

Section 1 – Adjustment of income¹

(1) If a taxpayer's income from international business relations with a related party is reduced as a result of the taxpayer's basing the income assessment on terms, particularly prices (transfer prices), that diverge from those which independent third parties would have agreed under the same or similar circumstances (arm's length principle), the taxpayer's income must, without prejudice to other provisions, be assessed to be as it would be under terms agreed between unrelated third parties. A partnership or co-entrepreneurship also constitutes a taxpayer as described in this provision; a partnership or co-entrepreneurship is deemed to be a related party if it fulfils the conditions set out in subsection (2). In applying the arm's length principle, it must be assumed that the unrelated third parties have knowledge of all significant circumstances of the business relations and that they are acting according to the principles applied by prudent and conscientious business managers. If the application of the arm's length principle results in larger adjustments than other provisions, then the larger adjustments must be made in addition to putting into effect the legal implications of the other provisions.

(2) A party is related to the taxpayer if

1. the party holds a direct or indirect stake of at least one quarter in the taxpayer (substantial stake) or is able to exercise a controlling influence directly or indirectly on the taxpayer, or, conversely, the taxpayer has a substantial stake in the party or is able to exercise a controlling influence directly or indirectly on that party, or

2. a third party has a substantial stake in both the party and the taxpayer or is able to exercise a controlling influence directly or indirectly on both, or

3. the party or the taxpayer, when agreeing on the terms of business relations, is in a position to exercise on the taxpayer or on the party influence that is not based on such business relations, or if one of them has an own interest in realisation of the other's income.

(3) For business relations as described in subsection (1), first sentence, the transfer price must primarily be determined by applying the comparable uncontrolled price method, the resale price method or the cost plus method, provided that arm's length prices can be determined that are fully comparable for these methods, following appropriate adjustments in respect of the business functions performed, the assets used and the opportunities and risks assumed (functional analysis); multiple values of this kind constitute a range. If such arm's length prices cannot be determined, partly comparable prices must be used as a basis for a suitable transfer pricing method, following appropriate adjustments. If, in cases described in the second sentence above, multiple partly comparable arm's length prices can be determined, the resulting range must be narrowed down. If, in cases described in the first sentence above, the price used by the taxpayer in the income assessment falls outside the range, or if, in cases described in the second sentence above, it falls outside the narrowed-down range, the median is applicable. If no partly comparable arm's length prices can be determined, the taxpayer must use the hypothetical arm's length method for the income assessment, with due regard for subsection (1), third sentence. To this end, the taxpayer must carry out a functional analysis and internal planning calculations to determine the supplier's minimum price and the recipient's maximum price (arm's length range), taking into account capitalisation interest rates that are adequate for the function and risk in question; the arm's length range is based on the respective profit expectations (profit potential). The income assessment must be based on

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

the price within the arm's length range that is most likely to correspond to the arm's length principle; if no other value is plausibly demonstrated, the mean of the range must be used as a basis. If the arm's length range used as a basis by the taxpayer is incorrect and a different arm's length range must therefore be assumed, an income adjustment can be dispensed with if the value used by the taxpayer lies within said different arm's length range. If a business function is relocated, including the corresponding opportunities and risks as well as any assets and other benefits transferred or licensed (business function relocation), and if the fifth sentence above is applicable to the relocated business function because there are no arm's length prices available for the transfer package as a whole that are at least partly comparable, then the taxpayer must determine the arm's length range on the basis of the transfer package. In cases described in the ninth sentence above, the individual transfer prices determined for all the assets and services concerned, following appropriate adjustments, must be recognised if the taxpayer plausibly demonstrates that no significant intangible assets or benefits were part of the business function relocation, or that the sum of the individual transfer prices applied, measured against the valuation of the transfer package as a whole, conforms to the arm's length principle; if the taxpayer plausibly demonstrates that at least one significant intangible asset is part of the business function relocation, and identifies that asset precisely, then individual transfer prices must be recognised for such elements of the transfer package. If, in cases described in the fifth and ninth sentences above, significant intangible assets or benefits are the subject of business relations, and if the subsequent actual trend in profits deviates substantially from the trend in profits on the basis of which the transfer price was set, it must be assumed in the absence of evidence to the contrary that there was uncertainty about the agreed price at the time of the transfer and that independent third parties would have agreed an appropriate adjustment rule. If no such rule was agreed, and if a substantial deviation as described in the eleventh sentence above arises during the first ten years following the transfer, an adjustment must be made under subsection (1), first sentence, by applying an appropriate one-off adjustment amount to the original transfer price as the basis for taxation in the fiscal year following the one in which the deviation arose.

