BNA International

Tax Planning International
Transfer Pricing

International Information for International Businesses

A Monthly Journal of Pricing Issues for Traditional and Electronic Business

Cost Sharing Agreements: Krauts vs. Yankees – New German Transfer Pricing Rules Compared to Their U.S. Counterparts

Georg F. Hirsch
Rockville, MD

Reprinted from the October 2005 issue of BNA International's
Tax Planning International Transfer Pricing

BNA International Inc., a subsidiary of The Bureau of National Affairs, Inc., Washington, D.C., U.S.A.

Krauts vs. Yankees – New German Transfer Pricing Rules Compared to Their U.S. Counterparts

Georg F. Hirsch
Rockville, MD

The Germans are following in America's footsteps, and, in some aspects, they may be more thorough. While the U.S. Treasury Regulations interpreting IRC Section 482 fill an impressive 280 pages,[1] the new German Administrative Principles of Transfer Pricing Documentation and Procedures (Administrative Principles) are "only" 76 pages long.[2] But there is more to come. The new set of guidelines, released on April 12, 2005, is "the first of a series of forthcoming publications by the German Federal Ministry of Finance[3] on transfer pricing and income allocation issues such as base shifting, continuing losses, and advance pricing agreements".[4]

Until now, German authorities had to rely largely on a 19-page document, the Administrative Principles of 1983 ("1983 guidelines"),[5] which remained without amendment for 16 years.[6] Starting in 1999, the German government began issuing separate guidelines relating to specific topics such as cost sharing, permanent establishments, and other selected topics,[7] but they were either very brief, or they amended, rather than superseded, provisions of the 1983 guidelines. Although the complete 1983 guidelines covered a mere 19 pages, the 83 pages of the new Administrative Principles supersede only two of ten brief chapters of the old guidelines: Chapter 8, relating to the administration of adjustments, [8] and Chapter 9, relating to procedure.[9]

The Administrative Principles represent the policies of the German tax authorities, interpreting at least four sets of German tax statutes and regulations.[10] Their provisions cover in part the same ground as Regulations Sections 1.482-1 and -3, IRC Section 6662(e) and related Treasury regulations, Section 6038A and related Treasury regulations, as well as other provisions scattered over the U.S. Code.

Even though the structuring of the German rules differs from comparable U.S. rules, a comparison is possible because both countries are industrial nations dealing with similar phenomena, including a plethora of in- and outbound investment activities. If one is willing to accept that stereotypes are at least in part based on truth, then there may be such thing as a "Yankee" vs. a "Kraut" approach to transfer pricing. The following are strong indications:

- the Administrative Principles uphold the long-standing character of the "Proper and Conscientious Business Manager" when discussing arm's length documentation;
- the Administrative Principles display – at least in part – love for detail;
- scepticism of transfer pricing rules and methods accepted in the U.S.; and
- love for punctuality, expressed in stiff penalties for tardiness in the furnishing of documentation.

A preliminary draft published in October of 2004 told government officials explicitly what has long been settled law, that is, to punish evildoers, and to spare those who do no evil. But that provision was stricken from the final version. It will, however, be discussed *infra* because its initial inclusion as well as the way it ultimately fell by the wayside casts an interesting light on inner fighting in the style of "Krauts".

I. What Happened – a Historical Background

Transfer pricing rules have existed for a long time. In Germany, transfer pricing has been regulated for at least 80 years,[11] and in the United States even longer.[12] While German law had adopted arms length principles for transfer pricing by 1925,[13] the IRS introduced the arm's length standard about ten years later.[14]

In 1968, the IRS came forth with extensive regulations that reinforced the arm's length standard as the leading principle for transfer pricing, providing guidance on specific methods and tests.[15] Going through several phases of change and amendment, the Section 1.482 regulations eventually became the regulations in its current, final version of 1994.[16]

As shown *supra*, the Germans have moved rather slowly by comparison. In fact, their moves were probably adjustments to policies now promoted by the OECD,[17] which were arguably triggered by the policy developments in one of its member countries, the United States. The chronology reflects tensions between the United States and other OECD countries.

Germany released its 1983 guidelines most likely in response to the 1979 OECD transfer pricing report.[18] In 1995, the OECD replaced the transfer pricing report with the final version of its Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the OECD Guidelines). A *Discussion Draft of*

TPTP ISSN 1472-0841

Part I: Principles and Methods gives two reasons for the revisions: clarifying ambiguities in the 1979 Guidelines, and responding to revisions of legislation and practices that had occurred in a number of countries since 1979.[19]

In the view of some commentators, Germans see Uncle Sam as the culprit.[20] What did the Americans do? According to Lymer's and Hasseldine's treatise *The International Taxation System*[21] "the U.S. has been the prime instigator of the introduction of more onerous and punitive *transfer pricing* rules and regulations" since the mid 1980s, "culminating in the s482 Final Regulations . . . released on 1st July 1994".[22] One possible reason was perceived transfer pricing abuse by foreign Multinational Entities (MNEs).[23] In addition, Congress introduced accuracy penalties for substantial and gross valuation misstatements in the context of transfer pricing in 1989.[24] To avoid these penalties, a taxpayer must be able to prove to the IRS that it set its transfer prices in accordance with one of the methods described under the Section 1.482 regulations. To this end, the taxpayer has to provide "contemporaneous documentation", that is, documentation that existed by the time a tax return was filed. And finally, the documentation must be given to the IRS within 30 days if the IRS requests it.[25]

It is well imaginable that stricter provisions in the United States caused worries in other parts of the world because America made it more difficult for MNEs to draw taxable profits out of the United States. According to commentators:

> European tax administrations felt particularly troubled by the potential adverse impact of the new U.S. transfer pricing rules on their tax revenues. This discomfort was based on the expectation that companies would voluntarily shift income to the United States in order to limit their exposure to U.S. transfer pricing adjustments and penalties.[26]

Thus, the OECD Guidelines of 1995 may at least in part be viewed as a response to those fears. In the view of American transfer pricing attorneys Marc M. Levey and Steven C. Wrappe "[t]he OECD Guidelines are generally consistent with the U.S. transfer pricing regulations".[27] The U.S. government, however, does not claim to have adopted any changes based on the 1995 Guidelines. Rather, it speaks of "[s]ome overlap" with the Guidelines, "but methods and applications [are] different".[28] At the same time, it makes sense that the U.S. regulations have features similar to the OECD Guidelines. If the 1995 Guidelines were in fact a response to the Section 1.482 regulations as established by 1994, they had to help other member states establish a level of leverage comparable with the United States so that the perceived income shifting into the U.S. would stop.

The 262-page OECD Guidelines devote one chapter alone to the documentation requirement, with a clear suggestion that "[c]ontemporaneous documentation helps minimise the use of hindsight".[29] With respect to penalties, the Guidelines are more cautious. Rather than recommending specific penalties, Chapter IV provides a portion describing the range of penalties in member states,[30] cautioning that "[i]t is difficult to evaluate in the abstract whether the amount of a civil monetary penalty is excessive",[31] and finally urging member states to weigh in "good faith error" and "a reasonable effort in good faith to set the terms of . . . transactions with related parties in a manner consistent with the arm's length principle"[32] – not dissimilar to the exceptions in the United States.

As of April 2005, when the German Administrative Principles were released, 16 European countries had already adopted the OECD Guidelines, and a few others had adopted them "with some important exceptions", according to a survey by KPMG.[33] The German adoption seems to preserve at least one national concept, which is personified in the "proper and conscientious business manager".

II. The Proper and Conscientious Business Manager

A. General Concept

The "proper and conscientious business manager" is a German character like the "reasonably prudent person" in American tort law.[34] While Germany has a civil law system, the proper and conscientious business manager is as present in German case law as the reasonably prudent person in U.S. common law. Just like a reasonably prudent person could be described as a private individual who slows down when driving on an icy road, or who puts her dog on a leash when walking a busy street, the proper and conscientious business manager is a professional with enough common business sense to avoid unnecessary financial troubles. A Google search for this character leads to more than 1,000 citations from courts who explain to a party what a proper and conscientious business manager would or should have done under any given circumstances.

B. The Proper and Conscientious Business Manager in Transfer Pricing

In the context of transfer pricing, the proper and conscientious business manager is a tough negotiator. This is evident in administrative guidelines, in court opinions, and in negotiations between tax professionals and tax bureaucrats.

