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Institut Finanzen und Steuern

Transfer pricing in the light  
of the Corona pandemic –  
short-, medium- and long-term  
perspectives

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## Transfer pricing in the light of the Corona pandemic – short-, medium- and long-term perspectives

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The Institute of Finance and Taxes presents you  
with the ifst publication 535a:

## **Transfer pricing in the light of the Corona pandemic – short-, medium- and long-term perspectives**

Both the German and the world economy are currently witnessing the worst economic recession since the post-war period, triggered by the Corona pandemic. The exact extent cannot yet be determined. Regardless to say, it is already foreseeable that the economic impact will be more significant than that of 2009 financial crisis, where it is becoming increasingly clear that there are winners and losers of this crisis.

A large number of multinational enterprises can no longer survive without government support, particular in industries such as service, tourism, industrial products and automotive. In order to survive in the short term, multinational enterprises are considering multiple options on increasing liquidity, in addition to the life-learned lessons that should be gained from this crisis. The transfer pricing system provides a tax representation of internal group and value chains processes. However, the transfer pricing system can be influenced by multiple factors including various internal and external objectives by stakeholders. These objectives are sometimes in conflict leading to double taxation. In the exceptional situation of the Corona pandemic with the short-term emphasis on liquidity, such conflicting objectives are expected to occur more frequently.

This ifst-publication specifically focuses on how multinational enterprises can take short-term measures to optimize liquidity in transfer pricing, the aspects that should be considered to avoid double taxation, and how transfer pricing systems can be adapted to future strategies. Changes to existing value chains and regulatory developments are also considered.

This publication highlights the basic principles of transfer pricing and its application to the current effects of the Corona crisis. The intention is to avoid an over-simplified and arbitrary representation on the present circumstances. Nevertheless, the authors acknowledge that many solutions will have to be developed on a case-by-case basis and documented accordingly.

Institute of Finance and Taxes  
*Prof. Dr. Johanna Hey*

Berlin/Cologne, 2020/2021

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## I. Introduction

According to initial estimates, the gross domestic product in Germany fell by 2.4% in the first quarter of 2020. The Ifo Business Climate Index for Germany fell to an all-time low of 74.3 points in April 2020. The German Federal Employment Agency (Bundesagentur für Arbeit) reported that by April 26, 2020, companies had registered short-time work for 10.1 million people. Large enterprises such as Lufthansa and Deutsche Bahn are seeking state aid in the billions. Both the German Trade Association (Handelsverband Deutschland, short HDE) and the Trade Association for Home Improvement, Building and Gardening (Handelsverband Heimwerken, Bauen und Garten; short BHB) assume that many retailers and home improvement stores will become insolvent. These results and case examples demonstrate that the Corona pandemic<sup>1</sup> has reached the real economy. In addition to quarantine measures, economists have observed declining demand, disruptions in global supply chains and restrained investments as the main causes.

Furthermore, forecasts also predict an economic downturn. The Council of Experts on the Assessment of Macroeconomic Development has therefore issued a special opinion entitled “The macroeconomic situation in the light of the Corona pandemic” which outlines potential economic consequences of the Corona pandemic for Germany. The opinion has presented various scenarios, depending on how quickly the economy recovers. Based on the assumed scenario, effects on gross domestic product and employment are expected beyond 2021. The OECD comes to a similar conclusion for the G20 countries in their report “Coronavirus. The world economy at risk”. The International Monetary Fund’s figures (at the end of April 2020) assume a 7% to 8% decline in the global gross domestic product by the end of 2020. The Corona crisis will therefore continue to affect national economies along with companies, households and local states in the medium term, although the exact extent of the crisis cannot be currently predicted as emphasized by various economic studies.

In this context, companies must consider the necessary actions and options in the short, medium and long term from a transfer pricing perspective. In the short term, it is necessary to discuss how transfer pricing can be used to manage

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<sup>1</sup> In the following report, the term Corona pandemic is in use based on the WHO classification. The term “COVID-19” is often used synonymously.

and influence liquidity. Furthermore, the pricing of various transactions must be reviewed for current and future transactions.

For example, is it possible to remunerate a routine entity “at cost” or even “cost minus”? Can benchmark studies be created and how can possible adjustment calculations be carried out? What kind of remuneration for an intra-group loan is at arm’s length? How can intangibles be evaluated in light of planning uncertainty? How should management fees and licenses be structured in times of Corona? These questions should be addressed considering existing intra-group contracts and the actual distribution of function and risk. Risk management is of particular importance here. In practice, it is necessary to discuss how tax audits can be carried out during the Corona crisis and how bilateral or multilateral procedures such as MAPs, APAs and joint audits are influenced. In the short, medium and possibly long term, we can expect to see an increase in working from home (“home office”). Therefore, it is necessary to consider whether this will lead to an increase in permanent establishments.

In the long term, we can expect changes in the value chain. Many multinational groups will reevaluate their existing supply chain structures and take appropriate restructuring measures. The Corona crisis has also led to a significant acceleration of digitization of business processes, data collection, data exploitation and forms of communication. With the possibility of restructuring, aspects of avoiding one-off tax effects such as exit taxes will be in primary focus, together with adjustments in existing transfer pricing systems.

In this ifst publication, professional practitioners of transfer pricing will analyze the above-mentioned topics. Questions relating to VAT, customs duty and withholding tax are not covered in this publication.

We want to use this publication to identify options of how tax transfer pricing can support the revised goals of companies in view of global crises, as well as provide support for transfer pricing planning and tax audit defense. Furthermore, we want to provide information on conflict management for future audits. The publication is thus explicitly targeted at corporate practitioners, and consultants. Furthermore, we invite the scientific community as well as the administration to discuss.

We would like to thank ifst for supporting this publication, the contributing writers for their valuable input, Manfred Naumann for his critical review

of some chapters, and Kamila Steuer, Nele Kemski and Stefanie Cernic for their editorial support.

We hope you enjoy reading this publication, and above all, wish you good health despite these circumstances.

Frankfurt

Jobst Wilmanns

Hamburg

Dr. Björn Heidecke

May, 2020

## **II. Summary**

This publication presents short, medium and long-term necessary measures and options from a transfer pricing perspective resulting from the economic developments of the Corona crisis. A summary overview is provided in this section below including references to the detailed report in the respective sections.

### **Economic Development**

According to initial forecasts, gross domestic product fell by 2.4% and 3.8% during the first quarter in Germany and the Euro area respectively. The Ifo Business Climate Index fell to an all-time low of 74.3 points in April 2020. The special report by the Council of Experts on the Assessment of Macroeconomic Development models three possible scenarios for future economic development. The baseline scenario assumes that the economic situation will normalize over the summer. GDP would fall by 2.8% in 2020. Recovery effects would then be expected in 2021, whereby GDP would return to the theoretical GDP level without the Corona Crisis by the end of 2021. An alternative scenario (distinct V scenario) assumes large-scale production closures and restrictive measures persisting over a longer period. Due to the sharp economic decline, especially in the first half of 2020, GDP would fall by 5.4% over the course of the year followed by rapid recovery in 2021, with an expected return to the theoretical GDP level without Corona by end of 2021/early 2022. The Council of Experts assume that in the third scenario (the 'long U'), government measures to contain the pandemic will last for a longer period. Decline will not be as significant compared to the distinct V scenario, however, will nevertheless lead to an increase in redundancies and companies filing for insolvency. The theoretical GDP level without the Corona crisis would not be achieved until late 2022.

Many industries will be affected by these economic developments. Notwithstanding the restrictive measures imposed by quarantine, reasons for economic decline include declining consumer behavior, restrained investment and disruptions in the supply chain. These economic developments are the predominant reason for the necessity for multinational enterprises to review their transfer pricing and respective frameworks (details in section III. P. 23 et seq.).



## **Liquidity Measures and Intra-Group Financial Transactions**

Within multinational enterprises, the aim is to identify and efficiently distribute liquid funds within the group. In this respect, the applicable tax regulations must be adhered to (in particular, the arm's length principle and documentation requirements). In order to ensure optimization on the allocation of liquidity, the following measures should be considered:

- Existing external credit lines are exhausted within the group;
- Existing external financing is reviewed, particularly with regard to breaches of any agreed covenants and associated consequences. For example, an increase in interest rates, providing further guarantees, or the potential termination of a contract;
- Cash pool conditions are reviewed including any changes in external refinancing. Investment conditions should also be passed on and base rates/limits for each participant are temporarily increased;
- Existing intra-group loans are reviewed with regard to the appropriateness of the terms and subsequent value. If necessary, adjustments should be made or new intercompany loans are issued;
- Intra-group guarantees are issued where necessary, in order to obtain external funding in the current situation;
- Alternative financing models are considered such as factoring, sale-and-lease-back or clearing accounts in order to achieve short-term liquidity effects;
- Existing intra-group transactions are reviewed for payment adjustments and the respective adjustments are documented (e.g. paying less today, but more in the future).

Prior to the implementation of the above measures, it should be considered that any contractual adjustments should be permitted by contract and that any adjustments can be economically justified and documented accordingly. This is of considerable importance for German documentation requirements with respect to intra-group transactions in order to defend transfer prices in tax audits and also from a German insolvency law perspective (details in Section V., p. 40 et seq.).

## **Risk Allocation as an Element of Transfer Pricing Analysis**

Following the publication of a risk report at the end of 2019, the World Economic Forum classified the outbreak of global infections of a low

probability of occurrence, but with a high impact in the event. Unfortunately, the Corona pandemic has made this risk a reality. It is expected that the impact of the corona pandemic including its social and economic consequences will lead to a new risk awareness in both companies and society. Risks have long been part of the functional and risk analysis and thus have a significant influence on the transfer pricing analysis. However, they are often regarded as secondary importance in both practice and tax audits. This is expected to change.

Risks arising from business activities must be distinguished in terms of their influence on the very substance of groups (strategic, functional and operational risks) as well as their underlying cause (external or internal). The OECD differentiates three levels in the analysis of the risk management function: (i) the risk mitigation and risk control function; (ii) the actual risk assumption; and (iii) the financial capacity to assume risks. The OECD often requires an appropriate remuneration for the risk management function and risk assumption. Depending on the degree of risk, there is an entitlement to unexpected profits, but also an obligation to assume unexpected losses if the risk materializes. The entitlement to excess profits or losses increases depending on the nature of the risk (strategic vs. functional/operational), the probability of occurrence, and the potential financial impact. Functional and operational risks are usually embedded in existing business relationships, such as goods transactions or services between affiliated companies, and therefore part of the arm's length analysis of these transactions. In the case of strategic risks, it seems difficult to identify comparable transactions in the market and apply the arm's length principle.

Neither in German tax law nor in the predominant cases of transfer pricing documentation has there been such a differentiated consideration on risks. With the exception of the regulations on profit attribution for Permanent Establishments (BsGaV), German tax law indicates that risk assumption is largely determined by contract. In contrast, the risk analysis performed in the course of transfer pricing documentation does not assess risks on an individual basis. Based on the 2017 OECD Transfer Pricing Guidelines, in particular the redrafted Chapter I and experience gained from the global Corona pandemic, multinational enterprises have currently the opportunity to reassess their risk exposure and adapt existing remuneration structures accordingly (details in section VI., p. 54 et seq.).

## **Intra-Group Contracts as a Framework for Options for Action**

Up until now, civil court rulings between related parties have been highly relevant for the determination of transfer pricing from a German tax law perspective. The reason being is that the German Fiscal Court (BFH) focuses considerably on the conclusion of contracts for the purposes of analyzing business transactions. According to the BFH's most recent case law, a contractual agreement within a group must be examined in detail for its third-party character, even in the case of a double taxation agreement (DTA). In consequence, deviation of relevant parts from market standard within a contract can trigger an income adjustment. However, according to the BFH, a complete requalification of a contractual relationship can only take place in exceptional cases.

The economic approach is gaining increasing importance in the transfer price analysis of intra-group relationships. This is shown, for example, by the most recent draft of the German Federal Ministry of Finance (BMF) on the ATAD Implementation Act and the OECD developments. The intra-group contracts must therefore be considered both on a national and international level from an economic perspective, but only to the extent that the actual conduct does not differ materially from the content of the contract. In order to avoid potential disputes, it is advisable to draw up written contracts taking into account the actual conduct, even if it may already be implied.

In light of the Corona crisis, three questions arise with respect to contracts. The first question is, whether the contract concluded contains wording that could be immediately relevant for the Corona crisis and limit the scope for further economic analyses. Clauses regarding natural disasters or unforeseeable circumstances may be relevant (so-called force-majeure clauses). This might also hold true for acceptance and delivery commitments, price guarantees and price adjustment clauses. Secondly, it is important to consider whether there are other legal possibilities or mandatory law outside the contract due to the Corona crisis, which could influence the economic analysis; for instance, regarding the remuneration of routine entities or the determination of the financing conditions. Thirdly, it should be considered how existing contracts should be structured or adjusted in the future in order to be able to reflect similar risks to the ones encountered during the Corona crisis.

While the first and second question serve to a certain extent as a guideline for the economic analysis, the amendments of existing contracts should be used

to document adjustments for actual circumstances and the alignment of intra-group remuneration on both sides. In this case, the hypothetical scenario of two prudent business managers transacting at arm's length provide significant guidance on balancing interests of transacting parties.

The basic motive for the fundamental adherence to the business relationship is expected as a principle in the group context. The sustainability of short-term losses and the medium- to long-term economic perspective of both sides should be considered as well as the contractual and legal obligations when carrying out any measures. For example, such measures include reducing the profit margin of a group company with a limited risk profile (routine companies e.g. contract manufacturers or distributors). Particular attention should therefore be paid to maintaining the profitability of the group during the total period, especially those with routine functions. If there is a distinct deviation between actual circumstance and third party behavior, a contractual adjustment with economically reasonable justification should be made and documented by both companies (at least in writing by both parties). This should lower the risk of a differing position being represented or applied by the tax authorities in a future tax audit. (details in section VII. p. 72 et seq.).

### **Remuneration of Companies with Routine Functions in Crisis Periods**

Due to the economic downturn, it is necessary to determine whether the entrepreneurs should solely bear the resulting losses or whether routine entities should also bear this risk.

One possibility for analysis is the preparation of a benchmarking study for the crisis period. The current economic development during the Corona crisis raises the question as to whether a database study with financial results up to and including 2019 will deliver comparable results for the years 2020, 2021 and potentially 2022. The suitability of data during a crisis compared to post-crisis periods should also be considered. It is already reasonable to assume that the respective data will not be reliable or limited due to the lack of comparability resulting from the vast difference in economic conditions.

Possible approaches to benchmarking studies for crisis periods include: (i) the consideration of loss-making companies; (ii) the extension of the period to reflect both the recovery and recession periods; (iii) the use of data from the financial crisis in 2008/2009; and (iv) adjustment calculations. A possible adjustment calculation could establish a projection model for the crisis

period using regression analyses. An exemplary data set from the automotive industry demonstrated that a projection model that compared sales growth to profitability is statistically robust and delivers reliable results for determining the crisis range. An analysis has to be performed on a case-by-case basis, taking into account industry sector data. The systematic approach must be documented (details in section VIII.1., p. 90 et seq.).

If the benchmarking study does not provide sufficient comparability despite adjustment calculations or support findings, comparable third party calculations would be performed. Within the group, the routine entity would undergo a hypothetical arm's length comparison. For example, it would compare closure costs in a scenario in which the routine entity receives a low margin or loss in the short-term, but achieves a higher margin in the long-term. It is also possible to address fixed and variable costs in this analysis. For example, according to the demand and supply theory in microeconomics, companies are willing to supply in the short-term if the variable costs are covered by the price.

The business analysis or hypothetical arm's length comparison has to be sufficiently documented, and if necessary, provided in the annex of the contract to include an analysis of the acceptance for all parties involved (details in section VIII.2., p. 109 et seq.).

### **Valuation of Intangible Assets, Price Adjustment Clauses and Licenses**

The hypothetical analysis of the arm's length principle must be performed in principle in both the valuation of individual intangible assets and the assessment of the transfer package as part of a relocation of function. In the performance of the analysis, transactional prices must be determined from the perspective of both the buyer and seller respectively. In essence, the maximum asking price from the point of view of the buyer and the minimum selling price from the perspective of the seller will need to be determined. For this purpose, asset valuations are therefore used. The question therefore arises as to how current risks can be considered in the asset valuation. The capitalization interest rate and planning data will be important parameters in this respect.

As the capitalization interest rate is regularly determined on the basis of long-term analyses of returns on the capital market, the methodology for deriving the capitalization rate to account for crisis periods remains unchanged if the recommended range for certain parameters are used. This is in accordance with the current advice from the expert committee on business valuation and business

economics (FAUB). Rather, uncertainties should be reflected in the evaluation of planning data, for example by setting up different scenarios with weighted probabilities of outcome. The adjusted planning calculations and resulting deviations must be documented. The underlying data including planning data at the time of valuation, transfer date and date of contract conclusion should be consistent. It should be avoided that the effects of the Corona pandemic are not included in the valuation although they were known at the time of transfer. Furthermore, price adjustment clauses should become more significant as a result of the additional uncertainty. License rates can be suspended after carrying out economic considerations if unrelated third parties would do the same in comparable situations. The hypothetical analysis of the arm's length principle can be of use in this case (details in section IX., p. 114 et seq.).

### **Permanent Establishments resulting from Home Office**

The pandemic and the resulting restrictions on mobility as well as the contact ban will have a particular impact on the question of whether a taxable permanent establishment will be assumed through the use of private residential premises as a home office, from which the business of the company is managed. The characteristic of permanent power of disposal is of central importance for the question as to whether home office can result in a permanent establishment. According to a court ruling by the BFH, there has to be a permanent, not merely temporary power of disposal over the premises or place where business is carried out for a permanent establishment to exist. Consequently, the employer would have to have power of disposal over the employee's home office in order to assume a permanent establishment. This is not the case in most instances. Thus, an employee's home office will generally not lead to a permanent establishment according to interpretation of German tax law.

However, it can be observed from the OECD, a tendency to distant themselves from the criteria of power of disposal. In principle, the OECD assumes that a home office workplace does not create a permanent establishment. At the same time, however, the OECD also identifies cases where home office can lead to a permanent establishment. This should be the case, for example, if the employee uses home office regularly or even continuously in accordance with instructions from the company or if the employer does not provide an office although an office would be necessary for the work performed. In the medium and long term, it remains to be seen whether the BFH will endorse the OECD's view on the existence of permanent establishments through employee home office.

In addition to the general considerations, the OECD addresses the question of existence of permanent establishments in its statement of 3<sup>rd</sup> April 2020 during the Corona pandemic. The OECD is of the opinion that the existence of a permanent establishment should generally not occur due to control measures against the Corona virus. Hence, employees working from their home office for a company based in a foreign country in principle does not result in a permanent establishment for their foreign employer during the Corona crisis. This is due to the lack of permanence and power of disposal in this respect. The same applies to permanent representatives who, due to their lack of ability to exercise authority, should not lead to a permanent establishment during the period of restrictions (details in section XI., p. 137 et seq.).

### **Advance Pricing Agreements (APAs)**

At each stage of an APA procedure, the taxpayer is well advised to determine the possible impact of the Corona crisis to identify and evaluate options for action. In principle, it should be considered that once an APA has been concluded, it represents a high value for all parties involved. The goal of avoiding double taxation has been achieved, and considerable resources have been invested by all parties in order to avoid a later investment of significant resources. This includes tax audits as well as subsequent national and international procedures.

The special nature of the current situation and its many challenges will hopefully not lead to an extensive revocation of APAs by the competent authorities if the respective conditions of validity are breached, or if an agreement cannot be reached due to persisting uncertainties. At the very least, considering the relevant lessons learned from the 2009 global financial crisis, it is expected that the responsible tax authorities will continue to have a strong interest in avoiding double taxation wherever possible.

The taxpayer has an important role to play in this regard. They have the advantage over the tax authorities in terms of knowledge of the impact of the crisis on their business success, and if applicable, business model. If such cases arise, it is generally advisable to inform the competent authorities concerned of respective changes in a timely and comprehensive manner. Sensible and well-founded proposals for adjustments in the transfer pricing method as well as the conditions for validity should be presented. The taxpayer should create this transparency towards the competent authorities simultaneously enabling all parties to work towards a reasonable solution suitable for all (details in Section X.1., p. 125 et seq.).

## **Audits in Crisis Periods**

The tax audits that had already commenced at the beginning of the pandemic or were already announced and scheduled with a tax audit notice can only relate to past tax audit periods. The tax authorities assume that the documentation obligations have already been fulfilled and that the transfer pricing documentation can be submitted within the prescribed deadlines, or that it has already been requested and submitted during ongoing audits.

Dependent on the progress of the tax audit, further queries on the factual background will already have been investigated and clarified by the submission of documents. In our opinion, tax authorities are understanding in terms of difficulties in obtaining supplementary documents. Consequently, the tax authorities regularly grant extensions of deadlines for the submission of documents or rescheduling of appointments for interim or final meetings without objection.

With regard to meetings, the local tax authorities of each state have varying approaches to dealing with the current challenges. Some authorities have allowed the installation and use of common communication programs on the business computers of tax auditors. Other authorities have declined for various reasons (e.g. data protection etc.).

Experience has shown that in general, the tax auditor examines and evaluates substantive legal issues without consideration of the current exceptional circumstances. This is also the result of the basic principle on tax uniformity. Nevertheless, the tax auditor has scope for discretion in the examination of the facts, which is not subject to judicial review (details in Section X.2., p. 131 et seq.).

## **Short- and Long-Term Effects on Value Chains and the Consequences for Transfer Pricing Systems**

The Corona crisis is a severe blow to global value chains and the related direct interdependencies between the individual stages of the value chain. Supply chains that had been developed over a number of years and tailored for efficiency were stable up until that point. With the outbreak of the crisis in China, supply chains collapsed in the first quarter of 2020. Even prior to the financial crisis in 2008/2009, companies had started demanding flexibility and dynamic behavior. Globalization, saturated buyer markets, customer orientation, intense competition, accelerated technological development and



increasing reduction of product life cycles have shaped the past few years. In consequence to the Corona crisis, companies are expected to review their value chains. The procurement function, production network and distribution functions should be specifically analyzed in order for companies to be more resilient in crisis periods, including adapting to current circumstances. Acceleration of digitalization can be seen as one such example. However, the exact structure is expected to vary on a case-by-case basis, dependent on strategic decisions considering income and cost considerations. Modifications to the value chain should therefore be examined at the beginning of the transfer pricing analysis. Possible medium to long term consequences include the redistribution of functions and risks with the necessity to: (i) adjust the transfer pricing system; (ii) reallocation of intangible assets in connection with the analysis of income adjustments (iii) exit-taxation; (iv) reallocation of functions and transfers of intangible assets; and (v) increase the number of permanent establishments. In the short term, it should be discussed who bears stand-alone and start-up costs considering the risk profile of production entities. The shift to online shopping raises the question on how to structure remuneration between local distributing entities and entities with an online presence. Increasing management functions could lead to an increase in group allocations. A possible interest in additional control by the shareholders could substantiate that additional costs are only to be charged proportionately and remain with the shareholders as shareholder costs (details in Section XII., p. 149 et seq.).

### **III. Economic Developments and Consequences for Transfer Pricing Analysis (Dr. Björn Heidecke)**

#### **1. Macroeconomic Development in Germany**

##### **a. Status Quo**

The Kiel Institute for World Economy noted a 2.4 % decline of the German gross domestic product (“GDP”) within the first quarter of 2020 compared to the previous quarter. Although normal developments were presented in January and February, there was a significant decline recorded in March. According to the forecasts made in the end of April 2020, there is expected to be a double-digit decline for the second quarter.<sup>2</sup> Evidence of current declines and projections is also reflected in the latest ifo business climate index dated 24<sup>th</sup> April 2020, featuring the two components current situation and future expectations.<sup>3</sup> The overall index was at a historic low of 74.3 points in April. In March, it was still at 85.9 points; in February at 96 points. The following graph illustrates the current development over the last 6 months. It shows that both current expectations and future expectations are falling rapidly. A review from 2008 presents the historical low of the overall index (middle line) and of business expectations (bottom line). It is only the assessment of the current situation (upper line) that is not as low as it was in the 2009 financial crisis (05/2009: 77.1; 04/2020: 79.5). Nevertheless, we cannot exclude the possibility that the assessment of the current situation will deteriorate even further below the value of the financial crisis in 2009.

A similar picture can also be observed for manufacturing, trade, construction and services when examining the individual sectors, both in terms of current and future expectations. The construction industry is the only sector that remains positive in the current situation.<sup>4</sup>

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<sup>2</sup> Cf. IfW from 30.4.2020, Corona: German GDP falls by 2.4 % in Q1, <https://www.ifw-kiel.de/de/publikationen/medieninformationen/2020/corona-deutsches-bip-sinkt-in-q1-um-24-prozent/>.

<sup>3</sup> The index reflects the assessment of the current situation and future expectations of more than 9,000 German companies in the commercial sector (manufacturing, trade and construction) that were surveyed.

<sup>4</sup> Cf. ifo Business Climate Germany, 24.4.2020, results of the ifo business surveys in April 2020, <https://www.ifo.de/sites/default/files/secure/umfragen-gsk/ku-202004/ku-2020-04-pm-geschaeftsklima-DT.pdf>.

Figure 1: ifo Business Climate Index Nov. 2019 to April 2020<sup>5</sup>

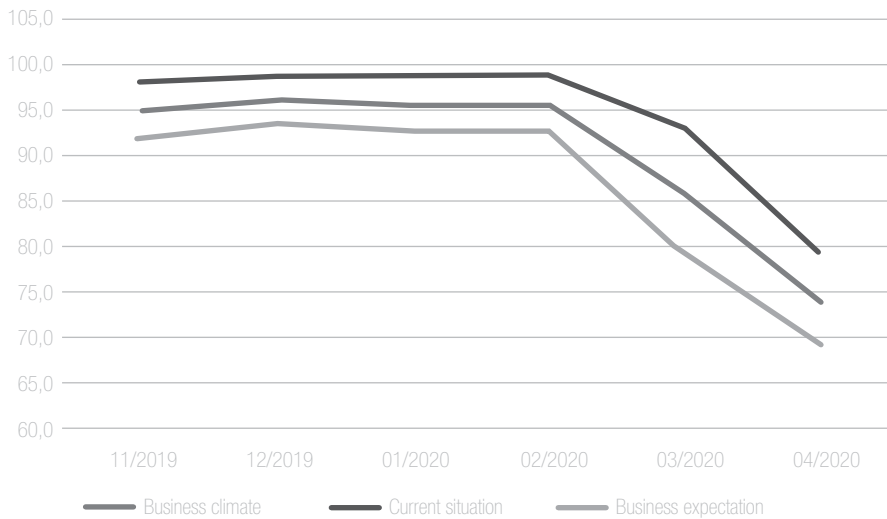
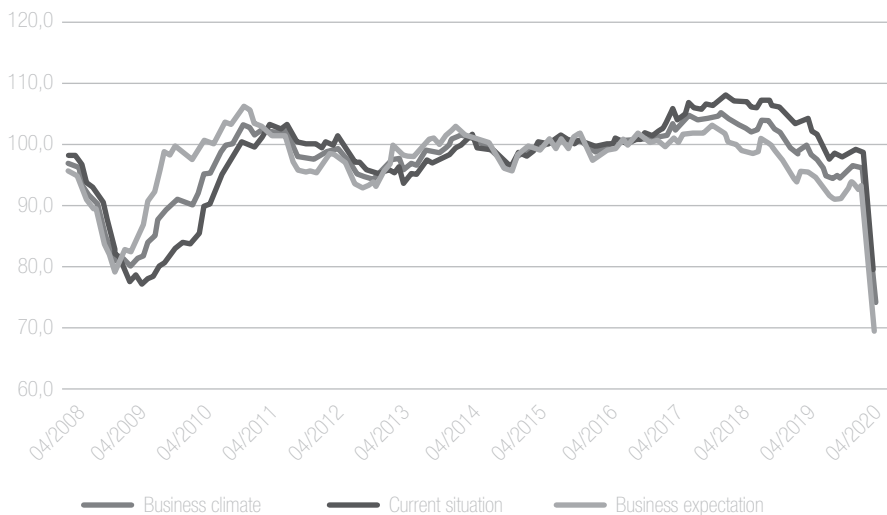


Figure 2: ifo Business Climate Index 2008 to 2020.<sup>6</sup>



The economic downturn is also reflected by the decline in the individual sector indices compared to 31<sup>st</sup> December 2019. The following chart

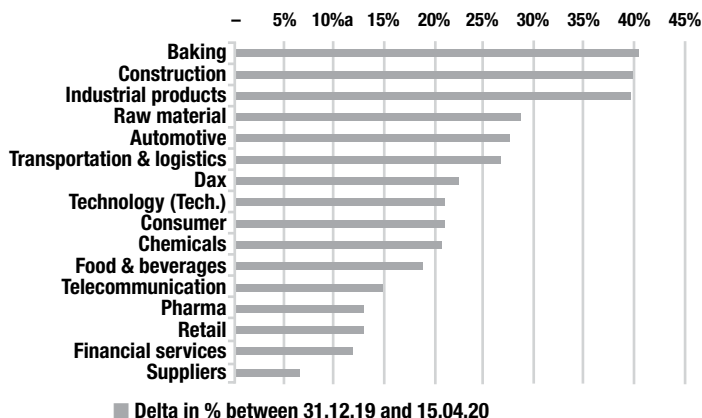
<sup>5</sup> Own illustration, data: Long term data for the ifo Business Climate Germany and its two components business situation and expectations.

<sup>6</sup> Own mapping, data: Long term data for the ifo Business Climate Germany and its two components business situation and expectations.

illustrates that the industrial sector in particular has suffered a significant decline exceeding that of the DAX. The retail and pharmaceutical industries recorded moderate declines.

Figure 3: Development of sector index 2020.<sup>7</sup>

**Losses per industry since 31.12.2019**



The various indicators (GDP, ifo business climate index and sector indices) clearly show the economic downturn in Germany as a consequence to the Corona crisis in March and April. This is the result of a decline in supply and demand. The Corona crisis has thus reached the real economy.

**b. Outlook**

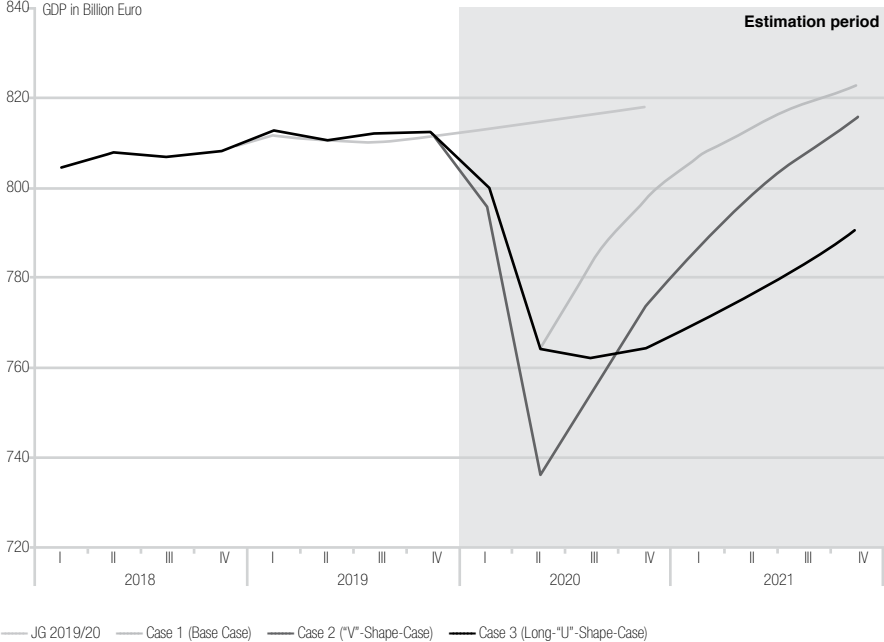
Under these circumstances, the question arises as to how the economy will develop in the short and medium term. One indication is provided by the aforementioned expectations of companies according to the ifo Business Climate Index. The German Council of Economic Experts (“Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung”) has addressed this question in further detail. In a special report by the German Council of Economic Experts, various scenarios are presented of how GDP in Germany could develop over the upcoming years as a result of the Corona crisis.<sup>8</sup> The report published at the end of March, is based on extensive data and experience

<sup>7</sup> Own mapping with data from Capital IQ.

<sup>8</sup> Cf. SVR of 22.3.2020, the overall economic situation in the face of the Corona pandemic.

from previous crises, including studies on the economic effects of influenza and SARS and the associated disruptions to value chains. The Fukushima disaster, major plant closures, and strikes are such examples. The resulting possible development of the varying scenarios is illustrated in the diagram below.

Figure 4: Possible scenarios “GDP development in Germany”.<sup>9</sup>



The upper line represents the performance according to the last annual report. This would be the expected performance without the Corona crisis. Three alternative scenarios are also presented. The base scenario (middle line) was assumed to be the most probable scenario at the end of March. In this case, the economic situation would have normalized over the summer. GDP would fall by 2.8 % in 2020. It would have been expected that recovery would appear in 2021, ensuring that original GDP performance to be achieved by the end of 2021. In the distinct V-scenario (bottom line), expectations of large-scale production closures would occur and restrictive measures would remain in place for a longer period. Due to the sharp decline, especially in the first half of 2020, GDP would fall by 5.4% during the course of the year. Recovery effects are expected

<sup>9</sup> SVR of 22.3.2020, the overall economic situation in the face of the Corona pandemic, 33.

in 2021, with the result that the potential level is expected to be reached again at the end of 2021/beginning of 2022 (extrapolation of the upper line into future years). In the “long U” scenario (black line), it is assumed that the restrictive measures will extend beyond summer 2020. Government intervention would have not been effective against preventing large-scale redundancies and bankruptcies. Investment and consumption would fall significantly, including knock-on effects on financial markets. In this scenario, GDP would fall by 4.5% in 2020. Economic growth would also be weak in 2021 and the potential performance level would not be reached until well into 2022.<sup>10</sup>

The report stresses that the uncertainty on future developments is currently very high, predominantly due to difficulties in obtaining data and the exceptional situation.<sup>11</sup> It is therefore challenging to assess the exact trends and effects on the individual sectors. Nonetheless, the scenarios and the development of business expectation as part of the ifo Business Climate Index indicate that the real economy is expected to decline considerably over the next 6 to 24 months. The following section will broaden the perspective and outline global developments.

## **2. Macroeconomic Development “Global”**

### **a. Status Quo and underlying causes**

The GDP decline in Germany is also present in the Euro Zone. According to initial estimates, GDP in the Euro Zone fell by 3.8 % in the first quarter. Other statistics for countries in the Eurozone include the following: France (-5.8 %); Italy (-4.7 %); Spain (-5.2 %); Belgium (-3.9 %); and Austria (-2.5 %).<sup>12</sup> An preliminary estimate for the USA assumes a decline of 4.8 % in the first quarter of 2020.<sup>13</sup>

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<sup>10</sup> Cf. SVR of 22.3.2020, the overall economic situation in the face of the Corona pandemic.

<sup>11</sup> SVR of 22.3.2020, the overall economic situation in the face of the Corona pandemic, 1.

<sup>12</sup> IfW of 30.4.2020, Corona: German GDP falls by 2.4 percent in Q1, <https://www.ifw-kiel.de/de/publikationen/medieninformationen/2020/corona-deutsches-bip-sinkt-in-q1-um-24-prozent/>.

<sup>13</sup> Bureau of Economic Analysis, Gross Domestic Product, <https://www.bea.gov/data/gdp/gross-domestic-product>.

An ifo study carried out by more than 1,000 economists globally concluded that the decline in investment, reduced consumer spending and disruptions in supply chains, in addition to the restrictive quarantine measures, were responsible for the severe decline (see Figure 5). This is evident both regionally and globally.