(4) Business relations for the purposes of this provision are

1. individual or multiple connected economic transactions (business transactions) between a taxpayer and a party related to the taxpayer

a) that are part of an activity of the taxpayer or the related party to which articles 13, 15, 18 or 21 of the Income Tax Act (*Einkommensteuergesetz*) apply or would have applied if the business transaction had taken place in Germany with the involvement of a taxpayer with unlimited tax liability and a domestic related party, and

b) that are not based on a partnership agreement; a partnership agreement is an agreement that directly results in a legal change in the partner status;

2. business transactions between a taxpayer's enterprise and its permanent establishment located in a different country (dealings).

If a business transaction is not based on an *in personam* agreement, it must be assumed, unless the taxpayer plausibly demonstrates otherwise, that independent prudent and conscientious business managers would conclude an *in personam* agreement or assert an existing legal position, which must be used as the basis of taxation.

(5) Subsections (1), (3) and (4) are applicable *mutatis mutandis* if, for business relations as described in subsection (4), first sentence, no 2, the conditions, especially the transfer prices used for tax purposes as a basis for allocating income between a domestic enterprise and its foreign permanent establishment or for assessing the income of the domestic permanent establishment of a foreign enterprise, are not consistent with the arm's length principle, and this results in a reduction of the domestic income of a taxpayer with limited tax liability or an increase of the foreign income of a taxpayer with unlimited tax liability. When applying the arm's length principle, a permanent establishment must be treated as a separate and independent enterprise, unless the permanent establishment's relationship to the enterprise requires a different type of treatment. In order to treat the permanent establishment as a separate and independent enterprise, it is necessary, as a first step, to attribute:

1. the enterprise's business functions that are performed by its staff (staff functions),
2. the enterprise's assets that are needed to perform its designated business functions,
3. the enterprise's opportunities and risks that are assumed on the basis of the business functions performed and assets assigned to it and
4. adequate equity (free capital).

In a second step, the type of business relations between the enterprise and its permanent establishment, together with the transfer prices for these business relations, must be determined on the basis of these attributions. The first to fourth sentences above are applicable *mutatis mutandis* to permanent representatives. The possibility of establishing an adjusting item in accordance with section 4g of the Income Tax Act is not restricted. The first to fourth sentences above are not applicable to business relations between a partner and his or her partnership, or between a co-entrepreneur and his or her co-entrepreneurship, regardless of whether the stake is direct or whether it is indirect as described in section 15 (1), first sentence, no 2, second sentence, of the Income Tax Act; in these cases, subsection (1) applies. 8If an agreement on the avoidance of double taxation is applicable and the taxpayer claims that the agreement's provisions contradict the first to seventh sentences above, such agreement takes precedence only insofar as the taxpayer proves that the other country is executing its right of taxation in accordance with the applicable agreement, and that the application of the first to seventh sentences above would therefore result in double taxation.

(6) The Federal Ministry of Finance is authorised to stipulate, by way of ordinances issued with the consent of the Bundesrat, more detailed provisions on the arm's length principle as described in subsections (1), (3) and (5) and on its uniform application, as well as principles for determining the free capital described in subsection (5), third sentence, no 4.