1. Administrative principles

The 1983 guidelines, upon which the Administrative Principles are built, explain as an initial matter that "the basis [of arm's length evaluations] is the common care of proper and conscientious business managers towards unrelated parties".[35] One example states that "a proper business manager of the disadvantaged entity would not tolerate such schematic assessment of a price, but would in the interest of his own entity strive for balanced pricing. Therefore, the income of the disadvantaged entity must be adjusted".[36]

The proper and conscientious business manager has also made his entry into the Administrative Principles. When negotiating a contract with a related foreign party, he would always make sure that he is entitled to any documentation which may be needed at a later time to justify a transfer price.[37] He will also use the transfer pricing method which promises the best comparability of data.[38]

While the two previous examples are signs of prudence rather than toughness, the character of the proper and conscientious business manager as an unrelenting negotiator appears in the discussion of price ranges.[39] Even though he is not mentioned "by name" here, his spirit is clearly present. While the German rules allow for a narrowing of price ranges by use of interquartile ranges, this mathematical determination does not seem to enjoy the same crucial position as it does in the U.S. under Regulation Section 1.482-1(e). Instead, interquartile ranges are chosen "if the necessary narrowing of price ranges

cannot be achieved by means of other transfer pricing methods *or considerations of plausibility*".[40]

In an example of such subjective plausibility consideration, the Administrative Principles state that "an entity which continuously permits the other party to hold it down to an unfavourable price at the fringe of the range, or which always allows the other party to dictate the price within a range, does not act according to arm's length principles".[41]

2. Courts

If a business manager is too generous towards his negotiation partner, the Federal Finance Court [42]becomes suspicious. It tells the would-be negotiator that his failure to cut out a better deal is an indication that the negotiation was not at arm's length. For example, the Court has held that "transferring intangible property within a chain of entities may constitute the distribution of hidden dividends if the consideration is less than would be expected when proper and conscientious business managers are involved".[43] In another opinion, the Court held that "a proper and conscientious leader of a tax accounting firm would have charged a group of corporate clients an appropriate fee for its tax counselling services".[44]

3. Tax administrators

The proper and conscientious business manager is not the only zealot in the German transfer pricing business. In the view of German transfer attorney and commentator Roland Pfeiffer,[45] German government bureaucrats love to tell a German businessperson how he or she should have negotiated a deal. But Pfeiffer says that the view of government agents is at times too narrow, stating that "the German tax administration has a strong tendency to view transactions in an isolated manner. The OECD is much more willing to look at transactions in a larger context".[46] Giving a practical example from his own dealings with the government, Pfeiffer describes a recent encounter during which he was told that a large corporation should have had the financial leverage to assert a lower purchase price for itself than it did:

> The government employee's understanding was that a large company has more negotiating power than a small company. But he did not see the other side, which is that a larger company can afford to cope with higher prices because its fixed costs per transaction are lower than those of a smaller company.[47]

Is it a typical German treat to tell others what to do? It would be a plausible explanation for the popularity of the proper and conscientious business manager. The character seems to allow everybody to step in the shoes of an expert. Who prevails in a dispute over the best strategy, however, may not so much depend on true expertise, but rather on who has the strongest leverage. This is perhaps the biggest disadvantage of the Germans' popular hero.

III. Love for Detail?

Products "made in Germany" have a worldwide reputation of meticulous craftsmanship. Diligent care for details is also characteristic of the Administrative Principles, at least where the authors cared to provide it. Areas in which the Administrative Principles are not very detailed are covered in the 1995 OECD Guidelines. The following describes areas in which the Administrative Principles provide more detail than the American Section 1.482 regulations, and other areas where German authorities seem to rely on the OECD Guidelines. It also discusses the extent to which German practitioners are expected to be familiar with the OECD Guidelines.

A. "Factual Case documentation" vs. "Arm's Length Documentation"

Both the Administrative Principles and the American Treasury Regulations address issues of documentation, and overall, the German rules appear to be more detailed than the U.S. rules. Section (*Textziffer;* hereafter *Tz.*) 3 of the Administrative Principles, which describes the general duties of taxpayers to provide documentation under Section 90(3) of the German Tax Procedures Act, fills 46 of the 76 pages, and two sub-sub sections devoted to factual case documentation and arm's length documentation are the core piece of *Tz.* 3, filling alone 20 pages.[48]

A group of German transfer pricing professionals who chose the English translations "factual case documentation" and "arm's length documentation" for the original German captions calls the distinction "comparable in principle to the approach required by the U.S. Regulations Section 1.6038A (factual case documentation) and U.S. Regulations Section 1.482 (arm's length documentation)".[49] This comparison is valid insofar as both IRC Section 6038A and the German factual case documentation requirements give the government access to information which already exists on the books of a company. The Section 1.482 regulations and German arm's length documentation, by contrast, require that the companies create new information in order to document the correctness of their transfer prices.

The comparison is not perfect, however, since the scope of Section 6038A and its regulations appear considerably narrower in scope than *Tz.* 3.4.11 of the Administrative Principles. Some of the provisions under Section 6038A are found elsewhere in the Administrative Principles, and part of the provisions under *Tz.* 3.4.11 overlaps with Regulation Section 1.482-1, which deals with arm's length documentation.

Looking beyond a purely formalistic comparison between Section 6038A and *Tz.* 3.4.11, a comparison between the Section 1.6038A regulations and Regulation Section 1.482-1 on one hand, and several corresponding German provisions on the other is rewarding because it shows potential differences in how the governments are trying to gain access to foreign information, and what type of information they may obtain.

1. Access to foreign information

Section 6038A empowers the IRS to get information about foreign entities from domestic corporations that are at least 25 percent foreign-owned. Section 6038A is triggered when the domestic corporation enters into transactions with the foreign shareholder or another related party.[50] The type of information includes basic data such as place of business and nature of business of the related parties,[51] as well as a list of specific records that are routinely kept in the course of business.[52] The IRS has the power to summon foreign documentation because it can force the domestic corporation into the role of a foreign related party's limited agent.[53] If the foreign party refuses to authorise the domestic corporation to be the agent, the IRS is free to adjust transfer prices to reflect arm's length transaction in its sole discretion.[54] In addition, a non-complying corporation becomes subject to penalties.[55] The purpose of Section 6038A is to ensure that the IRS gets the full picture of transactions

between U.S. corporations and their foreign investors who might otherwise refuse to provide crucial information.

The scope of "factual case documentation" in the German Administrative Principles appears to be broader in two ways. First, the German rules help tax authorities collect information both from inbound and outbound investments. Second, *Tz.* 3.4.11 requires not only the type of information described in Section 6038A and its regulations, but also information that needs to be created such as a function and risk analysis, which is found in Regulation Section 1.482-1(d).[56]

As a preliminary matter, all rules under the Administrative Principles include inbound as well as outbound investments because *Tz.* 1, the short introductory segment,[57] provides that all rules apply to transfer pricing between parties with a cross-border relationship as defined in Section 1 of the International Transaction Tax Act".[58] This definition includes both 25 percent foreign-owned German entities and 25 percent German-owned foreign entities, as well as parties under common control, parties where one has influence over the other by contract, and parties where one has an interest in the profitability of the other.

Even though outbound investments are not included in IRC Section 6038A, this might be a minor difference to the German regulations because in the case of outbound investments, the U.S. government has jurisdiction over the domestic investor. The interesting question is how the German government enforces its request for information from an outbound investor, since the mere fact that outbound investors are included in a German definition does not by itself oblige the outbound investor to comply.

To resolve the problem, the Administrative Principles dedicate one sub section (*Tz.* 3.3) to "Heightened Duties in the Case of Foreign Factual Documentation".[59] Under these rules, all parties, whether foreign or domestic, have the duty to investigate facts abroad and gather information.[60] A party is exempted from this duty, however, if it can prove that obtaining the information was legally and factually impossible.[61] Such exception is not spelled out in the Section 1.6038A regulations, but the "reasonable cause" exceptions under Regulation Section 1.6038A-6(b), which seem to focus on factual and legal errors, may also be read as including impossibility since the provisions are not written in an exclusive language.[62] The German exception might even be interpreted as being narrower than the exception under Regulation Section 1.6038A-6(b) because it does not allow for legal or factual errors. To the contrary, the proper and conscientious manager is expected to secure evidence in advance.[63]

The Administrative Principles go through detailed explanations under which circumstances a party can or cannot be expected to provide the information. Even legal impossibility is limited to cases where a party or its employees are at serious risk of severe sanctions; the fact that giving out certain information may be against the foreign law is not by itself sufficient to trigger the exception.[64] Excusable factual impossibility, on the other hand, includes a situation where it can be shown that a related party refuses to furnish information.[65] In this case, the party who is unable to retrieve such information is only obliged to provide other information to the extent possible.[66] Thus, the Germans are more forgiving than the Americans in this one instance of a foreign related party who stubbornly refuses to co-operate.

