed and accounted for separately. Standard terms agreed between related persons are nevertheless to be acknowledged as such; if one single consideration is charged for several supplies of goods or services then there is no objection to this if the aggregate consideration can be apportioned to the individual constituent supplies, or if unrelated parties would also agree on such aggregate prices. If there are several business agreements then m.no. 2.3. applies (the set-off of benefits).

2.1.5. In establishing arm's length prices, the data on the basis of which prices are determined in the market between third parties should be used. The prices in the market in which third parties would negotiate the business terms are decisive.

2.1.6. The following are, accordingly, the most relevant criteria for the determination of arm's length prices:

a) quoted market prices, standard trade prices determined in the relevant market (market prices), as well as other information about the market;

b) prices which the taxpayer, the related person or third parties have actually agreed for of corresponding supplies of goods or in the relevant market;

c) profit mark-ups, methods of costing or other business principles which influence the pricing in a free market (business data).

2.1.7. These data should be adequately adjusted, if necessary, to adapt them to divergent terms of the individual business transaction concerned, which are of importance in determining the arm's length price (example: market prices for goods of a standard quality are converted using a normal trade method to find a price for categories of goods for which no particular market price exists; c.i.f. market prices are to be adjusted as appropriate for business conducted on a f.o.b. basis). Customary commercial volume discounts have to be considered for.

2.1.8. A sound business manager will deduce the transfer price with the necessary diligence from the data which are available or which are accessible to him (cf. BFH- decision of 10 January 1973, BStBl II p. 322, cf. also m.no. 2.1.1.).
In this respect, he has the discretion in evaluating the situation and making his business decision which results from his participation in the general commercial activity and from the state of the market. On the other hand, the management of a taxpayer enterprise has to protect the enterprise's own interests vis-à-vis related persons and the group as a whole in the same way as it would versus third parties. The exercise of such discretion requires that the overall frame of reference matches the normal practices of the business operation, of the sector or of commercial activity generally.

2.1.9. The following examples illustrate the application of the principles:
Example 1
There is often only a range of prices available in the market for the determination of the arm's length price, within which independent market participants negotiate the price for individual business transactions on a case by case basis. Two related enterprises systematically determine the prices agreed between them at the upper or lower limits of the range without commercially justifiable reasons, whereby the profits of the disadvantaged enterprise are continuously reduced. A sound business manager of the disadvantaged enterprise would not accept such systematic determination of prices but would, in the interest of his own enterprise, be concerned with achieving a more balanced method of pricing. Therefore the income of the disadvantaged enterprise has to be adjusted.
Example 2
A distribution enterprise located in a low tax jurisdiction is interposed in the export activities of a German enterprise. Whenever goods are supplied to this enterprise, advantage is taken of the commercial discretion in such a way that the gross profit accruing to the distribution enterprise is unreasonably high given its function. A sound business manager of the disadvantaged German enterprise would not accept such an arrangement. The income has to be adjusted.

2.2. *Standard Methods for the Examination of Transfer Prices*

2.2.1. The standard methods described in the following are the most important criteria in the examination of transfer prices (cf. m.no. 2.4.1.).

2.2.2. **Comparable Uncontrolled Price Method**

The price agreed between the related persons is compared with prices which have been agreed in the market for comparable business transactions between unrelated parties.
This can be achieved (cf. m.no. 2.1.6. above) through:

a) external price comparison (comparison with market prices which can be established by means of market quotations, prices applying in the particular sector, or prices concluded between independent third parties);

b) internal price comparison (comparison with market derived prices which the taxpayer or a related person has agreed with third parties).

The business transactions compared should, as far as possible, be of the same kind (direct price comparison). Business transactions not of the same kind may be used if the effect of the deviating factors can be eliminated and the price agreed for such business transactions can be converted, pursuant to m.no. 2.1.7., into a price for the business transaction being compared (indirect price comparison; example: conversion of c.i.f. prices into f.o.b. prices).

2.2.3. **Resale Price Method**

This method takes the price at which goods purchased from a related person are resold to an unrelated buyer. The resale price is recalculated into the price which should be set for the supply of the goods between the related parties. For this purpose the resale price is adjusted to take account of normal price reductions customary in the market which reflect the function and risk of the reseller; if the reseller has processed or otherwise altered the goods then this is to be taken into account by appropriate price reductions. If goods are transferred through an entire chain of related persons then in certain circumstances a calculation can be made commencing with the (market derived) price for the final delivery to a third party and working back along the whole chain to its starting point. This applies correspondingly in the case of the supply of services.

2.2.4. **Cost Plus Method**

This method takes in the case of the supply of goods or services between related persons, the costs of the manufacturer or the supplier of services. These costs are determined by using the methods of calculation on which the supplying person also bases its pricing policy towards third parties or – if no supplies of goods or services are made to unrelated parties – which corresponds to business principles. Then, profit mark-ups customary in the business operation or in the segment of industry are made. In case of the supply of goods or services through a chain of related persons, this method has to be applied to each stage in turn, taking into account the actual functions (m.no. 2.1.3.) of the individual related enterprise.

2.3. *Set-off of Benefits*

2.3.1. The set-off between a taxpayers's beneficial and disadvantageous business transactions with related parties is only permitted if unrelated parties would have made such a set-off in their business transactions with each other. Accordingly, the benefits should be set-off against the disadvantages if in business transactions with its related party the taxpayer has accepted disadvantageous conditions, with a view to receiving compensating benefits from the related party within the overall framework of the business relationship under consideration.