Figure 5: Professional survey of the factors influencing economic development<sup>14</sup>

	Total	European Union	Other advanced national economies	GUS	Threshold and developing	Latin America	Middle East and North Africa	sub-Saharan Africa
Reduction of Investment	8,2	8,3	8,0	8,1	7,7	8,5	7,2	8,2
Increase in government budget deficits	8,0	8,2	7,3	7,3	7,7	8,3	7,6	8,5
Reduced consumer spending	7,9	8,0	8,2	7,2	7,4	8,2	5,1	7,8
Plant closures/production stops	7,6	7,9	6,9	7,2	6,9	7,7	6,2	7,5
Quarantine measures	7,6	7,7	7,0	7,7	6,9	8,2	6,4	7,1
Supply chain disruptions	7,5	7,5	7,5	6,8	7,4	6,9	6,4	7,7
Corporate insolvencies	7,0	7,1	6,8	6,8	6,1	6,9	6,3	7,3
Sick leave due to illness	5,3	5,4	5,1	4,5	4,3	5,6	5,4	5,7
Bank failures	3,7	3,8	3,2	4,2	3,8	3,8	3,3	4,6

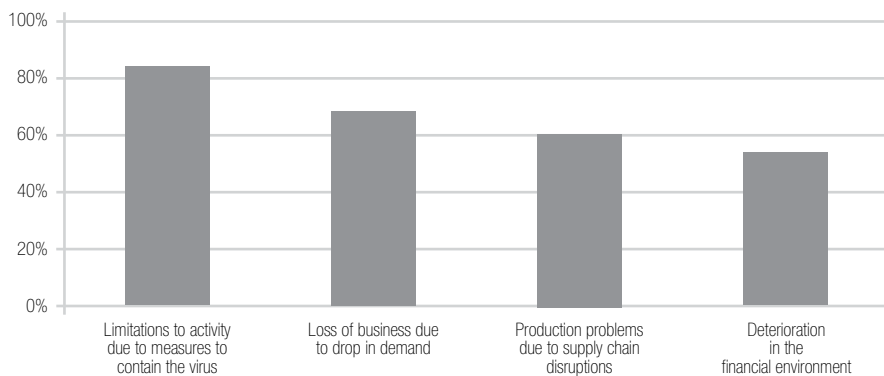
Note: The results are an average of the responses on a scale of 1 to 10, with 10 having the strongest impact.

An additional study carried out at the beginning of April confirmed the aforementioned results. The study dealt with economic developments in Special Economic Zones during the Corona crisis. Special Economic Zones can be seen as a good indicator for global trade as they represent more than 25% of world trade and are globally distributed. Representatives of the Special Economic Zones were interviewed in the study. As a result, more than 85 % of the respondents stated that they are currently and will be affected by the Corona crisis, with more than 40% expecting substantial restrictions. The results for the assessment of the underlying causes for economic decline is

<sup>14</sup> *Boumans/Link/Sauer*, COVID 19: Die Weltwirtschaft auf der Intensivstation. Erkenntnisse aus einer weltweiten Expertenumfrage, ifo Schnelldienst Nr. 5 (2020), 2.

also of interest (see following graph). Supply chain disruptions and declining demand are responsible for the economic downturn, in addition to the consequences of the quarantine.

Figure 6: Professional survey on the causes of economic downturn.<sup>15</sup>



The surveys in the Special Economic Zones and the analysis of the expert panel by the ifo Institute arrive to similar conclusions. Declining demand, disrupted supply chains and quarantine measures are the primary causes of the economic downturn.

## b. Outlook

McKibbin and Fernando<sup>16</sup> have analyzed possible economic effects for various regions and countries resulting from the Corona crisis at the beginning of March. Seven different scenarios have been analyzed. In more optimistic scenarios, they assume a decline of GDP for many countries in the range of 0.5% to 2% in 2020. In a middle scenario, they expect GDP to fall by approximately 3.5% to 5.0% in 2020 for several countries. In a more pessimistic scenario, they expect values of around minus 7.0% to minus 9.0%.<sup>17</sup> Using a different database and forecasting model, the International Monetary Fund (IMF) expects GDP of many countries to fall by between 6.0% and 7.0% (see following chart). They expect a recovery by 2021. Maliszewska,

<sup>15</sup> *Gern/Mösle*, The Impact of the COVID-19 Pandemic on the Global Economy – Survey-based Evidence from Free Zones, Kiel Policy Brief Nr. 139 (2020), 7.

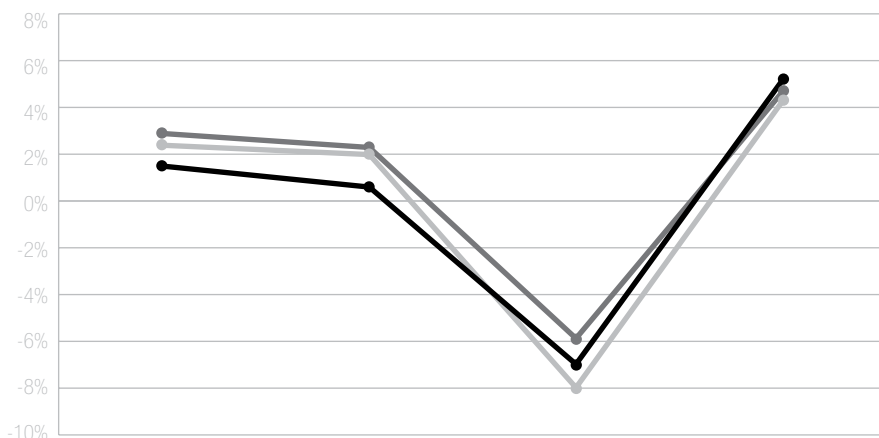
<sup>16</sup> McKibbin/Fernando, in Brookings Paper, <https://www.brookings.edu/research/the-global-macroeconomic-impacts-of-covid-19-seven-scenarios/>.

<sup>17</sup> In the middle or pessimistic scenario, the global economic costs would be 5,000 or 9,000 billion USD.



Mattoo and van der Mensbrugge are somewhat more optimistic (2020).<sup>18</sup> They assume a global GDP decline of about 2% in a positive scenario for 2020 and approximately 4% in a pessimistic scenario.

Figure 7: Development of the GDP in % compared to the previous year, from 2020, estimate.<sup>19</sup>



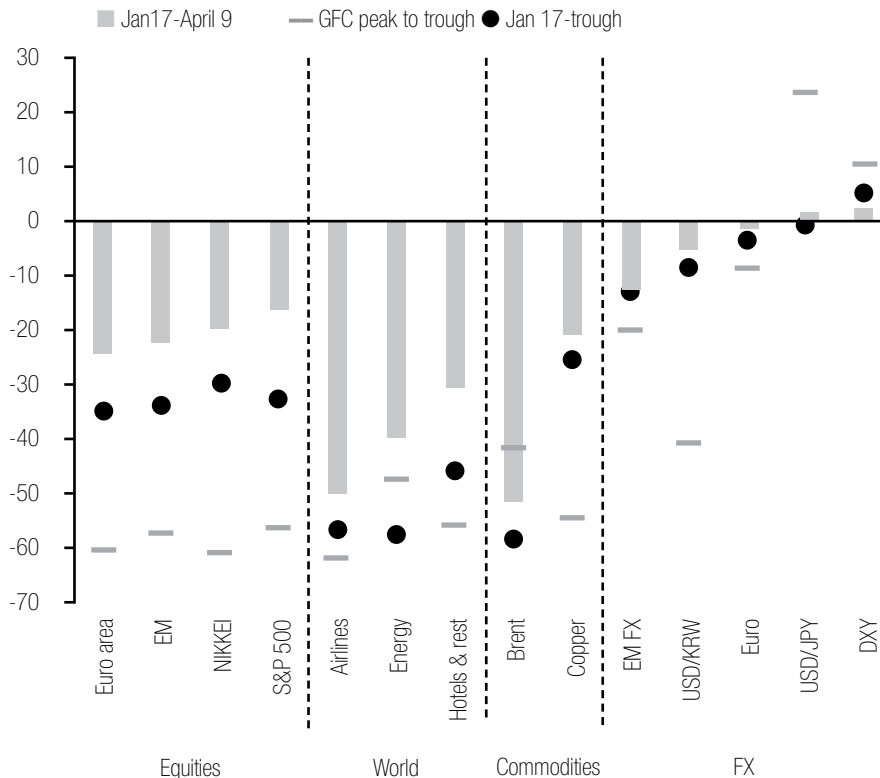
	2018	2019	2020	2021
Germany	1,5%	0,6%	-7,0%	5,2%
Spain	2,4%	2,0%	-8,0%	4,3%
USA	2,9%	2,3%	-5,9%	4,7%
Austria	2,4%	1,6%	-7,0%	4,5%
Belgium	1,5%	1,4%	-6,9%	4,6%
Canada	2,0%	1,6%	-6,2%	4,2%
Denmark	2,4%	2,4%	-6,5%	6,0%
France	1,7%	1,3%	-7,2%	4,5%
Italy	0,8%	0,3%	-9,1%	4,8%
Japan	0,3%	0,7%	-5,2%	3,0%
Singapore	3,4%	0,7%	-3,5%	3,0%
Switzerland	2,7%	0,9%	-6,0%	3,8%
UK	1,3%	1,4%	-6,5%	4,0%

<sup>18</sup> Cf. *Maliszewska/Mattoo/van der Mensbrugge*, The Potential Impact of COVID-19 on GDP and Trade: A Preliminary Assessment, Policy Research Working Paper Nr. 9211 (2020).

<sup>19</sup> Own illustration based on IMF data (International Monetary Fund, World Economic Outlook Database, April 2020).

In a subsequent report by the IMF, the effects of assets on financial markets are analyzed from the beginning of 2020 until the 9<sup>th</sup> April 2020 (see Figure 8). The chart below indicates the percentage changes for the share price in different regions (EM: emerging markets, Euro Zone, Nikkei and S&P 500), industries (energy, airlines and gastronomy/hotel), oil, copper, as well as foreign exchange. Although the impact of the Corona pandemic up until 9<sup>th</sup> April 2020 is not yet as significant compared to the overall effects of the financial crisis (“GFC - Global Financial Crisis”), substantial declines are evident in all areas. The points represented in the diagram below illustrate the expected effects to the part where they have reached the lowest point (trough). Expected impact in comparison to the financial crisis will be dependent on assets.

Figure 8: Global Developments Assets.<sup>20</sup>



<sup>20</sup> IMF, Global Financial Stability Overview, <https://www.imf.org/en/Publications/GFSR/Issues/2020/04/14/global-financial-stability-report-april-2020>, 3.

The IMF states that the Corona crisis could have a similar or even greater impact than the financial crisis in 2009. The extent will highly depend on how the virus continues to spread, the effectiveness of the containment measures and the timing of medication and vaccine development.<sup>21</sup>

### **3. Microeconomic Observations at Industry Level**

This section outlines some initial observations in selected industries based on interviews with companies in the respective sectors.

#### **a. Telecommunications**

Mobile operators are recording growth in their core markets. In some countries, network utilization is rising by 50%. For example, mobile phone usage in the UK has increased by 56% since mid-March. It is expected that the expansion of 5G will be delayed. At present, network operators are currently focusing on maintaining and strengthening their existing network. Disruptions in the supply chain could lead to a decline in hardware sales. Closures of physical store branches could lead to a decline in revenues.

#### **b. Technology**

A number of technology companies may experience a significant decline in sales. This is likely to have a particularly impact on companies that sell to technology companies that are significantly affected by the lockdown (e.g. tourism and gastronomy). Technology companies with a more diversified portfolio may be in a better position to adjust their main portfolio than smaller companies. In niche product areas such as video communications and medical technology, high growth rates are expected as a result of the corona crisis.

#### **c. Trade**

The crisis is changing demand at least in the short term in terms of essential products. The purchasing function and supply chain of retail companies are expected to be adjusted accordingly. Online trading is becoming increasingly

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<sup>21</sup> *Gopinath*, The Great Lockdown: Worst Economic Downturn Since the Great Depression, <https://blogs.imf.org/2020/04/14/the-great-lockdown-worst-economic-downturn-since-the-great-depression/>.

important especially in the times of store closures and long term sustainability. Contactless purchasing systems and modified loop management in retail stores are likely to be necessary after the crisis to ensure that customers and employees feel secure.

#### **d. Automotive Industry**

The automotive industry and its global supply chains are highly integrated. Major interruptions in production throughout Europe and the USA put considerable pressure on supply chains. At the same time, demand is expected to fall at least in the medium term, increasing the possibility of rising liquidity issues. In addition, production networks are expected to be significantly altered in order to be less dependent on any single location in the future.

#### **e. Transport and Tourism**

A considerable decline in demand, or even a complete standstill for a longer period is predicted to affect the transport and tourism industries as much as the aviation and hospitality sectors (hotels, food and beverages, events, etc.). Knock-on effects are expected on suppliers and service providers in neighboring sectors. Significant reductions in personnel, including severance payments and short-time work, are also anticipated in the short term. The recovery phase will be dependent to a large extent on the speed of companies' implementation of the necessary health and safety requirements for guests and employees.

#### **f. Energy and commodities**

The commodity markets are affected in many aspects by the Corona crisis. Business operations themselves are restricted by isolated outbreaks and government-imposed lockdowns, for example in South Africa and Peru. Demand for many commodities such as copper, iron ore and zinc remains low.

Oil, gas and chemical companies are in the midst of two crises; disagreements in the oil market and the effects of the Corona crisis. Oil prices fell dramatically when OPEC and Russia could not agree on production cuts, resulting in a high oil supply. The excess supply is coupled with lower demand from both consumer and industrial production.

In consequence, the short to medium-term outlook is likely to be poor, especially for specialized suppliers, smaller operators and companies with high levels of debt. The mining industry is only area to have benefited from the lower energy prices. On average, companies have energy costs between 20% and 25% of their direct operating costs, enabling them to benefit from the fall in energy prices. This is based on the assumption that companies have not hedged their prices.

Electricity and utility companies help to support cities and communities by deferring payments. Some providers offer hospitals with free supplies. Demand has fallen overall, however not collapsed. The greatest impact has been seen in production and manufacturing locations where industrial demand has fallen. Due to the decline in demand, prices on the wholesale electricity markets have fallen along with LNG and CO2 prices. On the renewable energy side, many companies are suffering from disruptions in the supply chain.

The oil and gas industry is facing an unprecedented shift in economic conditions that is lowering both demand and supply. The Corona crisis has severely curbed global demand for commodities, driving down the prices of oil and gas and related products (e.g. gasoline) to levels not seen for twenty years. Simultaneously, a supply surge affected the market as Russia and Saudi Arabia failed to restrict production flooding the market with excess supply.

#### **g. Construction Industry and Industrial Production**

The construction industry and industrial production are generally capital intensive markets with relatively high level of fixed costs compared to variable costs. Manufacturing activities often had to be reduced or even suspended altogether because consumer orders declined or ceased to emerge. At the same time, there had been a decline in supply as a result of staff's incapacity to work due to legal restrictions, including the complete closure of manufacturing facilities. In addition, there had been some abrupt changes of the products manufactured, away from the regular product portfolio to products which offered new profit potential, e.g. products for the health sector. For certain products that are introduced at a later stage in the industrial supply chain, such as radar equipment for ships, hysteresis effects can be expected. The crisis effect therefore occurs downstream, especially for equipment that are used in other products and machines that are currently not being manufactured.

## **h. Life Science and Health Care**

The industry expects an increased demand for certain medical products and prescription drugs. Increased activity in the development of vaccines and new standards of patient care should provide the industry with a boost. On the other hand, there are negative effects such as interruptions in supply chains and the suspension of therapies, for example in cancer. Delays in regulatory approvals and payments are also expected.

## **4. Summary and Implications for Transfer Pricing**

In light of the uncertainty, it is not surprising that the international studies mentioned above and the German Council of Economic Experts, emphasize the unpredictability of economic forecasts. Further economic development largely depends on the extent to which these effects can be reversed based on the finding that quarantine measures, declining consumer behavior, restrained investment and disruptions to supply chains are the cause of the economic downturn. For this purpose, political measures are being taken worldwide, including the development of vaccines, easing of quarantine restrictions, incentives for investment, and support for supply chains through subsidies and aid programs. At the industry level, most companies have already reacted with profit warnings to the capital markets and short-term measures to ensure liquidity. However, companies are highly concerned that it is currently difficult to make reliable short- and medium-term forecasts.

Considering the current economic position, it is reasonable to assume that transfer pricing analyses in 2020, 2021 and possibly 2022 will be affected by the economic crisis. The effects are likely to vary from one industry to another, dependent on the adverse effects by disruptions in supply chains, quarantine measures and decline in consumer demand. The effects on individual companies not only depend on the macroeconomic development of the industry, but also on the extent to which a company can adapt and how severely individual functions including sales, procurement and production are affected. This in turn depends on the organizational supply chain structure and regional expansion. The transfer pricing analysis should therefore be performed taking into account the industry, function and company specifics. Initial industry observations are outlined in Section 3 (p. 23 et seq.). Possible long-term changes in supply chains and relevant individual functions are described in Section XII. (p. 149 et seq.).

The expected declines in 2020, 2021 and potentially 2022 for company turnover and profits should be reflected in the financial results of comparable companies for benchmarking studies. In this respect, the question arises as to the validity of financial results of the comparable companies during the crisis period, and whether necessary adjustments will need to be made. Section VIII.1 (p. 90 et seq.) provides information on possible adjustments. Furthermore, it remains to be seen whether routine companies should also receive a share of the expected losses. For example, referring to the diagram of the German Council of Economic Experts (p. 24, should routine companies be remunerated at the upper end of the scale or should they bear part of loss as illustrated in the three other scenarios? Section VIII.2 addresses this question (p. 109 et seq.).

Uncertainty in forecast projections further influences both valuations of intangible assets and price-setting approaches. The question arises as to how current valuations can be performed, especially considering that planning data has a major influence in capital value-oriented methods. Section IX. (p. 114 et seq.) attempts to resolve this question. However, it can already be predicted that price adjustment clauses are expected to become more relevant in times of planning uncertainty.

## IV. State Measures (*Dietmar Gegusch*)

On March 13<sup>th</sup> 2020, the German Federal Finance Minister Olaf Scholz and the German Federal Economics Minister Peter Altmaier presented a package of measures to support companies in the course of the current Corona crisis.<sup>22</sup> This set of measures included not only more flexible regulations for short-time work compensation, extensive liquidity support measures in the form of guarantees and loans, but also tax policy measures. The aim of the tax policy measures is to mitigate the economic consequences of the COVID-19 pandemic for companies, in particular to avoid liquidity bottlenecks for taxpayers due to tax payments.<sup>23</sup>

### 1. Measures of the Tax Administration

With a letter dated March 19<sup>th</sup> 2020 (BMF letter<sup>24</sup> and similar state decrees on trade tax aspects<sup>25</sup>), the tax authorities implemented initial tax policy measures. According to the BMF letter, taxpayers who are demonstrably directly and not insignificantly affected for the purposes of income tax, corporation tax and VAT, can submit applications for tax deferral and for adjustment of advance tax payments for income and corporation tax until December 31<sup>st</sup> 2020.<sup>26</sup> These requests should be granted even if the taxpayers are not able to prove the specific value of each and every loss incurred. The BMF also suggests that

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<sup>22</sup> Cf. BMF, Ein Schutzschild für Beschäftigte und Unternehmen, [https://www.bundesfinanzministerium.de/Content/DE/Pressemitteilungen/Finanzpolitik/2020/03/2020-03-13-download-en.pdf?\\_\\_blob=publicationFile&v=4](https://www.bundesfinanzministerium.de/Content/DE/Pressemitteilungen/Finanzpolitik/2020/03/2020-03-13-download-en.pdf?__blob=publicationFile&v=4).

<sup>23</sup> Cf. presentation of the measures implemented by governments worldwide OECD, Tax and Fiscal Policy in Response to the Corona virus Crisis: Strengthening Confidence and Resilience.

<sup>24</sup> Cf. BMF v. 19.3.2020, Fiscal measures to take account of the effects of Corona virus (COVID-19/SARS-CoV-2), IV A 3 -S 0336/19/10007: 002.

<sup>25</sup> Cf. identical decrees of the supreme tax authorities of the “Länder” on trade tax measures to take account of the effects of the Corona virus (COVID-19/SARS-CoV-2)

<sup>26</sup> Cf. notes on concrete implementation see also FAQ “Corona” (Taxes) of the Federal Ministry of Finance, status: 8.4.2020, [https://www.bundesfinanzministerium.de/Content/DE/Standardarticles/themes/taxes/2020-04-01-FAQ\\_Corona\\_Steuern\\_Anlage.pdf;jsessionid=D3356C99DDF598E15AB024AA28C92764.deli%20very2-master?\\_\\_blob=publicationFile&v=8](https://www.bundesfinanzministerium.de/Content/DE/Standardarticles/themes/taxes/2020-04-01-FAQ_Corona_Steuern_Anlage.pdf;jsessionid=D3356C99DDF598E15AB024AA28C92764.deli%20very2-master?__blob=publicationFile&v=8).



strict requirements should not be imposed when reviewing the conditions for deferral and deferral interest should not be charged. Only applications for deferral of taxes due after December 31<sup>st</sup> 2020, and applications for adjustment of advance payments concerning periods after December 31<sup>st</sup> 2020, should require specific explanation.

Until December 31<sup>st</sup> 2020, enforcement measures are to be waived for all taxes (income and corporate tax) in arrears or due by that date. In these cases, late payment penalties for these taxes, arising in the period March 19<sup>th</sup> 2020 to December 31<sup>st</sup> 2020, shall be waived as of December 31<sup>st</sup> 2020. The general principles continue to apply to those only affected indirectly. According to the identical decrees issued by the supreme tax authorities of the federal states on March 19<sup>th</sup> 2020, taxpayers who are demonstrably directly and considerably affected may submit applications for a reduction of the base value for the purpose of advance payments of trade tax until December 31<sup>st</sup> 2020. It is not necessary to provide detailed proof of the value of the impact suffered. Applications for deferral and remission are to be submitted to the municipalities and only then to the tax office if the assessment and collection of trade tax has not been transmitted to the municipalities (§ 1 GewStG and R 1.6 (1) GewStR).

On April 9<sup>th</sup> 2020, the BMF in coordination with the supreme tax authorities of the German federal states, published two further BMF letters. The purpose of the first letter<sup>27</sup> is to give employers the opportunity to grant their employees aid and support in the form of allowances and payments-in-kind between March 1<sup>st</sup> 2020 and December 31<sup>st</sup> 2020 up to an amount of €1,500 tax-free in accordance with § 3 no. 11 EStG<sup>28</sup>. In addition, the second letter<sup>29</sup> contains extensive provisions for simplified proof of donations, for use by tax-privileged organizations in connection with Corona assistance or salary donations.

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<sup>27</sup> Cf. BMF v. 9.4.2020, Mitigating the additional burdens of the Corona crisis for employees - tax exemption for aid and support, IV C 5 - S 2342/20/10009: 001.

<sup>28</sup> This scheme was legally implemented in a later legislative procedure “Gesetz zur Umsetzung steuerlicher Hilfsmaßnahmen zur Bewältigung der Corona-Krise (Corona Tax Assistance Act)”.

<sup>29</sup> Cf. BMF v. 9.4.2020, Tax measures to promote aid for people affected by the Corona crisis, IV C 4 - S 2223/19/10003.

In a further letter dated April 24<sup>th</sup> 2020<sup>30</sup>, the BMF commented on the retrospective reduction of advance payments already made on income and corporation tax for the 2019 assessment period. Taxpayers directly and significantly affected by the Corona crisis, who have not yet been assessed for the 2019 calendar year, may (within the time limits set out in Section 37 (3) p. 3 of the Income Tax Act) request a reduction of the fixed advance payments for 2019. As it is often difficult to forecast and sufficiently explain the losses, the loss carryback from 2020 is calculated as a lump sum.

On May 6<sup>th</sup> 2020, the German Federal Cabinet adopted the government draft for a law on the implementation of tax relief measures to overcome the Corona crisis (Corona Tax Assistance Act), thus starting the parliamentary procedure. The draft law includes the reduction of the VAT rate for the catering industry, the tax exemption for parts of the employer's allowances for short-time work and the extension of the transitional arrangement for the application of § 2b of the German VAT Act.<sup>31</sup>

## **2. Further Measures**

In addition, the Federal Cabinet launched a set of measures with amendments in various areas of law on March 23<sup>rd</sup> 2020. The corresponding law passed the German Bundestag on March 25<sup>th</sup> 2020 and the German Bundesrat on March 27<sup>th</sup> 2020. According to the law, the insolvency law is to be relaxed and the possibility to conduct compulsory presence events online or to defer payments from certain contractual obligations shall be provided. Among other things, the law also provides for simplifications in restructuring law. For example, the maximum period between the closing date of the closing balance sheet of the transferring legal entity and the date of registration is to be extended from 8 to 12 months.

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<sup>30</sup> Cf. BMF v. 24.4.2020, Corona emergency measure: Application for a flat-rate reduction in advance payments already made for 2019, IV C 8 - S 2225/20/10003 :010.

<sup>31</sup> Draft Law of the Federal Government, Draft Law on the Implementation of Tax Aid Measures to Manage the Corona Crisis (Corona Tax Aid Law), BR-Drs. 221/20, on 15.5.2020 the Bundesrat commented on the draft law. On 15.5.2020, the Bundestag debated an identical draft bill of the government factions in a first reading.

## **V. Intra-Group Financial Transactions: Instruments of Liquidity Management and Arm’s Length Analysis during a Crisis** *(Ronny John, Anna Homeyer-Angerstein)*

### **1. Overview**

The companies’ need for financial resources is increasing due to the companies’ current economic situation, mainly driven by decreased revenues (to varying degrees depending on the sector). Thus, it is particularly important to have sufficient liquidity during a crisis (“cash is king”). While internal group resources are often used in the first step, depending on the duration of the crisis, more and more funds are raised on the capital market, or state aid is sought. It can also be observed that the effective interest rate on borrowed funds on the capital market increased sharply in March 2020.

However, even during a crisis, transfer prices must be determined and documented considering the arm’s length principle. This is increasingly important, particularly for intra-group financial transactions, as German legislators for the first time focus on the methodological arm’s length analysis within the framework of Section 1a German Foreign Tax Act – Draft (FTA-D) (as of December 2019) and the OECD published its final “Guidance on Financial Transactions” in February 2020. Both the OECD Guidelines and Section 1a FTA-D include the requirement that, in addition to the amount of the interest rate (arm’s length principle in terms of the value), the appropriateness of such intra-group transactions and adherence to the arm’s length principle must also be demonstrated on its merits (amount of borrowed capital, debt capacity analysis, etc.). Furthermore, the deductibility for tax purposes of interest expenses is limited, e.g. by thin capitalization rules or trade tax add-backs.

Accordingly, the changing economic and market environment has a significant impact on the liquidity situation of the companies as well as on the analysis for purposes of the arm’s length principle and respective documentation.

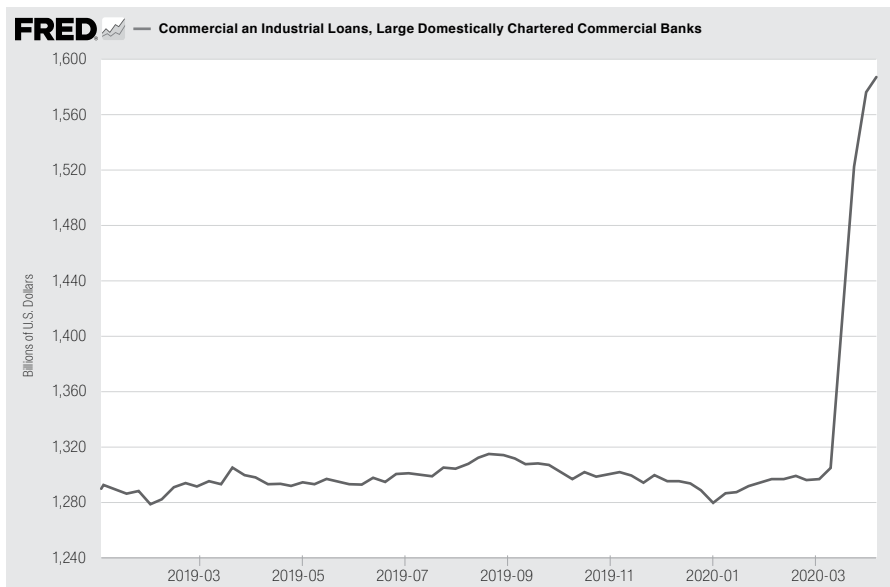
### **2. Effects of the Crisis on International Capital Markets and Companies**

The following section describes a selection of key developments on the capital market and their effects on companies.

## a. a. Liquidity Needs

During financial and economic crises, it is regularly apparent that, due to stagnating or even persistently negative cash flows, an increased need for financial resources is required.<sup>32</sup> This scenario was already evident shortly after the Corona crisis started to spread globally in March/April 2020, as shown below by the example of the USA.

Figure 9: Increase in financial resources required in the USA.<sup>33</sup>



## b. Situation of the Corporate Banking Industry

The Corona crisis is causing spillover effects on real economy and financial markets. Massive deteriorations in the credit ratings and the creditworthiness<sup>34</sup>

<sup>32</sup> See *Roeder*, IBFD 2009, p. 336; *Rinker*, BC 2020, p. 173.

<sup>33</sup> Board of Governors of the Federal Reserve System (US), <https://fred.stlouisfed.org/series/CIBOARD>.

<sup>34</sup> Vgl. S&P Global Market Intelligence as of 7.4.2020, <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/s-p-downgrades-hit-nearly-200-consumer-companies-during-coronavirus-outbreak-57948027>; Moody's Investors Services as of 7.4.2020, European Leveraged Finance, <https://www.moody.com/creditfoundations/Global-Leveraged-Finance-Market-View-05E003>.

of companies burdening the credit institutions' existing loan portfolio can be observed already. Due to the deteriorations of creditworthiness in addition to regulatory requirements (e.g. Basel II), more liable equity capital would typically have to be deposited for the respective portfolio. This makes it even more difficult for banks to grant new loans, despite the fact that the ECB is currently providing the markets with generous amounts of liquidity, the German Federal Financial Supervisory Authority has relaxed the regulatory rules and the state assumes part of the default risk on certain loans.

Despite the fact that the German Federal Financial Supervisory Authority has relaxed the supervisory rules,<sup>35</sup> credit institutions provide less external funding or only to significantly different conditions than before the crisis, which leads to (i) special termination rights for the bank, (ii) requirements for further collateral or (iii) significantly increased credit spreads.<sup>36</sup>

#### **b. c. Increase in Costs for Funds / Liquidity**

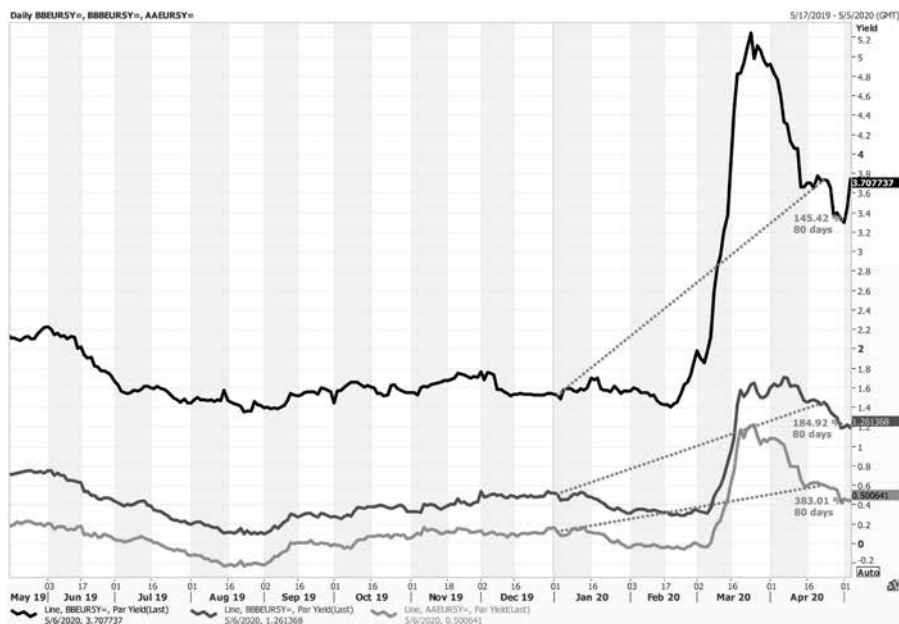
This rapid increase in the cost for borrowed funds since the worldwide spreading of the crisis is reflected in the development of the current interest rates (yield to maturity) of traded bonds on the capital market, as shown in the following chart.

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<sup>35</sup> Cf. Federal Financial Supervisory Authority as of 24.3.2020, Corona-Krise: BaFin erläutert veränderte aufsichtliche Anforderungen, [https://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Pressemitteilung/2020/pm\\_200324\\_corona-krise\\_aufsichtliche\\_anforderungen.html](https://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Pressemitteilung/2020/pm_200324_corona-krise_aufsichtliche_anforderungen.html); ECB as of 12.3.2020, EZB-Bankenaufsicht reagiert auf Coronavirus – vorübergehende Kapitalerleichterungen und operative Flexibilität für Banken, <https://www.bundesbank.de/resource/blob/828160/f4959e11f0565257c462b4fffa1b9772/mL/2020-03-12-capital-relief-download.pdf>.

<sup>36</sup> Cf. BR as of 2.4.2020, Coronakrise: Banken verweigern Hilfskredite, <https://www.br.de/nachrichten/wirtschaft/coronakrise-banken-verweigern-hilfskredite,Ruzqliw>.

Figure 10: Increase in the interest rate (yield to maturity) for EUR corporate bonds with a remaining maturity of 5 years with a rating (AA / BBB / BB).<sup>37</sup>



The chart above shows that the previously low interest rates (in part negative) from the low interest phase have increased considerably within a short period. The worse the rating, the higher the absolute increase (+2.3 percentage points or +3.7 percentage points at the peak at the end of March 2020). With credit ratings within investment grade, the increase in the example above is less than one percentage point, but the interest rate has approximately tripled (BBB) or quadrupled (AA).

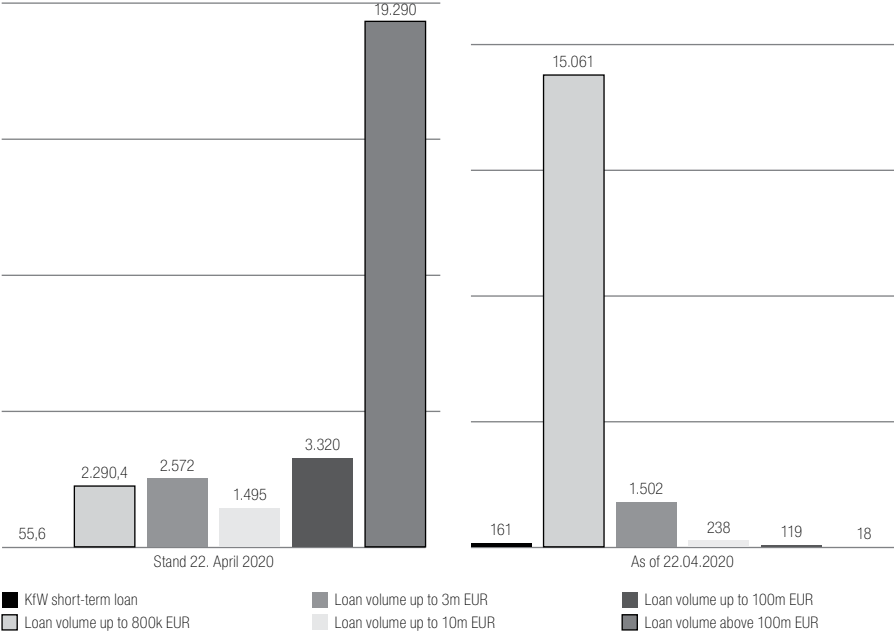
### c. d. Governmental Measures

To avoid liquidity shortages and to give companies access to (reasonably priced) loans, extensive government support measures were implemented, both in Germany and in other countries, including assistance loans and governmental

<sup>37</sup> Thomson Reuters Eikon database, bond data as of 21.4.2020.

guarantees.<sup>38</sup> Within four weeks, the German state owned KfW Bank received 17,099 applications for assistance loans with a total volume of approx. € 29 billion.

Figure 11: KfW Corona assistance loan volume (applied for so far).<sup>39</sup>



Within a multinational group a financing company or the parent company often raises external funding centrally and passes it on to other group companies. At present, there is an increased focus on providing liquidity within the group, where it is most urgently needed or where the value-creating divisions require financial support. As measures in accordance with company law, such as profit distributions, capital contributions or capital increases do not offer a short-term solution (or no solution at all, taking into account existing capital maintenance regulations) due to existing restrictions and formal requirements, the first step is to distribute internally and externally raised funds.