Sanctions for non-compliance, including violations against the foreign information requirement under *Tz.* 3.3, are found in Section 4 (*Tz.* 4) of the Administrative Principles. They will be discussed separately *infra*, but it is noteworthy that the provisions choose a domestic subsidiary failing to provide information about its foreign parent as the example to demonstrate how the evidential burden on the government is lowered when insufficient information is provided.[67] In that example, the German subsidiary provides insufficient information about technical data of a machine it has sold to its foreign parent. The German tax authority is obliged to make reasonable efforts of its own to determine a correct price. Once it has exhausted its own resources, it is entitled to make an estimate, but if there is a range of possible prices for the machine, it must choose the one that is most likely, rather than the value most disadvantageous for the taxpayer. This seems much more lenient than the "sole discretion" that is granted to the IRS in the case of non-compliance under Section 6038A(e)(3).

2. Type of information

While *Tz.* 3.3 deals specifically with foreign information, *Tz.* 3.4.11, labelled as "factual case documentation", elaborates further on the general requirements on documentation, whether originating in Germany or abroad. The scope of the information required under *Tz.* 3.4.11 is broader than the requirements under Section 6038A(b) and the Section 1.6038A regulations. It includes the type of information listed in Regulation Section 1.6038A-3(c)(2), but also analyses of functions, risks, capital used, and market conditions as found in Regulation Section 1.482-1. The Administrative Principles prescribe the application of function, risk, and other analyses both in the context of factual case documentation under *Tz.* 3.4.11 and arm's length documentation under *Tz.* 3.4.12. This is probably so because "factual case documentation" and "arm's length documentation", although formally divided up in the Administrative Principles, are closely related. The interrelation is highlighted by the fact that *Tz.* 3.4.11 makes cross references to corresponding sub Sections in the OECD Guidelines where analysis is required,[68] and those sub Sections are found in a part providing "[g]uidance for applying the arm's length principle".[69]

Under *Tz.* 3.4.11, the taxpayer has to collect and provide the tax authorities with data demonstrating how the taxpayer runs its own business, and how it shapes its own business dealings. The taxpayer also shows under *Tz.* 3.4.11 why it deems a specific method, for example, the comparable uncontrolled price method or the cost plus method, to be the most suitable. Under *Tz.* 3.4.12, the taxpayer then performs similar tests as under *Tz.* 3.4.11, but with a different purpose. This time, the goal is to demonstrate that unrelated businesses would establish their prices in a similar way.

The comparability analysis provision of Regulation Section 1.482-1(d) makes no formal distinction between "factual case analysis" and "arm's length analysis" like the equivalent German provisions under *Tz.* 3.4.11 and 3.4.12. The analysis under Regulation Section 1.482-1(d) serves both purposes – describing how the tested party runs its own business, as well as an analysis how comparable companies run theirs. This is evident from the language of Regulation Section 1.482-1(d)(3), which requires that each analysis be performed both for the controlled and the uncontrolled transactions.[70]

B. What the Germans Have and the Americans Lack

1. Value-added chain

The Administrative Principles put great emphasis on value chain data, which is described as part of the factual case documentation in *Tz*. 3.4.11.5. The "chain of value creation" is defined as the sum of all contributions to a service or product, beginning with research and development, and ending with delivery to the end user.[71] Such contributions include steps in between, such as purchases, production, storage, marketing, as well as management, book keeping, or internal communication.[72] The value of each contribution is defined as the difference between the price which the next member of the chain is willing to pay, and the accumulated value of all contributions received by the latest contributor.[73] Contributors include both corporations or segments of a corporation.[74]

No matter under which method the taxpayer tries to prove that its pricing was determined at arm's length, the German authorities require a detailed description of how each entity within a group adds to the value of a product. The authors of the Administrative Principles concede that "the functions and risk analysis and related arm's length analysis usually leads to sufficient information regarding the taxpayer's contribution to the value chain".[75] If, however, such information cannot be derived from a functions and risks analysis, the taxpayer has to furnish a value chain analysis to the extent legally and factually feasible.[76]

By comparison, value chain data seem to play a limited role under the Section 1.482 regulations. Both the resale price method and the cost plus method are used to determine to what extent a party contributes to the end price that the customer pays for a product or service. However, while "[t]he resale price method measures the value of functions performed",[77] and the cost plus method typically reflects a manufacturer's contribution to the value of a product,[78] none of these methods requires that a taxpayer determine its role in the chain value in comparison with other members of the chain.

2. Internal planning data

The German government is interested in the taxpayer's thought process. Under the German regulations on Section 90(3) of the Tax Procedures Act (GaufZ),[79] which builds one of the legal fundaments of the Administrative Principles,[80] a taxpayer has to maintain internal planning data such as pricing calculations or anticipated sales, costs, and profits.[81] The October 2004 draft of the Administrative Principles provided that a taxpayer was obliged to furnish such internal planning data to the tax authorities upon demand.[82] Furthermore, the Administrative Principles recommended that the tax authority only waive the receipt of internal planning data if the taxpayer has recorded and furnished third-party comparables with unlimited usability.[83] The mandatory language was stricken from the final version and replaced with a language that depicts the usage of internal planning data as an acceptable alternative to prices of third-party comparables, but only if usable third-party prices cannot be determined with reasonable effort.[84]

If arm's length documentation is based on internal planning data, the taxpayer has to add external data such as common profit margins or capital interest to the extent possible.[85] Guidance for the taxpayer on how to prepare internal planning data en lieu of third party comparables is very complex and detailed.[86] Notably, it includes – once again – the subjective character of the proper and conscientious business manager who would not stick to the upper or lower edge of a profit margin.[87] Internal planning data are only considered reliable if the taxpayer regularly adjusts expected figures to events as they occur.[88]

The change in treatment of internal planning data from the preliminary to the final version of the Administrative Principles is remarkable. It seems to reflect a shift from describing these data as something desirable from the viewpoint of the government to describing them as a last resort. This could be due to concerns that a taxpayer would otherwise be too willing to forego intense efforts to gather comparable third party data in favour of settling for more easily available internal planning data. Nonetheless, internal planning data may have the function in Germany that "unspecified methods" have in the Section 1.482 regulations, as discussed *infra*.

C. What the Germans Lack and the Americans Have

1. Treatment of intangibles – very few explanations

The IRS devotes a complete Section of the Section 1.482 regulations to measuring transfer prices involving intangible property. Regulation Section 1.482-4 explains how to use three specific methods, or – alternatively – unspecified methods.[89] One of the specific methods, the "comparable uncontrolled transaction method", was developed to adjust the comparable uncontrolled price method to the special requirements when evaluating intangible property transactions.[90]

The Administrative Principles specify no particular method for dealings with intangibles. One example illustrating arm's length analysis happens to involve licence fees and the specific adjustments that valid documentation on those fees requires.[91] Furthermore, the factual case documentation requirements describe the extent to which information on intangibles must be included. But no systematic distinction is made between the analysis of transfer prices for intangibles and transfer prices for tangible property.

The gap between the German and the American approach may be growing. So far, the Section 1.482 regulations have only distinguished between tangible and intangible property for the purpose of describing and explaining methods to determine an arm's length price. Proposed Regulations Section 1.482-9, published in September 2003, would provide a similar analysis for services transactions, adjusting the methods to the unique characteristics of services.[92] Until now, arm's length prices for services transactions have been determined under a different set of rules, and none of the methods used for tangible and intangible property were prescribed.[93] Different testing concepts for services and transfer of intangibles could lead to inconsistent results in transactions where the two overlap; Proposed Regulation Section 1.482-9 is an attempt to remedy this shortcoming.[94]

The German Administrative Principles not only dispense with a systematic distinction between tangibles and intangibles; they also lack any cross reference to the OECD Guidelines, which devote a complete chapter to "Special Considerations for Intangible Property".[95] This seems to be particularly significant because the Administrative Principles do refer to the OECD Guidelines in another area where their own guidance is sparse, which is the description of individual methods.