2.3.2. The set-off of benefits under m.no. 2.3.1. requires that:

the relevant business transactions are related to each other in such a way that permits the conclusion that the taxpayer would have also concluded the business transactions with the same person under arm's length conditions;

the benefits and disadvantages resulting from the individual business transactions can be quantified with the degree of care of a sound business manager; and

the set-off was agreed upon or was part of the commercial basis of the disadvantageous business transaction (BFH-decision of 8 June 1977, BStBl II, p. 704).

2.3.3. If the disadvantageous conditions have not been set-off during the financial year in which they had their impact then a set-off is only permitted if, at the end of the financial year at the latest, it is established when and against which benefits the disadvantages are to be set-off. The disadvantages must be set-off within the following three financial years. If the performance

resulting in a benefit is capitalised, this also constitutes a set-off.

2.4. *Application of the Methods*

2.4.1. There is no order of priority of the standard methods for the examination of transfer prices applicable to all groups of cases. The examination is based on the transfer prices determined by the enterprise. In examining the appropriateness of the method and application, it is to be assumed that a sound business manager

a) will be guided by the method which approximates most closely the circumstances under which arm's length prices are determined in commercially comparable markets;

b) in cases of doubt, will be guided by the method for which the most reliable relevant data on prices are available, derived from the actual conduct of the related enterprises concerned in their business transactions with third parties.

In this respect, the circumstances of the individual case must be considered.

2.4.2. Market conditions will often make it necessary to consider several methods in the determination of transfer prices. Accordingly, it is not objectionable if the standard methods are tailored to the circumstances of the particular case, combined or complemented by other elements to take proper account of the market conditions. In the examination of transfer prices several standard methods may be utilised.

2.4.3. Related enterprises often determine their transfer prices on the basis of generally applicable calculations of costs or calculated values or other similar methods of computation, or on the basis of centrally collected data. Such computation systems may be used as the basis for the examination of income allocation if they lead, with adequate accuracy, to the results which would follow from arm's length dealing. This requires that:

a) the computation systems are sufficiently differentiated and their details and application can be easily and comprehensively verified,

b) the computation systems ensure the requirement of correct and comprehensive inclusion of domestically earned income, and

c) at adequate intervals, the enterprises concerned examine the values and data included in their computation systems and adopt them to changed circumstances.

The computation systems should be examined as to their consistency and their appropriate application to the individual business transactions. In this respect, m.no. 2.3. should be observed.

2.4.4. In applying these principles:

a) the starting point are the actual functions of the related enterprises in the group;

b) an enterprise may not rely on a standard method which is in contrast to the given circumstances of the market and of the enterprise itself;

c) an enterprise may only rely on the application of a particular method for which it submits the required documentation;

d) an enterprise should not depart arbitrarily from an appropriate method of determining its transfer prices and from appropriate computation systems.

2.4.5. In applying the above principles, the business results which the taxpayer, related or third parties have achieved under comparable business conditions from comparable business transactions with third parties may be considered to determine special areas of examination, verify transfer prices or obtain supplementary criteria for the income allocation. The aggregate results of connected divisions of the business operation and their apportionment to the individual divisions within a group of enterprises may also be considered for these purposes. The income allocation may be based on the results within the meaning of the 1st and 2nd sentences alone if, because of special circumstances (e.g. where goods or a category of goods are predominately acquired or produced, processed and distributed solely within vertically structured groups of enterprises), the application of the standard methods would not lead to adequate results; the same applies the cases mentioned in m.no. 2.4.6. and where an estimate is made (e.g. under section 1 (3) AStG).

2.4.6. In special cases it is not possible to compare the actual circumstances with a similar situation among third parties, above all where, applying m.no. 2.1.1., business relations of that kind would not have occurred between third parties or would only have occurred with a substantially different commercial content. In such cases, the income allocation should be based on the adequate apportionment of the income arising from the business relations which sound business managers would have agreed.

3. Supply of Goods and Services

3.1. *Supply of Goods and Merchandise*

3.1.1. Basic Principle

If an enterprise supplies goods or merchandise to a related enterprise then the arm's length price is that price which third parties for the supply

- of similar goods or merchandise
- in comparable quantities
- to the same sales market
- at a comparable market level and
- at comparable terms for supply and payment

would have agreed, under the conditions existing in commercially comparable markets. M. no. 2.4.1. applies for the application of the standard methods.

3.1.2. Authoritative Conditions

3.1.2.1. All the circumstances of the individual case should be considered in examining the transfer price. The examination should be based in particular on:

1. the special kind, characteristics and quality as well as the innovative potential of the goods and merchandise supplied;
2. the conditions of the market in which the goods or merchandise are used, consumed, treated, processed or sold to third parties;
3. the functions and the market levels actually assumed by the enterprises involved (cf. m.no. 2.1.3.);
4. the supply agreements, in particular, liability conditions, periods of payment, rebates, discounts, the bearing of risk, warranty etc.;
5. in the case of long-term supply arrangements, the associated benefits and risks;
6. special circumstances of competition (cf. e.g. m.no. 3.1.2.4. 2nd sentence).

The conditions existing at the time the contract was concluded are authoritative; in the case of long-term contracts it is, however, necessary to examine whether independent third parties would have taken account of the associated risks by entering into appropriate arrangements (e.g. price adjustment clauses).

3.1.2.2. If special financial arrangements (e.g. payment terms or customer credit facilities which are unusual in the trade practice), part supplies of materials by the costumer, or auxiliary services are agreed in conjunction with the supply of goods or merchandise then this has to be reflected in the arm's length price. To the extent that separate contracts are concluded for these performances, a set-off of benefits within the framework of m.no. 2.3. is permitted.