<sup>38</sup> Romeike-Fänger, NWB-BB 2020; Focus Money Online as of 6.4.2020, Regierung garantiert Kredite komplett: Firmen bekommen bis zu 800.000 Euro, [https://www.focus.de/finanzen/banken/selbst-restrisiko-ist-wegen-corona-noch-zu-gross-banken-lassen-firmen-haengen-regierung-plant-100-prozent-garantie-fuer-kredite\\_id\\_11851706.html](https://www.focus.de/finanzen/banken/selbst-restrisiko-ist-wegen-corona-noch-zu-gross-banken-lassen-firmen-haengen-regierung-plant-100-prozent-garantie-fuer-kredite_id_11851706.html).

<sup>39</sup> KfW Bank, KfW-Corona-Hilfe, <https://www.kfw.de/KfW-Konzern/Newsroom/News/KfW-Corona-Hilfe-2.html>.

### **3. Presentation of Individual Instruments**

Given the changed conditions at the capital market and the need for additional liquidity, various questions arise, inter alia: Firstly, how should intra-group financing transactions such as loans, guarantees and cash pools be adjusted or structured to meet the arm's length principle? Secondly, how can liquidity be streamlined and optimized through intra-group transactions?

The following section outlines various instruments concerning these two key questions.

#### **a. Cash Pool (incl. Finance Management)**

Cash pools have increased in number and volume over the past years. However, cash pools are only set up within the group (so-called contract sui generis) and are generally individually adapted to the needs of the group. The main objectives of cash pools are, in particular, to reduce the external refinancing costs, to maintain liquidity within the group and to potentially improve creditworthiness while maintaining flexibility.<sup>40</sup>

Cash pools are particularly suitable intra-group financing instruments in times of crisis and event of liquidity shortages of individual participants. The advantages of this instrument are its flexibility (compared to loans) and the already existing contractual relationship (including operational structures) between the entities. In times of crisis, it would therefore be possible to increase limits/core amounts for cash pool participants, thereby ensuring that cash pool participants with liquidity surpluses could continue to deposit in the cash pool or to cover participants' needs accordingly. This can ensure a short-term distribution of funds within the group, especially when external financing (such as credit lines) are also available at a participant level, which then is used and could be deposited in the cash pool at short notice.

It should be noted, however, that cash pool deposits and loans should not remain largely unchanged in the cash pool for more than one year; otherwise, there would be a risk of reclassification into a medium-term to long-term loan during a tax audit. Cash pool deposits, like cash pool loans, should therefore be regularly monitored, adjusted and documented, taking into account certain basic amounts and arm's length cash amounts.

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<sup>40</sup> See *Schnell/John*, IWB 2015, p. 912.



Since securing liquidity is particularly crucial at the moment, a cash pool poses the challenge that the cash pool leader or even participants receive liquidity from the financial market/banks and make them available in the cash pool. Usually certain credit lines have already been arranged with the banks regarding the implemented cash pools, from which the cash pool, but also participants, can draw down up to a defined limit. However, external lending and deposit conditions - and possibly access to the cash pool - have changed because of the reduction of limits. These changed conditions should be passed on to the cash pool participants in a timely manner. Furthermore, changes in the risk position of the cash pool leader must also be taken into account in the context of its remuneration. The remuneration of the cash pool leader depends on the characteristics of the functional and risk profile. Both the OECD and the German tax authorities in principle assume that cash pool leaders have a function equal to a coordinating agent, unless the cash pool leader demonstrably performs significant functions and bears (as well as actually is economically able to bear) the corresponding risks.<sup>41</sup>

The above observations have to be taken into account accordingly with regard to the cash pool interest rate. The increase is then calculated from (i) the maturity premium, (ii) the increase in external financing costs and (iii) a higher risk premium due to additional functions performed and risks assumed (which are also likely to have increased as a result of the crisis). One has to bear the existing contractual provisions and the possibility of amending them in mind. If there is no contractual opening clause or if the conditions have been arranged flexibly - for example, depending on external parameters such as external financing costs - an adjustment of the cash pool is likely to be rather difficult. At the very least, an assessment of the contractual provisions is necessary, for instance, in case of force majeure (see Section VII, p. 72 et seq.). Any changes to the cash pool conditions should be contractually stipulated and documented for tax compliance purposes, all the while keeping insolvency law issues in mind. Furthermore, the effects of the changed interest rates should be examined with regard to existing thin capitalization rules and add-backs for trade tax purposes.

For the period after the crisis, we would like to point out that the terms and conditions adjusted for crisis purposes should be critically reviewed and, if necessary, adjusted again according to the then changed conditions.

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<sup>41</sup> Vgl. § 1a Para. 2 S. 1 FTA-D; OECD as of 2020, Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS Actions 4, 8-10, Cf. 10,129 et seq.

## **b. Guarantees**

Banks generally require their borrowers to provide collaterals to reduce the credit risks. Typically, a financially strong parent company or all of the borrower's group entities guarantee the loans extended by a bank to the individual group entities.<sup>42</sup> As a result, group entities receive more favorable loan conditions, as the expected default risk of the loan decreases in such constellation. Often, financial guarantees are issued instead of granting group loans when the group's internal financing company or parent company has a good credit rating.<sup>43</sup>

In the case of loan issuances - especially if subsidiaries are to be enabled to obtain external bank loans at preferential rates - a guarantee from the parent company may be helpful.

If, in the case of a cash pool, the cash pool leader is not the parent company, an intra-group guarantee by the parent company could be considered. To the extent that a benefit is demonstrable, the guarantee would have to be remunerated.<sup>44</sup> This would be the case if the risk position of the cash pool leader changed significantly (due to a massive deterioration in creditworthiness and possibly the risk of insolvency of individual subsidiaries). Here, the question arises whether a third party would have agreed to further allow drawdowns from the cash pool or intercompany loans under these circumstances and if so, to which conditions.

The amount of a guarantee fee - provided that the guarantee is regarded remunerable<sup>45</sup> - should be based on (i) comparable guarantee fees, insofar as these exist between third parties (CUP method), (ii) the interest benefit by a

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<sup>42</sup> Cf. *Baumhoff*, in Flick/Wassermeyer/Baumhoff (eds.), *Außensteuerrecht*, August 2011, § 1 AStG, Cf. 759.

<sup>43</sup> Cf. *Kaut/Birmans/John*, RdF 2012, p. 119.

<sup>44</sup> According to the OECD, however, cross-guarantees in the cash pool are generally not to be remunerated for lack of sufficient benefit, see OECD as of 2020, *Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS Actions 4, 8-10*, Cf. 10,148.

<sup>45</sup> The guarantee is usually eligible for remuneration if there is a legally binding obligation of the guarantor and the guarantor therefore explicitly assumes risks. Furthermore, a benefit should result for the warrantee with regard to the guarantee; see OECD as of 2020, *Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS Actions 4, 8-10*, marginal 10,163 et seq.

lower interest rate due to the receipt of the guarantee (yield method), (iii) the expected costs of the guarantor and the probabilities of default and recovery rates (cost approach, expected loss approach) or (iv) the additional capital required by the guarantor (capital support approach).<sup>46</sup> Comparable and publicly traded credit default swaps could also serve as an indication.<sup>47</sup>

The same applies to the granting of guarantees within the group, which should always be contractually defined and the conditions reviewed after the crisis. If necessary the granting of guarantees needs to be adjusted due to changes in the general conditions. Intra-group guarantees should also be documented for compliance and possible insolvency law matters.

### **c. Loans**

#### **aa. New Loan Issuance**

In addition to intra-group cash pools, there is still the option of granting intra-group loans. Particularly when in a crisis, if and to which conditions a third party would have agreed to grant such intra-group loan. Besides the appropriate interest rate, collateral, repayment ability, and other conditions should be taken into account.

Since intra-group loans are granted to affiliated companies that are currently likely in a weakened economic situation, comparatively high-interest rates for such loans are to be expected. This is particularly true, since - as already explained - significantly higher risk premiums for worse credit ratings are currently observed on the capital market.<sup>48</sup>

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<sup>46</sup> See. OECD as of 2020, Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS Actions 4, 8-10, Cf. 10,169 et seq.

<sup>47</sup> The use of credit default swaps was also proposed by the EU Commission in the framework of the aid measures in the 2008 rescue package for credit institutions in Germany and should therefore also be acceptable for tax purposes, see EU Commission on 27 October 2008, Schreiben zur Staatlichen Beihilferegelung Nr. N512/2008 - Deutschland, Rettungspaket für Finanzinstitute in Deutschland, [https://ec.europa.eu/competition/state\\_aid/cases/227880/227880\\_882422\\_55\\_2.pdf](https://ec.europa.eu/competition/state_aid/cases/227880/227880_882422_55_2.pdf), Cf. 22 et seq.

<sup>48</sup> See Thomson Reuters Eikon database, bond data as of 21.4.2020.

## bb. Existing Loan Transactions

### aaa. Intercompany Loans

Existing intercompany loans should be reviewed, especially if so-called covenants are included. For these intra-group loans related risks should be reassessed. As already mentioned, the interest rates on the capital market are currently significantly higher than before 2019. A third party would therefore make use of special termination rights or renegotiation options with regard to the provision of additional collateral and the agreed interest rates.

Furthermore, there is the possibility of temporarily suspending debt service. Currently, suspending debt service is also used between third parties.<sup>49</sup> However, this should be subject to certain conditions, which should be agreed upon in writing. Of particular importance would be: (i) a period for the suspension of debt service and (ii) possibly an extension of the term of the loan by the period of suspension or subsequently adjusted repayment instalments.

Another measure to support subsidiaries could be a waiver by the lender. However, this measure has its disadvantages, as it will not be recognized for tax purposes, if it is based on the shareholder relationship, since a third party would not usually waive its claims without further benefit. If, however, a waiver is made on the non-recoverable part of the claim and the shareholder had acquisition costs for this part of the claim, the waiver can lead to a loss of income from capital assets for tax purposes.<sup>50</sup>

Moreover, there is a possibility and potentially even the necessity of partial write-offs on intra-group loans, if it can be proven that these are no longer of value. However, such write-offs are only tax deductible to the extent that it can be proven that a third party would also have granted the loan under comparable circumstances.<sup>51</sup>

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<sup>49</sup> See DSGVO as of 25.3.2020, Corona-Krise: Aussetzung von Kreditzahlungen möglich, [https://www.dsgv.de/newsroom/presse/200325\\_PM\\_Tilgungsaussetzung\\_23.html](https://www.dsgv.de/newsroom/presse/200325_PM_Tilgungsaussetzung_23.html); Law on mitigating the consequences of the COVID 19 pandemic in civil, insolvency and criminal proceedings, Federal Law Gazette I 2020 No. 14, p. 569.

<sup>50</sup> See Federal Tax Court as of 6.8.2019 - VIII R 18/16, BB No. 47 2019, p. 2777.

<sup>51</sup> See Section 8b (3) S. 6 German Corporate Tax Act.

Other effects of the measures regarding thin capitalization rules, trade tax add-backs and further regulations should be taken into account as well.

Generally, any intra-group transaction or any change to an intra-group transaction should be agreed upon in a contract and documented for both tax and insolvency purposes. After the crisis, the conditions should once again be reviewed, adjusted and documented.

#### bbb. External Loans

Most groups have external bank loans or credit lines. We strongly recommend reviewing and potentially using them as far as possible.

Thereby it needs to be considered that generally certain ratios (so-called covenants) are agreed upon with the banks, on which (a) the interest rate is based and (b) to which special termination rights are tied. Typically, the external interest rate increases when these covenants decrease. Also, in these cases, the banks often have the right to re-evaluate the loan related risks, to demand additional collaterals and, if necessary, to make interest rate adjustments.

Thus, we recommend to review whether another group entity could obtain external funds at a more favorable interest rate and pass on these funds to another entity (see the investment of funds in the cash pool).

#### **d. Alternative Financing**

During the previous financial and economic crisis starting in 2008, alternative intra-group financing models such as factoring, sale-and-lease-back or current accounts were established. The first two financing models focus on the respective asset rather than the credit rating.

## aa. Factoring

Regarding factoring, it should be distinguished between non-recourse factoring and recourse factoring. Whereas the factoring company assumes the risk of bad debts and therefore holds the financing and service function when purchasing receivables during a non-recourse factoring transaction, this is not the case for recourse factoring.<sup>52</sup>

Compared to sale-and-lease-back, non-recourse factoring offers the advantage that receivables can be sold on a recurrent basis, and therefore generate ongoing liquidity effects. Usually, factoring does not require collaterals making factoring an attractive alternative for many industries, especially for medium-sized companies.<sup>53</sup>

The advantages of non-recourse factoring are essentially that (i) the factoring company bears the risk of bad debt (even if this risk is already included in the factoring fee) and (ii) a positive balance sheet effect is achieved, which has a corresponding impact on creditworthiness and thus positively effects the interest rates paid for external liabilities.<sup>54</sup>

Factoring fees regularly include components for (i) assuming the pre-financing function (interest component), (ii) assuming the risk of default (credit default fee), (iii) the administration of debt collection (credit administration fee and debt collection fee) and (iv) a profit element (which may also be implicitly included in the other components).<sup>55</sup> It is important to document the arm's length nature of the individual components of any cross-border factoring transaction between related parties.

Although factoring fees may currently be higher because of the considerable risk of default, this can be a good alternative to obtain short-term liquidity, if (i) no further funding by banks can be expected or (ii) the factoring fees in total would be cheaper than bank loans.

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<sup>52</sup> See *Stumpf*, BB 2012, p. 1050 et seq.

<sup>53</sup> See *Rohmann*, Börsen-Zeitung 2010.

<sup>54</sup> See *Rohmann*, Börsen-Zeitung 2010; *Stumpf*, BB 2012, p. 1046, p. 1049.

<sup>55</sup> See *Busch/Tenberge*, BB 2015, p. 2475 et seq.

## bb. Sale and Lease Back

In addition to the options mentioned above, companies already recognized leasing as an attractive alternative to bank loans during the last global financial and economic crisis.<sup>56</sup>

The concept of sale-and-lease-back, in which an asset is sold and then leased back to the seller, is the main instrument used for the receipt of short-term liquidity.<sup>57</sup> In doing so, liquidity can be reallocated within the group quickly. Nonetheless, current market conditions, which may also have a negative impact on the value of the asset, must be taken into account.

The leasing conditions have to be designed at arm's length, in accordance with the current market conditions and then documented. The determination of the leasing rate is usually based on the depreciation (determined from market value, useful life and expected sales price at the end of the useful life), the related cost of capital (or alternative investments), administrative costs, regular service and repair costs and a profit element. Commercial and tax law requirements must be taken into account when allocating the leased asset in the balance sheet and are still based on the so-called leasing decrees of 1971 to 1991.<sup>58</sup>

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<sup>56</sup> See *Waschbusch/Knoll/Druckenmüller*, StB 2009, p. 357.

<sup>57</sup> See *ibid.*, p. 358.

<sup>58</sup> See Federal Ministry of Finance as of 19.4.1971, Ertragsteuerliche Behandlung von Leasing-Verträgen über bewegliche Wirtschaftsgüter, German Federal Tax Gazette, I 1971, p. 264; Federal Ministry of Finance as of 21.3.1972, Ertragsteuerliche Behandlung von Finanzierungs-Leasing-Verträgen über unbewegliche Wirtschaftsgüter, German Federal Tax Gazette, I 1972, p. 188; Federal Ministry of Finance as of 22.12.1975, DB 1976, p. 172; Federal Ministry of Finance as of 23.12.1991, Ertragsteuerliche Behandlung von Teilamortisations-Leasing-Verträgen über unbewegliche Wirtschaftsgüter, German Federal Tax Gazette, I 1992, p. 13.

## cc. I/C Current Accounts

Along with the financing alternatives mentioned above, current accounts offer group companies a further option for providing short-term liquidity. Current accounts allow group companies the opportunity to receive funds and repay liabilities on a daily basis – as opposed to short-term loans.<sup>59</sup> In contrast to the cash pool, in which various cash pool participants regularly participate, internal current accounts represent a 1:1 relationship and - unlike the cash pool - can also be made available for long-term financing, if necessary.

Current accounts should always bear interest; otherwise, the payments may be classified as hidden profit distributions, which are generally subject to capital gains tax.<sup>60</sup>

If daily repayments were agreed, the interest on these accounts could be based on the interbank interest rates, similar to current bank accounts.<sup>61</sup> Otherwise, a correspondingly higher term-specific interest rate in accordance with the repayment period should be taken into account.

However, even when using current accounts, it should be considered that the conditions are contractually agreed and that the agreement includes provisions on the amount of the credit limit, interest, repayment date, currency, collateral, and others.

### e. Summary

The current crisis confronts companies with several economic and increasing financial challenges. Within multinational groups, it is now necessary to identify and efficiently distribute the existing liquidity within the group. In doing so, the applicable tax transfer pricing regulations must be taken into account (particularly the arm's length standard and documentation requirements). Therefore, for the optimal use of liquidity, especially the following points should be considered:

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<sup>59</sup> See *Brüninghaus*, in Vögele/Borstell/Bernhardt (eds.), *Verrechnungspreise*, 5th ed. 2020, Chapter P: Finanzierungsdienstleistungen im Konzern, Cf. 7.

<sup>60</sup> See Tax Court Munich as of 25.4.2016 - Ref. 7 K 531/15, BBK-Kurznachricht, 1/2017, p. 9.

<sup>61</sup> See *Brüninghaus*, in Vögele/Borstell/Bernhardt (eds.), *Verrechnungspreise*, 5th ed. 2020, Chapter P: Finanzierungsdienstleistungen im Konzern, Cf. 7.



- existing external credit lines in the group should be efficiently utilized;
- the existing external financing arrangements have to be examined, particularly regarding exceeding the agreed covenants and the associated consequences, such as interest rate increases, the need for further collaterals or guarantees and even contract terminations;
- cash pool conditions have to be checked, any changes in external refinancing and investment conditions should be passed on, and core amounts / limits per participant should be increased temporarily;
- existing intercompany loans should be reviewed concerning the adequacy of the conditions and their continued value and, if necessary, adjustments should be made, or new intercompany loans should be issued;
- if necessary, intra-group guarantees have to be issued to obtain external funding in the current situation and
- alternative financing models, such as factoring, sale-and-lease-back or current accounts should be considered to achieve short-term liquidity effects.

When implementing such measures additionally to the arm's length principle, other domestic tax law implications should be considered, e.g. thin capitalization rules and trade tax add-backs.

However, before implementing the measures mentioned above, it should be taken into account that any intended contract adjustments should be contractually permissible and that the economic reasons for any adjustments should be documented. This is of considerable importance for fulfilling the documentation obligations of the cross-border intra-group transactions to be able to defend the transfer prices in the context of tax audits, as well as from an insolvency law point of view.

Possible reporting obligations under DAC 6 should also be kept in mind, as it cannot be ruled out that measures taken may have to be classified as reportable structures (e.g. circular financial transactions).

## **VI. Risk as a Remuneration Element of Transfer Pricing Systems (*Jobst Wilmanns*)**

### **1. Significance of Risk as a Product of the Corona Pandemic**

Internationally operating enterprises are exposed to a variety of risks during the course of their business activities. These stem directly from the companies' entrepreneurial activities, but also from external influences such as the economic environment, political developments, technological advances, social and ecological changes or natural disasters and pandemics. Particularly the Corona pandemic is currently reminding the world economy how global events and the associated losses can threaten the existence of enterprises. In the past, enterprises, especially publicly traded companies, have already set up integrated risk and opportunity management systems, mostly for regulatory reasons, in order to identify major risks at an early stage, evaluate them and take consistent measures to realize opportunities and limit negative effects.

Transfer pricing system reflects enterprises' in principle cross-border business activities for taxation purposes. The core of the transfer pricing analysis is the functional and risk analysis. Historically, the functional analysis was derived from the actual economic activity, whereas the risk analysis was characterized by the identification of direct operational or functional risks as well as the possibly contractually determined assumption of these risks.

The OECD has included the topic "risk" in the OECD BEPS Action Plan under action point 9 and later implemented it in Chapter I of the OECD Transfer Pricing Guidelines 2017. However, studying chapter D.1.2.1 "Analyses of risks in commercial or financial relations" gives the impression that the writing of this chapter was a challenge for the authors and the content of the chapter was influenced by compromises between the participating member states.

The OECD makes the following statement at the beginning of the chapter mentioned above: "A functional analysis is incomplete unless the material risks assumed by each party have been identified and considered since the actual assumption of risks would influence the prices and other conditions of transactions between the associated enterprises. Usually, in the open market, the assumption of increased risk would also be compensated by an increase in the expected return, although the actual return may or may not increase depending on the degree to which the risks are actually realised. The level and

assumption of risk, therefore, are economically relevant characteristics that can be significant in determining the outcome of a transfer pricing analysis.”<sup>62</sup>

In summary, the following aspects become evident according to the quotation:

- risks must be identified;
- a risk analysis is not limited to the bearing of risks alone;
- risks must be assessed in terms of the probability of their occurrence and their potential financial impact;
- the assumption of risks is usually offset by higher returns, and
- a risk analysis can have a significant impact on the transfer pricing analysis.

In the following explanations, the significance of risks, the aspects presented, and the impacts on transfer pricing systems are examined in more detail.

## **2. Risks as Part of the Transfer Pricing Analysis**

### **a. Concept of Risk and Transformation to the Operational Level**

The OECD defines risk “as the effect of uncertainty on the objectives of the business”.<sup>63</sup> The OECD goes on to state “[i]n all of a company’s operations, every step taken to exploit opportunities, every time a company spends money or generates income, uncertainty exists, and risk is assumed”.<sup>64</sup>

In opportunity and risk reports of publicly traded companies, the term risk is directly associated with the term opportunity. This means that certain risks and certain opportunities in each case are linked to specific events and developments which are likely to occur and which could have substantial negative or positive financial and non-financial effects on the achievement of the objectives of the respective enterprise.<sup>65</sup> It can thus be summarized that the terms “opportunities and risks” are directly linked to the elements “events and

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<sup>62</sup> OECD 2017, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, para. 1.56.

<sup>63</sup> Ibid. marginal 1.71.

<sup>64</sup> Ibid.

<sup>65</sup> See, among others, the chapter risk and opportunity report of the annual reports of various listed groups.

developments”, “uncertainty” and “effects on the objectives of the business activity or the enterprise”. One should note that in risk analysis, the terms “material” and “significant” are decisive for further conclusions.

Transforming the abovementioned definitional aspects to the operational level includes the following aspects:<sup>66</sup>

1. Identification of the uncertainty factors: Defining developments and events that could have a substantial - positive or negative - impact on the business model of the enterprise or its business units.
2. Evaluation of the uncertainty factors: The opportunity and risk reports of the enterprise usually distinguish between strategic, functional and operational risks as well as the corresponding opportunities.
  - Strategic risks and opportunities are developments and events, which could significantly influence or endanger the existence of the enterprise. The typical observation time is five years.
  - Functional risks and opportunities are challenges inherent to business models. They are being dealt with on a permanent basis through organizational as well as operational measures by the various specialized functions on a global and regional level. Functional risks and opportunities are usually estimated for a planning period of up to two years.
  - Operational opportunities and risks are aspects that can influence the developments of actual short-term sales and earnings. These uncertainties are usually estimated for a period of less than one year.<sup>67</sup>
3. Impacts on business opportunities: The OECD reflects on this as follows: “Risk is associated with opportunities, and does not have downside connotations alone<sup>68</sup>; it is inherent in commercial activity, and companies choose which risks they wish to assume in order to have the opportunity to generate profits”.<sup>69</sup> To illustrate this, the OECD provides an example of an introduction of a product without expected demand being met or exceeded. The significance of a particular risk and opportunity thus depends on

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<sup>66</sup> OECD 2017, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, para. 1.71.

<sup>67</sup> See, among others, the chapter risk and opportunity report of the annual reports of various listed groups.

<sup>68</sup> “Intuitive associations”.

<sup>69</sup> OECD 2017, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, para. 1.71.

the likelihood and size of the potential losses and gains arising from that risk.<sup>70</sup> A supplementary example of this is the introduction of products that may involve high reputational risks. Similarly, the decision to concentrate the earnings opportunity only on one product or customer group (e.g. car manufacturers) may involve considerable risks.

4. Risk mitigation and opportunity optimization strategies: Companies pay significant attention on identifying and managing economically significant risks in order to maximize the positive returns that can be achieved by pursuing the opportunities associated with these risks.<sup>71</sup> To ensure this objective, enterprises have increasingly implemented the so-called “risk and opportunity management systems” as integral components of centralized and decentralized planning, management and control processes in their organizations.<sup>72</sup>

In the following, the individual opportunity and risk groups are discussed in more detail.

## **b. Opportunity and Risk Categories According to OECD**

For transfer pricing analysis, it is important to establish a framework for identifying the various uncertainties that may arise from the commercial and financial relationships of associated enterprises as well as their environment. In this context, the OECD distinguishes between externally and internally driven opportunities and risks in order to explain different causes of uncertainty. The OECD focuses on the “ability of a company to force, respond to and mitigate externally driven risks”.<sup>73</sup> In the following, these uncertainty factors are categorized into five groups.

1. Strategic or marketplace risks (and opportunities): these are external risks, which are largely caused by the economic environment, political and regulatory events, competition, technological advance, or social and environmental changes. The assessment of such uncertainties can be critical to the

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<sup>70</sup> Ibid.

<sup>71</sup> Ibid.

<sup>72</sup> See, among others, the annual reports of various listed groups, chapter Risk and Opportunity Report.

<sup>73</sup> OECD 2017, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, para. 1.72.

definition of the products and markets that a company is targeting, the skills that are needed to assess the uncertainties, and also the necessary investments in intangible and tangible assets as well as the talents of employees.

2. Infrastructure or operational risks (and opportunities): These are the uncertainties associated with the business execution. They may also include the effectiveness of processes and operations. For example, production stoppages can have a devastating effect on the work or reputation of an enterprise, whereas the successful management of such risks can significantly improve the reputation of an enterprise. Other examples may include the late introduction of products to the market, quality issues or the inability to supply in relation to the given demand.
3. Financial risks (and opportunities): If opportunities and risks arise, they affect the financial results of a company. This requires the ability to manage the liquidity and cash flow of the company/group and, in doing so, optimize the financial strength and creditworthiness of the group. Financial uncertainties can be caused externally, e.g. by political or economic shocks, but also internally through wrong decision making, lack of control, or other operational risks.
4. Transactional risks (and opportunities): These are operational risks (and opportunities) of business transactions in connection with goods and services, e.g. price and payment terms.
5. Hazard risks: These uncertainties include externally adverse events that cause damages or losses, including accidents and natural disasters. In many cases, such risks cannot be controlled by a company, but can only be mitigated through insurances. These risks include floods, wind catastrophes, but also pandemics such as the Coronavirus pandemic.

Determining the economic significance of an opportunity or risk and how it may affect the price of a particular transaction between related parties, is an element of the functional and risk analysis. Among other things, this involves showing the economic significance of the functions, opportunities and risks identified - measured by their frequency, nature and the benefits they may bring to the respective companies involved in a business transaction. In practice, this means that the risk-related functions of associated companies that are involved in a business transaction must be examined. The following questions need to be

asked with regard to the risk management of specific, economically significant opportunities and risks as well as the assumption of these risks:<sup>74</sup>

- Who performs the control and risk mitigation function?
- Who bears the upside and downside consequences or risk outcomes?
- Who has the financial capacity to assume risks, that could materialize, and who realizes profits from opportunities that are realized?

As a result, the involved company should always be remunerated appropriately for the risk management functions it actually performed. In general, the remuneration for the assumption of risk is calculated based on the probability of the risk to materialize and the potential financial impact on the company concerned in the specific case.

### **c. Evaluation of the Risks**

As it is generally the case when it comes to valuation issues, the OECD is not getting overly specific when it comes to assessing opportunities and risks. They provide only little guidance regarding this aspect. In this respect, it is worthwhile to look at the opportunity and risk reports of publicly traded companies. The following approach with respect to the evaluation of risks could be possible.

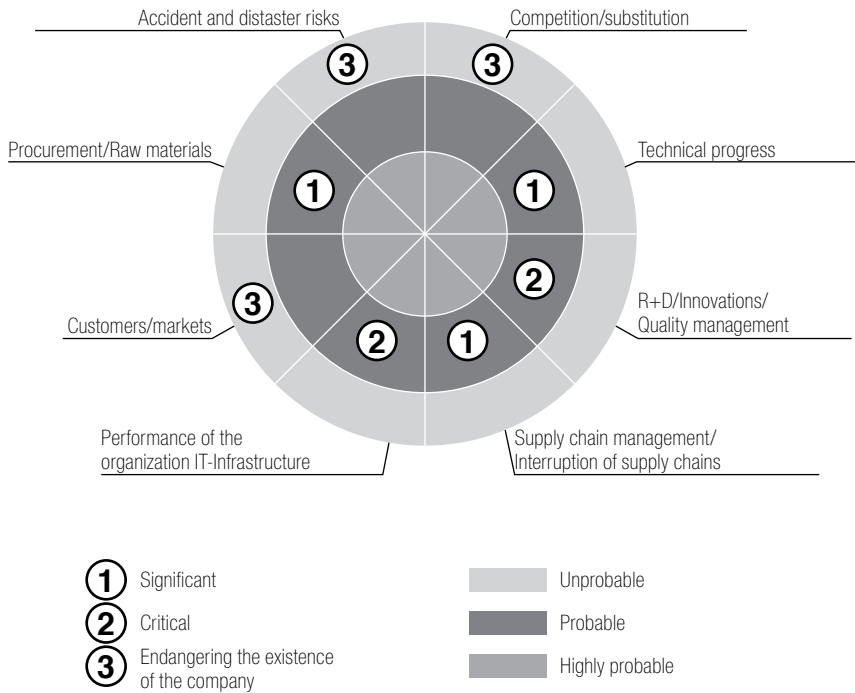
In a first step, the risk/uncertainty categories (as shown in VI.2.b.) are being clustered into strategic, functional and operational opportunities and risks.<sup>75</sup> In a second step, using a so-called risk radar, the opportunities and risks can then be assessed from the enterprise's perspective. Summarized for the enterprise, the various fields reflect the essential external and internal uncertainty factors that lead to opportunities and risks specific to the enterprise.

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<sup>74</sup> OECD 2017, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, para. 1.82.

<sup>75</sup> Cf. bullet point VI.2.a (p. 50 et seq.).

Figure 12: Risk radar.



In a third step, the opportunities and risks are classified per category based on the probability of occurrence as well as the potential financial impact, in case the risk materializes. In doing so, strategic risks can be classified as “significant”, “critical” and “threatening to the company’s existence”, while operational/functional risks are assigned specific financial ranges.



Figure 13: Risk matrix.<sup>76</sup>

Risk assessment*		
	Likelihood of occurrence	Potential financial effects
Strategic risks	unprobable	significant
	probable	critical
	highly probable	endangering the existence of the company
Functional and risk operational risks	≤ 10%	Tiered impacts on turnover/earnings
	> 10% ≤ 50%	
	< 50% ≤ 90%	
	> 90%	

\* as displayed in an opportunity and risk report of a listed group

The risk assessment, as presented here, forms the basis for the risk analysis (within the scope of the above-mentioned functional and risk analysis) and is subsequently decisive for determining remuneration systems in line with arm's length principles.

#### d. Risk Management as a Central Prerequisite for Risk Allocation

##### aa. The Term Risk Management According to OECD

A central component of the functional analysis is determining the way in which associated companies (that are involved in a business transaction) handle the assumption and management of the specific, economically significant opportunities and risks. It comprises the following elements and questions:

- Which enterprise or enterprises **perform** control functions and risk mitigation functions?
- Which enterprise or enterprises bear the upside and downside consequences of the risk outcomes? and
- Which enterprise or enterprises have the financial capacities to assume the risk?<sup>77</sup>

The central terms here are risk management or risk control. These designate the function (or ability) of assessing (i.e. evaluating) the risks associated with

<sup>76</sup> Own illustration.

<sup>77</sup> OECD 2017, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, marginal 1.60 no. 3.

the business activities as well as the possible options for reacting to these risks. Risk management is typically comprised of three elements:<sup>78</sup>

1. The capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with actual performance of that decision-making function.
2. The capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function.
3. The capability to mitigate risk, that is the capability to take measures that affect risk outcomes, together with the actual performance of such risk mitigation.

The presented capabilities to perform decision-making functions (as described above) require an understanding of the relevant opportunities and risks. Such an understanding needs to be based on a proper analysis and assessment of the foreseeable downside and upside risk outcomes of such a decision and the consequences of the decision for the business activity of the enterprise.<sup>79</sup>

At the same time, the OECD states that ongoing risk reduction activities (along the lines of the third element above) do not necessarily have to be linked to the first two capabilities. Instead, they can be outsourced, if necessary. However, such an outsourcing requires the ability of properly controlling the outsourced function whilst retaining the actual decision-making authority (with regard to the continuation of the service relationship with the involved service provider) by the outsourcing company.

Furthermore, the OECD correctly clarifies that risk management does not necessarily have to be a separate function in its own right. In many cases, it rather must be integrated into the respective operational functional units.<sup>80</sup> In other words, the OECD requires necessary competence and experience

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<sup>78</sup> OECD 2017, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, paragraphs 1.61, 1.65.

<sup>79</sup> OECD 2017, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, para. 1.66.

<sup>80</sup> OECD 2017, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, paragraphs 1.62, 1.76.

to make appropriate decision and judgement when outsourcing, as well as controlling and assessing the effects of such outsourcing.

A distinction must be made between the risk management function, and the bearing of or the assumption of risks. The assumption of risks means accepting the upside and downside consequences of the risk with the result that the associated enterprise (which assumes the risks) also bears the financial and other consequences, if that risk materializes.<sup>81</sup> Here, however, the OECD makes it clear that in principle, contractually agreed risk assumption must be in line with the actual behavior of the contracting parties involved, i.e., generally, risk assumption must follow risk control.<sup>82</sup> It must be noted, that the OECD nonetheless, consciously or unconsciously, often softens this principle by unclear wording or by creating room for interpretation. The reason for this may be that most transfer pricing systems are still solely based on the assumption of risk (as a result of risk analysis), while the required proof of an actual assumption of the elements “risk mitigation and risk control function”, “risk bearing” and “financial capability” would involve a very high administrative burden.

The associated enterprises performing the risk management functions (as described above) must always be remunerated for these control functions in relation to the risk types. Usually, the remuneration results from the consequences of the fact that an associated enterprise is assigned a risk and therefore realizes the positive consequences (opportunities) and has to bear the negative consequences if the risk materializes. In the event of a discrepancy between risk control and risk bearing, an appropriate allocation of income or expenses must be made.<sup>83</sup> However, the OECD does not specify how such an appropriate allocation is to be made. See Section VI.3.a. (p. 66 seq.) for more detail on this point.

#### bb. Interpretation under German Tax Law

The German tax law does not explicitly address the risk management function in its regulations and interpretations. This applies to the current law as well as the draft of the ATAD-UmsG with the exception of the regulations of the

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<sup>81</sup> Ibid., marginal 1.63.

<sup>82</sup> Ibid., marginal 1.88.

<sup>83</sup> Ibid., marginal 1,106.

BsGaV (Ordinance on the allocation of profits of permanent establishments). As a rule, the laws and ordinances speak of “assumed risks” or “risk-bearing”<sup>84</sup>, i.e. presumably of risk allocation under civil law. The GAufzV, too, only refers to “assumed risks” in its regulations on function and risk analyses<sup>85</sup>, i.e. once again probably a shortfall in the civil law. In the value-added contribution analysis (mentioned in § 4 No. 3b GAufzV), the risk aspect is not examined further – which is largely insufficient from the author’s point of view. If that approach was followed, value added contribution analyses would have to be questioned with regard to their meaningfulness in light of the OECD’s view. Similarly, the regulations on the relocation of functions do not specifically address the distinction between “risk mitigation and the risk control function”, “risk bearing” and “financial capability”. Rather, the legal presumption applies, that the documented function and risk analysis (and thus the risk bearing under civil law) is the basis of the tax assessment. In practice, the same can be observed in tax audits. The basis are the case laws in terms of opportunities and risks at best, and in exceptional cases the risk for tax purposes are allocated differently from what is stipulated under civil law. In this respect, the situation is that the German transfer pricing regulations do not fully follow the OECD approach described above.