2. Description of individual methods

When explaining the requirements of arm's length documentation, the Administrative Principles offer five methods: the comparable uncontrolled price method (CUP); the resale price method (RPM); and the cost plus method (CP) are regarded as equally valid;[96] in addition, the transactional net margin method (TNMM) and the profit split method (PSM) are offered, although with restrictions.[97] However, no specific explanations are provided on how to apply these methods. This is in stark contrast to the Treasury regulations, which dedicate Sections 1.482-3, -5, and -6 to the explanation of specific pricing methods, complete with a host of illustrative examples.

Rather than providing detailed guidance on how to use the methods, the Administrative Principles provide English translations for the methods and refer the reader to the appropriate provisions of the OECD Guidelines which offer specific explanations.[98] Since the German guidelines of 1983 are also very sparse with guidance, the 1995 OECD Guidelines become the reference of choice.[99]

This seems to be another remarkable difference between "Krauts" and "Yankees". While the Yankees provide excellent service with their Section 1.482 regulations for American practitioners, cynics would call this guidance, which is completely independent from the OECD Guidelines, isolationist. The Krauts, on the other hand, are getting more aligned with other OECD countries by relying in some details on the 1995 Guidelines.

Apparently, German practitioners are expected to be familiar with the OECD Guidelines. The weight that German courts give to the OECD Guidelines at least as persuasive authority is exemplified in a 2001 judgment of the Federal Finance Court, which cited Section 1.45 of the OECD Guidelines as authority supporting the recognition of price ranges for tax purposes.[100] The Court also used the OECD Guidelines to support the proposition that a comparability analysis can serve to limit a price range, and that data of a tested party may be adjusted to data of a comparable.[101]

3. Unspecified methods – less flexibility in Germany

One escape provided in the Treasury regulations does not exist in the Administrative Principles. Treasury Regulation Section 1.482-3(e) allows the use of "unspecified methods" where the others don't fit – provided that the taxpayer adheres to the general principles under Regulation Section 1.482-1. The absence of such a "catch-all" may be one reason why internal planning data serve as an alternative solution in Germany if not only the unconditionally accepted methods, but even the methods with limited acceptance, namely the transactional net margin method and the profit split method, fail to produce usable third-party comparables.

The draft of the Administrative Principles provided three specific situations in which arm's length documentation could entirely rely on internal planning data: If third-party comparables were unavailable either

1. because of the unique quality of the taxpayer's product or services; or
2. because third-party comparables could only be gathered with unacceptable effort; or
3. in the case of foreign related parties, such data could not be provided because of legal or factual impossibility.[102]

The first situation, relating to uniqueness of a product, comports with the example provided in Regulation Section 1.482-3(e), relating to "unspecified methods". In that example, a U.S. company produces *unique* vessels and sells them to a Canadian subsidiary.[103] Under the facts and circumstances of the example, it would be acceptable to use the purchase price that had been offered *bona fide* by an unrelated party to determine the correctness of the price actually paid by the Canadian subsidiary.

The comparison between the "unspecified methods" and the "internal planning data" is limited insofar as the German rules do not provide solutions like a *bona fide* offer; instead, they are limited to internal planning data. Furthermore, the three short and crisp descriptions of situations in which internal planning data could substitute for arm's length documentation were replaced in the final version of the Administrative Principles by lengthy, detailed provisions explaining under which circumstances comparable third party data are considered unavailable. The provisions pointing at uniqueness or at legal or factual impossibility to gather data from abroad are gone, perhaps because the authors of the German rules decided not to be nailed down to these three specific situations. Nonetheless, some common elements remain. Both countries show understanding for the possibility that sometimes the specified methods don't work. And in both countries, the rules provide that general principles of the specified methods should be preserved to the extent possible.[104]

IV. Weary of the Yankee Test

A. No Best Methods Rule

The United States has a "best method rule", and Germany does not. According to Regulation 1.482-1, "there is no strict priority of methods, and no method will invariably be considered to be more reliable than others".[105] The current regulations under Section 1.482-8 provide examples on how to apply the best methods rule.[106]

The 2004 draft of the Administrative Principles contained a short provision which could have been interpreted as a limited "best methods rule", providing that the taxpayer must choose the method that suits best its circumstances, and that in case of doubt, it has to select the method likely to yield the most reliable third-party comparables.[107] However, this provision was stricken from the final version, making even more clear what was already true for the draft version: there is a hierarchy. CUP, RPM, and CP, called "standard methods" under the German rules, are offered as potentially equal in value, depending on the taxpayer's situation.[108] Below the standard methods, there are two alternatives: TNMM, and the profit split method. The TNMM can only be applied if standard methods are inapplicable, and only for routine transactions that do not bear any significant risks.[109] The profit split method is only acceptable if standard methods are inapplicable or unreliable.[110] As an example for a situation in which the profit split method is considered suitable, the rules provide for a situation where several related parties, all of which serving in entrepreneurial functions, are equally involved in the preparation, implementation, and closing of an international deal.[111]

The Administrative Principles follow the OECD Guidelines, which express clear preference for transactional methods over other methods because "[t]raditional transaction methods are the most direct means of establishing whether conditions in the commercial and financial relations are preferable to other methods".[112] The "traditional transaction methods" under the OECD Guidelines are identical with the "traditional" methods under the Administrative Principles (CUP, RPM, CP), and what the OECD Guidelines label as "transactional profit methods" are the other methods tolerated in Germany under limited circumstances (TNMM, profit split method).[113]

The Comparable Profit Method (CPM) is the American counterpart of the TNMM. It uses, like the TNMM, net profits of comparable uncontrolled taxpayers to determine whether the amount charged in a controlled transaction is arm's length.[114] Although the CPM has been described as "a method of last resort",[115] it has nonetheless "become the most widely used of the four basic methods (CUP, RPM, CP, and CPM)" used in the United States.[116]

B. No Comparable Profit Method

When the OECD introduced the TNMM in its Guidelines as a replacement of the CPM, practitioners were wondering about the practical effects of the switch. Robert Culbertson, an international tax attorney based in Washington, D.C., concluded that:

> "[t]he OECD Guidelines and the U.S. regulations are fundamentally consistent because both documents base their acceptance of a net margin analysis on the foundation of comparability".[117]

But this is obviously not the view expressed in the Administrative Principles, which accept the TNMM under limited circumstances while flatly denying the CPM any recognition.[118] The reasoning consists of two short and terse sentences:

> "The comparable profit method does not lead to comparable third party results. Not being based on transactions, it uses net profits of business segments or corporations which are not suited for an analysis of comparability."[119]

The German position towards the CPM is even more rigid than the stance taken in the OECD Guidelines, which declare the CPM "acceptable only to the extent that they are consistent with these Guidelines".[120]

The Germans explain their acceptance of the TNMM with the proposition that companies with routine functions that engage in only one type of transactions allow a comparison between transactions of the tested entity and transactions of comparables.[121] The explanation further provides that a connection between the profit level indicator (PLI) and the transfer price of the tested entity can be made because comparable companies with routine functions bear relatively low risks.

The American approach to the CPM appears to be somewhat different. The comparability analysis under Regulation Section 1.482-5 provides that "comparability under this method is particularly dependent on resources employed *and risks assumed*".[122] Careful comparison of risks assumed implies the possibility that both the tested party and the controlled party or parties may in fact be exposed to high risks, so long as the risks are at comparable level. This difference between the German and the American approach, however, reflects only different views on what makes a net profit comparison reliable. It does not change the fact that both countries allow, at least under certain circumstances, net profitability as a means of evaluating transfer prices.

Another possible explanation why the German rules accept the TNMM but reject the CPM is the notion, cited above, that the CPM is "not based on transactions", and that it uses net profits "of business segments or corporations" rather than profits based on transactions. The same concern appears in the segment devoted to the TNMM, which provides that complex activities do not permit the aggregation of transactions.[123] Aggregation seems to be a crucial factor for application of the TNMM. If a transaction is too unique, it cannot be aggregated with other transactions and is therefore unfit for application of the TNMM. This is the reason why the transaction should be routine.[124]

It may be true that the CPM starts at the corporate level. The examples under Regulation Section 1.482-5(e) indicate this: Examples 1 through 3, based on the same fact pattern, deal with a U.S. distributor which is compared to other companies that are in the wholesale distribution business. The number of comparables is narrowed down by *dis*aggregation, since only "companies in the same industry segment that perform similar functions and bear similar risks" as the tested party make the final selection.