3.1.2.3. If goods or merchandise were produced by use of an intangible business asset (e.g. industrial property rights, a design, a copyright, an invention which is not legally protected, or by use of any other achievement which constitutes a technological improvement, a seed patent, a trade or business secret, or a similar right or asset) then, as a rule, their acquisition and subsequent use or consumption by the acquiror does not constitute an use of the intangible business asset; in such cases therefore, the buyer does not owe the payment of a royalty. If, nevertheless, a

royalty is charged by the manufacturer to the acquiror, then it cannot be recognised in principle for tax purposes. This does not apply, however, if the acquiror in some other way by using the goods or merchandise exploits an exceeding intangible business asset (e.g. by exploiting a patent within the meaning of m.no. 5.1.1. 2nd sentence), uses goods or merchandise in a patented process, or produces from them some other kind of legally protected business asset. However, also in these cases the use of the intangible business asset may not be included in the price of goods or merchandise; a set-off of benefits and disadvantages from the granting of the rights to use intangible business assets and the charge for the subsequent use shall be recognised.

3.1.2.4. In applying the standard methods it is necessary to disregard data and prices which are affected by particular competitive situations and therefore cannot be applied to the business relationship under consideration. This applies e.g. to prices:

1. which are established in special closed markets where prices are established differently from the market from or into which the supply is made;
2. which are the subject of special reductions in connection with the introduction of products in the market;
3. which are established outside or by circumventing, an otherwise existing patent protection;
4. which are affected by governmental price control or comparable measures.

Such prices have to be used to the extent that they can be adjusted pursuant to m.no. 2.1.7.

3.1.2.5. The arm's length price authoritative for the income allocation may deviate from the costums value on the basis of which the clearance or the turnover upon import is computed or from the other tax bases for computing the import within the meaning of section 11 UStG (cf. BFH-decision of 1 February 1967, BStBl III p. 495).

3.1.3. **Examples for the Application of the Standard Methods**

Example 1

A group enterprise supplies finished goods to a related distribution enterprise which acts as dealer. No market price or market derived price for the international supply of these goods by producers to wholesalers can be established; the related distribution enterprise is exclusively responsible for selling these goods within the respective marketing area. In this case the resale price method will generally be applied if, in sales to third parties, both parties base their concept of price on a particular discount to be accorded to exclusive agents. Distribution enterprises are enterprises which resell goods without substantial treatment or processing.

Example 2

A group enterprise supplies semi-finished products to a related manufacturing enterprise at a more advanced stage in the chain of manufacture. There is no market for such products. In this case the cost plus method will generally be applied if third parties in similar circumstances base their assessment of value on the costs of the merchandise increased by the amount of an appropriate profit mark-up.

Example 3

An enterprise transfers particular manufacturing functions to a foreign subsidiary. Production and distribution by the foreign company are closely tied in the business operation of the domestic enterprise. The articles produced are purchased by the parent company under a long-term arrangement. The subsidiary with its limited range of production could not in the long run survive as an independent enterprise. Between third parties, the production would have been carried out on a sub-contract basis (cf. also m.no. 2.1.2.). Accordingly, the transfer price may be determined using the cost plus method.

3.2. *Commercial Services*

3.2.1. **Basic Principle**

If an enterprise renders commercial services to a related enterprise then m.no. 3.1.2. and 3.1.3. apply accordingly. The rules concerning the market levels are only applicable to the extent that it is customary on the market for distinctions to be made between different groups of customers.

3.2.2. **Special Areas**
M.no. 5 applies to services related to research and development and m.no. 6 to administrative related services.

3.2.3. **Comparable Uncontrolled Price, Resale Price and Cost Plus Method**

3.2.3.1. Because of the variety of commercial services, it is regularly only possible to establish prices which are customary for the type of business concerned in the case of standardised services or in special areas (examples: transportation and insurance). In this respect, it is necessary to consider the forms of pricing which have been developed in particular parts of the service sector.

3.2.3.2. If comparable prices are not available then as a rule the cost plus method should be applied (the reason: services are not, as a rule, resold so that the resale price method is excluded).

3.2.3.3. If services are rendered in connection with the supply of goods then no separate transfer price can be charged for them, if in the case of third parties the services are normally included in the price of the goods (e.g. guarantee or maintenance services, or services supplied to maintain goodwill which are usual in the sector). Otherwise, m.no. 3.1.2.2. applies correspondingly.

3.3. *Advertising Costs*

3.3.1. Advertising costs should be borne by the related enterprise exercising the function for which the advertising is undertaken. If an enterprise carries out advertising on behalf of another related enterprise then the resulting services may:

a) be charged for as commercial services (m.no. 3.2.) to the extent that they correspond in their nature and scope to the services of independent advertising enterprises (e.g. the independent implementation of the entire advertising including the production, advertising material, copies etc.);
b) in other cases, be charged for according to the principles concerning administrative related services (m.no. 6.).

3.3.2. The foregoing principles also apply to related manufacturing and distribution enterprises. To the extent that the advertising measures relate to the functions exercised by both enterprises, it should be examined whether the advertising expenses have been adequately allocated between the enterprises involved. In this respect benefits from the cost allocation of advertising measures may be set-off via price arrangements when the goods are purchased or vice versa. M.no 1.4. applies to this set-off.

3.3.3. It is not objectionable if the allocation of costs among related enterprises in a group is governed by special pricing agreements based on a medium or long-term advertising plan. Such arrangements should be examined pursuant to m.no. 2.4.3. and, if applicable, m.no. 7.