### cc. Interim Conclusion

In the OECD Transfer Pricing Guidelines 2017, the OECD principally stipulates that risks are only being assumed, if the risks are also actually being controlled by the corresponding associated company, i.e., if the company can ultimately decide to enter into certain risky activities or to refrain from doing so, if it has the possibility to take appropriate measures to deal with these risks or to reduce these risks, and, if it is at least able to control the risks properly. The OECD rightly clarifies that risk management does not necessarily have to be an independent, separate function, but that it is often integrated into the respective functional units. In particular, this will usually be the case for functional and operational risks. In accordance with the arm’s length principle, risks and the associated (control) functions must be taken into account when determining transfer pricing systems. Strategic risks including the risks of accidents and catastrophes have often not been adequately considered in the functional

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<sup>84</sup> Cf. in this regard § 1 para. 3 sentence 1 AStG; in the explanatory memorandum to the draft 2008 Corporate Tax Reform Act on § 1 para. 3 sentence 6 AStG, the term “bear risk” is used.

<sup>85</sup> § 4 no. 3a GAufzV

and risk analysis in practice thus far. This is probably due to the fact that no differentiated analysis of risks with regard to the type and quality as well as the distinction between risk management and risk assumption has been performed to date.

According to the observations of the author, most countries are not sufficiently distinguishing between risk management and risk bearing respectively risk taking. The German tax law has not yet regulated the distinction between risk management and risk bearing respectively risk taking in an appropriately clear and unambiguous manner. Subsequently, the result would be international conflicts with regard to the qualification of risks as a component of transfer pricing (if the other country happens to represent the thus far not conclusively clarified OECD positions to a certain extent).

#### **e. Risk Allocation**

As already explained, the OECD clarifies, when an associated enterprise (contractually) assumes the risk (whilst not exercising control over the risk, and not having the financial capacities to bear the risk) the risk is allocated to the company that actually exercises control and has the financial capacity to bear any risks that materialize (contrary to the contractual arrangement). If several associated enterprises (actually exercising control and having the financial capacity to bear the risks) are identified, the risk should be allocated to the associated enterprise exercising the most control according to the OECD's interpretation.<sup>86</sup> It is interesting to note that the OECD allows the risk of a group of associated enterprises to be allocated to one single company within the group.

In contrast to intangibles,<sup>87</sup> which in principle an allocation would not be possible from German perspective, risks can also be allocated to several associated enterprises. (See also the possibility of allocating intangibles in the context of operating facilities). How this affects the remuneration of opportunities and risks, will not be discussed any further. We can assume that the distribution of the risk remuneration should be comparable to the

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<sup>86</sup> OECD 2017, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, para. 1.98.

<sup>87</sup> Author's note: Through the DEMPE analysis and the resulting entitlement to income, the inability to divide is economically negated.

DEMPE eligibility concept, i.e. probably according to - not yet clarified - profit-split principles.

### **3. Remuneration of Risks at Arm's Length**

#### **a. Principles**

The principle applies that the assumption of a risk should be matched by a reasonable expected return. In addition, risk management functions should be appropriately remunerated (insofar as they are not directly linked to the bearing of risk).<sup>88</sup> An entity's claim to profits or losses in respect of differences between actual (ex post) profitability and a reasonable estimate of (ex ante) profitability depends on which entity or entities in the group effectively assumes the risks identified in delineating the actual transaction.<sup>89</sup> An entity that assumes and controls risk is entitled to receive unexpected returns from opportunities, depending on the financial significance of the risk<sup>90</sup>. However, this entity may also be required to bear unexpected losses from the realization of the risk.<sup>91</sup> In turn, this means that an entity that does not assume and manage risk, is not entitled to receive unexpected returns from the relevant opportunities, but may also be required to incur unexpected losses from the realization of the risk. Consequently, a taxpayer who does both, assuming a risk whilst making efforts to reduce the risk, is entitled to a higher expected return than a taxpayer who assumes a risk or only reduces a risk, but does not do both.<sup>92</sup>

It can already be stated at this point that risk management and risk bearing are not considered "routine functions". Instead in the context of the measures described in Section VI.2.c. (p. 59 et seq.), they must be evaluated separately.

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<sup>88</sup> OECD 2017, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, para. 1.100.

<sup>89</sup> *Ibid.*, para. 6.72.

<sup>90</sup> Cf. chapter 2.4.

<sup>91</sup> OECD 2017, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, para. 1.106.

<sup>92</sup> OECD 2017, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, para. 1.106.

## **b. Application of the Arm's Length Principle**

In general and also in particular, the external price for the actual assumption of the respective risk can be determined directly based on external data - if the transaction under consideration and business relationships between third parties are comparable. In other words, the comparability criterion is met, if a comparable risk assumption in a comparable transaction between independent third parties can be identified (for an associated enterprise that assumes risk and controls the risk, which is part of the business relationship between associated enterprises).<sup>93</sup> The OECD specifies this requirement as follows: "If such a comparison is made, it is particularly relevant to establish that the enterprise assuming comparable risk in the uncontrolled transaction performs comparable risk management functions relating to control of that risk to those performed by the associated enterprise assuming risk in the controlled transaction".<sup>94</sup>

The OECD thus postulates two aspects:

- a) the direct link between risk management and risk assumption, and
- b) the difficulty of conducting an actual arm's length settlement.

In cases of management and the assumption of functional as well as operational risks (which are embedded in typical transactions, such as the supply of goods or services) the comparability analysis of transactions usually includes the risk types associated with the transaction under consideration. However, the more strategic risks or risks that are externally motivated, and the more the occurrence of the corresponding risk has a potential material or significant financial impact on the company or even the group, the more difficult it will be to find a comparable transaction. In such cases, the actual arm's length principle will be applicable to a limited extent, if at all.

If the actual arm's length comparison does not apply, the OECD assumes that independent valuation methods are to be applied. They are similar to those used for the valuation of intangibles. However, it should be noted that the OECD does not make any explicit recommendations in this regard.

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<sup>93</sup> Ibid., marginal 1.97.

<sup>94</sup> Ibid.

#### **4. The OECD’s “Six-Step Approach” for Economically Significant Risks**

Similar to the DEMPE analysis for intangibles, the OECD proposes a multi-stage procedure for risk assessment. This procedure comprises the following steps:

1. Specific identification of economically significant risks;
2. Contractual risk assumption;
3. Functional analysis in relation to the risks;
4. Interpretation of the steps (1) to (3);
5. Risk allocation and
6. Determination of the price of the business transaction, taking into account the consequences of the risk allocation.<sup>95</sup>

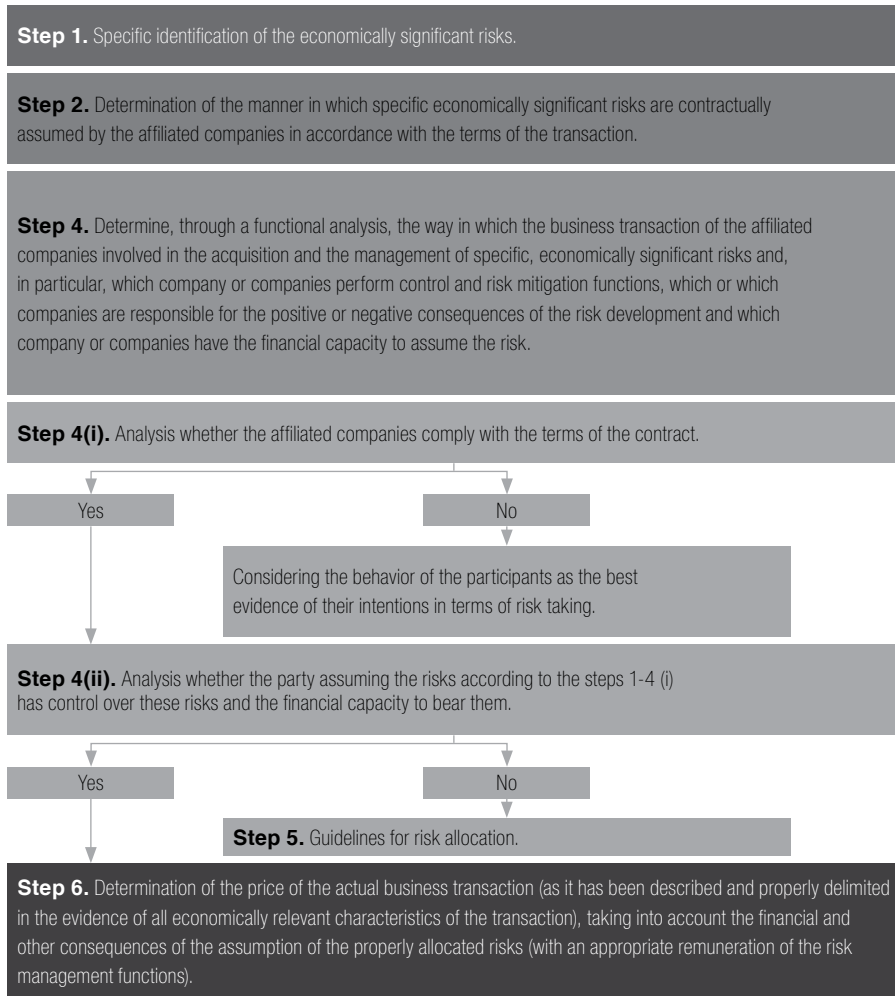
The aspects of these six steps have been specifically addressed in previous sections. This procedure and the decision-making processes are shown schematically in the following diagram.

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<sup>95</sup> OECD 2017, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, para. 1.60.



Figure 14: OECD “Six-Step Approach”.<sup>96</sup>



## 5. Risk as a Component of Transfer Pricing Systems

Transfer pricing systems reflect internal group business models. The various types of risks associated with the implementation of these value-creation systems are generally embedded in the usual transactions between affiliated companies, i.e.

<sup>96</sup> Own illustration based on OECD 2017, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, para. 1.60.

- Tangible goods transactions,
- Licenses (especially of intangibles),
- Services and
- Financial transactions.

In the context of the COVID19-pandemic and the financial impact on groups and companies, many business relationships will be scrutinized in terms of their “risk mitigation and risk control function”, “risk bearing”, “financial capability” and risk allocation. The following observations can be made regarding current transfer pricing systems:

- In documented function and risk profiles, the focus of an analysis is often the allocation as well as the assumption of functional and operational risks; strategic risks and risks that are externally motivated are often - if at all - seen as to be of secondary importance.
- German tax law only requires the analysis of the risk assumption or risk transfer, but not of the risk mitigation/risk control functions. A clear distinction between risk mitigation and risk control functions, risk bearing, the financial capacity to assume risk and the risk assumption itself is not yet anchored in the legal requirements for transfer pricing analysis.
- In many cases, the qualification and assumption of risk is not sufficiently clarified in contracts governing business relationships between associated enterprises.

Based on the new OECD Transfer Pricing Guidelines 2017, in particular the revised Chapter I, as well as the current experiences from the global Corona pandemic, opportunities for adapting and optimizing existing transfer pricing systems arise. One starting point could be a fundamental analysis of the existing functional and risk profiles with a focus on the risk side, i.e. an analysis of the existing risk allocation in the transfer pricing systems compared to a revised risk allocation taking into account the OECD requirements described above - linked to experiences from the past and present global crises. Consideration of the associated potential for change may relate to

- HQ functions in which the management and control with respect to significant risks are embedded;
- the existing financial capacities for risk assumption in a group;
- contractual arrangements for the assumption of risks and related compensation systems.

In the event of changes to the risk profile, it must be clarified on a case-by-case basis, whether aspects of the transfer of functions in accordance with the German regulations under Section 1 (3) AStG or from Chapter 9 on business restructurings of the OECD Transfer Pricing Guidelines 2017 will apply. However, as long as it is only a matter of reassessing risks without organizational intervention, no tax compensation payments should normally be made for the resulting valuation differences.

## **6. Summary and Outlook**

In the preceding sections, the influence of opportunities and risks on transfer pricing systems was analyzed in detail. Opportunities and risks are part of the functional and risk analysis and thus significantly influence the corporate character of the associated enterprises involved in a transaction (routine or non-routine companies). Risks from business activities have to be differentiated regarding their influence on the substance of the group (strategic, functional or operational risks) and the cause (externally or internally motivated risks). The OECD differentiates between three levels in the analysis of the risk management function, namely the risk mitigation and risk control function, the actual risk bearing and the financial capacity to assume risks. In its assessment of these “risk functions”, however, the OECD makes it clear through the eligibility to receive incomes (analogous to the DEMPE concept for the use of intangibles) that the actual conduct of the contractual partners involved is the determining factor, i.e. that in principle, for tax purposes, the assumption of risk follows (actual) risk control. It should be mentioned that although the OECD does not allow the clear assignment of the risk under consideration to an associated enterprise. Instead, it allows the allocation to a group of associated enterprises, if certain conditions are met.

The OECD postulates at various points that the risk management function and the bearing of risks should be adequately remunerated. Depending on the significance of the risk, there is an entitlement to unexpected profits, but also an obligation to assume unexpected losses if the risk event occurs. The range of sharing the excess profits or losses increases depending on the nature of the risk (strategic vs. functional/operational), the probability of occurrence and the potential financial impact, although the allocation method is completely missing. Functional and operational risks between associated enterprises are usually embedded in existing business relationships, such as transactions involving goods or services. They are therefore part of the arm’s length analysis of these transactions. In the case of strategic risks, it

appears difficult to identify comparable transactions in the market and thus to conduct an actual arm's length analysis.

Neither in German tax law nor in the majority of transfer pricing documentations has there been such a differentiated consideration of risks as presented by the OECD. On the one hand, German tax law, with the exception of the provisions of the BsGaV, is largely based on the contractually agreed assumption of risk, i.e. as a rule it is based on the allocation under civil law. On the other hand, risks are not assessed separately in the risk analysis (which is to be carried out in the transfer pricing documentation). It should be noted, however, that a national implementation of the OECD approach to "risks" will lead to an administratively higher compliance burden (especially obligations to cooperate and document), which would be comparable to the difficulties of implementing the DEMPE concept for intangibles.

Based on the new OECD Transfer Pricing Guidelines 2017, in particular the revised Chapter I, and, because of the experience from the global Corona pandemic, there are opportunities for groups to reassess the risk side and, in connection with this, to adapt existing remuneration mechanisms. It is reasonable to assume that strategic as well as externally motivated risks associated with the conduct of business activities will have a far-reaching influence on transfer pricing systems in the future.

## VII. Intra-Group Contracts as a Framework for Options for Action (*Markus Kircher, Andreas Leclaire, Conrad Marburg, Lara Sophie Worbs*)

### 1. Introduction

So far, from a German transfer pricing perspective, the civil agreements between related parties have been highly relevant for the determination of transfer pricing. That is because, according to consistent case law, the German Fiscal Court (BFH) focuses on the possibly concluded contract for the analysis of business transactions.<sup>97</sup> According to the BFH's recent case law, an intra-group contractual agreement must also be examined in detail whether it is at arm's length in double taxation agreement (DTA) cases, with the result that a deviation from the market standard of relevant parts of the contract can trigger an income correction.<sup>98</sup> However, a complete requalification of a contractual relationship can only take place in exceptional cases, according to the BFH.<sup>99</sup>

The current trend however is that the economic view is becoming increasingly important in the transfer pricing analysis of intra-group relationships. For instance, the most recent draft of the BMF on the ATAD Implementation Act and the OECD developments show this. According to the draft, the transfer pricing analysis must be based on the "actual circumstances".<sup>100</sup> In the explanatory memorandum to the law, a perception of contracts is specified more precisely. It states "[...] the contractual conditions of a business transaction must be taken into account insofar as they correspond to the actual conduct of the parties involved in the respective business transaction".<sup>101</sup> However, the legal tax consequences that arise, if the actual conduct of the parties to the respective transaction does not correspond to the contract concluded (or does not correspond in all aspects) are not explicitly addressed.

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<sup>97</sup> BFH v. 29.10.1997 - I R 24/97; last also BFH v. 27.2.2019 - I R 73/16, margin no. 21.

<sup>98</sup> BFH v. 27.2.2019 - I R 73/16, margin note 22.

<sup>99</sup> BFH v. 29.10.1997 - I R 24/97; BFH v. 27.2.2019 - I R 73/16, margin note 11 et seq.

<sup>100</sup> Cf. § 1 para. 3 sentence 1 AStG-E.

<sup>101</sup> BFH Commentary to § 1 para. 3 sentence 1 AStG-E.

The intended amendment to the law reflects the changed OECD Transfer Pricing Guidelines 2017 and implies to bring the German legal regulation in alignment with them. The OECD Guidelines state that the divergence of interests may not exist in the case of associated enterprises.

In transactions between independent enterprises the parties would ensure “[...] (i) that contractual terms are concluded that reflect the interests of both of the parties, (ii) that the parties will ordinarily seek to hold each other to the terms of the contract, and (iii) that contractual terms will be ignored or modified after the fact generally only if it is in the interests of both parties”.<sup>102</sup> The OECD Guidelines conclude that although written contractual agreements “[...] provide the starting point for delineating [...] how the responsibilities, risks, and anticipated outcomes arising from their interaction were intended to be divided at the time of entering into the contract”,<sup>103</sup> but in addition to written contracts, further information will regularly required to perform a transfer pricing analysis, or to provide information regarding the relevant contractual terms in sufficient detail.<sup>104</sup> If there are “material differences between contractual terms and the conduct of the associated enterprises in their relations with one another, the functions they actually perform, the assets they actually use, and the risks they actually assume, considered in the context of the contractual terms, should ultimately determine the factual substance and accurately delineate the actual transaction”.<sup>105</sup> This should at least clarify the international perspective that prevails in mutual agreements or arbitration proceedings (at least between OECD member states).

In contrast, the precise legal consequences of these OECD statements in German tax law have not yet been standardized. The adoption of the current draft of the ATAD Implementation Act would not fundamentally change this. At best, a corresponding tendency on the German legislature’s part can be identified, although it remains to be seen whether the case law will follow this “tendency”, which has not been bindingly formulated.

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<sup>102</sup> OECD 2017, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, para. 1.46.

<sup>103</sup> *Ibid.*, para. 1.42.

<sup>104</sup> *Ibid.*, para. 1.43.

<sup>105</sup> By “risk” the OECD generally also understands “opportunities”; OECD 2017, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, para. 1.46.

Intra-group contracts must therefore be taken into account both internationally from an economic point of view as well as on a national level, but only to the extent that the actual conduct does not deviate substantially from the content of the contract. If the actual conduct differs materially, the question arises as to what third parties would have agreed upon in the respective situation. Thus, both the German legislator and the OECD take up the relationship between contractual form and actual conduct. As a result, the relationship is likely to be represented by a continuum. If the actual conduct does not deviate materially from the contractual terms and the contract could have been concluded by third parties, the contractual terms must be taken into account for tax purposes. If, however, the contractual terms do not essentially match the actual circumstances, the actual circumstances should prevail, as far as the respective national regulations make this possible. A further conceivable constellation is the contract containing individual clauses not customary between third parties or the contract not containing clauses that would normally have been agreed upon between third parties. In these cases it should be considered, to what extent the contractual terms can be recognized as arm's length in nature.

However, the contradiction between the contractual terms on one hand and the actual conduct on the other hand can on closer examination and in certain cases, be resolved. The actual conduct of the two parties from a civil law point of view may ultimately reflect an implicitly agreed amendment to the contract or rather, this amendment can be derived from the conduct. An implicit, i.e. tacit, amendment of a contract is possible, provided there are no formal requirements to the contrary. However, taxpayers who invoke an implicit amendment to a contract bear the burden of proof, which can cause considerable problems in the relationship between associated companies. The "waiver" of compliance with explicit contractual provisions can also be regarded as "unusual conduct on the part of a third party" which virtually requires correction.

Practice also shows that insufficient or even missing (written) parts of intra-group contracts entail the risk that the tax authorities involved will assess a business transaction differently than the company intended. This is because in the absence of clear contractual agreements (as well as in the absence of conformity in contractual agreements) the tax authorities are to build their conclusions based on the actual circumstances and the actual conduct of the parties involved. It is obvious that unclear contractual wording, as well as insufficient documentation of the facts of the case, can lead to the conclusion that the financial administration is not in a position to draw the appropriate

conclusions, thus considerably increasing the scope for interpretation (scope for assessment) and the associated susceptibility to litigation.

In the context of the Corona crisis, three main questions arise regarding the relevance of contracts. The first question is, whether the contract concluded contains wording that could be of immediate relevance during the Corona crisis. Most obvious in this respect are force-majeure clauses. This also might hold true for acceptance and delivery commitments, price guarantees and price adjustment clauses. Provided that the clauses are at arm's length (customary in the market), they must also be taken into account for tax purposes and form the framework for an economic analysis of realistically available alternatives, as explained in Section VIII.2 (p. 109 et seq.). The second question one needs to ask is, whether there are other legal possibilities or if there even is a mandatory law to impact or limit the economic analysis. One example is to consider recourse to the interference with the basis of the transaction, impossibility and similar legal institutions. The third questions is how contracts should be designed or how existing contracts should be adapted in the future in order to be able to reflect similar risks to the ones we encountered during the Corona crisis.

This raises the overarching question of whether the contractual provisions agreed between the associated enterprises are sufficient to reflect the business transactions that may happen to be extraordinary, and their settlement in times of crisis in an economically appropriate manner. Insofar as the performance obligations and the associated risk allocation are (can be) precisely formulated and outlined in intra-group contracts, this improves legal certainty for the associated enterprises and reduces the risk of a divergent interpretation of the actual conduct by the tax authorities.

In a crisis situation, taxpayers should therefore take the opportunity to improve their position in advance to defend the applied transfer prices by means of written contractual agreements and thoroughful documentation of the actual circumstances for a subsequent tax audit or for a later mutual agreement or arbitration procedure.<sup>106</sup> This is all the more important in light of the increasing relevance of the ex-ante perspective for pricing in Germany.<sup>107</sup>

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<sup>106</sup> See already *Kircher/Moll*, DStR 2013, 1115.

<sup>107</sup> Cf. § 4 para. 1 no. 4a and b GAufzV; § 1 para. 3 AStG-E.



Below we will first present an overview of the legal framework and of possible solutions that can be considered in contractual negotiations between external third parties. This is followed by comments on the question of how existing intra-group contracts can be applied and, if necessary, adapted in line with arm's length principles in light of the Corona crisis and its economic consequences.

## **2. Legal Framework**

Intra-group contracts form the civil law framework. They cannot be structured discretionarily but are subject to legal constraints - like all civil agreements. Within these limits, civil law provisions based on private autonomy are dispositive. Mandatory law sets an absolute limit, which is indispensable. If the parties have not made any (or only partial) contractual arrangements, recourse to the statutory provisions and the model contained therein is required or possible with the consent of the parties to the contract.

Therefore, this section focuses on selected legal requirements and approaches to solutions in contractual negotiations between external third parties. In light of the worldwide outbreak of the Corona crisis, the question arises for many companies on the market as to how force majeure and a corresponding reference to force majeure or comparable legal institutions by their own company or the contractual partner should be dealt with. Respectively, what other measures can be taken, in particular to mitigate the economic consequences. In addition to these questions that need to be answered in the short term to overcome the crisis, it is also useful to take a long-term view, to reconsider contractual relationships for the future and to meet the need or even the necessity to adapt contracts. The legal consequences of possible supply bottlenecks, delays, or other disruptions in the supply and service chain play an important role here, and so does the possibility of amicably resolving these - also between third parties.

### **a. Ad hoc Measures**

#### aa. Force Majeure

#### aaa. Definition

The case law of German civil courts defines *force majeure* as an external event beyond the control of the company, caused by „acts of god“ or by actions

of third parties, which are unforeseeable according to human insight and experience, that cannot be prevented or rendered harmless by economically bearable means, even by the utmost care that can be reasonably expected in the circumstances, and are not to be accepted by the operating company due to their frequency.<sup>108</sup> Force majeure must therefore be unforeseeable, unavoidable and exceptional. Force majeure events are, for example, unforeseeable wars or risks of war and reactor accidents.<sup>109</sup> It must be made unreasonably difficult for the party affected by it to adhere to the contract.<sup>110</sup>

In the event of a review of the force majeure clauses in the context of a legal dispute, these standard clauses are regularly subject to a judicial review of their content in accordance with Sec. 307 (2) No. 1 BGB.<sup>111</sup> The reason for this is that it is primarily a matter of measuring the clauses against the content of the obligation in accordance with Sec. 276, subs. 1, BGB, so that these clauses may not change the standard for the risk to be borne, which the parties have agreed in individual contracts. This would normally also be an unreasonable disadvantage for the customer.<sup>112</sup>

#### bbb. Cases of Force Majeure

Although the affirmation of force majeure is always strongly dependent on the individual case, there are occasional relevant judgements from the area of travel law according to which epidemics can generally be regarded as force majeure.<sup>113</sup>

In the case of the Corona crisis, the official declarations and announcements of the Federal Foreign Office (Auswärtiges Amt), the Federal Government and the official measures taken to contain the crisis or pandemic are particularly relevant for classification. In our opinion, these particularly include the following:

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<sup>108</sup> BGH of 12 March 1987 - VII ZR 172/86, NJW 1987, 1938, 1939.

<sup>109</sup> OLG Düsseldorf of 15 February 1990 - 18 U 225/89, NJW-RR 1990, 573, 573; BGH of 23 November 1989 - VII ZR 60/89, NJW 1990, 572.

<sup>110</sup> *Oetker*, in commentary on the German Commercial Code, 6th edition 2019, § 346 marginal no. 81.

<sup>111</sup> *Thüsing*, in Contract Law and General Terms and Conditions of Business, 44 EL November 2019, para. 3.

<sup>112</sup> *Ibid.*

<sup>113</sup> Cf. AG Augsburg of 9.11.2004 - 14 C 4608/03 on the outbreak of the SARS virus; AG Homburg of 2.9.1992 - 2 C 1451/92-18 on the outbreak of cholera

- extensive border controls and partial border closures,
- state curfews and the declaration of certain territories as restricted or risk areas,
- drastic restrictions on international air traffic and
- state-imposed production restrictions or embargoes.

The assessments and recommendations of the World Health Organization (WHO) and national institutions such as the Robert Koch Institute (RKI) should also have an indicative effect. However, it is worth mentioning that, irrespective of such general assessments, in a specific case it must be a factually unavoidable event that cannot be eliminated by reasonable measures. Only then are the legal consequences triggered. The reasonableness must also be determined by weighing up the interests involved in each individual case.

An illegal violation of state orders such as embargoes, sanctions, etc. can of course not be considered as a possibility for proper commercial conduct.

On the other hand, additional financial expenditures caused by alternative means of transport are generally considered reasonable (e.g. air instead of sea transport) as well as difficulties in the procurement of raw materials or supplies. It may also be reasonable for the supplier to switch to substitute goods, provided this is possible in the delivery relationship concerned. It is therefore subject to the individual case whether an alternative finished product can be used.

In these cases, the customer is entitled to demand an alternative source of supply or an alternative transport route in order to avoid or avert the obstacle for performance to be assessed as reasonable.

If, on the other hand, the supply requires certification of the suppliers, substitution is often not possible or only possible with considerable delays. Depending on the individual case, this may lead to unreasonableness, which may then result in an affirmation of force majeure.

As a result, in addition to these sometimes somewhat abstract considerations, the concrete regulatory content of the respective force majeure clause is also important here. If the latter already mentions, for example, epidemics, pandemics, diseases or quarantines as well as various government measures or warnings as force majeure cases, this should increase the chances that a contractual partner can invoke force majeure. If, on the other hand, such a

specification is missing, the contractual partner could argue that the parties have already reached a final agreement on when a case of force majeure should and should not occur.

### ccc. Legal Consequences

The legal consequences of force majeure depend first of all on whether and with what content the parties to the contract have concluded a clause which contains provisions relating to force majeure and its legal consequences. Thus, the force majeure clause may release the parties mutually from their contractual performance obligations for the duration of the force majeure and indemnify the supplier - both in a manner permitted under GTC law - from any claims for damages.<sup>114</sup>

On the other hand, or in addition, further legal consequences may be agreed upon. For example, an exclusion of revocation for merely temporary postponement of the delivery and performance dates, the exclusion or agreement of an automatic termination of the contract, an extraordinary right of termination if the force majeure event lasts longer than a certain period of time, or an obligation to inform the other contracting party comprehensively about the expected duration and all efforts made.

### bb. Legal Regulations

In assessing such obstacles regarding performance, German non-standardized law must always refer to the provisions on impossibility of performance under Sec. 275 BGB or on interference with the basis of the transaction within the meaning of Sec. 313 BGB.

#### aaa. Impossibility

If it is objectively or subjectively impossible to provide the service in accordance with Sec. 275 para. 1 BGB, it would lead to a lapse of the obligation to provide the service with the consequence of the loss of the claim to the consideration in accordance with Sec. 326 para. 1 BGB. If the performance of the service is to be assessed as grossly disproportionate according to Sec. 275 para. 2 BGB

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<sup>114</sup> *Thüsing*, in contract law and general terms and conditions clauses, 44 EL November 2019, para. 22 et seq.

(factual impossibility), at least a temporary right of refusal to perform on the part of the obligated party must be assumed. However, it should be noted that a supplier is principally responsible and also bears the risk for compliance with the agreed delivery dates. Thus, for example, he cannot plead that he was unable to raise the funds required for the delivery. The payment obligation also remain, provided that the contractual partner has properly fulfilled the obligations.

#### bbb. Interference with the Basis of the Transaction

The assumption of a disruption of the basis of the transaction only rarely takes place. For this to be the case, among other things, the actual circumstances must have changed considerably after the conclusion of the contract, without these circumstances being part of the contract. Examples for this are massive difficulties in performance, such as shortage in raw materials or material increase in the price of raw materials or significant equivalence problems (e.g. massive inflation). On the contrary, significant cost increases do not generally lead to the application of Sec. 313 BGB, even if the risk assumed in each case is not unlimited.<sup>115</sup> In the case of supply contracts, it is a common assumption that the purchasing and procurement risk lies with the supplier, which is a consequence of the nature of the contract.<sup>116</sup>

An adjustment of the contract can only be considered as an exception if circumstances outside the debtor's sphere of influence and risk cause such a blatant disproportion between performance and consideration that it is no longer reasonable to adhere to the contract.<sup>117</sup> In practice, case law has assumed economic impossibility in these cases. The preconditions may therefore be present, for example, in the event of an excessive increase in production costs, e.g. by a factor of 15; by 60%; in the event of unforeseeable excessive procurement difficulties or in the event of serious disturbances caused by measures of state economic control.<sup>118</sup> The classification of unreasonableness requires a comprehensive weighing of interests taking into account all

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<sup>115</sup> *Grüneberg*, in Palandt, BGB, 79th ed. 2020, § 313 marginal no. 20.

<sup>116</sup> *Lange*, NJOZ 2013, 577, 580.

<sup>117</sup> *Grüneberg*, in Palandt, BGB, 79th ed. 2020, § 313 marginal no. 32.

<sup>118</sup> *Ibid.*

circumstances of the parties concerned.<sup>119</sup> The result of the weighing of interests is difficult to predict in each individual case.

If the obstacle for performance thus exclusively disturbs the equivalence relationship between the contractual partners, for example in the event of an increase in procurement prices, it can lead to an adjustment of the contractual regulations in accordance with Sec. 313 BGB. It is necessary here that adherence to the current contract is unreasonable because circumstances, which have become the basis of the contract, have changed significantly after the conclusion of the contract and the parties. If they had foreseen the change, they would not have concluded the contract or would have concluded it with different contents. A prerequisite is always that the disruptive event does not fall within the sphere of risk of one of the parties. Since the manufacture and delivery of goods are generally assigned to the supplier's sphere of risk, such adjustments are only conceivable in exceptional cases.

#### cc. Practical Information

However, these legal consequences are only a first indication. In practice, the force majeure clause used must always be interpreted and assessed on an individual case-by-case basis with a reasonable assessment of the overall circumstances; as the parties may reach deviating agreements both on an individual contractual level and in the course of the inclusion of corresponding GTC clauses. Thus, it is quite conceivable on the level of individual contracts that the parties may agree on a stricter liability in the sense of a liability obligation, independent of fault by assuming either a procurement risk or a guarantee. If, on the other hand, it should be a clause subject to content control under the General Terms and Conditions of Business, it is subject to the standard of Sec. 307 BGB, whereby the evaluations of Secs. 308 and 309 BGB are also to be applied in business legal transactions.

Typically, regulated legal consequences include rights of postponement, mutual information obligations, rights of rescission and – in the case of continuing obligations – termination rights for the parties, but also possible repayment obligations if one party has already made an advance payment, or extensive releases from liability.

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<sup>119</sup> Ibid., § 313 marginal 24.

#### dd. UN Sales Law

If the parties have agreed on the application of the UN Convention on Contracts for the International Sale of Goods (CISG) in the case of cross-border supply contracts (because they have not excluded it, for example), the exemption under Art. 79 CISG generally applies in cases of force majeure. This stipulates in para. 1 that a party is not liable for the non-performance of one of its obligations if it proves that the non-performance is due to an impediment beyond its control and that it could not reasonably be expected to take the impediment into account when concluding the contract or to avoid or overcome the impediment or its consequences.

Art. 79 CISG limits the liability for damages generally independent of fault in the UN Convention on Contracts for the International Sale of Goods, in case of uncontrollable obstacles. However, the debtor is indeed liable for damages if he disregards the obligation to notify the creditor as stipulated in Art. 79 para. 4 CISG.

Since the provision is dispositive according to Art. 6 CISG the parties may, particularly in the context of force majeure clauses, also make deviating provisions, which then – as already mentioned – require examination in the individual case. However, if the standard is applicable, this relatively broad provisions are generally advantageous for the supplier concerned, if he can demonstrate and prove that his delivery has been omitted or delayed due to the Corona crisis. This is likely to be successful, for example, in the case of state-ordered production stops or an embargo.

Finally, in connection with Art. 79 CISG, it should be noted that this provision only regulates the absence of fault on the part of the respective contracting party, but not the question whether and how the contract is continued.

#### ee. Refusal of Acceptance

Disruptions in the supply and service chain may not only affect the supplier side, but also the buyer side, for example if the production of final products in supply chains designed for just-in-time delivery is discontinued due to a pandemic and therefore the supply of intermediate products is temporarily not required. Against this background, the question arises as to the legal consequences if the customer temporarily stops purchasing the preproduction products.

According to German non-unified law, the customer is generally in default of acceptance (Secs. 293 et seq. BGB) if he does not accept or refuses to accept the goods duly offered to him by the supplier. For this purpose, it is first of all necessary that the supplier offers the goods in the manner stipulated in the contractual agreement (cf. § 294 BGB), including delivery at the contractually agreed delivery time, delivery of the goods to the agreed place of delivery or provision of the goods ready for transport at the place specified for collection. The customer does not have to refuse acceptance expressly.

The default of acceptance by the customer explicitly does not presuppose any fault. Because of the delay in acceptance, the supplier may demand compensation from the customer for additional expenses in accordance with § 304 BGB (e.g. storage costs or additional transport costs), but in principle no compensation for damages.

## **b. Escalation Levels**

From a civil law perspective, various alternative courses of action arise in the event of disruption or change in the contractual circumstances, which can be depicted in the context of four escalation levels. On the first level, the parties involved should jointly seek alternatives to the contractually agreed arrangements, which are no longer acceptable under the current circumstances, taking into account the aspect of mutual reasonableness. The next stage offers the possibility of suspending the contractual obligations to perform – for the duration of the circumstances preventing the obligation to perform - and to provide comprehensive information on the reason and for the duration for the prevention of performance to the respective other party. At the third stage, an adjustment of the existing contract may be made, which is intended to serve as a milder means of terminating the contract. In those cases in which no further alternative can be found, the performance obligations cannot be further suspended or individual regulations cannot be adapted. The last escalation stage has been reached. As an *ultima ratio*, the contract can also be terminated, if it is no longer reasonable for the contracting parties to adhere to the contract. This graduated approach with the motive of choosing the most appropriate means is also generally relevant for intra-group contracts and efforts to find a solution within the group that is arm's length and meets the interests of the group while avoiding escalation, and should also be recognized in the context of a future tax audit.