Regulation Section 1.482-5(b)(1) specifies that a comparable party's profit level indicator (PLI) is applied to the tested party's "most narrowly identifiable business activity for which data incorporating the controlled transaction is available".[125] Independent from the chosen pricing method, the Section 1.482 regulations allow for aggregation of transactions, but only if products or services are sufficiently related.[126] Overall, it appears that both TNMM and CPM are looking for a tested party that is not complex, whether this is achieved by aggregation or by disaggregation.

Robert Feinschreiber's book *Transfer Pricing Methods; an Applications Guide* conducts a comparison between TNMM and CPM. The author of the comparison, Delores Wright, sees the most significant difference in the fact that the CPM, following general principles under Regulation Section 1.482-1, uses the interquartile range to cut off fringe values of price ranges. The TNMM as described in the OECD Guidelines allows for the full range of results.[127] Wright gives an example for the significance which involves a U.S. manufacturer and its German subsidiary. It is determined that the German subsidiary has a PLI of nine percent. The full range of PLIs among comparables runs from four percent to 10 percent, while the interquartile range is five percent to eight percent. According to Wright, the IRS would likely adjust the PLI to the midpoint of 6.5 percent, while the Germans would likely find the nine percent return appropriate, "thus requiring that the issue be settled by the competent authority process, with the possibility that double taxation would result".[128]

This would be a convincing case why the difference *does* matter, except that Wright's example has been superseded by the realities of the Administrative Principles. The new German rules provide for an interquartile range, just like the U.S. regulations.[129]

In consideration of the foregoing, the distinction between TNMM (acceptable) and CPM (unacceptable) may be a bit artificial and exaggerated in its rigor; or, maybe, it is just a play with words, since the Germans are willing to use net margins in limited circumstances, no matter which name they attach to the method.

V. Punishing Sloppiness and Tardiness

Who punishes harder – the Yankees or the Krauts? This question is just as important for taxpayers as the rules themselves because the severity of punishment will greatly influence the taxpayer's decision whose rules to break, if any. And, of course, it is also important to know what kind of failure triggers the most significant penalties.

A. To Err Is Human if the Error Is Documented

Both Germany and the United States use arm's length ranges where the search for an arm's length price does not lead to a single result.[130] Falling outside the range can be costly, but in both countries, the costs are mitigated when the taxpayer shows contemporaneous documentation.[131]

With or without documentation, the IRS may adjust the taxpayer's result to any point within the range, but "such adjustment will ordinarily be to the median of all the results".[132] Since the median of these results is based on unrelated transactions that have been selected under the premise of highest possible accuracy, the result of putting a taxpayer in the median should be somewhat realistic. It may be noted, however, that the language of the regulations, using the words "will ordinarily", does not necessarily bind the IRS to the median of a range.

The Germans have a different and perhaps more differentiated approach,[133] but they arrive at a similar result as the Americans. Citing other applicable law on which the Administrative Principles are based, the provisions make the main point that the goal of an estimate is the finding of the result that is most likely to be true, that authorities must never make an arbitrary estimate to the disadvantage of the taxpayer, and that estimates of a punitive character are always unacceptable, even if the taxpayer has made a gross misevaluation.[134] Based on these principles, the German authorities are entitled to choose any adjustment within the range so long as it appears to be the most accurate adjustment.

Even if not punitive in character, adjustment by several percentage points can have serious tax consequences, no matter in which country the transfer price is adjusted. If, for example, a net margin based on $100 million sales is adjusted down from nine percent to 6.5 percent,[135] the difference in dollar amounts would be $2.5 million, and the adjustment of the actual transfer price would be increased accordingly.

On top of the adjustment, a taxpayer in Germany who fails to furnish adequate documentation is now subject to a "surcharge" (*Zuschlag*) of five to 10 percent of the tax adjustment undertaken by the German government, with a minimum of €5,000.[136] This extra surcharge[137]may be unpleasant to taxpayers subject to German transfer pricing rules, but it is still more benign than the 20-40 percent that are imposed under U.S. tax law.

American taxpayers who surpass certain thresholds of misevaluation become subject to accuracy penalties under Section 6662(e) and (h). Congress and, via the Section 1.6662-6 regulations, the IRS, provide a very detailed system of penalizing taxpayers either based on the degree of valuation misstatement, or on the adjustment of gross receipts. A substantial valuation misstatement carries a penalty of 20 percent of the underpayment, and in the case of a gross valuation misstatement, the penalty is doubled to 40 percent.[138]

Under Regulation Section 1.6662-6, the IRS may not assert an inaccuracy penalty to transfer prices sufficiently supported by any specified or unspecified method, so long as the taxpayer also provides contemporaneous documentation.[139] The result is similar to that in Germany, since documentation alleviates the consequences of error. The two governments only have different ways of encouraging the documentation, as one country waives a penalty as a reward for compliance, while the other adds a surcharge for non-compliance.

B. To Be Late Can Cost a Million

The Germans punish tardiness. In addition, at least arguably, they penalise sloppy or non-existing bookkeeping even if the taxpayer has accurate prices. Both issues will be explored in a moment.

As shown, both countries provide that contemporaneous documentation mitigates the consequences if the taxpayer's transfer price is incorrect. No provision, however, exists in American tax law that requires contemporary records per se. Even the penalties under Section 6038A for domestic corporations that are at least 25 percent foreign-owned are only applicable to the extent that there is a maintenance requirement,[140] and such requirement exists only for the purpose of resolving disputes over the taxing of transactions with related parties.[141]

If the penalty under Section 6038A is applicable, the domestic corporation has to pay an initial $10,000 for each taxable year during which failure to provide or maintain documentation occurs.[142] If 90 days after the IRS has made a demand the taxpayer still fails to comply, the penalty rises by $10,000 for each started 30-day interval of non-compliance.[143] The regulations specify that no upper limit exists for penalties in the event of continued failure to comply.[144] It would take the non-complying corporation a little over eight years to reach the sum of $1 million – the cap on German penalties for delayed documentation.[145]

Under the German Tax Procedures Act,[146] any natural or legal person who is obliged to keep books under laws other than tax law is also required to fulfil the same book keeping duties for purposes of taxation.[147] The Tax Procedures Act provides specific instructions on how records have to be maintained.[148] Thus, an obligation to keep records *per se* exists in Germany – at least on paper. The only monetary consequences, however, occur in the context of transfer pricing disputes because only then, lack of compliance leads to diminished burden of proof for the German authorities and to potential surcharges, as discussed *supra*. No provision in the Tax Procedures Act or the regulations expanding on the Tax Procedures Act provides for a penalty or surcharge for failure to keep books.

The bottom line seems to be that in both countries, taxpayers have to choose whether they use their documentation to avoid adjustments and penalties, or whether they keep their records to themselves at the cost of unabashed government adjustments.

Once a dispute has been unleashed, the Administrative Principles provide at least two ways of enforcing compliance. One is by means of a *Zwangsgeld* (enforcement penalty) in the amount of up to €25,000.[149] More drastic, however, is the imposition of penalties for delayed submission of documentation. The daily minimum rate is €100, with a cap of €1 million.[150] There seems no fixed cap, however, on the daily penalty, since €100 is a minimum, and the government may decide that many important documents are missing on a given day. This makes the German penalty appear stiffer than the cap-free penalty under Section 6038A, apart from the fact that the scope of the Section 6038A penalty is narrower.

When looking at the new German penalties as a whole, it seems a bit like the German government wanted to rattle the sabre, but then it got cold feet – especially after earning criticism from taxpayers and their supporters.

VI. Bureaucrats Spare No One?

The 2004 draft of the Administrative Principles contained a curiosity that was telling. It said that if a taxpayer fails the arm's length test, and if the government has a reasonable indication that the taxpayer has committed a criminal act, then it *must* initiate a criminal proceeding.[151] What sounded so dramatic, however, was only common fare because under the German Criminal Procedure Act, a prosecutor has always to initiate a court investigation if actual evidence of a crime is present unless otherwise provided by law.[152]

It seems that the German government initially intended to send a message to every governmental official that the crackdown on flawed transfer pricing had begun. Maybe it also wanted to make a point to taxpayers. But then, the government withdrew the provision completely.