3.4. *Costs of Market Penetration*

3.4.1. When products are introduced into the market, manufacturing enterprises and their distribution affiliates frequently incur increased costs or reductions in revenue in the introductory period. Among third parties, these are usually borne by the distribution enterprise only to the extent that it can still realise an adequate commercial profit from the business relationship.

3.4.2. Among third parties such costs or reductions in revenue are also allocated so that:

a) the distribution enterprise bears a greater share of costs or reductions in revenue and in return is granted delivery prices which enable it to set-off the shortfall in its profits within a foreseeable time after the introductory period; or

b) the producer bears a greater share of the costs or reductions in revenue and within a time the introductory period is able to set-off the shortfall in its profits if necessary by higher delivery prices.

The corresponding set-off between the manufacturing enterprise and the distribution enterprise will, as a general rule, be calculated in advance on the basis of projected profitability and subject to a contractual agreement. If these conditions are met, such an apportionment may also form the basis for an allocation of income among related parties.

3.4.3. Costs and reductions in revenue which follow from the efforts of a distribution enterprise to substantially increase or to protect its market share by aggressive pricing or similar measures should in principle be borne by the producer.

3.5. *Start-up Costs*

In the case of newly formed companies or companies which are expanded or substantially reorganised, so-called start-up costs are incurred in the expectation that profits will be realised in later financial years. Such costs are, in principle, to be borne by the newly formed, expanded or reorganised company.

M.no. 3.4. applies where, during the start-up period, costs and reductions in revenue result from the introduction of products into the market.

4. Interest and Similar Remuneration

4.1. *General*

In case of financing services between related parties, the first question to be examined is whether a real loan was provided or whether a constructive dividend or a constructive equity contribution (hidden capital) occurred. Charges for interest may only be recognised for tax purposes in the case of real loans.

A constructive dividend or a constructive equity contribution (hidden capital) has to be assumed if a repayment of the principal could not be seriously expected from the outset (BFH-decision of 16 September 1958, BStBl III p. 451). Furthermore, hidden capital is to be assumed if, in the individual case, this form of providing equity capital is, for legal or commercial reasons, the only one possible or if the legal framework of the contract proves to be so unusual that it would have to be regarded as an abuse of legal structuring within the meaning of section 42 AO.

4.2. *Authoritative Interest Rates*

4.2.1. If a person provides credit (e.g. loans, mortgages, credits for goods, credits on current account) to a third party then the arm's length price is the interest rate at which third parties would have granted the credit under comparable conditions in the money or capital markets (cf. BFH -decision of 25 November 1964, BStBl 1965 III p. 176). The examination has to consider the interest rates at which banks provide credit to third parties in comparable circumstances (borrowing rates).

4.2.2. In examining the interest, all circumstances of the individual case must be taken into account. The examination should be based in particular on:

1. amount and duration of the credit;
2. nature and purpose of the credit;
3. securities and the credit standing of the borrower (considering special conditions which third parties would also grant to the borrower in view of its affiliation to the group);
4. the credit currency, the exchange rate risks and opportunities (cf. m.no. 4.2.3.) and hedging costs, if any;
5. in case of transmitted credits the costs of refinancing (for further details cf. m.no. 4.3.3.);

6. other circumstances of granting the credit, especially the conditions in the capital markets (cf. in particular m.no. 4.2.4.).

The circumstances of the individual case may make it necessary to apply interest rates other than those specified in m.no. 4.2.1. if also third parties would orientate themselves to them. If the examination shows that there was a range of interest rates, m.nos. 2.1.8. and 2.4.6. should be observed.

4.2.3. If the credit was provided in a foreign currency then, by applying m.nos. 4.2.1. and 4.2.2., the interest rates in the currency area of that foreign currency shall be considered, provided that also third parties would have agreed on the credit in that currency under comparable circumstances. Measures which third parties would have taken in order to spread the exchange risk (e.g. by means of clauses preserving the value of the credit in real terms or by forward exchange contracts at the borrower's expense) shall also be considered.

4.2.4. If the taxpayer had been able to borrow or to grant the credit in the currency of the credit agreement in money or capital markets located outside the currency area of the currency involved at interest rates more favourable to the taxpayer, then these interest rates shall also be considered.

4.2.5. The circumstances at the time the credit was provided are decisive. However, it should be examined whether in the case of medium or long-term credit arrangements fluctuations in the level of interest rates are taken into account by means customary among third parties (such as termination or interest adjustment clauses).

4.2.6. In the examination no objections need to be raised, even if otherwise warranted, in cases in which, due to compulsory legal provisions in the country of residence of the related party or for similar reasons distinct from the credit arrangement itself, loans are granted at favourable interest rates or interest-free where investment of equity capital would have been required. If this provision is invoked, then the mere fact that the loan bears no or low interest does not entitle revaluation decrease the loan to its going-concern value.

4.3. *Particular Issues*

4.3.1. In case of receivables arising from the supply of goods and services it should be examined whether

- the charges for interest are customary trade practice,
- the parties to the transaction make charges interest in comparable business transactions, in the reverse direction.

Otherwise, m.no. 4.2. remains unaffected.

4.3.2. Under certain circumstances credits are provided which, for business reasons distinct from the credit relationship itself bear low or no interest at all. This, for example, can be the case if

a) the parent company grants an interest-free credit for goods to a related distribution enterprise in order to promote the sales of its products;

b) the related distribution enterprise is economically not in a position to establish by its own means a depot, which by order of the authorities is required to obtain licenses for the import of goods of the parent company, whereupon it obtains an interest-free loan from the parent.

In the examination, it should be observed that there is an adequate set-off under the terms of m.no. 2.3. in the relationship on which the interest arrangement is based.