### c. Response Options and Risk Allocation

In addition to the ad hoc assessment, existing contractual relationships or those to be concluded in the future should be re-examined as a matter of principle to determine whether there is a need for adjustment in order to regulate situations comparable to Covid-19 in the future in a contractually unambiguous manner that is tailored to the respective risk circumstances. Such an analysis was increasingly observed following earlier pandemics or comparable cases of force majeure, particularly regarding contracts between independent parties.

#### aa. Reservation of Self-Supply

For the (intermediate) supplier, their respective pre-supplier's failure to deliver is generally not to be classified as force majeure, even if the supplier can invoke force majeure in individual cases. The concept of force majeure and the cases that fall thereunder do not include a delivery failure by suppliers. However, these cases can be regulated in contracts within the framework of self-supply reservation clauses.

Reservations of self-supply serve to protect the seller as part of a supply and production chain from claims for damages by customers, if in the seller's relationship with his suppliers the delivery of goods is delayed or cancelled altogether. The regulation of self-supply reservations is permissible, at least in business dealings.<sup>120</sup> The condition is that the seller has concluded a congruent cover transaction and that no delivery is made from this transaction through no fault of the seller (not only in cases of force majeure).<sup>121</sup> The reservation of self-supply thus presupposes a lack of fault on the part of the seller and not a case of force majeure.

Reservations of self-supply in standard clauses are ineffective as reservations of withdrawal in the sense of Sec. 308 No. 3 BGB in dealings with non-entrepreneurs. If they neither make an exception for short-term delivery disruptions nor indicate whether they should also apply. In case the user is responsible for the disruption of supply, e.g. because he failed to purchase the goods in question in good time by means of a so-called congruent covering

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<sup>120</sup> BGH of 14 November 1984 - VIII ZR 283/83, NJW 1985, 738, 739; BGH of 26 January 1983 - VIII ZR 342/81, NJW 1983, 1320, 1321.

<sup>121</sup> *Hopt*, in commentary on the HGB, 39th edition 2020, § 346 marginal 40.

transaction,<sup>122</sup> or because he is not supplied by his supplier due to his own failure to pay.<sup>123</sup> Otherwise, reservations of self-supply are permissible, both in non-commercial and commercial transactions.<sup>124</sup> Sec. 308 No. 3 BGB principally can, according to Secs. 307 Para. 2 No. 1, 310 Para. 1, also be applied in dealings between entrepreneurs, whereby the requirement of concrete specification of the reason for the solution is to be handled more generously.<sup>125</sup>

#### bb. Price Adjustment Clauses in Case of Cost Increases

In other cases, for example if raw material or production costs rise or fall, the orders themselves or the underlying agreements could contain an adjustment clause allowing the price or delivery arrangements to be adjusted. In this case, these adjustment clauses would have priority.<sup>126</sup> Such price adjustment clauses must be substantiated in terms of content, i.e. the price adjustment clause must be specific both in its contractual prerequisites and in its content.

The supplier's contractual partner must be able to derive the extent of possible price increases from the wording of the contract at the time of conclusion of the contract and must be able to check the justification of a price increase demanded by the supplier with reference to the clause based on the price adjustment clause itself.<sup>127</sup>

Clauses on price increases and complication granting a right of withdrawal in the event that the performance of the supplier becomes considerably more expensive or is otherwise more difficult than anticipated at the time of conclusion of the contract are also considered. Generally, the supplier must bear cost increases up to the "sacrificial limit" of economic impossibility and cannot exempt himself from this risk by means of a form, especially since he could otherwise easily circumvent the prohibition of price increase clauses in

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<sup>122</sup> *Grüneberg*, in Palandt, BGB, 79th ed. 2020, § 308 marginal no. 20; BGH of 26 January 1983 - VIII ZR 342/81, NJW 1983, 1320, 1321.

<sup>123</sup> *Wurmnest*, in Münchener Kommentar zum BGB, 8th ed. 2019, para. 308 no. 3 marginal no. 8.

<sup>124</sup> *Grüneberg*, in Palandt, BGB, 79th ed. 2020, § 308 marginal no. 20.

<sup>125</sup> *Ibid.*, § 308 marginal 23.

<sup>126</sup> *Lange*, NJOZ 2013, 577, 580.

<sup>127</sup> BGH of 19 November 2002 - X ZR 243/01, NJW 2003, 507, 509.

§ 309 No. 1.<sup>128</sup> Price adjustment clauses are to be measured on the basis of the content control pursuant to § 307, Subsection 1, No. 1, BGB, in particular the circumstance whether one party has the right to unilaterally change the price.<sup>129</sup>

With regard to possible adjustment clauses, the Price Clause Act (Preisklauselgesetz, hereinafter referred to as “PrKIG”) must also be taken into account. It describes the legal framework for the admissibility of such clauses. In particular, the PrKIG is intended to avoid the risk of inflation, which could result from an uncontrolled chain reaction of price increases. In principle, the prohibition of price clauses in Sec. 1 para. 1 PrKIG does not include clauses according to which the total price is to be adjusted proportionally if a cost element (e.g., raw material or energy price) changes (cf. Sec. 1 para. 2 No. 3 PrKIG). Under Sec. 1 para. 2 No. 3 PrKIG, for example, clauses are permissible if the factors relevant to the adjustment directly influence the creditor’s cost price for providing the consideration.<sup>130</sup>

With regard to adjustment clauses, it should be noted that they are subject to strict requirements, which the user of the clause has to respect and which sometimes are difficult to comply with. In the event of non-compliance, the authorized dealer risks that the clause will become non-transparent and thus is ineffective.<sup>131</sup> If an adjustment clause were to be used, care would therefore have to be taken to lay down a very detailed provision, since a gaping provision on price adjustment can lead to considerable uncertainty and disadvantages for the contracting parties.

### cc. Economic / Hardship Clauses

An economic clause - in different manifestations – particularly within long-term supply contracts concluded by manufacturers, regulates the conditions of a general claim to contract adjustment in the event of fundamental changes in circumstances on a contractual basis in more detail.<sup>132</sup> Generally, such

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<sup>128</sup> *Wurmnest*, in Münchener Kommentar zum BGB, 8th ed. 2019, § 308 no. 3 marginal no. 9.

<sup>129</sup> BGH of 28 October 2009 - VIII ZR 320/07, NJW 2010, 993 (994).

<sup>130</sup> *Hilber*, BB 2011, 2691, 2699.

<sup>131</sup> *Budde*, in Handbuch des Vertriebsrechts, 4th edition 2016, paragraph 39, marginal 73.

<sup>132</sup> BGH of 23 January 2013 - VIII ZR 47/12, NJW 2013, 2745, 2746.

clauses are based on the contractually agreed distribution of risk. As a result, an adjustment is not made if risks materialize that are exclusively in the risk sphere of only one contractual party (e.g. the risk that the market price for natural gas falls below the agreed fixed price).<sup>133</sup> A contractual provision of this kind takes precedence over the statutory provision on disruption of the business basis (Sec. 313 BGB). Economic clauses may contain, for example, provisions to the effect that contractual provisions are to be adjusted to the changed circumstances. In case technical, economic or legal conditions under which the contractual provisions (e.g. prices and conditions) were agreed upon, fundamental change and adherence to the contract is unreasonable because the intentions to achieve a fair balance of the mutual economic interests of the contracting parties can no longer be guaranteed.<sup>134</sup>

### **3. Reflection of the Arm's Length Principle in Contract Adjustments**

In light of freedom of contract, there is generally a large scope of action within the framework of dispositive law, which is used in negotiations between unrelated third parties. This wide scope also exists under civil law between associated companies. It can be a challenge to preserve the regulations mandated by the primacy of the arm's length principle. Due to the absence of a divergence of interests between the parties in a group of companies, tax law jurisdiction has therefore developed the legal institution of the dual ordinary and conscientious manager.<sup>135</sup> In this case, a negotiation situation is imagined in that two managers face each other who each pursue the interests of their fictitiously independent company (not the group), i.e. they try to achieve the best possible results for their company on the basis of their respective business objectives.<sup>136</sup>

This legal institution is not levered even in crisis. In the practical application of this legal institution, it is advisable to first of all orientate oneself on the behavior actually observed on the market in order to maintain the arm's length

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<sup>133</sup> Ibid.

<sup>134</sup> Ibid.

<sup>135</sup> Basic BFH of 16.3.1967, BStBl. III 1967, 626.

<sup>136</sup> BFH v. 17. 5. 1995, I R 147/93, para. 18; *Vögele/Raab/Braukmann*, in *Vögele et al.*, *Handbuch der Verrechnungspreise*, 5th ed. 2020, Chapter C, para. 26; *Borstell*, in *Vögele et al.*, *Handbuch der Verrechnungspreise*, 5th ed. 2020, Chapter N, para. 93, 224.

principle. The procedures agreed by the company with its own business partners (unrelated suppliers, customers, etc.) can therefore provide important pointers. It can be observed between independent business partners that, if there is a mutual economic interest in the business relationship, (possibly temporary) solutions are usually found (deferrals, granting of loans, waiver of payment, contract amendment, etc.) in order to essentially maintain the business relationship, i.e. to avoid a default of the business partner, for example.

However, in unprecedented situations such as the current pandemic, market observations of sufficiently comparable transactions will generally not (yet) be available for decision-making. Furthermore, especially during the crisis, the arm's length principle for affiliated companies must also be assessed in light of the specific interests of the group and taking into account group effects. For this reason, the selection of alternative courses of action that are possible under civil law on the one hand and reasonable in a group context on the other hand will not necessarily be identical with all courses of action observable between independent parties. In this respect, the recourse to the hypothetical arm's length comparison with the fiction of two orderly and conscientious managers remains as the fictitious actor, which, however, in the framework of the notional mutual reconciliation of interests offers a considerable scope for action.

As a rule, we can expect the basic motivation for fundamentally sticking to the business relationship in a group context. For every measure taken, the viability of losses in the short-term must be considered. Furthermore, the medium- and long-term economic perspective of both sights should be kept in mind. Such measures might include e.g. the reduction of the margin within the group, when said group has a limited risk profile (routine company, such as contract manufacturer or sales company). Particular attention must be paid to maintaining the profitability of the group companies, especially during the entire period and particularly to that of routine companies with usually rather lower capital resources and thus lower ability to bear losses.

The more clearly and conduct in the group that deviates from the status quo is expressly and verifiably agreed upon, the lower the risk a different position can be presented conclusively or even enforced in future tax audits by the tax authorities. Such adjustments might include an agreement on a clearly formulated force majeure clause or a reservation of self-supply. Furthermore, it is advisable to thoroughly document the adjustments regarding an

economically reasonable explanation by both parties to the controlled transaction at least by means of stipulations.

In order to improve the long-term crisis resistance of the selected transfer pricing system for the future, existing intra-group contracts should be reviewed based on current experience and adapted promptly if necessary. Beyond the measures to overcome the crisis, existing intra-group contracts should also be reviewed to determine whether they are (still) suitable to regulate the facts actually realized by the contracting parties or whether adjustments should be made to take any changes in the underlying circumstances into account that may have occurred since the conclusion of the contract - also due to the crisis.

A major impetus for the review of existing contracts will - in all probability - result from the fact that, based on the experience from the Corona crisis, the localization of risk management will assume greater importance and the actual allocation of risks will be put to the test. This could lead to contract adjustments in line with further development of actual function and risk profiles. If this is implemented accordingly, groups can emerge stronger from the crisis, increase the stability of their transfer pricing system and thus reduce the risk of a tax correction in a future tax audit.

## **VIII. Economic Analysis for Routine Companies** *(Dr. Nael Al-Anaswah, Dr. Björn Heidecke, Kai E. Schafer)*

In light of the economic gloom set out in section III. (p. 23 et seq.), it is necessary to review whether in the transfer pricing system only entrepreneurs should bear the losses or whether routine companies should also take risks. In other words, with reference to the graph in the special report of the Council of experts (p. 18), it is necessary to ask whether routine companies continue to follow the trend that allows economic development without the consequences of the Corona crisis or whether their remuneration should also show the economic downturn that is currently being observed and is expected for the next one to two years.

In order to answer this question and achieve an arm's length analysis, two approaches could be taken into consideration, which are not mutually exclusive but can be carried out in parallel.

If the transaction-related net margin method with reference to databases is appropriate for arm's length testing, there is a possibility to prepare a benchmarking study for the crisis period. The economic situation of the crisis period would be empirically taken into account in the benchmarking study. Thus, the choice of method would remain unchanged compared to the pre-crisis period. However, it is necessary to ask how the effects of the crisis can be reflected in an appropriate manner in order to ensure sufficient comparability of the comparative data with those of the tested party. If only pre-crisis data is chosen for the crisis years, the arm's length margin is likely to be overestimated because economic conditions — one of the comparative criteria — are not sufficiently comparable. Possible approaches to increase comparability include the consideration of loss-making companies, the extension of the observation period or adjustments. Discrepancies with the necessary comparability between crisis and non-crisis years could be reduced or avoided altogether by such approaches.

A complementary analysis could be conducted to support empirical evidence and the application of the transaction based on the net margin method. In such a more analytical approach, the question of what a third party routine sales unit or a foreign routine producer would do in such a situation is addressed further. If the latter did not have a secure legal position, for example with regard to a guaranteed margin or purchase quantity, various alternatives would be

compared and evaluated from a business management perspective. In absence of other applicable methods or to support the application described above - the transaction based on the net margin method with an adjusted range - the routine unit in the group context would perform a hypothetical arm's length comparison, i.e. evaluate various alternatives from its point of view.

In the following, we will first discuss how a pricing range in a crisis can be determined. Subsequently, explanations on the hypothetical arm's length comparison are presented as supplementary or - if the comparability is doubted despite adjustment calculations of the benchmarking a study besides the comparable companies - the sole method is to be applied instead.

## **1. Benchmarking Studies for crisis periods**

### **a. Potential Challenges and Possible Solutions**

When applying the TNMM method for arm's length analysis, benchmarking studies are necessary and common best practice and required in some jurisdictions. Benchmarking studies are used to identify companies that are comparable in terms of functions assumed and risks borne to the extend possible. In addition to the assumed functions and borne risks, the particularities of assets, contractual conditions, business strategy and economic circumstances in the respective market must be taken into account when assessing comparability.<sup>137</sup>

The current economic development in the wake of the Corona crisis raises the question of whether a database study with financial figures up to and including 2019 will provide comparable results for the years 2020, 2021 and presumably 2022 and whether data from times of crisis will be suitable for post-crisis periods.<sup>138</sup> It depends on the answer to this question whether a benchmarking study with financial figures up to and including 2019 that can be taken into account to benchmark and test the years 2020 to 2022. Similarly, the question

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<sup>137</sup> Cf. administrative principles - procedures, BMF of 12.4.2005, IV B 4 - p 1341 -1/05, BStBl. I 2005, margin note 3.4.12.7 and also the OECD of 2017, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax administrations, margin note 1.36 et seq.

<sup>138</sup> The duration during which economic performance is affected by the Corona pandemic varies from industry to industry. An industry-specific analysis is therefore an essential



arises as to whether benchmarking studies with financial figures from the crisis years should be taken into account for pricing and testing the post-crisis years.

As in Chapter II. (p. 13 et seq.), the economic framework data during the period of the Corona crisis and the time lag may not be comparable with the years up to and including 2019 and from 2022/2023 onwards, depending on the industry. Both the German legislation and the OECD consider the “economic circumstances”<sup>139</sup> or the “economic circumstances of the parties involved and of the market on which they operate”<sup>140</sup> as an essential criteria for comparability. Therefore, we may conclude that both pre-crisis benchmarking studies taking into account pre-crisis financial data of peer companies, and post-crisis benchmarking studies using financial data of peer companies from the crisis period, are not readily comparable because the economic circumstances are not comparable.

The question now arises as to which options are available for the preparation of benchmarking studies. The following approaches are possible, firstly for the crisis period and secondly for the years after the crisis.

### **Preparation of benchmarking studies for crisis periods<sup>141</sup>**

**Consideration of loss-making companies:** When benchmarking studies are prepared, companies with permanent losses are usually excluded. This may seem appropriate and in accordance with the decree that permanent losses “indicate” incomparability at a first glance.<sup>142</sup> Nevertheless, even in times of economic stability, one should not directly derive “incomparability” from this indicator. Ultimately, the criteria for the selection of comparable companies is not profitability, but the comparability of the companies to

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<sup>139</sup> Cf. administrative principles - procedures, BMF of 12.4.2005, IV B 4 - p 1341 - 1/05, BStBl. I 2005, margin note 3.4.12.7.

<sup>140</sup> OECD 2017, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, paragraph 1.36.

<sup>141</sup> Cf. *Engler*, IStR 2009, 685 ff; *Engler/Reinert*, Verrechnungspreise, 4th ed. 2015, marginal 263 ff; *Hayri/Clark*, Firm Profitability in Recessions: Part I, 10, Transfer Pricing Report 905, 2002; *Hayri/Clark*, Firm Profitability in Recessions: Part II, 11 Transfer Pricing Report 29, 2002.

<sup>142</sup> Cf. administrative principles - procedures, BMF of 12.4.2005, IV B 4 - p 1341 -1/05, BStBl. I 2005, margin note 3.4.12.7.

be compared. Profitability is not a criterion of comparability here.<sup>143</sup> The indication that permanently loss-making companies are not comparable is particularly unlikely to apply in times of a widespread economic downturn. On the contrary, losses are likely to be common in many industries. Therefore, in each case, reasons must be given why permanent loss-making enterprises should or should not be excluded, with reference to the comparability criteria. In order to take the economic downturn into account, a benchmarking study that also takes permanent loss enterprises into account could be appropriate.<sup>144</sup> Cataldi and Alfano (2020) argue similarly, and also refer to the Italian case law. According to them, the use of permanent loss-making companies in benchmarking studies for the period of the financial crisis, would have been allowed.<sup>145</sup>

**Extension of the period:** An extension of the benchmarking study period between eight and ten years can be useful to cover both the growth and the recession phase.

**Capital adjustment accounts:** If inventories, receivables, and liabilities during the Corona crisis are assumed to be above the usual amounts, a distortion in comparison to the comparable companies could result from different commitments to capital. This could be offset by usual capital adjustment calculations.<sup>146</sup>

**Using financial crisis data from 2008/2009:** The range of post-crises can serve as a starting point for the analysis of tested parties. Nevertheless, it is important to consider the long period between 2008/09 and today. This could affect the comparability through other effects such as industry-specific developments.

**Using financial data exclusively from the crisis period:** As soon as the crisis years are recorded in the database, these data could be used.

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<sup>143</sup> Cf. *ibid.*

<sup>144</sup> Cf. also *Cataldi/Alfano*, ITPJ 2020.

<sup>145</sup> Cf. *ibid.*

<sup>146</sup> Cf. for example *Bittner and Jann* ITPJ 2011, 14 et seq.

**Adjustment calculations:** The decree admits “reliable adjustment calculations” must be carried out to ensure at least limited comparability.<sup>147</sup> The decree establishes high requirements for adjustment calculations. Accordingly, “adjustment calculations based solely on estimates not specifically justified ‘empirical values’ are [not sufficient] [...]”.<sup>148</sup> It is possible that financial data from the pre-crisis period could be adjusted to achieve a “crisis effect”.

### **Preparation of benchmarking studies for the post-crisis period**

**Using pre-crisis financial data:** It is possible to use pre-crisis financial data, i.e. the years up to and including 2019, even though this may lead to a limitation of comparability. However, due to the rather short time between 2019 and 2023, the limitation should not be as significant.

**Adjustment calculations:** In contrast to the adjustment calculations for the crisis period, based on financial data without the influence of the crisis, it is possible to base the post-crisis period on the financial data of the crisis period and to run through adjustment calculations to eliminate the “crisis effect”.

This section explains one way of performing an **adjustment calculation** to determine a **range for a crisis period**, following a paper by Hayri and Clark (2002). They use a regression analysis for the years 1991 to 2001 to measure the influence of the sales level on the profitability of the comparable companies (manufacturing and distribution companies in the electrical and automotive industries).<sup>149</sup> In addition, the EU Joint Transfer Pricing Forum conducted a study using regression analysis to analyze the impact of major recession on the profitability of independent service providers in Europe.<sup>150</sup> The methodological approach chosen here is rooted in macroeconomics and is therefore more difficult to transfer to the individual company level. Engler / Reinert (2015) also discuss this approach.<sup>151</sup> The contribution to both

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<sup>147</sup> Cf. administrative principles - procedures, BMF of 12.4.2005, IV B 4 - p 1341 - 1/05, BStBl. I 2005, margin note 3.4.12.5b.

<sup>148</sup> Cf. *ibid.* marginal 3.4.12.6b.

<sup>149</sup> Cf. *Hayri/ Clark*, Firm Profitability in Recessions: Part II, 11 Transfer Pricing Report 29, 2002.

<sup>150</sup> Cf. EU Joint Transfer Pricing Forum, BM Contribution to Illustrate Available Generic Evidence Relating to Intra Group Services Profit Margins, 2009.

<sup>151</sup> Cf. *Engler/ Reinert*, Verrechnungspreise, 4th ed. 2015, recital 270.

approaches majorly differentiates in the definition of regression equation as well as in the choice of industry and years. The model for performing adjustment calculations in crisis periods and thus also the regression equation, which we describe in the following, is based on correlations between sales growth and profitability.

The basis of the presented approach is the correlation between relative sales growth (growth rate) and profitability. The BMF recognizes such regression models for adjustment calculations, since it allows a regression analysis as a possible calculation model.<sup>152</sup>

The further contribution is structured as follows: In section b. below, there is an overview of the method. In section c. the methodology is presented in detail. The model for performing an adjustment calculation in crisis periods is thus derived theoretically. A numerical example in section d. Section e. provides an overview of the documentation requirements of an adjustment calculation, section f. summarizes.

## **b. Methodical Approach: Overview**

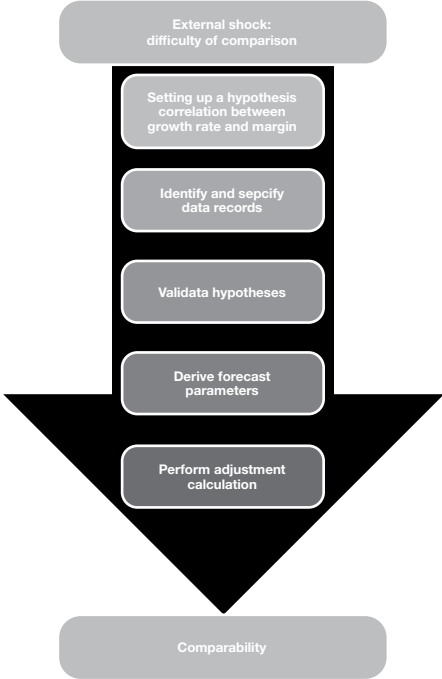
The following figure<sup>153</sup> illustrates the necessary steps of a model in order to perform adjustment calculations during a crisis period.

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<sup>152</sup> Cf. administrative principles – procedures, BMF of 12.4.2005, IV B 4 – p 1341 – 1/05, BStBl. I 2005, recital note 3.4.12.4.

<sup>153</sup> Own illustration

Figure 15: Transition – Derivation of the model.



First, an economic theory is used to develop hypotheses on the correlation between growth rate and profitability. To test these hypotheses, suitable data records must be identified and specified in the second step. The data set can be used to validate the hypotheses through descriptive analysis and graphical representations. Subsequently, the forecast parameters for the adjustment calculation are derived using suitable regressions.<sup>154</sup> In a final step, these can then be used to derive to the actual adjustment calculation.

**c. Methodological Procedure in Detail**

The following section explains the methodological procedure in detail. In section d. you will find a numerical application.

<sup>154</sup> *Cataldi and Alfano* (2020) also consider adjustment calculations using regression models, even if they do not specify the possible regression model.

## **Development of hypotheses based on the correlation between growth rate and profitability**

In order to measure the impact on the profitability of a company due to drop in sales, caused by an external parameters, it is first necessary to understand the economic correlation between the two parameters. It seems difficult to economically justify a direct influence of the amount of sales on the profitability of a company. However, it is reasonable to assume a positive correlation between the growth rate and profitability. Furthermore, it is assumed that the correlation is stronger when the growth rate of a company is negative.<sup>155</sup> This leads to the following hypotheses:

*Hypothesis 1: Positive correlation between growth rate and margin.*

*Hypothesis 2: Positive correlation stronger for enterprises with negative growth rate.*

These hypotheses are based on economic theories and are used to determine the model. However, it is necessary to ensure its applicability. It is only appropriate to test and quantify the described correlation between growth rate of sales and profitability for statistical significance. If the correlation is also statistically significant, the quantification of correlation can be used in the course of an adjustment calculation.

### aa. Identification and Specification of Data Records

The initial point of the application is the identification of suitable data records. Suitable data records should contain a sufficient number of comparable companies and the corresponding financial ratios. Furthermore, the data records should cover at least one crisis year over a long period. An indicator of company profitability is the margin.<sup>156</sup>

Ideally ( $N \times T$ ) complete data vectors consisting of sales, growth rate, margin and the absolute margin change can be derived for a number of comparable

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<sup>155</sup> See *Schmalensee*, Inter-Industry Studies of Structure and Performance in *Schmalensee/Willig* (Issue), *Handbook of Industrial Organization*, 1989, p. 951 et seq.

<sup>156</sup> Margin is defined here and below as EBIT margin.

companies  $i = 1, 2, 3, \dots, N$  and a certain period  $t = 0, 1, 2, \dots, T$ .<sup>157</sup> Growth rate and margin are defined as decimal numbers and not in percent. Crux of the matter for all subsequent steps are the data vectors.

The following paragraph bb. explains how the hypotheses performed in section i. can be validated using the data vectors.

#### bb. Validation of Hypotheses

In order to verify hypothesis 1 as well as the influence of the crisis period, the annual ranges for growth rate and margin are calculated.<sup>158</sup> Provided the ranges shown in the graph are qualitatively similar over time, the hypothesis cannot be rejected immediately. The crisis year should be clearly recognizable by a significant drop in the ranges.

In a further step, subdividing the data vectors strengthens the hypothesis. The ranges for margins combined with the negative growth rate should be below the range of all margins and well below the range for margins combined with a positive growth rate. The discrepancy between the divided ranges and total range might already be a first step towards the validation of hypothesis 2. Provided that the results of the described descriptive analyses are positive in terms of the hypotheses, the next step is to examine the correlation between growth rate and margin for its statistical significance and, in addition, to quantify the correlation for use in an adjustment calculation.

#### cc. Derivation of Forecast Parameters

A linear single regression using the “least squares method” is used to test statistical significance and to quantify the impact of the growth rate on the margin.<sup>159</sup>

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<sup>157</sup> The observations in  $t = 0$  are needed to calculate the growth rate and the absolute margin change in  $t = 1$ . The first complete data vector is available for  $t = 1$ .

<sup>158</sup> Range here and below is the arithmetic range. Each observation is equally weighted.

<sup>159</sup> Linear single regression using the “least squares method” draws a straight line through the data pairs. The target value of this straight line is defined as sum of the squared differences from the actual value  $Y$  and the value  $y$  derived from the straight line. The straight line is positioned to minimize this sum. The squaring of the differences is used for weighting.

In order to avoid possible sign conflicts, the dependent explanatory variable  $Y$  is defined as the **absolute margin change** and the independent explanatory variable  $X$  as the growth rate.<sup>160</sup> Assuming the margin does not change with a zero growth rate, the introduction of a constant is not necessary. Consequently, in case of a perfect data set,  $(N \times T)$  data pairs are included in the regression.

The important key figures of this regression are slope parameter of the regression, i.e. the coefficient  $\beta$ , the associated  $P$ -value as well as the coefficient of determination  $R^2$ .<sup>161</sup>

Hypothesis 1 cannot be rejected if the coefficient  $\beta$  is positive and statistically significant to level  $\alpha$ .<sup>162</sup>

For further verification of hypothesis 2, the data pairs are subdivided again into those with a positive and those with a negative growth rate and each is subject to a regression.

Hypothesis 2 cannot be rejected if a) the coefficients  $\beta$  of both regressions are positive and statistically significant at level  $\alpha$  and b) the coefficient  $\beta$  of the regression paired exclusively with data pairs with negative growth rate is greater than the coefficient  $\beta$  of the regression exclusively paired with data pairs with positive growth rate.

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<sup>160</sup> Otherwise, changes in GDP or the business climate could serve as explanatory variables. With such an approach, the question is whether the causality can be sufficiently theoretically substantiated. Moreover, choosing individual parameters as explanatory variables runs the risk of missing other explanatory variables. Consequently, a consistent approach would require several variables to be included in the regression and the effects of, say, GDP to be estimated.

<sup>161</sup> The coefficient  $\beta$  quantifies the influence of the explanatory variable on the dependent variable, the  $P$ -value measures the significance of the coefficient  $\beta$ . The smaller the  $P$ -value, the more statistically significant is the coefficient  $\beta$  and thus the influence. The coefficient of determination  $R^2$  is a measure of the model's quality.  $R^2$  indicates the percentage of the scatter explained by the regression in the total scatter in the data. The  $R^2$  is defined from zero to one, where  $R^2 = 1$  reflects perfect explanatory content. Other models could be performed, such as panel data regression. These models are more often methodologically precise. Nevertheless, the question remains whether the additional precision is in relation to the effort and traceability.

<sup>162</sup> This is the case if the  $P$ -value of the coefficient  $\beta$  is smaller than  $\alpha$ . Typical significance levels are 1 %, 5 % and 10 %.



The coefficient  $\beta$  is used to quantify the correlation, or the influence of the growth rate on the absolute change in margins. If the growth rate of an enterprise in year  $t$  is 100 % or 1, the margin of the enterprise increases by  $\beta$  ceteris paribus. If the growth rate of an enterprise in year  $t$  is -12 % or -0.12, the margin of the enterprise decreases by  $\beta \times (-0.12)$  ceteris paribus.

Further subdivisions of the data pairs may be useful to examine and understand the strength and significance of the correlation in more detail. One possibility is, for example, to subdivide the period of observation more precisely and, given the new data sets, to carry out the regressions explained above again.

Provided that the hypotheses could be confirmed by the regressions, these results can be used in the course of prognoses and adjustment calculations to establish or increase the comparability of comparable companies and the tested party.

#### dd. Implementation of Adjustment Calculation

In order to compare the margins of comparable companies from the past with margins of the tested party during a crisis period, three steps are necessary.

First, a comparison range is formed using the  $N$ -weighted average margins of the last three observation years  $T - 2$ ,  $T - 1$ ,  $T$  of comparable companies.<sup>163</sup>

The margins of comparable companies are then forecasted for the year  $T + 1$  using coefficient  $\beta$  of the regression. This coefficient quantifies the influence of growth rate on the absolute change in margins directly and thus indirectly the influence of growth rate on the margin itself.

In the event of a relative growth rate of the tested party of  $-\delta$  caused by an external unexpected events, the margins of the comparable companies are adjusted in  $K$  by  $\beta \times (-\delta)$ . This corresponds then to the forecast margins in  $T + 1$ . A range can be calculated using the  $N$  forecast margins of the benchmark companies, which can be compared to the margin of the tested party during a crisis period.

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<sup>163</sup> Weighted average margin is defined here and below as the average margin weighted by sales.

In addition, it is useful to create an adjusted comparison range for the years  $T - 1, T, T + 1$ . This is analogous to the calculation of the original comparison range. Sales of the benchmark companies in  $T$  are adjusted by factor  $-\delta$  as a forecast for year  $T + 1$ , the margins in  $T + 1$  have already been forecasted using the coefficient  $\beta$ . The adjusted comparison range can thus be compared with the weighted average margin from the crisis period and two previous years of the tested party.

This section has demonstrated how hypotheses derived from economic theories on correlations between turnover and margin can be empirically tested by descriptive analysis and with the help of suitable data records. Furthermore, regressions were explained to test the statistical significance of the relationship and to quantify it. The results can then be used for an adjustment calculation. This methodology is applied to actual data in the following section d.

#### **d. Application Example**

The comments on economic theory and hypotheses outlined at the beginning of section c. are not repeated here. Rather, this section will focus on these hypotheses and apply the model for the implementation of adjustment calculations during crisis periods in conjunction with empirical data. The section is structured in the same way as section c. or the scheme in section b.

##### **aa. Identification and Definition of Data Records**

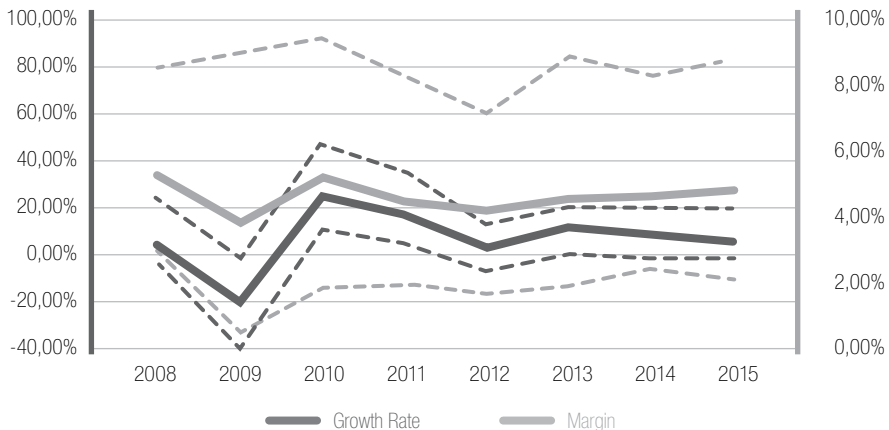
The data record contains the financial ratios of 74 comparable companies (routine companies) from the “Automotive Manufacturing” sector. The observation period covers the period 2008 to 2015. 529 valid and complete data vectors, consisting of sales, growth rate, margin and absolute margin change, are available. The crisis year 2009 and the crisis period 2009 to 2011 are included in the data records.

Paragraph bb. tests the economic hypotheses for empirical validation using descriptive analyses of the data vectors.

## bb. Validation of the Hypotheses

In order to test these hypotheses, the annual ranges of growth rate and margin were calculated for the years 2008 to 2015. Figure 16 shows the growth rate range on the left and the margin range on the right.

Figure 16: Range – growth rate and margin 2008 - 2015. <sup>164</sup>



Hypothesis 1, positive correlation between growth rate and margin, is supported by the similar development of the annual ranges of growth rate and margin. The influence of the crisis in 2009 also evidences the significant decline in both variables.

Table 1 further illustrates this by dividing the data vectors into those with a negative and those with a positive growth rate. The range for margins associated with a negative growth rate is well below the overall range and the range for margins associated with a positive growth rate.

Furthermore, it can be concluded that the influence of a negative growth rate on the margin is stronger than the influence of a positive growth rate. The range for margins with negative growth rate is further distant from the total range than the range for margins with positive growth rate. Consequently, Hypothesis 2, should not be disregarded due to its stronger correlation between negative growth rate and margin, at this point.

<sup>164</sup> Own illustration.

Table 1: Range – margin. Total observation period

<b>Growth rate</b>	<b>Lower quartile</b>	<b>Median</b>	<b>Upper quartile</b>
<b>Negative</b>	1,01%	3,46%	6,99%
<b>Total</b>	1,94%	4,59%	8,84%
<b>Positive</b>	2,51%	5,11%	9,40%

The descriptive analyses provide positive results regarding the hypotheses. The model cannot be rejected at this point. The following paragraph cc. focuses on testing statistical significance and quantifying the relationship between growth rate and margin.

#### cc. Derivation of the Forecast Parameters

The data pairs used are differentiated according to the observation period a) 2008-2015, b) 2009 (crisis year) and c) 2009-2011 (crisis period) and according to the growth rate associated with the margin a) all, b) negative and c) positive. Consequently, nine regressions and nine coefficients  $\beta$  can be derived.

The results of regression are summarized in the table below.<sup>165</sup>

Table 2: Summary of regression results

No.	Growth rate	Period	Observations	$\beta$	P-value	R2
1	Total	2008-2015	529	0,0572	0,0000	0,1261
2		2009	64	0,1954	0,0000	0,4230
3		2009-2011	200	0,1096	0,0000	0,2911
4	Negative	2008-2015	174	0,2044	0,0000	0,2389
5		2009	48	0,2117	0,0000	0,4709
6		2009-2011	67	0,2219	0,0000	0,4929
7	Positive	2008-2015	355	0,0463	0,0000	0,1438
8		(2009	16	0,1111	0,0801	0,1902)
9		2009-2011	133	0,0797	0,0000	0,2475

The coefficients  $\beta$  measure the influence of growth rate on the absolute change in margins. For example, if growth rates are -10 % and -0.1, the enterprise's margin decreases ceteris paribus by  $0.1096 \times (-0.1) = 0.0110$  and 1.10 percentage points in model 3 and by  $0.2044 \times (-0.1) = 0.0204$  and 2.04 percentage points in model 4.