By comparison, none of the U.S. transfer pricing rules has ever made such specific references to criminal procedure, nor is there a criminal statute with regards to transfer pricing. Sections 7021 *et seq*. provide for criminal fines and jail sentences in the event of wilful tax evasion, and in one of the leading transfer pricing cases on the subject of wilful tax evasion,[153] the Second U.S. Circuit found that the trial court's "finding of criminal intent beyond a reasonable doubt [was] amply supported by the evidence".[154] This case, however, is only helpful as guidance on the degree of devious conduct needed to prove a defendant guilty. It says nothing about the triggering point for initiating a criminal investigation.

This triggering point, however, is likely to be as low as in Germany even if it is not spelled out in the transfer pricing regulations. The IRS has Criminal Investigation (CI) agents in place who gather information on their own, accept tips from other segments and divisions within the IRS, or collect information from members of the public or from other government agencies.[155] Michael Saltzman's treatise "IRS Practices and Procedure" states that "[a]s a matter of policy . . . the Service requires that possible criminal prosecution be given precedence over its civil aspects".[156]

So, why did the Germans first trumpet out common fare and then lower their voice? Because the taxpayers did not like the tone, they showed it in their responses. The Government had literally asked for it, since the publication of a preliminary version in October 2004 was meant to gather feedback. For example, attorney Pfeifer's accounting firm Deloitte & Touche opined in a letter to the German government that:

> while it is undoubted that the penal rules of tax law are generally applicable in the context of transfer pricing, the effect of heavily emphasising penal aspects is questionable. It might lead to an inappropriate exacerbation of the climate in local auditing, and at worst, it may result in intimidation of taxpayers. . . . Furthermore, German tax authorities have correctly admitted that the determination of transfer prices is not an exact science, and that therefore considerable discretion must be granted.[157]

If nothing else, the German government showed sensitivity to the concerns of the taxpayer community.

VII. What Might Come Out of This

A 19-page document was probably insufficient to make German corporate taxpayers think more seriously about their pricing arrangement. And now that Germany has tightened the grip, it will have better means to keep tax revenue from disappearing into countries that already had stricter regulations in place.

New problems, however, may be on the horizon. Recent cases in the European Court of Justice led to the recognition that the Free Establishment clause of Section 43 under the E.C. Treaty is taken very seriously. In *Lankhorst Hohorst GmbH v. Finanzamt Steinfurt* and *Petri Mikael Manninen*,[158] the governments of Germany and Finland, respectively, had to change their laws because the European Court of Justice found that they discouraged investment in Germany in the case of *Lankhorst* and investment abroad in the case of *Maninen*. Even though neither case dealt with transfer pricing, the Danish government responded by adjusting its transfer pricing regulations because it anticipated that foreign taxpayers would otherwise use the principles pronounced in these cases to claim discrimination. While detailed transfer documentation was initially only required between Danish entities and foreign related parties, the same documentation is now also required for dealings within Denmark without foreign participation, to put domestic and foreign investors on equal footing. The reasoning was that foreign investors might feel discriminated if they have to undergo the extra labour and expenses of extended documentation.[159] It is not unlikely that the German regulations will have to adjust to this principle as well, but at this point, the Administrative Principles do not contain any provision that would make the rules applicable for intra-German transactions.

VIII. Summary

Keeping the inevitable fact of stereotyping in mind, it seems as if the Germans have been able to put their stamp on the new regulations by preserving their favourite character, the proper and conscientious business leader. They also have preserved their reputation for loving order and punctuality. As for the love of detail, they have only in part lived up to their worldwide reputation. Other signs of toning down are showing, for example, the recognition of non-transactional

transfer pricing methods, even if only within limits. For now, there may still be "Yankee rules" and "Kraut rules", but as the world is growing together, the differences are likely to disappear over the years to come – for the sake of efficiency, and perhaps at the expense of some quirks that are endearing unless a taxpayer is in the grip of the authorities.

The above paper was completed by the author as part of his Graduate Honours Seminar 'Practical Topics in International Tax' at the Georgetown University Law Center.

The author wishes to express his gratitude for advice and information to Adjunct Professor Sean Foley, Principal, Global Transfer Pricing Services, KPMG, Washington, D.C.; Adjunct Professor Steven Wrappe, Partner, Deloitte Tax LLP, Washington, D.C.; Roland Pfeiffer, attorney, German Transfer Pricing Team at Deloitte GMBH, Düsseldorf, Germany; and Dr. Markus Brem, economist, director of GlobalTransferPricing, Hirblingen, Germany. Making their time and expertise available, they were of invaluable help.

1 26 CFR Section 1.482-1 through -8 relate to 26 USC Section 482, an essential transfer pricing Section which provides that:

"[i]n any case of two or more organisations, trades, or businesses (whether or not incorporated, whether or not organised in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organisations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organisations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of Section 936(h)(3)(B), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible."

In addition, there is Prop. Regulation Section 1.482-8 (current Regulation Section 1.482-8 will be redesignated if and when Prop. Regulation Section 1.482-8 becomes final), and Prop. Regulation Section 1.482-9. *See* 63 Fed. Regulation 11177 (March 6, 1998); 68 Fed. Regulation 53447 (September 10, 2003).

2 Original title: Grundsätze für die Prüfung der Einkunftsabgrenzung zwischen international verbundenen Unternehmen und zwischen anderen nahe stehenden Personen mit grenzüberschreitenden Gschäftsbeziehungen in Bezug auf Berichtigungen, Ermittlungs- und Mitwirkungspflichten sowie Verständigungs- und EU-Schiedsverfahren (Verwaltungsgrundsätze-Verfahren).

3 Bundesministerium für Finanzen.

4 Alexander Vögele, Markus Brem et al., *Economic Analysis Prevails in German Documentation*, Tax Planning International Transfer Pricing; Volume 5 Number 12; December 17, 2004 (describing a preliminary draft of the Administrative Principles released on October 18, 2004).

5 Original title: Schreiben betr. Grundsätze für die Prüfung der Einkunftsabgrenzung bei international Verbundenen Unternehmen (Verwaltungsgrundsätze) Vom 23. Februar 1983 (BStBl. I S. 218)(BMF IV C S – S 1341 – 4/83). Geändert durch BMF v. 30.12.1999 (BStBl. I S. 1122).

6 Richard M. Hammer, Cym H. Lowell et al., International Transfer Pricing – OECD Guidelines; Part II. OECD Guideline Applications in Specific Countries; Chapter 14. OECD Transfer Pricing in Foreign Countries; 14.06 Germany [REVISED]; 14.06[1] Introduction.

7 Id.

8 Durchführung von Berichtigungen.

9 *Verfahren*.

10 These are: (1) the Tax Procedures Act (*Abgabenordnung;* AO); (2) the Introductory Law to the Tax Procedures Act (*Einführungsgesetz zur Abgabenordnung*; EGAO); (3) the International Transactions Tax Act (*Gesetz über die Besteuerung bei Auslandsbeziehungen,* a.k.a. *Außensteuergesetz*; AstG); and (4) regulations on Section 90(3) of the Tax Procedures Act (*Gewinnabgrenzungsaufzeichnungsverordnung*; GaufZ).

11 According to Hammer, Lowell et al., see *supra*, "[t]he German tax authorities have audited transfer prices at least since 1925, when the German income tax code first applied the arm's-length principle to international businesses".

12 *See, e.g.*, Regulation 41, Articles 77 and 78, of the War Revenue Act of 1917, granting the Commissioner the authority to require related corporations to file consolidated returns "whenever necessary to more equitably determine the invested capital or taxable income". *See also* Revenue Act of 1921, Pub. L. No. 67-98, ch. 136, 240(d), 42 Stat. 227, 260, permitting the government to require consolidated accounting of groups of related corporations "for the purpose of making an accurate distribution of apportionment of gains, profits, income, deductions, or capital between or among such related trades or business".

13 *See supra*.