4.3.3. If a domestic enterprise involves a foreign related party in raising funds in a foreign market the following principles apply: If the related party acts

a) as an agent or as a general commission agent then the raising of the funds abroad is to be attributed directly to the domestic enterprise. The related party has merely a claim against the domestic enterprise for a commission which adequately reflects its activities. It should be

assumed, in particular, that a related party acts as an agent if it raises funds in its own name on behalf of the domestic enterprise in capital markets with favourable interest rates;

b) as creditor, then the interest to be paid to the related party by the domestic enterprise should be calculated pursuant to m.nos. 4.2.1. and 4.2.2.;

as an accounting office or merely lent its name to the transaction, then it has provided no services which require remuneration. Nor can booking charges be recognised since the raising of the funds is a business event to be booked by the domestic enterprise.

4.3.4. If a foreign enterprise involves a domestic related party in credit transactions or in order to take advantage of particular investment possibilities inland then m.no. 4.3.3. applies correspondingly.

4.4. *Guarantees and Similar Obligations*

4.4.1. If a person assumes a guarantee for a related party then the resulting legal consequences (e.g. subsequent payments under the guarantee) can only reduce that person's income for tax purposes if, exercising the prudence required of a sound business manager, he would also have assumed the guarantee for third party (BFH-decision of 19 March 1975 – BStBl II p. 614); this requires that the assumption of the guarantee has a commercial reason outside the shareholding relationship.

4.4.2. To the extent that the conditions of m.no. 4.4.1. are met, a commission payment should be charged for the assumption of the guarantee insofar such as commission would have been agreed also between third parties BFH-decision of 19 May 1982, BStBl II p. 631). This is, for example:

1. the case, if the guarantee provides a benefit to the debtor, especially if it saves him financing costs or provides access to a particular capital market. A commission payment is accordingly to be charged when e.g. the guarantee is assumed for a financing company issuing bonds in foreign capital markets in order to finance group investments with these funds;
2. not the case, if the guarantor because of own business interests would have granted the guarantee without charge to a third party. Such a business interest of the guarantor may exist in certain cases in which a guarantee is assumed for the benefit of a distribution enterprise.

4.4.3. The above principles apply correspondingly to other obligations (e.g. stand-by letters) to the extent that such obligations have the characteristics of a guarantee.

5. Transfers of Rights to exploit Patents, Know-How or other Intangible Business Assets; Commissioned Research

5.1. *General aspects*

5.1.1. If a related enterprise is granted the right to exploit an intangible business asset (cf. m.no. 3.1.2.3.) then the arm's length price has to be charged therefor. This also applies if the receiving enterprise does not exploit the intangible business asset, but derives or will presumably derive an economic benefit therefrom (e.g. the protection resulting from reserve patents or from defensive patents). Regarding the right to use the group name cf. m.no. 6.3.2.

5.1.2. Charges for exploitation rights will not be recognised for tax purposes where the exploitation rights are connected with the supply of goods or services and, if in the case of third parties, the exploitation of the intangible business assets is included in the price of the goods and services; where separate invoices are charged for goods and services, on the one hand, and for exploitation rights on the other, then a set-off of benefits against disadvantages shall be recognised.

5.1.3. If the holder of the exploitation right itself makes available to the transferor an achievement which is not legally protected and which constitutes a technological improvement or a similar

achievement (know-how) which the holder of the exploitation right derived in the course of exploitation, this shall be taken into account when examining the remuneration. If such party makes available know-how independently of such exploitation then it should be charged between the parties concerned like between third parties.

5.2. *Determination of the Arm's Length Price*

5.2.1. The transfer price should be based on the individual intangible business assets for which rights of exploitation have actually been transferred. In principle, intangible business assets used by a licensee can only be considered jointly if technically and commercially they form a single unit.

5.2.2. In principle, the arm's length prices for the use of intangible business assets should be charged via a remuneration on the basis of an appropriate basis of determination (e.g. turnover, volume, lump sum payments). For tax examination purposes the Federal Tax Office may, as far as possible, determine within what ranges payments for the transfer of rights to exploit intangible business assets typically fall. In applying these data it should be assumed that among third parties the terms of the use of intangible business assets are negotiated differentiated.

5.2.3. If the adequacy of the agreed royalty cannot be evaluated sufficiently by using the comparable uncontrolled price method then it has to be considered for the examination that a sound business manager of the licensee would only pay a royalty up to an amount which leaves to him an adequate commercial profit from the licensed product.
A sound business manager will, as a rule, make this decision after having analysed the expenses and revenue which are expected to result from the transfer of the intangible business assets. As to evidence cf. m.no. 9.

5.2.4. Where prices are invoiced separately, the cost plus method may be considered in exceptional cases. Costs may be used as the basis for estimation when royalty payments are being verified.

5.3. *Commissioned research*
If an enterprise undertakes research and development at the request of another enterprise (commissioned research) then the results obtained belong not to the research enterprise, but to the enterprise making the request. In these cases the cost plus method is usually applied for determining the adequacy of the remuneration.

6. Administration Related Services within the Group

6.1. *General aspects*
Among related enterprises, tasks of administration, management, control, consultancy or similar functions for the entire group are often assumed centrally or regionally through the parent company, intermediate subsidiaries or similar facilities. In no case can remuneration be charged for these activities to the extent that their legal basis are the shareholding relationship or other circumstances establishing the affiliation (cf. m.no. 1.3.2.4. to 1.3.2.7.). Only to the extent that beside these activities such facilities render services to related enterprises, charges may be recognised under the following principles.