The coefficients  $\beta$  are consistently positive and statistically significant at the typical significance levels; the relevant  $P$ -values are without exception zero. Therefore, hypothesis 1 cannot be rejected. Furthermore, the coefficients  $\beta$  in models 4-6 for margins associated with negative growth rates are significantly higher than in models 7-9 for margins associated with positive growth rates. Consequently, Hypothesis 2 cannot be rejected either.

Furthermore, the impact of growth rate for margins combined with a negative growth rate hardly depends on the period considered. This leads to the assumption that a company with declining sales will not be affected by the phase of the business cycle. This assumption is not supported by the results for margins associated with a positive growth rate or the overall view.

<sup>165</sup> Own illustration

Moreover, the higher explanatory content of the regression model in the crisis year or period should be mentioned. A considerable part of the variance in data can be explained by means of regression, especially in regressions 2, 5 and 6.

The statistical significance of the hypotheses was successfully tested and the correlation between growth rate and margin was indirectly quantified by the coefficients  $\beta$ . In the following section dd. the actual adjustment calculation in the event of a crisis, i.e. a drop in the growth rate, is performed using these results.

#### dd. Implementation of the Adjustment Calculation

The adjustment calculation using the results of the preceding paragraph cc. is carried out in the same way as described in paragraph dd. of section c.

First, the comparative range for margins of benchmark companies is established for the last three years of observation, i.e. 2013-2015. This consists of the weighted average margins of 74 benchmark companies.<sup>166</sup> Table 3 shows the comparative range.

Table 3: Comparative range 2013-2015

Lower Quartile	Median	Upper Quartile
2,30%	5,35%	8,76%

Next, the forecast range for 2016 and the resulting adjusted comparative range for the years 2014–2016 must be calculated. This is illustrated below using the regression models 1 and 6 as examples, as well as a decline in sales of 20, 40 and 60 % respectively.<sup>167</sup>

<sup>166</sup> Due to deficiencies in the data set, only 73 valid weighted average margins can be calculated. To maintain consistency with the subsequent adjustment calculations, only 57 of the 73 benchmark companies are included in the calculation.

<sup>167</sup> Due to the imperfect the data, only 57 margins can be predicted for the year 2016. Merely 57 companies for comparability, which have a valid predicted margin for 2016, are incorporated into the calculation for the adjusted comparability range.

Table 4 shows the forecast ranges for 2016 for the different models and sales declines. For example, in model 1, with a sales decline of 20%, i.e. a growth rate of -0.2, the margins of the benchmark companies are reduced by  $0.0572 \times (-0.2) = 0.0114$  or 1.14 percentage points in 2015. This corresponds to the forecast margin for 2016. The forecast range is calculated using these forecast margins.

Table 4: Forecasted range 2016

Model	Sales decline	Lower quartile	Median	Upper quartile
<b>1</b>	20%	0,96%	3,68%	7,63%
	40%	-0,18%	2,54%	6,48%
	60%	-1,33%	1,39%	5,34%
<b>6</b>	20%	-2,33%	0,39%	4,34%
	40%	-6,77%	-4,05%	-0,10%
	60%	-11,21%	-8,49%	-4,54%

The effect of the decline in revenue is evident in the forecast range for 2016. The range for a 20% decline in revenue in model 1 with a low coefficient  $\beta$  - which is low in times of crisis - is already well below the comparative range for the years 2013 to 2015. The forecast decline in margins in model 6 with a high coefficient  $\beta$  can be described as significant. In order to check whether the tested party is at arm's length, the margin of the tested party in the crisis year should be compared with the forecast range of benchmark companies for the year 2016.

Table 5 shows the adjusted comparison ranges for the years 2014 to 2016, e.g. in model 2, if sales fall by 40%, i.e. a growth rate of -0.4, the sales of the benchmark companies are reduced by 40% in 2015. Using forecast margins for the year 2016, weighted average margins can be calculated for the years 2014 to 2016. These are used to determine a new, adjusted comparison range.

Table 5: adjusted comparative range 2014-2016

Model	Sales decline	Lower quartile	Median	Upper quartile
1	20%	1,93%	4,77%	8,97%
	40%	1,75%	4,54%	8,75%
	60%	1,70%	4,47%	8,66%
6	20%	1,01%	3,80%	8,13%
	40%	0,23%	2,98%	7,39%
	60%	0,05%	2,78%	6,95%

The effect of the decline in sales is considered over several years. This is justified by the weighing of the margins. A low margin in case of a high decline in sales is only included in the calculation of the weighted average margin to a minor extent. Nevertheless, the lower quartile and median are always significantly below the comparative range of the years 2013 to 2015. In order to check whether the tested party is at arm's length, the weighted average margin from the crisis year and the two preceding years of the tested party should be compared with the adjusted range of the benchmark companies for the years 2014 to 2016.

#### e. Documentation

The GAufZV requires the taxpayer to document calculations when applying the chosen transfer pricing method.<sup>168</sup> Since the adjustment calculation is part of the application, it must be documented to provide an expert third party with the ability to understand the adjustment as part of the arm's length analysis<sup>169</sup>. The 2005 decree specifies that the adjustment calculations performed by the taxpayer and the calculation models used, such as regression analyses, must be explained with regard to database studies.<sup>170</sup>

<sup>168</sup> Cf. § 4 para. 1 no. 4E GAufZV.

<sup>169</sup> Cf. § 2 para. 1 GAufZV.

<sup>170</sup> Administration principles – procedures, BMF as of 12.04.2005, IV B 4 – S 1341 – 1/05, BStBl. I 2005, recital 3.4.12.4.



Regarding adjustment calculations, the OECD stipulates transparency. This includes an explanation of the adjustments performed, the reasons why the adjustments are considered appropriate, the calculation itself, the adjustment per comparative value and an explanation of why the adjustment increases comparability.<sup>171</sup>

## **f. Summary**

This contribution has illustrated how to derive an economic model, both theoretically and empirically based, for performing adjustment calculations in crisis periods. Necessary inputs can be obtained from databases. The analysis can be performed with Excel as well as statistical software solutions.

The application of the theory using the example of “automotive manufacturing” is a first indicator for the empirical validity of the methodology. The values obtained could provide a starting point for an adjustment calculation in practice. The quality of the adjustment calculation can be improved if, in the actual practical application, starting from the data set for the respective industry, hypotheses are first tested and subsequently the factors for the adjustment calculation are derived.

The adjustment calculation must be documented in a transparent manner. In particular, the adjustment mechanism should be explained and the explanation of comparability should be supplemented.

However, one soft spot of the regression model is the absolute change in margins only depending on the growth rate. This is probably not the reality. Rather, other variables will affect the absolute margin change or the margin itself.<sup>172</sup> Considering this context, it seems advisable to at least name other variables influencing the margin and explain the direction of the possible effect.

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<sup>171</sup> Cf. OECD as of 2017, OECD transfer pricing guidelines for multinational companies and tax administrations, recital 3.54.

<sup>172</sup> In econometrics, this is referred to as “distortion due to omitted variables”. The coefficients  $\beta$  can thus both under- and overestimate the actual influence of the explanatory variable on the dependent variable (cf. Hackl, Einführung in die Ökonometrie, 2005, 96 et seq.)

## **g. Consideration of State Aid**

In addition to the technical illustration, the consideration of state aid is briefly discussed.

First of all, the OECD stipulates subsidies should be taken into account as a comparability criterion when selecting a comparable set of companies for benchmarking studies.<sup>173</sup> However, it could further be argued that such subsidies, and thus inaccuracies in the range limitation, are taken into account. Though the OECD accepts such an argument, it also recognizes that differences cannot always be eliminated, for example, if they only relate to the company under investigation and not to the comparable companies.<sup>174</sup> If structural differences in state aid exist when comparing individual countries, an adjustment calculation may be necessary and a limitation of the range may not be sufficient. It is plausible to assume, however, that government aid in the wake of the Corona pandemic is present in many countries, meaning no structural differences can be identified between the benchmark companies. Since differences in market situations are compensated by the range concept in other respects as well, there is strong evidence for following this line of argument with regard to government aid.

In addition to the reflection in the context of the benchmarking analysis, the question arises whether government aid is due to the routine entity or the principal. An example illustrates the problem. Assuming a routine entity achieves a sales return of 5% with government aid. Without government aid, it achieves a loss of minus 4%. According to the benchmarking study, the lower quartile is assumed to be 3%. Hence, it could be argued that the government aid should be excluded from the analysis. An adjustment from minus 4% to at least 3% would thus be necessary. However, a third party is aware of the government support and considers this during the negotiation situation. Possibly no adjustment is to be made at all since a third party would only have continued business with the routine entity if at least part of the advantage from the government support could be received. Government support (or similarly also subsidies) may have been the reason for the establishment of a routine entity in Germany. In light of this, it seems advisable in any case to weigh up how state aid should be taken into account in a negotiation situation with a

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<sup>173</sup> OECD of 2017, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, para. 1.132.

<sup>174</sup> Ibid., marginal 2.79.

third party and whether the government support was the initial trigger for the establishment or continuation of the business relationship.

## **2. Hypothetical Arm's Length Comparison**

### **a. Preliminary Considerations**

In light of the information provided in Section VI. (p. 54 et seq.), the question arises whether the OECD provides information on the assumption of the risk from the Corona crisis or comparable events. It distinguishes between various risk categories. It states that this is “[...] likely to include adverse external events that may cause damages or losses, including accidents and natural disasters. Such risks can often be mitigated through insurance, but insurance may not cover all the potential loss [...]”.<sup>175</sup>

No further details are given. In particular, it does not explain how compensation can be paid. In the Corona case at hand, the first question is, whether this could have been covered by insurance. In view of the numerous imbalances currently observed in entire industries, but also in individual companies, it is to be assumed assume that third parties have not - at least not to a large extent - insured themselves against such risks. One exception is likely to be so-called business closure insurance, which is certainly present in the catering sector. This involves covering fixed costs and small profits for a limited period of time. Often, however, such insurances seem to be useless because they do not cover the new virus.<sup>176</sup> Therefore, the first step of the transfer pricing analysis is to examine whether it would have been possible to obtain insurance, the maximum limits, the events and whether third parties would have done so regularly. If so, a comparison of third parties could be used to determine who might have decided against obtaining insurance. With regard to the contribution in Section VI. (p. 54 et seq.), this would be part of the risk management function. Due to the fact, that third parties generally are not covered for catastrophes in their insurance policies, it should not be objected for a group of multinational enterprises to have one.

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<sup>175</sup> OECD 2017, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, para. 1.72e.

<sup>176</sup> Cf. Fromme/Nöthling, controversy concerning Corona insurance escalated, <https://www.sueddeutsche.de/wirtschaft/betriebsschliessungen-streit-um-corona-versicherung-eskaliert-1.4860856>

Furthermore, the question arises who bears the risk. “[...] [The risk should be allocated to the enterprise] exercising control and having the financial capacity to assume the risk [...]”<sup>177</sup> In the present case, as insolvencies and government support have shown, it is likely that even third-party entities are regularly unable to bear the risk financially, meaning OECD’s control concept is ineffective and the risk cannot be directly assigned to any group entity. The OECD agrees with this view. According to the OECD, “in exceptional circumstances, it may be the case that no associated enterprise can be identified that both exercises control over the risk and has the financial capacity to assume the risk. As such a situation is not likely to occur in transactions between third parties, a rigorous analysis of the facts and circumstances of the case will need to be performed, in order to identify the underlying reasons and actions that led to this situation.”<sup>178</sup>

In conclusion, there is a lack of clear explanation regarding a risk such as the economic consequences of the Corona pandemic. As a rule, it is unlikely that insurance policies could have been obtained prior to the outbreak. The risk control concept is often likely to fail because such risks cannot be assigned in terms of control. In such cases, the OECD recommends a thorough analysis of the individual case.

## **b. Methodological Approach**

How can such a case be solved methodologically? The first approach is presented above with an adapted benchmarking study for crisis periods. The application of the transaction-related net margin method remains the preferred method. Legislature dictates the application of the hypothetical arm’s length principle, if the outcome of the case is that the adjustment is insufficient for establishing comparability or for the support of the analysis.<sup>179</sup> These three standard methods should not be applicable. Otherwise, the application of the transaction-based net margin method would not be appropriate. The profit split is unlikely to work because of its routine nature.

According to the hypothetical arm’s length comparison, the taxpayer must determine the minimum price of the service provider and the maximum price

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<sup>177</sup> OECD 2017, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, para. 1.98.

<sup>178</sup> *Ibid.*, marginal 1.99.

<sup>179</sup> Cf. §1 para. 3 p. 5 AStG.

of the service recipient based on a functional analysis and internal planning calculations. The taxpayer must take into account take capitalization interest rates that are appropriate to the function and risk (agreement range). The agreement range is determined by the respective profit expectations (profit potentials). A bilateral analysis must be performed, considering two ordinary and conscientious managers. Slightly broader, an economic analysis is to be performed, taking into account the legal framework.

Thus, the BMF states in the explanatory memorandum to a new § 1 AStG as a preliminary remark on the application of the arm's length analysis: "Therefore, an economic and legal reflection and, in conjunction with this, the application of economically based procedures recognized by the professional public, as stipulated in particular in the OECD Transfer Pricing Guidelines, is necessary in any case, taking into account legal circumstances, in order to demonstrate that an applied transfer price is in accordance with the arm's length principle and thus corresponds to the arm's length price.<sup>180</sup> According to the explanatory memorandum of the law, the above-mentioned "reflection" is required particularly in the absence of comparable transactions." In such cases [i.e. in the absence of comparability], a "reflection" is required in particular on how third parties would have treated the transaction in question.<sup>181</sup>

This corresponds to the idea of the hypothetical arm's length comparison. "If no comparable values - i.e. in particular prices and other terms and conditions of a business transaction, cost allocations, profit mark-ups, gross margins, net margins or profit splits - can be determined, it must be demonstrated by economic reasoning and, consequently, by the application of economically based procedures accepted by the professional public, that a transfer price applied is in accordance with the arm's length principle and thus corresponds to the arm's length price. This is expressed in particular in the hypothetical arm's length price. No valuation method is specified with the hypothetical arm's length comparison; instead, economically accepted valuation methods are used."<sup>182</sup>

The OECD advocates a comparable opinion by considering the concrete market situation including realistic alternatives. "When assessing the terms

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<sup>180</sup> Preliminary remark on § 1 AStG-E.

<sup>181</sup> Statement of reasons for § 1 para. 3 p. 3 AStG-E.

<sup>182</sup> Legal reasoning to § 1 para. 3 sentence 7 AStG-E.

of a potential transaction, independent companies compare the transaction with the alternatives realistically available to them and only enter into the transaction if they do not see any alternative clearly more attractive way to achieve their business objectives.” In other words, independent companies would only enter into a transaction if they are not expected to be worse off than with their next best alternative.<sup>183</sup>

As a result, the hypothetical arm’s length comparison is applicable in the absence of (or in support of) other methods. In this case, a bilateral approach is to be performed considering both parties. The exact execution of the hypothetical arm’s length comparison is not provided. Rather, it is required to choose an economically plausible approach. The legal framework and realistic options for action must be considered.

### **c. Application of the Hypothetical Arm’s-Length Comparison**

The analysis should initially start with the legal framework. In particular, it should be examined whether the routine entity had a promise of yield or acceptance. If so, the question is whether this commitment would also apply to third parties. Even in Corona times such legal guidelines would probably not be abandoned by a third party, or at least they would be taken into account as a negotiating argument with the contracting party. Furthermore, it is necessary to analyze realistic alternatives for action a routine entity would possess on the market. Due to the general economic development such as short-time work, closures and government support, it is unlikely to receive secure remuneration even in a third-party relationship. In a third step, the realistic alternatives are to be evaluated from the point of view of the routine entity (but also of the client) and the hypothetical arm’s length comparison is to be performed. It is possible, for example, that a routine entity might see closure costs as an alternative. A further option would be a low margin or even a loss in the short term and in return at least the chance or promise of a higher margin in the long term. In this case, the routine entity and the client would share the loss and then participate equally in the profit of the profit range. If the customer, for its part, has delivery obligations, a third party contract manufacturer could take advantage of this in the negotiations and demand a slightly higher margin. Similarly, if the buyer had a guaranteed commitment, he might be able to do the same. A third party would probably

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<sup>183</sup> OECD 2017, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, margin note 1.38.

not insist on the commitment either, if there was a risk of the contracting party going insolvent as a result and no business could be done with them in the long term.

A further consideration can include fixed and variable costs. According to microeconomic supply theory, for example, companies are prepared to offer in the short term, if the average variable costs are covered by the price.<sup>184</sup> A contract manufacturer would then be willing to deliver if it covered at least its variable costs. Such a unilateral microeconomic view does not suffice, as Raffel concludes. Based on a microeconomic approach, Raffel calls for an individual lower price limit to be determined in each individual case, for example depending on liquidity requirements, but also on long-term planning.<sup>185</sup> The remarks on microeconomics and business administration show the absence of “the” lower price limit at which an external third party would be willing to offer. This emphasizes how there cannot be an ultimately valid approach to applying the hypothetical arm’s length principle. As the BMF rightly states, it must be guided by economic thinking. No matter how the hypothetical arm’s length comparison is performed arithmetically or analytically in consideration of the legal and economic framework data, it is well documented and appropriately substantiated. Fourthly, the deviation from the existing contract should be documented with plausibility verification and calculation (see Section XII., p. 149 et seq.).

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<sup>184</sup> Cf. for example Varian, *Grundzüge der Mikroökonomik*, 4<sup>th</sup> ed. 2005.

<sup>185</sup> Cf. Raffel, *Kurzfristige Preisuntergrenzen als betriebswirtschaftliches Problem*, 1961.

## IX. Valuation of Intangible Assets (*Dr. Marc C. Hübscher*)

Regarding the valuation of intangible assets and the valuation of the transfer package in the context of a transfer of functions, the hypothetical arm's length comparison must generally be carried out in both cases (unless limited comparable comparative values are available at the least).<sup>186</sup> In hypothetical arm's length comparisons, the reservation prices must be determined from the point of view of both, the selling and the receiving company. This means that, from the point of view of the selling company, the minimum ask price, and, from the point of view of the receiving company, the maximum willingness to pay, need to be determined. "For this purpose, the service provider must determine the minimum price of the service provider and the maximum price of the service recipient on the basis of a functional analysis and internal planning calculations, taking into account capitalization interest rates that are appropriate to the function and risk (agreement range); the agreement range is determined by the respective profit expectations (profit potential)."<sup>187</sup> The BMF decree on the relocation of functions states that business valuations can be used as a basis for this. This includes e.g. the standards of the Institute of Auditors (IDW) S1 "Principles for the Execution of Business Valuations" (as amended 2008) and S5 "Principles for the Valuation of Intangible Assets": "For the transfer pricing determination in these cases, in particular the financial benefit to be expected in the future from the transfer package (or from the concerned intangible assets respectively) is decisive. Such a value results from business valuations based on capital value-oriented methods that can be recognized nationally (e.g. IDW S1/2016) or IDW S 5/2015) or internationally (e.g. ISO 10668)."<sup>188</sup> The analogous application of the decree for the valuation of intangible assets is obvious, as with the hypothetical arm's length comparison, the legislator is generally requiring the same method here again.

These standards regulate the details of the valuation. In the following, we first give a brief overview of the various capital-value-oriented methods. We will then deal with the planning calculation as the basis for the assessment. In a

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<sup>186</sup> Cf. *Heidecke*, Country Chapter Germany, in *Heidecke/Hübscher/Schmidtke/Schmitt* (Hrsg.), *Intangibles in the World of Transfer Pricing. Identifying – Valuing – Implementing*, 2020 (forthcoming).

<sup>187</sup> Section 1 para. 3 sentence 5 AStG.

<sup>188</sup> BMF as of the 13<sup>th</sup> of October 2010, *Verwaltungsgrundsätze Funktionsverlagerung*, BStBl. I 2010, marginal no. 62.

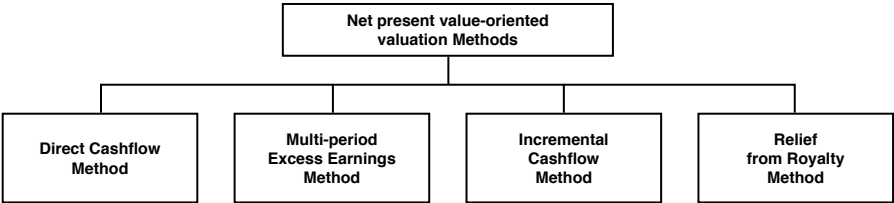


final step, it is discussed how to deal with certain uncertainties using the example of the Corona crisis in the context of the planning calculation.

### 1. Overview of Net Present Value-Oriented Methods

In international valuation theory and practice, various capital-value-oriented methods for the valuation of intangible assets have become generally accepted.<sup>189</sup> Since the legislator is generally basing the application of the hypothetical arm’s length comparison on profit potentials, whilst the decree is speaking explicitly of capital-value-oriented methods, without however, specifying a method, the various common methods should be applicable. In any case, it should be borne in mind that (when applying the hypothetical arm’s length principle), the valuation must be carried out from the point of view of both the selling and the receiving enterprise, i.e. twice. In light of the prerogative of the net present value-oriented methods, this section discusses the net present value-oriented methods. These approaches derive the value from the future profit value of the transfer package or the intangible value by discounting the expected future cash flow with an appropriate, risk-adjusted capitalization interest rate with respect to a certain key date.<sup>190</sup> The following diagram shows the usual capital value-oriented valuation methods.

Figure 17: Net present value-oriented valuation methods.<sup>191</sup>



<sup>189</sup> Cf. IDW S 5/2015; *Menninger*, Bewertung immaterieller Vermögenswerte, in Peemöller (eds.), *Praxishandbuch der Unternehmensbewertung*, 6th ed. 2015; *Moser*, Bewertung immaterieller Vermögenswerte: Grundlagen, Anwendung anhand eines Fallbeispiels, Bilanzierung, Goodwill, 2017; *Heidecke/Hübscher/Schmidtke/Schmitt* (eds.), *Intangibles in the World of Transfer Pricing. Identifying - Valuing - Implementing*, 2020 (forthcoming).

<sup>190</sup> Cf. for example *Ballwieser*, Unternehmensbewertung - Prozess, Methoden und Probleme, 6<sup>th</sup> ed. 2011; *Diedrich/Dierkes*, Kapitalmarktorientierte Unternehmensbewertung, 2015.

<sup>191</sup> Own illustration.

This is not the place to present and discuss the net present value-oriented procedures in detail.<sup>192</sup> The valuation methods focus on different approaches, which are particularly characterized by how the cash flows attributable to the object of valuation can be determined.

The *direct cash flow method* is usually applied whenever the valuation object can generate independent cash flows.

The *multi-period excess earnings method* is regularly applied if, firstly, it is the central intangible value (*leading asset*) of a company or a business unit and, secondly, the company or business unit does not generate independent, directly separable cash flows.<sup>193</sup> The idea behind this method is that all cash flow components are deducted from corporate planning, so that *ideally* the cash flow resulting from the use of the valuation object remains.

The *incremental cash flow method* also starts with the cash flow of a company or business unit and extracts the extra cash flow to a certain extent that can be generated by using the intangible value comparing it to companies for which this intangible value is not available.<sup>194</sup>

The *relief from royalty method* assumes the hypothetical case that the company does not hold ownership of an intangible asset but instead purchases it from a hypothetical third party having to pay an appropriate license for its use.<sup>195</sup> Accordingly, the royalties saved are the basis for the valuation of the asset.

To calculate the capital value of the object of valuation, the cash flows (that have been determined in different ways through their respective procedures) are discounted with a term-specific, risk-adjusted capitalization interest rate,

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<sup>192</sup> Cf. in detail the article in Heidecke/Hübscher/Schmidtke/Schmitt (eds.), *Intangibles in the World of Transfer Pricing. Identifying - Valuing - Implementing*, 2020 (forthcoming).

<sup>193</sup> Cf. Becker 2020, in Heidecke/Hübscher/Schmidtke/Schmitt (eds.), *Intangibles in the World of Transfer Pricing. Identifying - Valuing - Implementing*, 2020 (forthcoming).

<sup>194</sup> Cf. Hayn/Schlegel, *Market approach and Incremental cash flow method*, in Heidecke/Hübscher/Schmidtke/Schmitt (eds.), *Intangibles in the World of Transfer Pricing. Identifying – Valuing – Implementing*, 2020 (forthcoming).

<sup>195</sup> Cf. Hübscher/Ehrhart, *Relief-from-Royalty Approach*, in Heidecke/Hübscher/Schmidtke/Schmitt (eds.), *Intangibles in the World of Transfer Pricing. Identifying - Valuing - Implementing*, 2020 (forthcoming).

which is determined according to the prevailing opinion by applying the *capital asset pricing model* (CAPM).<sup>196</sup> There is an equivalence between the numerator (cash flow) and the denominator (capitalization rate), according to which expected values are to be applied in the numerator and risk-equivalent interest is to be applied in the denominator.<sup>197</sup>

As the capitalization rate is regularly determined on the basis of long-term analyses of returns on the capital market, the method used to derive the capitalization rate remains unchanged in accordance with the latest information from the German valuation expert committee FAUB. They value the capitalization rate for example in the case of crises such as the Corona crisis, and, in the case of recommended ranges for individual parameters in terms of the amount.<sup>198</sup> This means that even greater importance is attached to determining expected values in the budget calculations in crisis situations.<sup>199</sup>

## **2. Planning Calculations as the Basis for Capital Value-Oriented Valuation Methods**

Planning calculations are always forecasts that quantify the conceptual anticipation of future economic trade.<sup>200</sup>

Forecasts are, by their very nature, subject to more or less pronounced uncertainty due to this future orientation.<sup>201</sup> For further discussion, it is helpful to differentiate between uncertainty in terms of undefined and defined uncertainty.

*Undefined* uncertainty is constitutive for every form of forecasting and thus inherent in planning, because every plan specifies future expectations. If a past

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<sup>196</sup> Cf. IDW S 1/2016, marginal 118 f.

<sup>197</sup> Cf. *ibid.*, recital 90.

<sup>198</sup> Cf. IDW 2020a, 3.

<sup>199</sup> Cf. *ibid.*, 2.

<sup>200</sup> Cf. *Hübscher/Heidecke*, Calculating Planning Data and Its Plausibility, in Heidecke/Hübscher/Schmidtke/Schmitt (eds.), *Intangibles in the World of Transfer Pricing. Identifying – Valuing – Implementing*, 2020 (forthcoming).

<sup>201</sup> Cf. *Priddat*, Erwartung Prognose Fiktion Narration. Zur Epistemologie des Futurs in der Ökonomie, 2016; *Priddat/Kabalak*, Ungewissheit als Herausforderung für die ökonomische Theorie: Nichtwissen, Ambivalenz und Entscheidung, 2013.

event, i.e. an already established business, is available, the starting point for operational planning is the prior course of business, which is supplemented on the one hand by strategic considerations and on the other hand by overall social and economic trends as well as industry-specific market developments.<sup>202</sup> The weighing of entrepreneurial opportunities and risks results in ranges. Considering probability, these ranges are being condensed into expected values. Expected values, however, are always quantified options from a range of opportunities and risks - their probability may change because of new findings. Any interaction of various internal and external sources of information, however it might be, therefore always leads to an open and ambiguous course of business. Moreover, it becomes less clear, the longer the planning period is set.

One can speak of *defined uncertainty*, if facts which lead to a normal<sup>203</sup> business performance being significantly disturbed, have occurred or become apparent. A risk becomes an acute problem, if there is the threat of an initially unquantifiable loss being sufficiently probable on its merits.<sup>204</sup> We will return to this in the next section.

With the IDW practical note 2/2017, “*Beurteilung einer Unternehmensplanung bei Bewertung, Restrukturierungen, Due Diligence und Fairness Opinion*” (German: “*Assessment of a business plan in valuation, restructuring, due diligence and fairness opinion*”), the IDW has developed a framework for the procedure regarding the assessment of a planning calculation, i.e. the uncertainty inherent in planning that is not defined. Even though the practice note is expressly referring to corporate planning, this procedure is also applicable without restriction to planning calculations for intangible assets. This is particularly the case because planning for intangible assets, as described above, is regularly an extract from corporate planning from which those cash flows, that can be allocated to the corresponding intangible asset, are identified and separated.

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<sup>202</sup> On the distinction between strategic and operational planning cf. *Hübscher/Heidecke*, Calculating Planning Data and Its Plausibility, in *Heidecke/Hübscher/Schmidtke/Schmitt* (eds.), *Intangibles in the World of Transfer Pricing. Identifying - Valuing - Implementing*, 2020 (forthcoming).

<sup>203</sup> Cf. *Link*, *Versuch über den Normalismus. How normality is produced*, 4th ed. 2009.

<sup>204</sup> Cf. *Hübscher*, Post-Corona Politik: was meint ‚systemrelevant‘, in *Bring-Brink et al.* (eds.), *Lehren aus Corona: Impulse aus der Wirtschafts- und Unternehmensethik*, 2020 (forthcoming).

The practice note provides a taxonomy of analytical procedures for assessing the uncertainty inherent in any planning calculation in terms of whether the assumptions on which the planning calculation is based are plausible, i.e. comprehensible, consistent and free of contradictions. For the examination of the planning calculation, a distinction in the practical note between computational-formal and material analysis procedures is made:<sup>205</sup>

- The computational-formal analysis procedures serve in particular to assess the computational correctness, the traceability of the documentation and consistency of the planning.
- The material plausibility analysis assesses whether the assumptions on which the planning is based as well as the results stemming from the assumptions and the planning model have overall been derived with an appropriate consideration of opportunities and risks. The material analysis procedures can be divided into the analysis of material, internal and external plausibility:
  - In the context of the analysis of the material, *internal* plausibility, the consistency of the planning assumptions with the explanations of the management and those responsible for planning as well as the findings from the company analysis are examined.
  - Within the scope of the examination of material, *external* plausibility, it is particularly important to analyze the extent to which the assumptions of the planning are consistent with the results of the market and competition analyses (based on the framework conditions prevailing at the time of planning).

The assessment of the planning calculation must result in a statement which, according to Damodaran, can give an answer to the three P questions: Is the planning process *possible*, *plausible* and *probable*?<sup>206</sup>

### 3. Forecasts Under Certain Uncertainty

In addition to the plausibility check of the planning calculation under undefined uncertainty, risks that lead to certain uncertainties, if they are sufficiently probable represent a particular challenge. Within the framework of the strategy for the protection of critical infrastructures, the German Federal Ministry of the

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<sup>205</sup> For the following IDW PH 2/2017, 3 et seq.

<sup>206</sup> Cf. *Damodaran*, Narrative and Numbers. The Value of Stories in Business, 2017, 92–109.

Interior, Building and Community has distinguished between various types of hazards (cf. fig. 18).<sup>207</sup>

Figure 18: Taxonomy of hazards.<sup>208</sup>

Natural events	Technical/human failure	Terrorism/crime and war
Extreme weather events, including storms, severe low, temperature drops, floods, heat waves, droughts	System failure, including under- and over-complexity in the planning stage, hardware and/or software errors	Terrorism
Forest and heather fires	Negligence	Sabotage
Seismic events	Accidents and disasters	Other crime
Epidemics and panemias in humans, animals and plants	Organisation failure, including deficits in risk and crisis management, insufficient coordination and cooperation	Civil wars and wars
Cosmic events, including cosmic energy, doorway storms, meteorites and comets		

While the hazard category of technical and human failure is essentially to be assigned to undefined uncertainty, because the cause of the associated hazards and problems can often only be reconstructed *ex post*, the hazard categories of natural events and terrorism/crime and war are mostly, but not exclusively, subject to certain uncertainties. The reason for the danger of war and crime often has something to do with the political and social instability of a region. Although the same applies with a certain probability to terrorism, it has an atopic character nevertheless and can therefore not be specified precisely. In the case of pandemics, such as Covid-19, it cannot immediately be assumed from the start, i.e. in November 2019 in the Chinese region of Wuhan, that an epidemic is going to develop into a pandemic, as, in this case, the WHO only declared it in March 2020. While in this case the event is known, the socio-economic consequences are far from certain and sometimes not even known.<sup>209</sup> Thus it is a case of certain uncertainty. In a special report, for example, the German Council of Economic Experts has developed various scenarios for the economic effects of the Corona crisis, which are known as V-, pronounced V- and long U-scenario.<sup>210</sup>

<sup>207</sup> Cf. BMI as of 17<sup>th</sup> of June 2009, National Strategy for Critical Infrastructure Protection (KRITIS Strategy), 7.

<sup>208</sup> *Ibid.*, 5.

<sup>209</sup> Cf. DB as of January 3<sup>rd</sup> 2013, Report on Risk Analysis in Civil Protection 2012.

<sup>210</sup> Cf. SVR as of March 22<sup>nd</sup> 2020, The overall economic situation in view of the Corona pandemic, 24 et seq.

In addition to various expert opinions and analyses for sectors, the economy and society, the IDW has also published statements on how to deal with the Corona crisis in the context of the audit of financial statements<sup>211</sup> and the assessment of planning accounts.<sup>212</sup> According to these statements, the Corona crisis is primarily to be classified as a value-determining event,<sup>213</sup> which is also relevant to the question of the valuation date at first.

For the assessment of the planning accounts given the occurrence of a risk, current planning adjustments will have to be discussed in principle, as existing planning accounts, which usually have to be approved by various corporate bodies, are based on a state of knowledge in the past. However, whether planning adjustments are necessary at all, and if so, to what extent, can be assessed if the following four areas are analyzed in detail:

- It can be observed that the effects of the Corona crisis on different economic sectors and different regions sometimes vary considerably. Therefore, *firstly*, it must be examined whether the business model (on which the respective intangible assets are based) is influenced or impaired by the Corona crisis at all. In particular, the question has to be answered, whether the identified impairments would also occur, if the Corona crisis had not spread. In other words, it needs to be worked out what exactly the causes of a change of plan are: Is it a business model that is no longer promising in itself or is it a healthy business model that is impaired by an external risk such as the Corona crisis?
- If the latter is relevant, secondly it, must be analyzed how long this impairment can be expected to last. Will there be a short-term impact of three to twelve months? Is there going to be a medium to long-term impact on the course of business? In the context of macroeconomic analyses of the Corona crisis, different time courses are discussed, ranging from an impairment mainly in 2020 to scenarios extending into the years 2022 / 2023.<sup>214</sup> There is currently no consensus on the duration of impairments of affected business models.

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<sup>211</sup> Cf. IDW 2020b.

<sup>212</sup> Cf. IDW 2020a.

<sup>213</sup> Cf. IDW 2020b, 2.

<sup>214</sup> Cf. OECD as of March 2<sup>nd</sup> 2020, OECD Interim Economic Assessment. Corona virus: The world economy at risk; SVR as of the 22<sup>nd</sup> of March 2020, The overall economic situation in the face of the Corona pandemic.

- *Thirdly*, the uncertainty regarding the duration and the extent of the impairments leads to the fact that planning calculations should not only be sensitized to essential parameters in a basic scenario. Rather, this situation requires the planning of different scenarios that show the course from the impairments back to a normal course of business given different periods with different intensities.
- Finally, *fourthly*, the importance of expected values in planning calculations is emphasized very clearly. As a result, the steps mentioned so far lead to the need of assessing certain uncertainties in terms of duration, extent and dynamics. The resulting scenarios must in turn be weighted with probabilities of occurrence in order to take the possible effects of the Corona crisis on the valuation of intangible assets into consideration adequately.