14 Regulation 86, Art. 45 (1935).

15 *See* Marc M. Levey & Steven C. Wrappe, *Transfer Pricing: Rules, Compliance and Controversy* (draft of 2nd Ed., Chapter 1, at ¶140.02) (citing Treas. Regulation Sections1.482-1, 1.482-2; TC 6952, 1968-1 C.B. 218, 33, Fed. Regulation 5849 (April 16, 1968)).

16 *Id.*, at ¶140.07.

17 The OECD (Organisation for Economic Co-operation and Development) had 30 member states as of April, 2005. Both the United States and Germany are founding members who joined the OECD at its inception in 1961.

18 Transfer Pricing and Multinational Enterprises, report of OECD Tax Committee adopted May 16, 1979. *See* Hammer, Lowell et al., *International Transfer Pricing – OECD Guidelines*; . . . Chapter 14. OECD Transfer Pricing in Foreign Countries; 14.06 Germany [Revised]; 14.06[5][a].

19 *See* Tax Management Foreign Income Portfolios, Transfer Pricing 895-1st T.M., Transfer Pricing: European Rules and Practice Detailed Analysis: Part 23; II. Basic German Transfer Pricing Rules; C. Transfer Pricing Standards; 2.B: "OECD commentary to Art. 9 and the OECD Transfer Pricing Guidelines".

20 *See* Tax Management Foreign Income Portfolios, Transfer Pricing 895-1st T.M. . . . "OECD Commentary to Art. 9 and the OECD Transfer Pricing Guidelines", stating in its "Comment" on the OECD Commentaries that

"[i]n Germany, it is common opinion that there has been only one significant reason for the revision of the previous reports, i.e., the developments in transfer pricing legislation and practice in the United States since 1986. It is believed that, but for the U.S. developments, there was basically no need for revisiting the issue of transfer pricing. Both the German tax authorities and German taxpayers felt rather comfortable with the consensus reached in the 1979 Report and the Administrative Guidelines based on that report."

21 Andrew Lymer & John Hasseldine, *The International Taxation System* (Kluwer Academic Publishers, 2002).

22 Lymer & Hassedline, *The International Taxation System* at 166 (emphasis in the original).

23 Jake Pickle (D-TX), Congressman from 1963-1995 and member of the Committee on Ways and Means, accused foreign companies in Committee hearings of "under-paying up to 30 billion dollars of taxes a year through transfer pricing abuses". *See* Lymer & Hasseldine at 165. A study by the IRS put the figure at a maximum of $3 billion. *See* Lymer & Hasseldine at 165, FN8, citing the Economist of 25 July 1992.

24 *See* 26 USC Sections 6662(e),(h); added Dec. 19, 1989, P.L. 101-239, Title VII, Section 7721(a), 103 Stat. 2395.

25 26 USC Section 6662(e)(3)(B)(i)(I) through (III).

26 *See* Tax Management Foreign Income Portfolios . . . "OECD Commentary to Art. 9 and the OECD Transfer Pricing Guidelines", "Comment" on the OECD Commentaries.

27 Levey & Wrappe, *Transfer Pricing: Rules, Compliance and Controversy* (Chicago: CCH Incorporated, 2001), at 142.

28 *See* KPMG survey, "Snapshot of Global Transfer Pricing Compliance Requirements. Based on a review of KPMG's transfer pricing practice 2004".

29 OECD Transfer Pricing Guidelines, Chapter V, 5.20 at 158.

30 OECD Transfer Pricing Guidelines, Chapter IV, 4.18 – 4.23 at 102-03.

31 OECD Transfer Pricing Guidelines, Chapter IV, 4.24 at 103.

32 OECD Transfer Pricing Guidelines, Chapter IV, 4.28 at 104-05.

33 See supra, FN 28.

34 German: Ordentlicher und gewissenhafter Geschäftsleiter.

35 1983 guidelines, Paragraph 2.1.1: "Zugrunde zu legen ist die verkehrsübliche Sorgfalt ordentlicher und gewissenhafter Geschäftsleiter gegenüber Fremden". (court citations omitted).

36 1983 guidelines, Paragraph (Textziffer; hereafter Tz.) 2.1.9, Example 1.

37 Tz. 3.3.3 (relating to securing evidence in advance (*Beweisvorsorgepflicht*)).

38 Tz. 3.4.10.1 (dealing with general requirements of documentation and choosing a transfer pricing method).

39 Tz. 3.4.12.5

40 Tz. 3.4.12.5(d) (emphasis added).

41 Tz. 3.4.12.5(c) (citing Tz. 2.1.9 of the 1983 guidelines).

42 *Bundesfinanzhof*.

43 *Bundesfinanzhof*, Judgment of 9 August 2000, I R 12/99. Note that German cases, like many European cases but unlike cases in the United States, are identified by dates and identification numbers, but not by the names of parties.

44 *Bundesfinanzhof*, Judgment of 23 June 1993, IR 72/92

45 Roland Pfeiffer, attorney with Deloitte & Touche in Düsseldorf, Germany, is the author of several articles regarding international transfer pricing rules.

46 Telephone interview on April 3, 2005.

47 Same telephone interview.

48 Tz. 3.4.11 deals with factual case documentation (*Sachverhaltsdokumentation*); 3.4.12 addresses arm's length documentation (*Angemessenheitsdokumentation*).

49 Vögele, Brem et al., *Economic Analysis Prevails in German Documentation*, *see supra*.

50 26 USC Section 6038A(a); 26 USC Section 6038A(c)(2), defining "related party", which includes foreign entities holding, directly or by attribution, at least 25 percent of the shares of the domestic corporation.

51 26 USC Section 6038A(b).

52 *See* 26 CFR Section 1.6038A-3(c)(2).

53 26 USC Section 6038A(e)(1).

54 26 USC Section 6038A(e)(3).

55 26 USC Section 6038A(d)(1) prescribes a $10,000 penalty for each tax year for which the corporation fails to furnish the required information, and if the failure continues after receipt of a 90-day letter, the penalty increases by $10,000 for each 30-day period. *See* 26 USC Section 6038A(d)(2).

56 *See* 26 CFR Section 1.482-1(d)(1).

57 Tz. 1 is entitled Allgemeines (General Provisions).

58 Außensteuergesetz, see supra.

59 Erhöhte Mitwirkungspflichten bei Auslandssachverhalten.

60 Tz. 3.3.1.

61 Tz. 3.3.2(b).

62 26 CFR Section 1.6038A-6(b)(1), the general provision, states that "[c]ertain failures may be excused for reasonable cause, *including*" failures to maintain proper records (emphasis added). This language would not by itself exclude the failure to obtain certain information. Regarding the type of good cause acceptable to the IRS, Regulation Section 1.6038A-6(b)(2)(iii) provides that "[t]he determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances", and that circumstances "*include* an honest misunderstanding of fact or law". (emphasis added). The inclusion of error does not expressly exclude factual or legal impossibility; at least, a taxpayer could argue this if faced with such impossibility.

63 *See* Tz. 3.3.3, as discussed *supra*.

64 Tz. 3.3.2(e).

65 Tz. 3.3.2(b).

66 *Id*.

67 Tz. 4.4, dealing generally with lowering of evidential restrictions on the government in the case of non-compliance with documentation requirements (*Minderung des Beweismaßes bei Verletzung der Mitwirkungspflichten*).

68 OECD Guidelines, Sections 1.31 through 1.35.

69 OECD Guidelines, Chapter 1.C.

70 *See* 26 CFR Section 1.482-1(d)(3)(i) through (v).

71 Tz. 3.4.11.5, 2nd sentence.

72 Tz. 3.4.11.5, 4th paragraph.

73 Tz. 3.4.11.5, 3rd paragraph.

74 *Id*.

75 Tz. 3.4.11.5, 5th paragraph.

76 *Id*.

77 26 CFR Section 1.482-3(c)(1).

78 *See* 26 CFR Section 1.482-3(d)(1), providing that "[t]he cost plus method is ordinarily used in cases involving the manufacture, assembly, or other production of goods that are sold to related parties".

79 Gewinnabgrenzungsaufzeichnungsverordnung (GaufZ), see supra.

80 See supra.

81 GaufZ, Section 1(3), 4th sentence.

82 Administrative Principles, October 2004 draft, Tz. 3.4.9.4(a).

83 Administrative Principles, October 2004 draft, Tz. 3.4.9.4(e). Under the draft as well as under the final version, the usability of prices of unrelated parties is "unlimited" if either the business conditions are identical to the conditions between the related parties; differences exist but have no effect on the pricing; or existing differences have been sufficiently adjusted by the taxpayer. *See* final version, Tz. 3.4.12.7.