6.2. *Prerequisites for the Charges*

6.2.1. A separate charge is possible if independently of the shareholding relationship (cf. m.no. 6.1.) between third parties a remuneration would have been paid for the services. The charge must be agreed in advance and proved by the paying enterprise. No charge is allowed if the services or costs of this facility are allocated to the receiving enterprises in some other form, e.g. via charges for the intra group supply of goods or services at arm's length prices which already take account of these costs or services respectively.

6.2.2. Remuneration for such services would be charged between third parties only if they
- are clearly distinguishable and measurable and
- are rendered in the recipient's own interest (i.e. presumably provide a benefit and save own costs).

Services may not be charged if a subsidiary utilises them only because of considerations relating to the circumstances of the parent company, and if the subsidiary, considering only its own circumstances, would not have utilised the services had it been an independent enterprise.

6.2.3. The services must actually be performed. The mere availability within the group is not sufficient since, as a general rule, third parties only pay for services which have actually been rendered. However, where the volume of services fluctuates there is no objection if an average amount of remuneration is charged which corresponds to the services actually rendered over a period of years.

6.3. Examples

6.3.1. Applying these principles remuneration is chargeable e.g. for:
- the rendering of bookkeeping services and similar services e.g. specific consultancy services concerning the related enterprise's own economic and legal affairs;
- the temporary transfer of personnel including transfers involving the management of the related enterprise;
- the training and continued education as well as the social security of personnel in a related enterprise in the related enterprise's interest;
- services provided by the parent company for the procurement of goods and services which the respective subsidiary has obtained or utilised directly;
- the provision of services on call customary to the market, to the extent that it is proven that the subsidiary needs such services and has actually made use of the services to an adequate extent.

6.3.2. On the other band, a parent company cannot charge remuneration e.g. for:
- so-called group support, including the right to use the group name and benefits derived from the mere fact of legal, financial and organisational integration in the group;
- the activities of its own board of directors and supervisory board as such, and for its shareholders' meetings;
- the legal organisation of the group as a whole, as well as production and investment planning for the entire group;
- activities which reflect its shareholding function including general organisation as well as control and group audit in support of the group's headquarters;
- protection and administration of the participations;
- the group management and for such management functions subordinate enterprises which the group's top management has assumed in order to improve the preparation, implementation and control of its own management measures. These include planning, entrepreneurial decisions and coordination.

6.4. *Determination of the Arm's Length Price*

6.4.1. Arm's length prices for administration related services may be charged to the extent that services between unrelated parties are comparable in their nature and scope with the intra group administrative service under consideration. In this respect it should be taken into account that the parties involved have a long-term relationship. To the extent that comparable market prices are not available, the arm's length price shall, as a rule, be determined using the cost plus method. It shall also be considered that a sound business manager of the recipient would not, as a rule, agree to pay remuneration for services in excess of the expenditure which would be incurred if it

were to carry out the administrative function itself using its own resources, or it were to contract it out to local third parties.

6.4.2. The determination of the price under the cost plus method should be based on separate analyses of

1. the individual services rendered and
2. the costs attributable to the individual services.

shall be assumed. The taxpayer is obliged to provide documentary evidence (section 90 (2) AO).

7. Income Allocation through Cost Contribution Arrangements

7.1. *General aspects*

7.1.1. If expenditures for

a) research and development or

b) administration related services (m.no.6.2.)

are priced within a group by means of cost contribution arrangements then the cost contribution arrangement shall be considered for the income allocation if the consideration for the transfers or services can only be evaluated in aggregate, or if the determination of the costs separately attributable to the individual services is difficult. Such cost contribution arrangements shall be examined in accordance with the following principles (cf. also m.no 2.4.3.).

7.1.2. The costs actually incurred regarding such services within a group shall (as in the case of a pool) be determined by means of a recognised cost accounting method on a full-cost basis (direct and indirect costs) and shall be allocated according to a recognised method of accounting. It is required that the cost contribution arrangement (m.no. 7.2.) be concluded in advance in clear and unambiguous terms and that it be actually implemented. A cost contribution based on a percentage – determined independently from the costs – of the turnover of the taxpayer enterprise, or of a similar reference base, cannot be recognised for tax purposes.

7.1.3. Upon implementation of the cost contribution arrangement no separate charges can be made for the transfer of the right to exploit intangible business assets, for the transfer of know-how and for services to which the taxpayer enterprise is entitled under the cost contribution arrangement (m.no. 7.2.1. no. 2). Pursuant to section 5 (2) EStG these business assets may not be capitalised; the cost contribution is not subject to withholding tax within the meaning of section 50a (4) EStG.

7.1.4. The tax recognition of the cost contribution requires that the research and development, and the flow of administration related services (m.no. 6.2.) are clearly distinguishable and supported by evidence. The aggregate of costs attributable to them must be easily separable. These requirements are in general met if:

1. there is a central organisation within the group responsible for providing such services, whose results are utilised either by the group as a whole or by particular sub-groups of companies, and
2. the costs which arise in other parts of the group from complementary or supporting activities of the same kind (affiliated departments) are also aggregated within this central organisation.

7.1.5. A cost contribution arrangement may be recognised for tax purposes only if the requirements of m.no. 1.4. are met and if also the enterprise which charges the cost contribution incorporates the agreement in its business accounts and computations for tax purposes. The cost contribution arrangement must also be taken into account in the commercial balance sheet to the extent that the same is binding for the tax balance sheet.

7.1.6. A profit mark-up on the costs to be shared cannot be recognised for tax purposes in view of the

absence of entrepreneurial risk. This does not rule out that, within the framework of the full-cost computation, an adequate interest on deployed equity as well as a contribution to management and general administrative expenses are included in the costs to be shared.