#### **4. Practical Considerations on Price Adjustment Clauses, Valuation Date and Royalty Payments**

From a practical point of view, the uncertainty in planning, which is reflected in an increasing volatility of the expected value as well as the presumably simultaneously decreased expected value of future earnings, lead to the fact that an initially determined value for an intangible asset or a transfer package deviates due to the effects of the Corona pandemic. The Corona pandemic is a value-determining event.<sup>215</sup> It therefore depends on when the valuation date is, which assumptions and planning data the valuation is based on and when the transaction is being carried out. If the Corona crisis occurred between the valuation, the valuation date and the execution of the transaction (i.e. usually the conclusion of the contract), third parties would probably have renegotiated or not executed the transaction. In order to avoid potential conflicts, it is therefore advisable that the valuation assumptions and target figures on the valuation date and conclusion of the contract are both either before or after the Corona crisis.

It is also to be expected that price adjustment clauses will become more relevant because of the increased uncertainty. Since a higher volatility of the expected value of the planned values leads to the deviation from the calculated value being greater, *ceteris paribus*, a larger range should be selected for the price adjustment clause in order to achieve a similarly rapid adjustment. In addition, against the background of the additional uncertainty, it is necessary

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<sup>215</sup> Cf. IDW 2020b, 2.



to reconsider whether a longer adjustment period should be chosen. This could take account of the fact that the effects of Corona are then sufficiently reflected in the actual figures. At the same time, however, this would also increase the risk of what a third party might have as a compensation.

Finally, the question of whether any royalty payments should be suspended as a result of the Corona pandemic is addressed. In this respect, reference is made to first of all, the general information regarding contractual framework conditions and risk assumption in the sense of the hypothetical arm's length principle. According to the latter, it would be conceivable, for example, that the licensee and licensor agree and economically justify reducing the license in the short term (e.g. for liquidity reasons), but that the licensee pays more in the long term (once the business has stabilized again). Such a profit-related license could be laid down in an amendment to the contract.

However, the opinion of the tax authorities from the BMF letter on brand offsetting can also be used without prejudice to this. It says: “[...] *the offsetting of a license fee may be unreasonable, as far as it is recognizable that a sustained loss situation of the licensee arises.*” Even if this is formulated very vaguely, it could be derived from this that, at least for trademarks, no license is to be offset in case of loss.<sup>216</sup>

## **5. Final Remark**

Both for the valuation of individual intangible assets and for the valuation of the transfer package in the context of a relocation of functions, the hypothetical arm's length comparison must generally be carried out unless at least limited comparable comparative values are available. As a rule, the application is based on future performance values and the use of capital market-oriented methods. A central element in determining the future profit value is the budget calculation. Due to the uncertainty inherent in any forecast, the assessment of the budget calculation is an important step. In particular, the plausibility examination of the budgeting is challenged, if risks or events occur which could have an impact on the planned payment surpluses (whose amounts are regularly even more difficult to forecast than that of a normal business development).

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<sup>216</sup> Cf. BMF as of April 7th 2017, No. 8.

The importance of expected values in planning calculations is particularly emphasized when estimating certain uncertainties. Certain uncertainties, such as the Corona crisis, require an estimate to be made as to whether this event can be expected to have any effect on planning and thus on the value. If this is the case, a detailed analysis is required in terms of duration, intensity and dynamics. Such an analysis must be condensed into expected values using various scenarios in terms of their probabilities.

It is interesting: in the moment when defined uncertainties arise, it becomes particularly clear what planning calculations actually are: the determination and condensation of *expected values* that quantify the mental anticipation of future economic trade.

## **X. Procedural Aspects (*Claudia Lauten, Oliver Liche*)**

In the following, the procedural aspects on tax audits and advance pricing agreements triggered by the Corona crisis should be discussed. Not only obvious aspects play a role here, such as delays in answering auditor inquiries due to the complete closure of companies, but also hurdles to physically ascertaining the facts and holding final meetings. Advance Pricing Agreements that have been in place for years can suddenly become threatened in their continued application, such that the challenges of maintaining arm's length conditions in abruptly changed economic circumstances can be compounded by the resurgence of already eliminated double taxation risks.

### **1. Advance Pricing Agreements**

By concluding an Advance Pricing Agreement (APA), the countries involved commit under international law to apply the same transfer pricing mechanism for the taxation of certain intra-group service or supply relationships over a predefined period of time. Domestically, an APA is first implemented in the form of an advanced tax ruling with the taxpayer and then by means of tax assessment notices. It is an administrative procedure available on application.<sup>217</sup> Before discussing the possible effects of the Corona crisis, the procedure will be briefly outlined.<sup>218</sup>

If the taxpayer so wishes, the submission of the application may be preceded by a preliminary meeting, the so-called pre-filing meeting. This provides the opportunity to present the case to the tax authorities in advance, discuss relevant parameters and agree on the documents to be attached to the application. In Germany, the competent authority responsible for this is the Federal Central Tax Office (BZSt). After the competent authority has initiated proceedings, negotiations between the competent authorities of the relevant states involved take place.

If successful, these negotiations lead to an agreement, the APA. This agreement defines the essential parameters of the transfer pricing mechanism on which

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<sup>217</sup> See also BZSt of 2020, <https://www.bzst.de/DE/Unternehmen/EUInternational/AdvancePricingAgreements/advancepricingagreementsnode.html>.

<sup>218</sup> Cf. for further details of the procedure *Sassmann/Lauten*, in Vögele/ Borstell/ Bernhardt (eds.), *Verrechnungspreise*, 5th ed. 2020, Chapter E, reference 730 et seq.

the taxation is to be based, as well as the application period and the conditions for application (“Critical Assumptions”). During the application period, the taxpayer is obliged to submit an annual report (“Compliance Report”) of whether the parameters set out in the APA and the critical assumptions have been maintained.

The impact of COVID-19 on APAs may on the one hand concern APAs that have already been concluded, but for which the application period is not yet completed, while on the other hand, it may also be necessary to consider the consequences of COVID-19 for ongoing application procedures.

#### **a. Need for Action in the Case of APAs Already Concluded**

As a rule, an APA is concluded for several years. Internationally, a period of four to five years is common. Sometimes negotiations between the competent authorities to conclude an APA can take several years,<sup>219</sup> which often means that by the time the APA is finalized, the first years of the application period have already passed. Therefore, there is likely a large number of cases where the APA has already been concluded, and where the application period has started, but not yet expired. Different scenarios can be considered for such cases:

##### **aa. Significant Change in Actual Circumstances**

Global economic conditions may influence business models, value chains or profitability ratios, which in turn may have a direct impact on transfer pricing systems and the arm’s length nature of the resulting transfer prices. Despite the far-reaching impact COVID-19 has had on global economic conditions, there are indeed cases imaginable, in which the essential facts for the respective APA (especially regarding the relevant circumstances and the critical assumptions) have not changed in such a manner to have consequences for the APA.

This may be because either the economic circumstances in the individual case have remained largely unchanged, or although they have changed, the change is ultimately irrelevant for the transfer pricing methodology. For example, the existing methodology may be designed in such a way that it can still fulfill the arm’s length principle despite a considerable drop in turnover. In many cases

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<sup>219</sup> Cf. as an example EU Joint Transfer Pricing Forum. Statistics on APAs in the EU at the end of 2018, [https://ec.europa.eu/taxation\\_customs/sites/taxation/files/apa-and-map-2019-3.pdf](https://ec.europa.eu/taxation_customs/sites/taxation/files/apa-and-map-2019-3.pdf).

however, the transfer pricing methodology will no longer function correctly if there is a significant change in economic circumstances, particularly in relation to the financial figures. This raises the question of how the taxpayer should deal with such a situation, which is discussed below:

If the APA's critical assumptions are complied with, in spite of the arm's length principle being violated, and the taxpayer adheres to the conditions as set out in the APA, the tax authorities should not be entitled to deviate from the APA. In such cases, it would therefore be irrelevant whether or not the transfer pricing methodology still corresponds to the arm's length principle in light of the altered circumstances. The taxpayer is also under no obligation to inform the responsible authorities of its assessment in this regard, and its obligation is limited to the submission of the required annual compliance reports.<sup>220</sup>

If the taxpayer were to adjust the transfer pricing mechanism in the above scenario in order to comply with the arm's length principle, the German rules would require the tax authorities to make an adjustment. In the end, the transfer prices agreed upon in the APA would still be the basis for taxation.<sup>221</sup>

If the taxpayer wanted to deviate from the APA for tax purposes, it would have to:

- Either change the underlying facts, e.g. the relevant distribution of functions and risks, or change the transaction itself. This would then eliminate the binding effect of the APA, the actual situation would have to be evaluated under general tax procedures and the risk of double taxation would return.<sup>222</sup>
- Alternatively, work towards amending the APA. This is the only way to reliably ensure that double taxation is avoided. Whether this requires a formal application should be clarified directly with the relevant competent authorities. Experience has shown that communication can be significantly simplified if the taxpayer prepares the relevant points for the first meeting in a structured and comprehensible manner, including how the arm's length transfer pricing methodology should work in the context of the Corona crisis.

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<sup>220</sup> Cf. also *Sassmann/Lauten* on the compliance report, in *Vögele/Borstell/Bernhardt* (eds.), *Verrechnungspreise*, 5th ed. 2020, Chapter E, reference no. 748.

<sup>221</sup> Cf. BMF of 5.10.2006, BStBl. I 2006, 594, reference no. 6.4.

<sup>222</sup> Cf. BMF of 5.10.2006, BStBl. I 2006, 594, reference no. 6.5.1.

## bb. Critical Assumptions

The critical assumptions constitute a contractual part of the APA. If they are not respected, the APA may be revoked by any of the competent authorities involved.<sup>223</sup> The assumptions are defined according to the nature and characteristics of the respective case. An example catalogue of possible critical assumptions can be found in the BMF letter dated October 5<sup>th</sup> 2006.<sup>224</sup> These can refer to general factors in the sphere of the taxpayer (e.g. shareholding relationships), components from the interaction of the taxpayer with the market (e.g. market conditions and market shares), transaction parameters (e.g. function and risk profile) or also purely external factors (e.g. exchange rates or market interest rates). They set the framework within which the competent authorities want to be bound by the APA, and therefore they make it part of the APA.

Depending on what has been agreed in each case, the COVID 19 crisis may lead to a violation of one or several of the critical assumptions. This should at least be checked in relation to critical assumptions based on market conditions, as it opens the possibility for the competent authorities to revoke the APA, irrespective of whether there is also a breach of the arm's length principle. The risk of double taxation would then be revived.

In any case, it is recommended that a verification of compliance with the critical assumptions be carried out for each APA that has been concluded, but whose application period has not yet expired. If it should turn out that the critical assumptions are not complied with, in whole or in part, due to the COVID-19 crisis, it is usually advisable to inform the competent authorities immediately and to work towards a solution. A lack of compliance would become obvious when the annual compliance report is submitted, anyway, and a timely notification from the taxpayer should make it easier for the competent authorities to work towards a solution that is satisfactory for everyone. Such a solution could provide for the critical assumptions to be changed by agreement between the competent authorities involved, or for the transfer pricing mechanism to be adjusted - which, under international law, is also only possible by agreement between the authorities.

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<sup>223</sup> Cf. *ibid.* reference 6.5.2.

<sup>224</sup> Cf. BMF of 5.10.2006, BStBl. I 2006, 594, reference 3.7. and Annex 1 "Draft preliminary agreement procedure - model agreement".

The revocation of the APA by a competent authority or authorities will generally be the least favorable solution from the taxpayer's point of view.

## **b. Options in Ongoing APA Procedures**

Where ongoing APA procedures have not yet been concluded by agreement of the competent authorities, the following aspects should be considered in light of the Corona crisis:

### **aa. Interaction between the Competent Authorities**

Usually, ongoing cases are dealt with in physical meetings of the competent authorities and - if successful - an agreement is reached. Due to the current situation, such meetings, which are usually held once or twice a year depending on the country, are not possible for the time being. Experience to date shows that the communication concerned has been partly replaced by telephone and video conferences, but also partly adjourned for an indefinite period. This depends on several factors, such as the progress of the case, the complexity of the facts, cultural differences or language barriers, which are more easily overcome in physical meetings with the use of interpreters.

In addition, in some countries (e.g. Japan, South Korea) the teams entrusted with the procedure are regularly exchanged within the competent authority. Overall, there is a risk that in some cases there will be delays, sometimes substantial, in the processing and concluding of ongoing APA procedures.

It is recommended that this point be addressed directly to the competent authorities in order to obtain a realistic estimate of the duration of the procedure in each case, and to ask to what extent the taxpayer can support the process, if necessary.

### **bb. Transfer Pricing Methodology**

Similar to the APAs already concluded, the Corona crisis means that the transfer pricing methodology originally intended, may no longer comply with the arm's length principle. In this case, the content of the application could remain valid for the application already submitted, but the taxpayer should consider which methodology or which modification to the methodology is appropriate to reflect the current special circumstances for the current

and possibly for future years. An analysis of this should be performed on a case-by-case basis, as generalized comments are unlikely to be helpful. The current uncertainty in many areas as to how things will develop in the short, medium and long term, makes such an analysis a challenge, but not necessarily impossible.

This also applies if an APA application has not yet been submitted, but is currently in preparation. Here too, it should be examined on a case-by-case basis to what extent the intended transfer pricing mechanism, as well as the critical assumptions, can or should be adjusted in order to provide a realistic basis for the competent authorities to reach an agreement, despite the current uncertainty.

#### cc. Critical Assumptions

In the case of ongoing procedures or applications still to be submitted, there is still room to formulate the critical assumptions in order to take into account the Corona crisis. It would be desirable here that the assumptions are not linked to a hypothetical scenario in which the Corona crisis has not occurred, but rather support a transfer pricing concept that is acceptable to the competent authorities involved, despite the fact that this crisis has occurred.

The current situation confirms the approach that has already been frequently pursued in the past, namely to formulate the critical assumptions as openly as possible and with as few restrictions as possible. The critical assumptions are necessary, and reflect the legitimate interest of the competent authorities to be bound by the APA agreements only within a certain framework. At the same time, however, they should not be so restrictive, particularly with regard to external factors, that they would seriously affect the successful avoidance of double taxation.

#### **c. Conclusion**

At each stage of an APA procedure, the taxpayer is well advised to identify the possible impact of the Corona crisis on its case, and to identify and assess options for action.

In principle, it should be borne in mind that an APA, once concluded, is of high value for all parties involved. The goal of avoiding double taxation has been achieved, and considerable resources have been invested by all parties



involved in order to avoid a later significant use of resources - in tax audits as well as in later national and international proceedings.

Hopefully, the specific nature of the current situation and its many challenges will not lead to a situation where competent authorities will revoke the APAs en masse in the event of a breach of the relevant critical assumptions, or where they will refuse to reach an agreement in ongoing proceedings due to the current uncertainties. At the very least - also in light of the relevant experiences from the global economic crisis in 2009 – it should be expected that the responsible tax authorities will continue to have a great interest in avoiding double taxation as much as possible.

The taxpayer has an important role to play here: it has a knowledge advantage over the authorities as to what impact the crisis has on the success of its business and, if applicable, its business model. As a rule, it is advisable to inform the relevant competent authorities about such impacts promptly and thoroughly, particularly to indicate any change of facts and ideally to propose sensible and well-founded adjustments to the transfer pricing methodology and the critical assumptions. This transparency should be established simultaneously with all responsible competent authorities, so a solution acceptable to all can then be jointly worked on.

## **2. Tax Audits**

The tax field audit serves the tax authorities to control the accurate and legally compliant determination of income by means of an inspection of usually extensive books and records. The aim of the tax field audit is to ensure complete and correct taxation and the correct determination of the tax base in each individual case.

The tax field audit represents a specialized procedure for the fulfillment of the tax authorities' general investigatory role and can – per definition – only be directed at the examination of existing circumstances.<sup>225</sup>

It should be noted that the tax authorities are not obligated to conduct a tax field audit. Rather, the tax laws entitle the tax authorities to carry out control

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<sup>225</sup> Cf. *Intemann*, in Koenig (eds.), *Abgabenordnung*, 3rd edition 2014, § 193 Rz. 14 et seq.

activities. Whether and how the tax authorities use this authority is at their discretion.<sup>226</sup> This applies with regard to questions

- during the ongoing audit procedures, such as (i) where the audit procedures are carried out, (ii) what documents and information are requested from the taxpayer and (iii) the deadlines within which the taxpayer must provide the information,
- before the start of the audit procedures, such as (i) which taxpayers will be audited (selection processes), (ii) at what intervals the audits are carried out, and (iii) what periods are audited.

In this light, two major groups of audits with reference to timing emerge: (a) tax audits that are ongoing or have already been announced during the pandemic, which by their very nature only relate to past assessment periods and must be commenced, continued and completed under the restrictions imposed by the crisis, and (b) future tax audits, relating to assessment periods during which the pandemic has affected the operations of the entities.

#### **a. Current Tax Audits**

Tax field audits already started at the beginning of the pandemic, or already announced and scheduled, can only refer to past assessment periods. Usually these current tax audits extend over three assessment periods, which themselves are typically two years in the past. As a rule, taxpayers have already prepared their annual financial statements, submitted the corresponding tax returns to the responsible tax office and complied with the declaration and disclosure requirements. In addition, the tax authorities assume that tax documentation obligations have also been fulfilled and that transfer pricing documentation can be sent to the tax authorities in a timely manner or, for ongoing tax audits, has already been requested and submitted.<sup>227</sup> Depending on the progress of the tax audit, more extensive factual issues will already have been investigated and clarified through the submission of documents.

In this light, discussions and experiences from current tax audits show the following characteristics:<sup>228</sup>

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<sup>226</sup> Cf. *ibid.*, § 193 Rz. 56 et seq.

<sup>227</sup> Cf. § 90 para. 3 AO.

<sup>228</sup> These observations should not be generalized, but reflect experience and observations from current and completed tax audits.

- The restrictions on mobility and lockdown measures affect both the tax authorities and the respective taxpayers. Difficulties in procuring supplementary documents are therefore easy for both sides to understand. Consequently, the tax authorities regularly grant extensions of deadlines for the submission of documents, or adjustments to deadlines for interim or final meetings, without hesitation. This is most often the case, as any rejections are likely to be corrected in the context of a review as an improper failure to exercise discretion in light of the current exceptional circumstances.
- The lockdown and the restrictions on personal contact also force virtual meetings to be held via different communication channels (e.g. video conferences etc.). International corporations regularly use these communication channels in their business operations and have also used these in the past. Employees are therefore appropriately equipped and partially trained in the use of these communication channels. For various reasons, the German tax authorities' IT equipment is often not yet geared to participating in virtual conferences.<sup>229</sup> Therefore, it is common practice to hold telephone conferences, use external premises or hold physical meetings in compliance with distancing and hygiene regulations.
- The different state tax authorities deal with this challenge in different ways. Some authorities have allowed the installation and use of common communication programs on the auditors' business computers. Other authorities reject this for various reasons (e.g. data protection). The course of the audit and the way in which the information is transmitted are correspondingly different.
- Experience shows that the tax auditors examine and evaluate substantive legal issues without taking the current exceptional circumstances into account. In fact, as currently ongoing tax audits can only concern matters that have already been implemented in the past, they are completely unaffected by the current circumstances. Explanations from the taxpayer with reference to the current exceptional situation are therefore regularly - appropriately - rejected by the tax auditors. Irrespective of this, the tax audit has a scope of assessment in the examination of the facts, which is not subject to judicial review.

As a result, tax auditors are regularly flexible in procedural matters and in a manner appropriate to the severe restrictions caused by the pandemic. With

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<sup>229</sup> Due to the federal structure, the IT equipment regularly varies from one federal state to another.

regard to questions of substantive law, they - appropriately - decide without taking the special effects resulting from the current pandemic into account.

As things stand, it is not expected that this different approach in terms of procedural and substantive legal aspects will change in the further course of the pandemic.

## **b. Future Tax Audits**

Future audits will relate to (a) the period of the pandemic itself and (b) the subsequent periods impacted by the effects of the pandemic, depending on the assessment periods being audited.

- During the period of the pandemic, taxpayers have and will take various operational measures to respond to the changed situation. These will regularly have more or less extensive tax consequences for domestic or foreign affiliated companies. In order to be able to adequately present the considerations underlying these measures within the scope of the tax audit for these assessment periods, all decision making concerning the measures should be recorded, evaluated and prepared sufficiently. This should not only be done in the interest of a transparent tax audit, but also in light of the duties of disclosure and proof, as well as the duty to preserve evidence.<sup>230</sup> This includes, among other things, management meeting minutes, presentations on decision-making, calculations to determine the effects of the operational measures, correspondence with affiliated companies and third parties, applications for government assistance, revised budget figures and renegotiations of third-party contracts.
- Similarly, preparations should be made for audits for subsequent periods after the pandemic. It is assumed that these subsequent periods will also be affected by the pandemic and its economic effects to a greater or lesser extent, presumably with decreasing effects over time. In order to be able to demonstrate these effects in later years during a tax audit, the above-mentioned documents and information should be kept on hand in case they need to be made available to the tax authorities.

In both cases, transfer pricing documentation should be reviewed for consistency with the adjustments made due to the pandemic. This should ensure that the presentation of the master and local files is consistent and does not contain

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<sup>230</sup> Cf. § 90 para. 2 AO.

any contradictions across countries. In addition to the ongoing documentation, it must be checked whether the pandemic has led to extraordinary business transactions that create special documentation obligations.<sup>231</sup> Think, for example, of adjustments to long-term intra-group contracts that have a significant impact on earnings, restructurings and significant adjustments to functions and risks.

In the end, the taxpayer should prepare extensive proof for both the period of the pandemic and the period thereafter. This will help the taxpayer to sufficiently and convincingly answer questions from the relevant tax auditor.

### **c. Digital Audits / Virtual Final Meeting: Limits and Possibilities**

The special situation during the pandemic, specifically regarding social distancing measures, not only offers numerous and different challenges, but also various opportunities. One such opportunity may be the further development of digitalization within the framework of tax field audits.

In the year 2000, the tax authorities began a fundamental modernization and mechanization of tax field audits by means of the cryptic sounding abbreviation “GDPdU,” as a synonym for the digitally performed tax audit. Since then, the auditors have been able to analyze mass data quickly and without gaps by using IT. The use of special audit programs and statistical analyses has since made it possible to increase audit efficiency, reduce audit duration and, in particular, to focus on the audit of cross-border issues.<sup>232</sup>

It is expected that these framework conditions will not change, even in spite of the current exceptional situation. On the contrary, it can be hoped that the digital exchange of data will receive a further boost in order to bring in further aspects. Conceivable would be, for example

- the use of virtual workspaces (file hosting). All content of the audit is stored centrally.
- the implementation of digital management systems for tax audits, which in particular standardize, control and simplify the process of tax audits and the exchange of information,

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<sup>231</sup> Cf. § 90 para. 3 AO in connection with § 5 GAufzV.

<sup>232</sup> Cf. *Krüger/Schult/Vedder*, Digitale Betriebsprüfung GDPdU in der Praxis - Grundsätze zum Datenzugriff und zur Prüfbarkeit digitaler Unterlagen, 2010, 5.

— virtual communication solutions, as described above, to further reduce travel times.

In fact, virtual workspaces and management systems for tax audits are already available on the market and are used by taxpayers.

In the context of the current situation, the question may also arise as to whether final meetings may be conducted in virtual form or whether the results of such virtually-conducted final meetings would be legally effective. In principle, the final meeting serves the purpose of reaching an agreement on the audit results in order to avoid further disputes. Nevertheless, the statements made in the final meeting are essentially neither binding on the tax authority nor on the taxpayer.<sup>233</sup> Rather, the statements are usually only of a provisional nature and are in this respect legally non-binding agreements.<sup>234</sup> With this in mind, the taxpayer or the tax authority should be free when deciding the form and the choice of the final meeting's location - whether virtual or physical - as their results are in any case summarized in the final audit report.

The current situation impressively demonstrates the advantages of digital solutions for the preparation and management of a tax audit. This not only concerns current tax audits, but also the use of digital documentation solutions for the documentation of transfer pricing.

As a result, the use of digital solutions and the extent to which they become established in the market will depend crucially on the extent to which the tax authorities are prepared to use such solutions in the context of a tax audit. The current exceptional situation may give this a push in the right direction; whether and to what extent this will be acted upon is at last for the tax authorities and the taxpayers to decide.

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<sup>233</sup> Cf. *Intemann*, in Koenig (eds.), *Abgabenordnung*, 3rd ed. 2014, § 201 Rz. 17.

<sup>234</sup> Cf. *ibid.*

## **XI. New Ways of Working during the Corona Crisis: Tax Consequences Through Home Office (*Oliver Liche, Sophia Matheoschat*)**

One of the numerous effects of the pandemic is the change in work place location resulting from the social distancing and associated restrictions on mobility. This has led to an increase in home-based work, commonly referred to in Germany as “remote work” or “home office”, inter alia highlighted in a recent study by Bitkom.<sup>235</sup> According to this study, one in five of the working population in Germany is already working from home for the first time due to the Corona crisis. But also prior to this period, the proportion of home office work had been increasing continuously.<sup>236</sup> It is expected that the trend will continue in the “post-Corona” era and that the crisis will trigger an accelerated increase. The most recent debate at the end of April supported this fact, brought about by employment minister Hubertus Heil with his demand for a “right to a home office”. Scientists also anticipate an increase in home office resulting from the Corona crisis. Josephine Hoffmann of the institute for industrial economics and organization (Fraunhofer-Institut für Arbeitswirtschaft und Organisation), for example, stated in an interview at the end of March, “[...] that [Corona with regard to the home office] will really change something.”<sup>237</sup>

From an income tax perspective, the short-term and potentially long-term consequences of an increase of home office raises a number of questions including (i) the existence of permanent establishments, (ii) the assessment of unrestricted tax liability and (iii) the allocation of DEMPE functions. These issues arise in situations where employees of a foreign company work in Germany either on a short-term basis, e.g. due to travel restrictions, or alternatively on a short-term / long-term basis due to their place of residence. Furthermore, situations are also possible in which employees of a German company spend time in a home office abroad.

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<sup>235</sup> Bitkom v. 18.3.2020, Arbeit im Homeoffice nimmt deutlich zu, <https://www.bitkom.org/Presse/Presseinformation/Corona-Pandemie-Arbeit-im-Home-office-nimmt-deutlich-zu>.

<sup>236</sup> Bitkom v. 18.3.2020, Vier von zehn Unternehmen setzen auf Homeoffice, <https://www.bitkom.org/Presse/Presseinformation/Vier-von-zehn-Unternehmen-setzen-auf-Homeoffice>.

<sup>237</sup> DW v. 20.3.2020, Corona\_ Einmal homeoffice – immer homeoffice, <https://www.dw.com/de/coronavirus-einmal-homeoffice-immer-homeoffice/a-52861159>.

In the following sections, the topic on the existence of permanent establishments and limited tax liability through home office will be addressed. The aspects of employment tax and social security law will not be considered in this report. The report addresses cases in which employees of a foreign company are present in Germany for a short or potential longer period.

## **1. Set up of Permanent Establishments: Characteristics and Application to Home Office**

The concept of a permanent establishment is governed by both national and international tax law, whereby the provisions within the scope of double taxation agreements take precedence over national regulations on cross-border relationships.<sup>238</sup> However, this is only applicable if there is a permanent establishment in Germany under national law. Therefore, the existence of permanent establishment must first be established under national law and then whether it is restricted by the double taxation agreement. In the following section, it will be discussed whether a permanent establishment is established under German tax law and if applicable, whether it is restricted under the OECD Model Tax Convention.<sup>239</sup>

The set up of a permanent establishment (hereafter referred to as “PE”) in Germany through home office is possible in three circumstances, (i) Fixed Place of Business PE, (ii) Place of Management PE and (iii) the Permanent Representative PE. In the following sections, the specific characteristics of PEs will be presented and their application to home office discussed.

### **a. Fixed Place of Business**

The general case of a PE is a Fixed Place of Business. Accordingly, a PE is any fixed place of business or premises serving the activities of an enterprise.<sup>240</sup>

A PE by means of a Fixed Place of Business is deemed to exist if. (i) there is a business premise or facility (ii) which has a fixed connection to a certain

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<sup>238</sup> §§ 12, 13 AO.

<sup>239</sup> In a specific case, an examination must be carried out on the basis of the relevant DBA. For reasons of illustration, the OECD Model Convention is used in this contribution.

<sup>240</sup> § 12 S. 1 AO.



point of the earth's surface (iii) of a certain duration (iv) where the taxable person has more than temporary power of disposal and (v) which directly serves the business of the enterprise.<sup>241</sup>

A **business premise or facility** can be any physical property or group of physical assets. It is important to note that these can be the basis of any business activity.<sup>242</sup> The most common case for home office should therefore be the Fixed Place of Business. This can also be a structurally non-separate area in an apartment.<sup>243</sup> Home office can constitute a Fixed Place of Business according to domestic law, since an apartment is a physical property. This also applies if there is no structurally separate area in an apartment and only the corner of the room is used for home office purposes.

The business premise or facility has a fixed connection to a certain point on the earth's surface if it has a temporary connection. This does not require a fixed connection with the earth's surface.<sup>244</sup> For example, market stalls or sales stands with changing locations may be deemed business premises.<sup>245</sup> Only a spacial limitation and local fixing is required.<sup>246</sup> These prerequisites are clearly fulfilled for a home office. There is a spacial limitation as well as a local fixation.

Whether a **certain duration** is present depends on the circumstances of each individual case. In the opinion of the tax authorities and according to court rulings by the German Federal Fiscal Court, a PE is considered to be of a certain duration if it exists for more than six months.<sup>247</sup> Consequently, a certain duration could be assumed if home office lasts longer than six months.

In addition, the PE must **directly serve the business of the enterprise**. This is the case if the business activities of the company are carried out through home

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<sup>241</sup> Cf. *Brüninghaus* in Vögele/Borstell/Bernhardt, Handbuch der Verrechnungspreise, 5th ed. 2020, Kapitel K: Einkunftsabgrenzung bei Betriebsstätten, marginal no. 12.

<sup>242</sup> Cf. *Drüen* in Tipke/Kruse § 12 AO, marginal no. 4; Gersch in Klein § 12 AO, marginal no. 2.

<sup>243</sup> Cf. BFH v. 15.7.1986 - VIII R 134/83, BStBl. II 1986, 744.

<sup>244</sup> Cf. BFH of 30.10.1996 - II R 12/92, BStBl. II 1997, 12.

<sup>245</sup> Cf. *Kruse* in Tipke/Kruse § 12 AO, marginal no. 9.

<sup>246</sup> *Gersch* in Klein § 12 AO, marginal no. 2.

<sup>247</sup> Cf. BFH, 19.5.1993 - I R 80/92, BStBl. II 1993, 655; BMF, Betriebsstättenerlass, marginal 1.1.1.1.

office.<sup>248</sup> It is not relevant whether significant or insignificant activities are performed.<sup>249</sup>

There must be a **power of disposal** over the fixed business premises that is **not merely temporary**.<sup>250</sup> This is the case if the taxpayer has been granted a legal right which cannot be easily withdrawn or changed without their consent.<sup>251</sup> Examples of this are ownership or rental of business equipment.

The characteristic of not merely temporary power of disposal is of central importance in the question of whether home office can lead to PE establishment. According to German Federal Fiscal Court rulings, permanent and not merely temporary power of disposal over the premises or place of business must exist in order for a PE to exist.<sup>252</sup> Consequently, the employer would have to have a power of disposal over the employee's home office workplace in order for a PE to exist. This is generally not the case.

For this reason, an employee's home office will not generally establish a PE, at least not according to the general interpretation of German national tax laws.

However, it can be observed from the OECD, a tendency to distant themselves from the criteria of power of disposal.<sup>253</sup> In principle, the OECD assumes that a home office workplace does not establish a PE.<sup>254</sup> At the same time, however, the OECD also identifies cases where home office can lead to a PE. This should be the case, for example, if the employee uses home office regularly or even continuously in accordance with instructions from

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<sup>248</sup> Cf. *Brüninghaus* in Vögele/Borstell/Bernhardt, Handbuch der Verrechnungspreise (Fn. 7), Kapitel K: Einkunftsabgrenzung bei Betriebsstätten, marginal no. 18.

<sup>249</sup> Cf. BFH v. 30.8.1960 - I 148/59 U, BStBl. III 1960, 468.

<sup>250</sup> Cf. BFH of 11.10.1989 - I R 77/88, BStBl. II 1990, 166.

<sup>251</sup> Cf. BFH of 17.3.1982 - I R 189/79, BStBl. II 1982, 624.

<sup>252</sup> Cf. BFH of 11.10.1989 - I R 77/88, BStBl. II 1990, 166.

<sup>253</sup> Cf. *Wassermeyer*, in *Wassermeyer/Kaesler*, Art. 5 OECD-MA Kommentierung.

<sup>254</sup> This assessment was again confirmed by the OECD on 3.4.2020. Cf. OECD of 3.4.2020, Secretariat Analysis of Tax Treaties and the Impact of the COVID-19 Crisis, nos. 8, 9.

the company or if the employer does not provide an office although an office would be necessary for the work performed.<sup>255</sup>

The German Federal Fiscal Court and the tax authorities have rejected such an interpretation due to the lack of a clear power of disposal on the part of the employer. However, it cannot be ruled out that this may change in the future.

The OECD definition of a PE largely corresponds to the national definition of a PE.<sup>256</sup> Accordingly, a PE is established by means of a fixed place of business through which the activities of a company are wholly or partly carried out.<sup>257</sup> Double taxation agreements also feature similar characteristics in terms of a fixed place of business, permanence, power of disposal and business activity.

The main difference between the national concept of a PE and the OECD Model Tax Convention is that the OECD regard active business activities of the PE as a prerequisite. While double taxation agreements generally limit the scope of the PE to significant qualitative and quantitative activities, auxiliary activities could also constitute a PE under national law.<sup>258</sup>

## **b. Place of Management**

A place of management PE is located where the authority to legally represent the company is given. This does not require a fixed place of business or facility.<sup>259</sup> Rather, it depends on the place where the management is regularly present in order to manage the business.<sup>260</sup>

In this context, the **place of management** is the place where the authority to manage is formed.<sup>261</sup> This means that it represents the place from which

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<sup>255</sup> Cf. *Wassermeyer*, in *Wassermeyer/Kaeser*, 148. edition, January 2020, Art. 5 OECD-MA, marginal no. 18.

<sup>256</sup> Cf. *Brüninghaus* in *Vögele/Borstell/Bernhardt*, *Handbuch der Verrechnungspreise* (Fn. 7), Kapitel K: Einkunftsabgrenzung bei Betriebsstätten marginal no. 20.

<sup>257</sup> Cf. Art. 5 OECD-MA.

<sup>258</sup> *Brüninghaus* in *Vögele/Borstell/Bernhardt*, *Handbuch der Verrechnungspreise* (Fn. 7), Kapitel K: Einkunftsabgrenzung bei Betriebsstätten, marginal no. 21, 22.

<sup>259</sup> In particular, the site of the management is always considered a permanent establishment, § 12 p. 1 AO.

<sup>260</sup> Cf. BFH of 23.1.1991 - I R 22/90, BStBl. II 1991, 554.

<sup>261</sup> See § 10 AO.

management imposes necessary measures of some importance.<sup>262</sup> This is essential for the conduct of day-to-day business. This includes actual and legal acts in the ordinary course of business operations as well as organizational measures that are part of the administration of the company.<sup>263</sup>

The location where management decisions of the business is formed may also be the residence of the worker if the center of the professional activity and business planning is located at their home office.<sup>264</sup>

The duration of the activity can be important as to whether the activity in home office actually establishes a place of management PE.

It should be noted that this must not only be a temporary power of disposal, but also a power of disposal derived from the business establishment's sustainable long-term activity.<sup>265</sup> Since the duration of the activity is not defined in more detail neither by law nor by existing court rulings, a duration of activity of more than six months, as is the case for construction and installation work,<sup>266</sup> can also provide an indication for other business activities.<sup>267</sup>

Consequently, a permanent activity of a managing director out of the home office could under national law constitute a Place of Management PE.<sup>268</sup>

Double taxation agreements do not define the term Place of Management PE separately. However, the place of management is explicitly listed as a PE.<sup>269</sup> Furthermore, when managing directors of a company carry out activities abroad, the possible establishment of a Permanent Representative PE must be considered (see following section). The German Federal Fiscal Court

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<sup>262</sup> Cf. BFH of 9.7.2003 - I R 4/02, BFH/NV 04, 83.

<sup>263</sup> Cf. *Rengers*, in Blümich, EStG/KStG/GewSt, 150. Delivery November 2019, § 1 KStG, marginal no. 37.

