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German Tax and Legal News

MOF issues draft transfer pricing guidance for intercompany financing arrangements

Draft guidance provides details about the application of new TP rules included in the Growth Opportunities Act that was introduced in March 2024

On 14 August 2024, the German Ministry of Finance (MOF) issued a draft decree that would revise and supplement chapter J of the 2023 administrative regulations on transfer pricing principles (see GTLN dated 6/27/23), which includes guidance for intercompany financing relationships. The draft decree is based on the newly introduced provisions governing the arm's length principle for financing transactions between related parties as introduced in section 1 (3d) and (3e) of the Foreign Tax Act (FTA) by the Growth Opportunities Act earlier this year. The new rules generally are effective as from 1 January 2024.
The draft decree includes guidance, in particular, related to the arm's length nature of the financing relationship itself (section 1 (3d) sentence 1 no. 1 FTA), the determination of an arm's length interest rate (section 1 (3d) sentence 1 no. 2 FTA), and the classification of financing relationships as low function and low risk, i.e., routine services (section 1 (3e) FTA). The highlights of the draft decree are summarized below.

Debt capacity and business purpose test

In order to treat interest expense as being deductible for German tax purposes, a taxpayer must credibly demonstrate that (i) they could have served the debt for the entire term of the financing arrangement from the inception and (ii) the debt is economically needed and used for the purpose of the company. The test is primarily aimed at the debt capacity of the borrower and the intended use of the debt.

The conditions that would be needed to qualify under the debt capacity and business purpose test are specified in more detail in the draft decree. With regard to the ability to service debt, it would need to be examined in particular whether "sufficient assets or cash flows can be expected from the outset." This explicitly would include, among others, the assets acquired by the additional debt. Relevant indicators would include the existence of a fixed repayment date, obligation and modalities for the payment of the interest, right to enforce the repayment of the principal, and payment of the interest and the ability of the borrower to obtain financing from third parties. The MOF also clarifies that the requirement to refinance the debt would not preclude the arm's length principle in this regard.

In order to substantiate that the conditions of the debt capacity and business purpose test are fulfilled, the conditions would need to be cumulatively met with a high degree of probability, i.e., the taxpayer would need to demonstrate that the debt can be serviced (and actually is being served) by, e.g., providing business forecast calculations, documentation for what purpose the funds are used, etc.

The draft decree emphasizes that the guidance refers to the tax deductibility of interest expenses and therefore would only be applicable for inbound financing structures. Additional noteworthy points include:

- Under extraordinary circumstances, high-risk financing arrangements might qualify as being at arm’s length (e.g., startup financing);
- Borrowing solely for the purpose of a leveraged dividend should not contradict the purpose of the company;
- In case of acquisition financing, debt planning that includes capital buffers and the short-term contribution of excess capital into a cash-pool should generally be regarded as being at arm's length; and
- If the taxpayer cannot credibly demonstrate that the conditions of the business purpose and debt capacity test are met, the tax deductible portion of the interest expense would be reduced only by the non-arm’s length portion of the interest expense, i.e., not necessarily a complete disallowance of the interest expense.

Maximum arm’s length interest rate test

According to the new rules, the arm's length character of the interest rate of a cross-border intercompany financing arrangement generally must be based on the group's rating and external financing. However, the taxpayer has the ability to demonstrate that a different rating is more in line with the arm's length principle.

With regard to the determination of the applicable group rating, the draft decree for the first time includes a hierarchy based upon officially published ratings from a rating agency would need to be used first. Private (i.e., unpublished) ratings from rating agencies would have lower priority. The group rating could also be determined by using standard market rating software, although the appropriate consideration of qualitative factors would then need to be documented. If the respective group does not have a rating, the group rating could also be derived for simplification purposes from the group's external financing costs from third parties at the time when the loan is granted.