7.2. *Contents of the Agreement*

7.2.1. A cost contribution arrangement will serve as the basis for income allocation if:

1. the agreement covers research and development costs which relate or will relate to the commercial activity of the taxpayer enterprise, as well as the costs of administration related services, which are actually provided in the interest of the taxpayer enterprise; and if the taxpayer enterprise actually uses, or can be expected to use, the results of the research and development and of the administrative services;
2. the agreement confers upon the taxpayer enterprise a specific right, definite in nature and scope, to take advantage of the activities of the central organisational unit and affiliated departments in exercising the tasks assigned to it, and the right to request services from the central organisational unit or to place orders with it;
3. the agreement bases the cost contribution on the costs (including indirect costs) which
   a) are attributable to the activities of the central organisational unit and the affiliated departments and
   b) actually arose in the accounting year.

   The costs must be clearly distinguishable by reference to the agreement. Under the requirements of nos. 1 and 4, costs of basic research may also qualify for sharing;
4. the arrangement includes an apportionment formulae in proportion to the share in which the taxpaying enterprise actually uses, or can be expected to use the results of the research and development and the administration related services provided within the group. This share shall be ascertained by applying business principles and using the degree of care of a prudent manager. The ratio of the turnovers of the related enterprises to each other may only be applied as a basis if this is a useful standard for determining the actual or expected benefits for the related enterprises involved;
5. the agreement provides that the costs are to be reduced by the amount of any revenues of the central organisational unit or the affiliated departments and which result from activities or business assets falling within the scope of the cost contribution arrangement;
6. the agreement provides that the costs borne by the taxpayer enterprise itself with respect to tasks falling within the scope of the cost contribution taken into account following the same principles as apply to the central organisational unit, be included in the costs to be shared, and be credited against the amount of the cost contribution.

7.2.2. No set-off of benefits can be made between the individual services in a cost contribution arrangement and other services outside the scope of the cost contribution arrangement.

7.2.3. If expenditures for research and development and for administration related services are charged under an uniform cost contribution arrangement then the costs to be shared and the cost apportionment formulae for both types of services must be verifiable separately.

7.2.4. The tax office may, upon application of the taxpayer, also accept other arrangements for individual cases if this is appropriate given special circumstances (such as the multilateral use of the cost contribution arrangement, or absent individual provisions regarding the cost computation and distribution within the meaning of m.no. 7.2.1.) and provided that the domestic results of the cost contribution arrangement do not differ significantly from those of a contract which conforms to the requirements of m.nos. 7.1. to 7.2.3.

7.3. *Implementation of the Agreement*

7.3.1. The recognition of a cost contribution arrangement for tax purposes requires that the enterprise adjusts it to changed circumstances. In particular, the cost apportionment formula must be

adjusted if there is any alteration in the division of responsibilities within the group underlying the agreement.

7.3.2. If a group charges costs on the basis of cost contribution arrangements, then the costs so shared may not be passed on a second time, e.g. by inclusion in prices for goods or services.

7.4. *Evidence*

7.4.1. If the allocation of income should be based on a cost contribution arrangement then the taxpayer enterprise must upon request

1. submit the agreement together with all additional agreements and by means of verifiable documents prove the benefits to the taxpayer enterprise from the research and development and the flow of administration related services;
2. explain the division of responsibilities within the group underlying the agreement and the functions performed by the group unit involved, and submit verifiable documents regarding the criteria relevant for establishing and applying in every instance the cost apportionment formula;
3. submit all directions given for the inclusion, determination and apportionment of costs, the bookkeeping instructions given, and the computation of the cost contribution (in particular details of the kinds of costs-classified according to cost units – covered by the cost contribution).

Submission of documents for the cost contribution computation which are exclusively located abroad may be waived to the extent that the taxpayer enterprise submits a cost contribution computation which shows that both the underlying obligation for and the amounts of the cost contribution were arrived at in accordance with the terms of the agreement, and which has been audited and bears a notice of confirmation to these effects by a German chartered accountant or tax consultant or by a German accounting or tax consulting firm.

7.4.2. As provided in section 90 (2) AO the tax authority may require further data, documents and evidence necessary under the circumstances of the individual case. This applies in particular

a) it cannot be expected that the tax authorities in the country of the parent corporation will upon request render administrative assistance in an examination of the cost apportionment system and its annual results;
b) for the purpose of providing evidence that the requirements of m.no. 7.1.4. 1st and 2nd sentences are met in cases where a group lacks the organisational requirements specified in m.no. 7.1.4. 3rd sentence; or
c) if individual requirements within the preceeding m.nos. are not met, or particular evidence cannot be submitted, and if these shortcomings are set-off by additional requested evidence.

8. Method of Adjustment

8.1. *General aspects*

8.1.1. An adjustment should be made to the extent that

a) the requirements for a constructive dividend are met, according to the principles applicable thereto; in this case it is also necessary to examine if withholding tax on capital investments (*Kapitalertragsteuer*) has to be levied (BFH-decisions of 28 January 1981, BStBl II p. 612, and of 19 May 1982, BStBl II p. 631);
b) the requirements for a constructive equity contribution are met, by increasing the book value of the shareholder's holding in the tax balance sheet;
c) the adjustment is solely based on section 1 AStG, by making an addition to profit outside the balance sheet.

8.1.2. The adjustment should be made for the year in which the benefit conferred affected the profits.

8.1.3. The adjustment of income does not affect the attribution for tax purposes of the underlying business assets; in particular for Property Tax purposes remains unaffected.

8.2. *Method of Taxation*

8.2.1. The amount of adjustment should be attributed to the same category of income as the income adjusted.

8.2.2. The provisions for the avoidance of double taxation should be applied, where applicable, to the amount of the adjustment.