<sup>264</sup> Cf. BFH, 28.7.1993 - I R 15/93, BStBl. II 1994, 148.

<sup>265</sup> Cf. BFH of 18.3.1976 - IV R 168/72, BStBl. II 1976, 365.

<sup>266</sup> § 12 S. 2 No. 8 AO.

<sup>267</sup> Cf. *Gersch*, in Klein, AO, 14th edition 2018, § 12 AO, marginal 7.

<sup>268</sup> § 12 S. 2 No. 1 AO.

<sup>269</sup> Art. 5 para. 2a OECD-MA.

also shares this view. Accordingly, the managing director can also act as a permanent representative of his own company.<sup>270</sup>

As already explained in connection with the Place of Management PE, the duration of the activity will also be relevant for the Permanent Representative PE.

In summary, it can be said that no PE is generally established in the case of temporary activity from home office working, even in the case of cross-border management by the managing director.

However, should the activity last a certain duration (usually longer than 6 months), the managing director may lead to PE establishment. In this respect, this only applies if the other requirements are also applicable, especially in the management and conduct of day-to-day business activities in home office. Experience shows that this is more likely to be fulfilled in smaller one-man businesses, where the case of the Place of Management PE may be the exception.

### c. Permanent Representative

The term “permanent representative” serves as a supplementary tax basis to the concept permanent establishment.<sup>271</sup> According to German tax law, the permanent representative is (i) a person, who (ii) sustainably, (iii) serves the business of a company, and (iv) is subject to the instructions of the company.<sup>272</sup>

Any natural person or legal **entity** may act as a permanent representative.<sup>273</sup> This also includes employees of a company.<sup>274</sup> In order to establish a PE in Germany, they do not have to have their domicile, registered office or

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<sup>270</sup> Cf. BFH of 23.10.2018 - I R 54/16, according to BMF v 12.7.2019 intended for publication in BStBl. II; § 13 AO.

<sup>271</sup> Cf. *Gersch*, in Klein, AO, 14th edition 2018, § 13 AO, marginal no. 1.

<sup>272</sup> § 13 S. 1 AO.

<sup>273</sup> Cf. *Koenig*, in Koenig, AO, 3rd ed. 2014, § 13 AO, marginal 6.

<sup>274</sup> *Kaminski*, Ständiger Vertreter, [https://www.haufe.de/steuern/steuer-office-basic/staendiger-vertreter-abc-intstr\\_idesk\\_PI27\\_HI3707625.html](https://www.haufe.de/steuern/steuer-office-basic/staendiger-vertreter-abc-intstr_idesk_PI27_HI3707625.html).

place of management in Germany.<sup>275</sup> Nevertheless, they must reside in the country for what is deemed to be more than temporarily or occasionally.<sup>276</sup> Depending on the duration of the activity, these requirements may apply to the employee of a company working from home.

A **sustainable** activity exists if it is designed for a certain duration, is based on an overall plan and is intended to be repeated.<sup>277</sup> With regard to a minimum duration, there are different views in literature, ranging from no time limits<sup>278</sup> to a minimum duration of 6 months.<sup>279</sup>

Any activity of an economic nature for the company is considered to be **representation**.<sup>280</sup> This can include both the conclusion of legal transactions and acts similar to legal transactions, as well as actual dealings.<sup>281</sup> It is disputed whether auxiliary and secondary activities can also be representative work if they are directly beneficial to the actual purpose of the enterprise.<sup>282</sup>

The permanent representative must be subject to the **instructions of** the party represented, as is the case, for example, in an employment or service relationship or other contractual relationships under contract law.<sup>283</sup> In addition, the representative may also be bound by instructions if the person represented is able to execute their will, for example, as a result of economic dependence.<sup>284</sup>

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<sup>275</sup> RFH from 4.3.1927 - I B 1/27, RFHE 20, 310.

<sup>276</sup> FG Niedersachsen from 25.3.2003 - 6 K 961/99, EFG 2003, 1626.

<sup>277</sup> Cf. *Kruse*, in Tipke/Kruse, AO/FGO, 159. delivery January 2020, § 13 AO, marginal 7.

<sup>278</sup> Cf. *Koenig*, in Koenig, AO, 3rd edition 2014, § 13 AO, marginal 6.

<sup>279</sup> Cf. *Heinsen*, in Beermann/Gosch, AO/FGO, 150. delivery December 2019, § 13 AO, marginal no. 8.

<sup>280</sup> Cf. *Koenig*, in Koenig, AO, 3rd edition 2014, § 13 AO, marginal 6.

<sup>281</sup> BFH, I R 127/68, BStBl. II 1971, 776.

<sup>282</sup> Approving: *Heinsen*, in Beermann/Gosch, AO/FGO, 150th delivery December 2019, § 13 AO, marginal no. 5, Rejecting: *Kruse*, in Tipke/Kruse, AO/FGO, 159th delivery January 2020, § 13 AO, marginal no. 4.

<sup>283</sup> *Koenig*, in Koenig, AO, 3rd edition 2014, § 13 AO, marginal 6.

<sup>284</sup> *Frotscher*, in black/Pahlke, AO/FGO, § 13 AO, marginal no. 8.

Based on the facts described above, it can be assumed that a permanent representative working from home establishes a PE.<sup>285</sup> However, the concept of a permanent representative is to assume, analogous to the concept of a PE, a fixed place of business, which serves to carry on the business of the entity represented.<sup>286</sup> In addition, also analogous to the concept of PE, the represented person must have at least permanent, not merely temporary power of disposal over the representative's own place of business.<sup>287</sup>

In international tax law, the Permanent Representative PE<sup>288</sup> can be regarded as a counterpart to the concept of the permanent representative. Accordingly, a Permanent Representative PE is established if a representative of a company becomes active in a contracting state in which the company is not resident. According to the old version of the OECD-MA where characteristics are still in force today (the DBAs), the existence of a power of attorney was a mandatory requirement for the establishment of a Permanent Representative PE.<sup>289</sup> In the new version of the OECD-MA, this is no longer a requirement. Rather, it is sufficient if a person generally plays a primary role in negotiating contracts that are concluded routinely and without any substantial change by the company.<sup>290</sup>

## 2. Establishment of unlimited Tax Liability

Similar to the question of establishment of a PE, a home office can lead to unlimited tax liability in Germany of a foreign company. Possible is the circumstance where the managing director of a foreign company residing in Germany on an interim basis (e.g. due to travel restrictions or due to home office), permanently or possibly for only a few days.<sup>291</sup>

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<sup>285</sup> For example *Kahle/Kindich*, IStR 2016, 85.

<sup>286</sup> Cf. *Gersch* in Klein, AO, 14th edition 2018, § 13 AO, marginal no. 3.

<sup>287</sup> Cf. *Gersch* in Klein, § 13 AO, Rn. 3.

<sup>288</sup> Art. 5 para. 5 OECD-MA.

<sup>289</sup> So also still mentioned as a prerequisite by *Wassermeyer*, in Wassermeyer/Kaesler, Double Taxation Commentary, 148th Delivery January 2020, Art. 5 OECD-MA, marginal no. 201c.

<sup>290</sup> *Wassermeyer*, in Wassermeyer/Kaesler, 148th Delivery January 2020, Art. 5 OECD-MA, marginal no. 83.

<sup>291</sup> This paper does not analyse the case in which the foreign employee has access to the premises of a German corporation, for example because he maintains an office there.

Under national tax law, unrestricted corporate tax liability exists, amongst others, for companies<sup>292</sup>, which have their management<sup>293</sup> or registered office<sup>294</sup> in Germany.

As explained above, the place of management is regularly the location where management decisions are made. In individual cases, this can also be the home office of the managing director. The registered office of the company is the place determined by law, the articles of association, contract, business incorporation or equivalent documents.<sup>295</sup>

If the place of management and registered office of a company are located in different countries, the company may be resident in any of these countries resulting in double or multiple residences.<sup>296</sup> Thus, in the absence of further regulations, the company would possibly be subject to unrestricted taxation in two countries leading to double taxation.

The so-called “Tie-Breaker Rule” therefore provides that a company is resident in the country where the “place of effective management” is located.<sup>297</sup>

The factual circumstances are important to determine the location of the place of management. Purely legal facts (stipulation of a place of management in the articles of association) do not play a role here. Rather, a qualitative element must be considered as the “place of effective management” clearly defines.<sup>298</sup>

In this respect, the term “place of effective management” largely corresponds to the German national definition “place of management” from § 10 AO.<sup>299</sup>

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<sup>292</sup> Section 1 (1) sentence 1 KStG, complete list section 1 (1) sentence 1 no. 1 - no. 6 KStG.

<sup>293</sup> § 10 AO.

<sup>294</sup> § 11 AO.

<sup>295</sup> § 11 AO.

<sup>296</sup> Art. 4 para. 1, para. 2 OECD-MA.

<sup>297</sup> Art. 4 para. 1, para. 2 OECD-MA.

<sup>298</sup> *Wassermeyer*, in *Wassermeyer/Kaeser*, 148th Delivery January 2020, Art. 4 OECD-MA, marginal 100.

<sup>299</sup> LHP, Der „Tie-Break“ im Internationalen Steuerrecht, <https://www.lhp-rechtsanwaelte.de/themen/international-tax-law/tie-breaker-rule/>.



If there are several managing directors working from different locations, each location can be considered as the place of management. According to court rulings by the German Federal Fiscal Court, the activities at the respective locations must be weighted accordingly. The location of most importance in terms of operational and economical respect can be deemed to be the center of the place of management.<sup>300</sup> However, this principle is not feasible if several people perform equivalent management tasks from different locations.<sup>301</sup>

If there are several places of effective management, the place where the majority of board members maintain their offices should be considered. Other relevant factors may be used to determine the place of effective management, for example, the location of centralized administration functions.<sup>302</sup>

However, the cases outlined above are likely to be rare and limited to small number of businesses.

### 3. Conclusions for Taxpayers

The pandemic and the resulting restrictions on mobility and the contact ban will have a particular impact on whether the use of private residential premises as a home office for managing the business of the company constitutes a taxable PE.

This question was addressed by the OECD in its statement dated April 3, 2020, which considered that control measures against the Corona virus should generally not lead to a PE.<sup>303</sup> According to this statement, employees who work for their foreign employer from their **home office** during the Corona crisis should generally not establish a PE for their foreign employer. This is due to the lack of permanence and power of disposal in this respect. The same applies to permanent representatives who, due to their lack of ability to exercise authority, should not lead to a **Permanent Representative PE** during the period of COVID-19 restrictions.

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<sup>300</sup> BFH of 5.11.2014 - IV R 30/11, BStBl. II 15, 601.

<sup>301</sup> Ibid.

<sup>302</sup> Cf. *Wassermeyer*, in *Wassermeyer/Kaesler*, 148 Delivery January 2020, Art. 4 OECD-MA, marginal 102.

<sup>303</sup> Cf. OECD Secretariat, 3.4.2020, Statement

It is true that the statement of the OECD Secretary-General is a recommendation that is by no means binding for individual countries. The German tax authorities may have a different opinion and some countries have already issued guidelines for dealing with international issues, for example Ireland, the UK and Australia.

However, the OECD's statement can at least provide an interpretation when applying national legislation and in some cases, help to assess the PE risk arising from the Corona crisis. Nevertheless, it remains to be seen how individual national tax authorities will react to the international issues raised.

In the medium and long term, it is unclear whether the BFH will follow the OECD's view regarding the establishment of PEs by home office working. In the taxpayer's interest, it would be favorable for the BFH to sustain its current perspective in view of the immense administrative burden that such a regulation could entail.

However, as the use of home office workplaces increases, the greater the need for the uniformity of tax regulations within the OECD countries. The Austrian Federal Finance Court has already endorsed the OECD's view and argued in a court judgement that the employer already has actual power of disposal over the employee's home office if business activities are performed from their home office.<sup>304</sup> With the increasing relevance of home office workplaces beyond the current Corona crisis, further cases on the subject are certain to arise in front of the BFH. The position of the BFH itself will be of significant importance.

With regard to a Permanent Representative PE, it can be stated that under normal circumstances, PE establishment by a managing director living abroad can be avoided by means of specific measures. For example, the managing director should normally ensure that activities important to the company (e.g. signing contracts, management decisions) are only performed from the company's registered office. The Corona crisis has restricted the freedom to travel, and if after the crisis, cross-border management became the standard over a longer period of time, appropriate measures for compliance may become impossible. The managing director will naturally make decisions that are important for the company and will therefore establish a Permanent Representative PE if a certain time period is exceeded.

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<sup>304</sup> BMF from 27.6.2019, EAS Express Reply Service, 010221/0323-IV/8/2018.

In consequence, ongoing and regular monitoring of possible arrangements on the location of employee workplace is highly recommended. A review of the tax consequences of cross-border relationships is particularly advisable in the case of new hires and changes to existing set-ups, in order to take advantage of opportunities for restructuring at an early stage and to be able to meet all registration and obligatory requirements in a timely manner.

## **XII. Supply Chain Management – Impact of the Corona Crisis on Value Chains and Transfer Pricing Systems (Jobst Wilmanns, Dr. Björn Heidecke)**

### **1. Introductory Remarks**

The Corona crisis disrupted global value chains and the related dependencies between the individual stages of the value chain. The beginning of the crisis in China caused in the first quarter of 2020 a collapse of previously stable supply chains, although they have been developed over many years and have been trimmed on efficiency. Not only since the financial crisis in 2008 / 2009, but even before that, companies have been required to be flexible and dynamic. The factors that have influenced the actions of corporations can be summarized in the following keywords: globalization, saturated buyer markets, customer orientation, intense competition, accelerated technological development or increasing shortening of product life cycles.<sup>305</sup> In order to meet these requirements, it is no longer the organizational structure that dominates the workflows (process follows structure), but the processes that shape the organizational structure (structure follows process).<sup>306</sup> If the corporate strategy is taken into account, this would be the basis for the organizational solution, which is necessary for the implementation of the strategy. This results in the postulate “structure follows process follows strategy”.<sup>307</sup>

However, due to the Corona crisis many things are being shaken up now. From a risk point of view, the group’s headquarters are now exploring possible options to avoid a comparable “shutdown” in the future. As consequence of the strategy changes following the risk evaluation, the group’s existing process models should be reviewed.

The changes in group strategies and the resulting changes in processes and organizational units lead to the consideration of the tax chances and risks associated with these changes.

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<sup>305</sup> *Bach/Brehm/Buchholz/Petry*, Wertschöpfungsorientierte Organisation, 2012, 133.

<sup>306</sup> *Ibid.*

<sup>307</sup> *Ibid.*

## **2. Overview of Possible Effects of the Corona Crisis on Value Chains**

In the context of the considerations made in Section 1. and the possible transfer pricing implications, the following section discusses possible changes in strategy and the associated changes in value creation processes. The overview is based on a sequential consideration of the flows of goods and services taking into account that in the age of digitalization, value chains are increasingly changing from one-dimensionally arranged to multi-dimensionally interconnected processes.

### **(1.) Procurement Process**

In the light of the Corona crisis, the fundamental objective of the procurement function is, on the one hand, the maintenance of supply chains and, on the other hand, the establishment of an external and internal supplier portfolio in order to avoid excessive dependencies. In order to achieve these goals, a deeper understanding of the procurement process (“demand to pay”) is required. In principle, the procurement organization can be divided into a strategic and an operational level.<sup>308</sup> The strategic procurement process deals with the coverage of general material and service requirements in the group across all cases. This is connected with aspects of strategy development and, derived from this, e.g. decisions regarding global sourcing, single sourcing or supplier portfolio, which must then be implemented in the group. The operational procurement process covers the entire process - starting with the determination of concrete requirements and finishing with creditor management.

The significance of the procurement in the value creation process, i.e. whether it has a strategic or operational / supporting role, depends on the industry but also on the depth of added value of the respective group.<sup>309</sup> However, it is already foreseeable today that procurement processes will play a decisive role in the strategic aftermath of the Corona crisis.

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<sup>308</sup> *Bach/Brehm/Buchholz/Petry, Wertschöpfungsorientierte Organisation, 2012, 146 f.*

<sup>309</sup> *Ibid., 148 f.*

## **(2.) Operation / Production Process**

The production process is largely determined by two objectives, namely process and resource efficiency. The entire supply chain management in the area of operations / production is focused on the cross-company coordination of material and information flows across the entire value-added process from goods receipt to goods issue. Therefore, the compatibility of the order processing procedure with the supply chains of upstream and downstream partners is of strategic importance. In the context of risk allocation in the processes described above, aspects such as the number of products, made-to-order production vs. stock production, production levels (single-level vs. multi-level) and organization of production as well as production quantities are now being re-analyzed and adjusted.<sup>310</sup> Similarly, the return from shutdown will result in (initial) costs due to insufficiently functioning supply chains, lack of demand, but also the resumption of processes.

## **(3.) Inventory Management / Outbound Logistics Process**

The Corona crisis did not only cause the shut down of production units, but also caused the interruption of logistics chains. Ports were closed and flights were cancelled. These flights would not just have handled business travelers but also freight. For the industry, the disruption of supply chains was a major problem, as there were no necessary materials and intermediate products available to continue production. Various industries and also corporations anticipate a start-up phase of minimum 6 weeks before the logistics hubs, such as ports and airports, will be re-opened. For the future, several groups have already announced that, in addition to the already mentioned reactions to this global crisis, they see warehousing policy as an important component for a smooth supply chain organization. There is a further argument here, namely that at the current low interest rate level, the costs of capital commitment caused by higher inventory levels are considered a controllable financial indicator.<sup>311</sup>

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<sup>310</sup> *Bach/Brehm/Buchholz/Petry*, Wertschöpfungsorientierte Organisation, 2012, 165

<sup>311</sup> *Giersberg*, Warum das Lagern wieder wichtiger wird, <https://www.faz.net/current/economy/world-economy-china-supply-chains-are-again-16729656.html>.

#### (4.) Marketing and Sales Process

Due to the political guidelines on “physical distancing”, personal, physical customer contacts and negotiations have more or less come to a standstill. The focus is on so-called Customer Relationship Management (CRM) systems, which have three main components, namely

- Operational CRM system, i.e. the digital support of all processes at the point of sale
- Analytical CRM system, i.e. the digital evaluation of the data generated in the process and its subsequent optimization
- Communicative CRM system, i.e. the control, support and synchronization of all communication channels to the customer.<sup>312</sup>

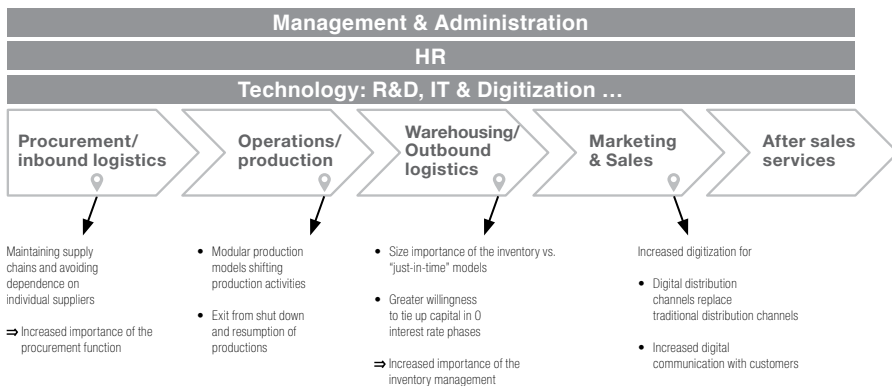
With this development, the ongoing Corona crisis is driving the process of digitization of sales processes.

The following diagram summarizes the aspects presented as a basis for the following tax analysis.

Figure 19: Supply Chain Reorganisation.<sup>313</sup>

#### Supply Chain Reorganisation

Possible effects of Covid-19 on the value chain



<sup>312</sup> Bach/Brehm/Buchholz/Petry, value added organisation, 2012, 161.

<sup>313</sup> Own illustration.

### 3. Tax Consequences

In the following Section, we will further elaborate the individual aspects mentioned above and examine possible medium to long-term transfer pricing implications.

#### a. Procurement Function

As explained above, one can distinguish between the strategic and operational levels of procurement. The importance of procurement depends on both the industry and the depth of value added of the respective group. The first studies cited disrupted supply chains as one of the reasons for the economic slowdown in the wake of the Corona pandemic (see Section III., p. 23 et seq.). The global dependence on individual locations is also underlined by the following graph showing, for example, the dependence of global supply chains on China. It shows that countries such as the USA obtain 30% of their intermediary products from China. In Germany, the figure is 10 to 15 %. Although the observation may be more differentiated depending on industry and company, this macroeconomic observation shows that the functioning of individual regions is important for the global economy. The question is how corporations react to this.

Figure 20: Procurement of intermediate products from China - global.<sup>314</sup>

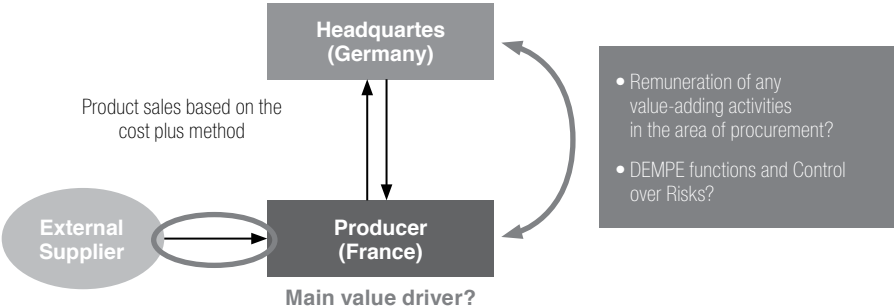


<sup>314</sup> World Economic Forum v. 6.4.2020, Supply chains have been upended. Here's how to make them more resilient, <https://www.weforum.org/agenda/2020/04/supply-chains-resilient-covid-19/>.



Due to the Corona pandemic, corporations are likely to focus on the security and stability of value chains - at least in the short to medium term. A key factor is procurement. Therefore it is expected that the flexibility of procurement processes and the reduction of associated risks will become the major focus. Hence, one can expect increased (risk) management with regard to procurement sources. Strategic importance receives the identification and analysis with regard to an increased coordination with direct suppliers (tier 1), an analysis of the further 2 / 3 tier supply network if possible, and the development of alternative procurement sources (e.g. regions). Control towers for group-wide supply chain management together with procurement and digital solutions are likely to increase. It is still unclear whether the procurement function will be performed more centrally in the future, or whether centralized control will take place alongside strengthened local purchasing. The following chart illustrates this.

Figure 21: Illustration of procurement function.<sup>315</sup>



From a transfer pricing perspective, possible adjustments to the procurement function must be evaluated. While analyzing of the facts, following aspects need to be examined on a case-by-case basis: a) what role plays procurement today and in the future for the success of the business, b) who performs the functions regarding the procurement and who bears the associated risks and c) whether new intangible assets such as digital procurement tools may be added. With regard to any intangible assets, a DEMPE analysis is to be performed: Who performs key functions? Who makes key decisions? Who controls risks?

If the strategic procurement function together with (risk) management and the cultivation of relationships with suppliers is seen as a strategic competitive factor in the future, it should be reconsidered whether cost-based remuneration is appropriate or whether at least part of the residual result should be allocated

<sup>315</sup> Own illustration.

to it. With regard to the operational handling of procurement, it is questionable whether this justifies residual remuneration. Finally, this is probably a matter of implementing strategic framework concepts. At the same time, the question arises whether a small profit margin remains appropriate for the function performed or whether the profit mark-up should be adjusted.

If there are adjustments in the allocation of revenue, for example because a stronger central procurement function is being established or responsibility is being shifted from the countries to the HQ, IP transfer or relocation of functions must be examined and corresponding transfer package assessments performed. If the local procurement function has only been provided with routine compensation and some of the functions that have also been taken over locally will be performed centrally in the future, exit taxation should not be necessary. In this case, a valuation on individual basis as a result of the escape clause is regularly considered.<sup>316</sup>

## **b. Production**

Similar to procurement process, the production process is also likely to be reviewed in the medium to long term. One should analyze the number of products, contract manufacturing vs. stock production, choice of production location and network, flexible production and digitalization of production control. Companies have to study these strategically important issues taking costs and revenues into consideration. The later was also confirmed by Felbermayr from the Kiel Institute for the World Economy.<sup>317</sup> According to him, the worldwide division of labor has also advantages. Doubling production facilities could lead to rising costs and consequently to higher commodity prices. Companies would make very careful strategic considerations in this respect. Nevertheless, Felbermayr expects more production facilities to be built in countries of end customers and that resulting into a significant decrease of freight traffic. This could also open up an opportunity regarding the quality. Further, the World Economic Forum notes that the ability to collect production data and to use this data for production

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<sup>316</sup> Cf. *Puls/Storm*, Steuerliche Rahmenbedingungen von Funktionsverlagern, in Heidecke/Schmidtke/Wilmanns (eds.), Funktionsverlagerung und Verrechnungspreise, 2017, 91; § 2 FVerlV; the most recent draft of the AStG-E in the version of 27.3.2020; see also *Heidecke/Nanavaratorn* (forthcoming)

<sup>317</sup> Deutschlandfunk Kultur v. 7.4.2020, The world will remain highly networked, [https://www.deutschlandfunkkultur.de/ifw-chef-felbermayr-ueberglobalisierung-die-welt-wird.1008.de.html?dram:article\\_id=474273](https://www.deutschlandfunkkultur.de/ifw-chef-felbermayr-ueberglobalisierung-die-welt-wird.1008.de.html?dram:article_id=474273).

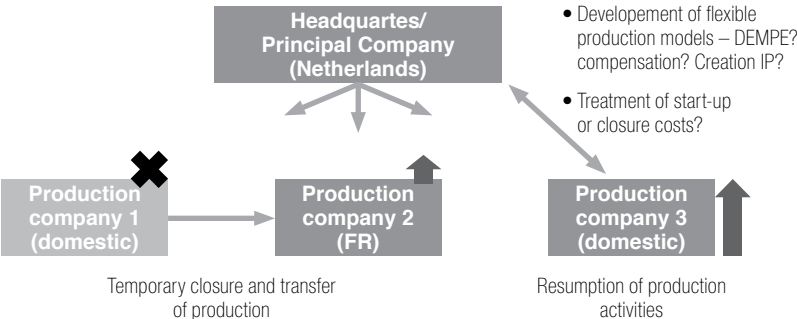
control in order to control a more flexible and modular production network is becoming more important as a result of the Corona crisis.<sup>318</sup>

In addition to increasing production, the number of warehouses and thus capital demand are also likely to increase.

In the short term, the resumption of production is likely to lead to start-up and idle capacity costs, which are initially incurred by the production company. In addition, the interruption of the supply chain has led to short-term adjustment costs of the production network.

The following diagram illustrates various aspects by way of example.

Figure 22: Exemplary effects of production.<sup>319</sup>



From a transfer pricing point of view, the current and future allocation of functions and risks have to be assessed and the adjustments have to be documented. Any adjustments and the introduction of new control systems have to be assessed with regard to their value contribution and remunerated accordingly. In particular profit allocation should be discussed if a new value-generating software is introduced as an intangible asset. In this case, the DEMPE concept requires the identification of the main decision makers, function and risk carriers. Data models are of particular importance here. If production structures are to become more flexible, good production planning is necessary for efficient control, which should be digitalized. In this respect, the development and maintenance of data models plays a greater role in value

<sup>318</sup> Cf. World Economic Forum v. 6.4.2020, Supply chains have been upended. Here’s how to make them more resilient, <https://www.weforum.org/agenda/2020/04/supply-chains-resilient-covid-19/>.

<sup>319</sup> Own illustration.

creation. The corresponding remuneration of the models should be assessed using the DEMPE concept.

If production structures change in the short or also in the medium to long term, it should be determined if the criteria of relocation of functions and transfer of tangible or intangible assets are met. If the local production function was merely compensated based on routine remuneration, no transfer package assessment should be necessary. Generally, in this case, an individual valuation according to the escape clause is considered.<sup>320</sup> Nevertheless, it must be examined whether, for example, long-term purchase commitments, valuable expertise, machines, inventories or customer relationships are also transferred. For this purpose, individual arm's length transfer prices have to be determined.

With regard to new warehouses, risks of creation of permanent establishments have to be examined. Even if in many DTAs, warehousing is seen as an auxiliary activity, this could be questioned in the future a) in light of anti-fragmentation rules under the Multilateral Instrument<sup>321</sup> and b) in light of a new classification of the warehouses as a "non-auxiliary activity".

Any start-up and closure costs must be assessed on a case-by-case basis. In the case of principal models, they must always be borne by the principal. Nevertheless, the specific allocation of functions and risks must be taken into account. Furthermore, it could be argued that in the current situation an external third party producer also has to bear idle costs and start-up costs. The risk of idleness is normally not insured. Within the group, it is necessary to check whether the production contracts provide for purchase obligations (see also Section XII., p. 149 et seq.). If this was the case, a third party could also refer to this and claim acceptance as part of the commitment or at least use this as a negotiating argument in a hypothetical arm's length analysis (cf. Section VIII.2., p. 109 et seq.).

Furthermore, the Corona pandemic leads to an additional storage risk due to declines in the sales market, combined with obsolescence, spoilage and technical overhaul as well as capital commitment. If one assumes that the usual volumes were produced at the beginning of the crisis, a third party would also bear such

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<sup>320</sup> Cf. *Puls/Storm*, Steuerliche Rahmenbedingungen von Funktionsverlagern, in Heidecke/Schmidtke/Wilmanns (eds.), Funktionsverlagerung und Verrechnungspreise, 2017, 91; § 2 FVerIV; the most recent draft of the AStG-E in the version of 27.3.2020; see also *Heidecke/Nanavaratorn* (forthcoming)

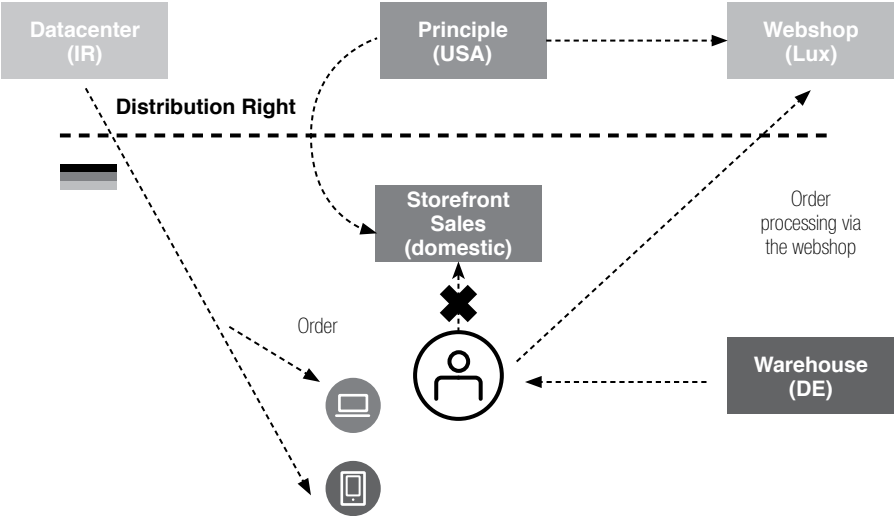
<sup>321</sup> Cf. e.g. *Heidecke/Lappe/Linn*, IWB 2016.

risks because it would not have been able to react, either. Nevertheless, it must be examined whether the routine group entity produced normal quantities or whether it already had a higher production volume before Corona due to the entrepreneur’s guidelines. If this were the case, then the question would be whether the additional storage risk should be borne by the entrepreneur.

**c. Distribution**

One can already observe digital distribution channels displacing stationary trade. New sales measures are used increasingly, including increasing digital interaction with customers, e.g. via apps and new online chat campaigns. Existing delivery models are likely to be expanded and new delivery models for the digitally sold products will emerge. This should lead to an increase in the number of warehouses and logistics centers. As with production networks, the use and evaluation of data and its value for sales, product range planning, pricing and marketing will increase. The following figure illustrates possible changes.

Figure 23: Illustration Supply Chain Online.<sup>322</sup>



Also in the case of sales the respective facts with regard to functions, risks and intangible assets now and in the future must be assessed. In this context, the DEMPE functions and, consequently, the arm length remuneration of

<sup>322</sup> Own illustration.

new intangible assets, e.g. created through the development of web shops and apps, must be analyzed. In view of possible additional warehouses, the question also arises as to whether permanent establishments be created and who assumes the additional warehousing risks (see above).

The data model must also be analyzed, i.e. who collects, stores and processes the data. Usually, the customer's inquiries in the front-end (i.e. the web shop) are processed on a server in the back-end. This server then triggers the order and the purchase order to the warehouse as well as the invoice, if necessary with a third party payment processor. The data processing and data storage is carried out on a server of a third party, e.g. Microsoft, Amazon or Apple. The question regarding who has access to the server and who uses the data arises. Usually only the central unit has access to the server. It extracts the data, evaluates it in BI, and provides feedback to the development team for adjusting the web shop and the back-end, for example. It controls the data strategy and the intangible assets such as an algorithm. The local sales entities or web s receive often only summarized data in a dashboard format. The question from the transfer pricing point of view is how the central entity is to be remunerated for data processing, for example, by means of a license, if it is not already included in the payment flow of the web shop. However, the question also arises as to whether the local entity is to be remunerated for the fact that "its" customers order in the web shop and it thus "provides local data". In this case, a transaction is likely to be missing, so that remuneration is usually difficult to justify. However, at least against the background of the current OECD discussions on Pillar 1 and 2, it is to be expected that states will be willing to access such sales or earnings, for example by using the argument of "local customers".<sup>323</sup>

A special feature of web shops is the remuneration of the stationary sales units for generating sales via the web shop and the apps. In such a model of "mobile sales", the sales entities are involved in brand development, but the sales are generated in other companies, possibly also abroad. It would be questionable whether third parties would have received remuneration from the web shop operator for local activities. First, the question will be whether the sales company has an exclusive distribution right, for example in Germany. If this was the case, the question would arise whether it can demand a usage fee for the transfer of the distribution right or how the distribution right should be structured in order to exclude such claims.

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<sup>323</sup> Cf. for example *Heidecke/Pandeya-Koch/Wilmanns*, IWB 2019.

If no exclusive right of use has been granted, it is questionable whether there is a business relationship to be remunerated at all. Ultimately, a third party could also buy the producer's goods and offer them online without the local distribution company being able to refuse to do so and demand compensation for the attraction of customers. If a remuneration is nevertheless demanded, it could only be an intermediary provision, for example to be measured by a berry ratio,<sup>324</sup> or a service fee for local marketing support.

#### **d. Management Functions**

One can expect that additional risk control functions and control elements, for example for the supply chain, will be created at the level of the group's headquarters or at shareholder level. In addition, some control functions in the local entities, but also at the group's headquarters, are likely to be duplicated, for example to avoid risk in the future. This raises the question of how the resulting costs will affect the group's cost allocation. According to the previous principle, the costs are to be allocated to the beneficiaries under the causation principle. For costs that cannot be directly allocated, an appropriate cost allocation key is chosen. Shareholder costs are not to be allocated.

The question is thus whether the additional activities represent shareholder costs or not. The OECD states: "whether these activities [i.e. costs of managerial and control (monitoring) activities related to the management and protection of the investment as such in participations] fall within the definition of shareholder activities as defined in these Guidelines would be determined according to whether under comparable facts and circumstances the activity is one that an independent enterprise would have been willing to pay for or to perform for itself".<sup>325</sup>

In practice, the first question that one may ask is why the additional costs are incurred. For example, are there any new legal requirements, is this a result of a shareholders' decision or an additional measure to ensure the functionality and efficiency of the group.

The next question that should be answered is whether a third party would be willing to pay compensation. This could serve as a benchmark for measuring

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<sup>324</sup> Cf. so angedacht von *Schmidtke* (forthcoming).

<sup>325</sup> OECD 2017, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, para. 7.10.

how much unrelated companies invest in additional risk protection. It is not implausible that third parties would also invest additionally and that the costs would also increase. This would mean that an additional levy would be justified. However, possibly only pre-existing interest in additional control by the shareholders could justify that the additional costs are only to be charged proportionately and will remain with the shareholders as shareholder costs. Detached from the question of whether it is a matter of shareholder costs or not, one could argue that the simple increase in costs cannot be passed on. In our opinion, this would not be the right point of analysis, because both costs related to shareholder expenses as well as costs related to non-shareholder expenses can increase.



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