In order to successfully prove the arm's length character of a rating derived from the group rating, the credit assessment, including the (arm's length) qualitative and quantitative factors, as well as the potential group support, would need to be documented. To analyze the group support, the draft decree defines several aspects that would need to be considered. In particular, the borrower's economic and strategic importance, the financial size, and the interdependence within the group are mentioned in this regard. As a result, the strategic importance of the borrower for the group would need to be determined, on the basis of which a rating - based on S&P rating methodologies - could be determined using a top-down approach (i.e., notching down based on the group rating) or bottom-up approach (i.e., notching up based on the standalone rating). According to the draft decree, a successful proof of the arm's length principle would require that qualitative and quantitative factors are both taken into account appropriately, distortions due to intragroup transactions are eliminated ("arm's length ratios"), the rating is comprehensible and replicable, and standard market rating methodologies are used at the time the loan is granted.

The draft decree also includes further details related to the timing of the new rules based on section 1 (3d) FTA. Following the draft decree, the new rules would not apply to financing expenses that are based on contractual arrangements concluded and implemented before 1 January 2024. However, the rules would be applicable even for such arrangements that have been concluded before 1 January 2024 if substantially amended after 31 December 2023, or if existing beyond 31 December 2024. In this respect, only "old loans" that expire or are repaid in 2024 and have not been significantly modified would be exempt from the rules. Otherwise, the rules would apply to all taxable periods that begin on or after 1 January 2024.

Financing relationships as low-function and low-risk services/routine services

Section 1 (3e) FTA states that a low-function and low-risk service exists where a financing relationship is (i) arranged by one company with another company in a multinational group of companies or (ii) passed on from one company to another company within a multinational group of companies. In the draft decree, the MOF clarifies that an arm's length remuneration for a financing relationship generally would need to be determined by primarily using the comparable uncontrolled price method, according to which the role of the financing company generally has no influence on the choice of method and price determination for the financing transaction (e.g., the loan). Further highlights in connection with qualifying an intercompany financing relationship as a routine service as described in the draft decree are briefly summarized below:

- Even if financing functions are generally regarded as support functions for the value-creating core business function, there might be exceptions where these functions are considered a central component of value creation (e.g., in the case of banks or insurance companies); and
- If the financing function is located in Germany, there would be no requirement for the tax authorities to qualify these services as routine services. However, the tax authorities would need to provide evidence of a deviating assumption by means of a functional and risk analysis, whereby the same obligations to provide evidence would apply for the taxpayer, i.e., the criteria must be met with substantial likelihood.

Comments

The draft decree is welcomed as it is generally follows chapter X of the OECD transfer pricing guidelines and explicitly refers to such guidelines several times. This should demonstrate the general commitment of the German tax authorities to recognize OECD standards when interpreting the newly introduced provisions in the FTA. The guidance, in

addition, contains some helpful clarifications, e.g., with regard to the determination of ratings and various aspects that would need to be taken into account when assessing the arm's length nature of a financing relationship. The fact that a rating derived from the group rating could also be determined by using a bottom-up approach (i.e., based on a standalone rating) is also a highly welcomed approach, as this should ease the general focus on the group rating as provided by the law.

Unfortunately, the wording of the draft decree indicates a focus on inbound cases only. However, it is expected that the guidance provided by the draft decree would be applicable equally for inbound and outbound cases. The fact that the application of the regulations would only be excluded for financing relationships that were legally concluded before 1 January 2024 and that were neither significantly changed after 31 December 31 2023, nor continued beyond 31 December 31 2024, also does not provide the expected legal certainty regarding potential retroactive effects. Considering that the legal situation at the time the “old loans” were granted – and thus also at the time the transfer price was set – was different (e.g., with regard to OECD recommendations and case law), the application of the new rules to old loans would most likely result in controversial discussions with the tax authorities in these cases.

From a practical perspective, taxpayers are facing a significantly higher documentation burden. Taxpayers should analyze which loan transactions might be covered by the new transfer pricing rules and how the retroactive application of the new rules might affect them. Ultimately, the application of the new rules might result in an increased requirement to rely on mutual agreement procedures in order to eliminate double taxation.

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