8.2.3. Within section 34c EStG and the relevant provisions of double taxation conventions, no tax credit is available for taxes which a related person owes abroad on that part of its profit which corresponds to the amount of the adjustment.

8.2.4. If a taxpayer subject to unlimited tax liability is a shareholder of a foreign subsidiary within the meaning of section 3 AIG and if the amount of the adjustment leads to an increase in the book value of the holding in the tax balance sheet then the amount of the adjustment increases the basis of computation for the reserve under section 3 (1) AIG.

8.3. *Subsequent Compensation for Income Reductions*

8.3.1. If the parties involved offset a domestic income reduction by balancing payments and thereby create the situation which would have occurred following the arm's length principle then such offset shall:

a) in case of constructive dividends be treated in principle as constructive equity contribution;
b) in case of constructive equity contributions be treated as a repayment of capital;
c) in case of events leading to an adjustment based solely on section 1 AStG be offset outside the balance sheet against the addition to profit made for purposes of the adjustment (m.no. 8.1.1.c).

8.3.2. If a participation is sold, or the foreign company is liquidated, then the proceeds received on sale or liquidation are to be reduced by the amount of the addition to profit under m.no. 8.1.1.c) outside the balance sheet to the extent that this amount has not yet been offset otherwise.

9. Procedure

9.1. *Cooperation in Determination and Producing Proof*

9.1.1. The parties involved shall cooperate in determining the correct allocation of income in accordance with the generally applicable rules (in particular section 90 (2) AO). They must thereby also

a) clarify facts abroad themselves and
b) procure proof which is situated abroad.

In doing so they must exhaust all the legal and factual possibilities available to them; these include, in particular, all means derived through participations or derived from the common interests of the related parties.

9.1.2. Domestic taxpaying enterprises are obligated to cooperate; foreign related enterprises are obligated to cooperate only to the extent that their own tax liability is in question (e.g. as the

recipients of a constructive dividend). The obligation of a domestic enterprise to investigate and provide proof also extends to those facts and proof which are relevant for domestic taxation which are maintained and documented in the books and records of foreign related enterprises.

9.1.3. A party involved cannot rely on the fact that he is unable to clarify facts or procure proof pursuant to section 90 (2) sentence 3 AO if he could have done so according to the facts of the case and the state of relations. The related parties could meet these requirements by agreeing to assist each other in clarifying facts and providing proof (evidence precaution; c.f. BFH-decision of 16 April 1980, BStBl 1981 II p. 492). In the case of business relations between related parties this also applies to the determination and proof necessary for income allocation in particular. Therefore, a domestic enterprise cannot rely on its related enterprise abroad (e.g. the parent company) not making the proof or documents available.

9.1.4. If in the examination of income allocation involving one company in a group it is necessary to consider the circumstances of another company in the group then the extended obligation to cooperate pursuant to section 90 (2) AO extends to these circumstances as well. The domestic enterprise is required to make evidence precaution therefor pursuant to m.no. 9.1.3. if necessary.

9.2. *The Scope of the Obligation to Cooperate*

9.2.1. The obligation to cooperate extends to all circumstances which are relevant to the determination and examination of transfer prices. These include in particular

a) the data required for the examination of the transfer price which is available or which would be accessible to a sound business manager of an independent enterprise;

b) the business data, records and information from related enterprises which are required for the examination of the transfer price.

M.no 9.1.4. applies to the extent that the circumstances of related enterprises are relevant.

9.2.2. If a taxpayer enterprise determines transfer prices in a particular way (m.no. 2.4.2) or if it uses particular tabulated values or centrally collected data (n.no. 2.4.3), then it must:

a) insure that the necessary documents therefor are collected and can easily be examined

b) if requested, cooperate within the framework of m.no. 9.1. in the examination whether the transfer prices determined also appear plausible when utilising other methods (m.no. 2.4.2. 3rd sentence).

M.no. 2.4.4.c) remains unaffected.

9.2.3. As regards the obligation to cooperate in cases of cost contribution arrangements reference is made to m.no. 7.4.

9.2.4. In the cases of relationships with related enterprises which are not subject to a significant level of taxation, section 16 AStG shall be considered. The special obligation to disclose information which this provision imposes rests on the different tax levels in such cases and excludes a mere test of plausibility.

9.3. *Legal Consequences of Insufficient Cooperation*

9.3.1. In the event that an enterprise does not fulfil its obligation to cooperate then the tax office may, if necessary, adjust its income by making an estimate pursuant to section 162 AO. Thereby, a set of facts may be assumed when determining the ground for and the amount of the adjustment which are implied by practical experience (c.f. BFH-decision of 17 July 1968, BStBl II p. 695).

9.3.2. Absent any other guidelines for making the estimate, section 1 (3) AStG shall be applied. This rule also applies to adjustments based on legal provisions other than section 1 (1) AStG.

10. Miscellaneous

10.1. *Repeal of other Administrative Rules*
M.no. 1 of the introductory circular of 11 July 1974 to the Foreign Tax Act (BStBl 1974 I p. 442) is no longer applicable to cases of income allocation within the meaning of this circular.

10.2. *Transitional Provisions*
If, in view of this circular, enterprises rearrange their affairs (e.g. by concluding or adjusting cost contribution arrangements) then the examination of previous time periods under the arm's length principle will remain unaffected. The rearrangements as such do not generate detrimental legal consequences for the past for the enterprise. In the case of rearrangements undertaken within a period of three years after the publication of this circular, it may be assumed that they were taken in view of this circular.