84 Tz. 3.4.12.6(a).

85 Tz. 3.4.12.6(b).

86 Id.

87 Id.

88 Tz. 3.4.12.6(c), requiring adjustment between "*Soll- und Ist-Zahlen*".

89 *See* 26 CFR Section 1.482-4(a)(1) through (4).

90 26 CFR Sections 1.482-4(a)(1); 1.482-4(c).

91 Tz. 3.4.12.1.

92 *See* Prop. Regulation Section 1.482-9, "Explanation of Provisions" A.1, "Services Transactions".

93 *See* 26 CFR Section 1.482-2; Prop. Regulation Section 1.482-9, "Background" A. Services Transactions.

94 *Id*.

95 *See* OECD Guidelines, Chapter VI.

96 Tz. 3.4.10.3(a).

97 Tz. 3.4.10.3(b),(c).

98 Tz. 3.4.10.3(a) through (c).

99 OECD Guidelines, Chapter II (Traditional Transaction Methods) and Chapter III (Other Methods).

100 *Bundesfinanzhof*, Judgment of October 17, 2001, IR 103-00, at p. 9.

101 *Id.*, at p. 10.

102 Administrative Principles, October 2004 draft, Tz. 3.4.9.4(b).

103 26 CFR Section 1.482-3(e)(2) (emphasis added).

104 *See* 26 CFR Section 1.482-3(e)(1), providing that "[a]ny method used under this paragraph (e) must be applied in accordance with the provisions of Section 1.482-1". By comparison, the Administrative Principles provide that arm's length price documentation based on internal planning data must apply the principles of a suitable transfer pricing method. *See* Tz. 3.4.12.6(b).

105 26 CFR Section 1.482-1(c)(1).

106 Another set of Proposed regulations under Section 1.482-8 exists, but the current Section 1.482-8 regulations will only be redesignated and not abolished once the proposed regulations become final. *See supra*.

107 Administrative Principles, October 2004 draft, Tz. 3.4.8.5.

108 Tz. 3.4.10.3(a).

109 Tz. 3.4.10.3(b).

110 Tz. 3.4.10.3(c).

111 *Id*.

112 OECD Guidelines, Chapter II, at 2.49 (page 71).

113 OECD Guidelines, Chapter III(B) (page 72ff).

114 *See* 26 CFR Section 1.482-5(a). Note that both the comparable profit method (CPM) and the transactional net margin method (TNMM) examine the net profit margin in relation to a nominator such as sales, assets, costs, or resources employed. *See* 26 CFR Section 1.482-5(b)(4); OECD Guidelines, Chapter III.B(ii)(a), Section 3.26. The purpose is to measure the absolute profit amount of in dollars that a business achieves in relation to its size, so that its profitability can be accurately determined.

115 *See, e.g.*, Joel B. Rosenberg, Barbara N. McLennan et al., *Transfer Pricing Comparability: Concepts, Methods and Applications*, Corporate Business Taxation Monthly; Volume 5 Number 3 December 2003 at 7.

116 Id.

117 Robert E. Culbertson, A Rose by Any Other Name: Smelling the Flowers at the OECD's Last Resort, Tax Notes Int'l Aug. 7, 1995, at 380.

118 Tz. 3.4.10.3(d).

119 *Id*.

120 OECD Guidelines, Chapter III.A, Section 3.1. The Guidelines offer no further comment regarding the CPM.

121 Tz. 3.4.10.3(b).

122 26 CFR Section 1.482-5(c)(2)(ii) (emphasis added).

123 Tz. 3.4.10.3(b).

124 *Id*., as discussed *supra*.

125 Re. "profit level indicator" *see supra*.

126 26 CFR Section 1.482-1(f)(2)(i).

127 Delores R. Wright, *Transfer Pricing Methods; an Applications Guide* (Robert Feinschreiber, ed., John Wiley & Sons, Inc. 2004) at 238-39.

128 *Id*. at 240-41.

129 Tz. 3.4.12.5(d); 26 CFR Section 1.482-1(e).

130 26 CFR Section 1.482-1(e)(1); Tz. 3.4.12.5

131 *See* discussion infra.

132 26 CFR Section 1.482-1(e)(3).

133 The German rules provide that a taxpayer's non-compliance with the documentation requirement leads to diminished burden of proof for the government, and they describe several scenarios under which the government is permitted to make an estimate of the correct transfer price within a range. Depending on the scenario, there are subtle differences as to the degree of likelihood to which the result is accurate. *See* Tz. 4.4 through 4.6.

134 Tz. 4.5, 1st through 3rd paragraph.

135 *See* Wright's example, *supra*.

136 Tz. 4.6.3.

137 Note the avoidance of the term "penalty".

138 *See* 26 CFR Section 1.6662-6(a)(1). If measured by the degree of error ("transaction penalty"), 26 USC Section 6662(e)(1)(B)(i) defines a substantial valuation misstatement as 200 percent more or 50 percent or less than the amount that is determined to be correct. The valuation misstatement is "gross" under Section 6662(h) if it is 400 (or 25 percent) of the amount determined to be correct. If measured by the adjustment of the taxpayer's gross receipt ("net adjustment penalty"), a substantial valuation misstatement penalty is triggered if the adjustment is more than $5 million, or more than 10 percent of the taxpayer's annual gross receipts, whichever is the smaller amount. In the case of gross misstatement, these numbers are replaced with $20m adjustment and 20 percent of gross receipts, respectively. *See* 26 CFR Section 1.6662-6(c)(3).

139 26 CFR Sections 1.6662-6(b)(3);(c)(1);(d)(2),(3).

140 *See* Regulation Section 1.6038A-4(a), providing penalties for failure to maintain records "as required by Section 1.6038A-3". Under Regulation Section 1.6038A-3(a)(1), records must be kept "to the extent they may be relevant to determine the correct U.S. tax treatment of transactions with related parties".

141 26 CFR Section 1.6038A-3(a)(1).

142 26 USC Section 6038A(d)(1); 26 CFR Section 1.6038A-4(a).

143 *See* 26 USC Section 6038A(d)(2); CFR Section 1.6038A-4(d)(1).

144 26 CFR Section 1.6038A-4(d)(4).

145 See Tz. 4.6.3, discussed infra.

146 Abgabenordnung (AO), see supra.

147 AO, Section 140.

148 AO, Section 147.

149 Tz. 4.1. It is noteworthy that the maximum amount was spelled out in the 2004 draft. The final version provides that this enforcement penalty may be raised, but regarding the amount, it only makes a reference to Section 328 et seq. of the underlying Tax Procedures Act, which provide the sum. The change may have psychological reasons as will be further discussed *infra*.

150 Tz. 4.6.3.

151 Administrative Principles, October 2004 draft, Tz. 2.7.

152 Criminal Procedure Act (*Strafprozeßordnung*), Section 152(2).

153 *United States v. Berger*, 456 F.2d 1349 (2d Cir. 1972).

154 *Berger*, 456 F.2d at 1352. The case dealt with a U.S. apparel manufacturer which had made arrangements with a wholly owned, Jamaica-based subsidiary that caused the subsidiary to realise profit margins of almost 30 percent where in absence of such arrangements, the margin would have been about one-third. *Berger*, 456 F.2d at 1350.

155 Michael L. Saltzman, *IRS Practice and Procedure* (Copyright © 2005 by RIA; current through 2004 Supplement No. 3), at 12.03.

156 Saltzman, *IRS Practice and Procedure* at 12.01[3].

157 Letter by Heinz-Klaus Kroppen and Stephan Rasch, Deloitte & Touche, to the Federal Ministry of Finance (*Bundesfinanzministerium*), November 11, 2004.

158 Case C-324/00 Lankhorst-Hohorst GmbH [2002]; Case C-319/02 Petri Mikael Manninen [2004].

159 Axel Eigelshoven and Roland Pfeiffer, Neue Verwaltungsvorschriften für die Dokumentation von Verrechnungspreisen in Dänemark (New Administrative Regulations for Transfer Pricing Documentation in Denmark), Steuerrecht; Dokumentation von Verrechnungspreisen; Group 5, Denmark, at 157ff.