Germany: New Transfer Pricing Rules May Limit Interest Deduction in Inbound Cases

What's new

The Growth Opportunities Act (Wachstumschancengesetz), which came into force on 28 March 2024, brought significant changes to Germany's transfer pricing (TP) rules for intercompany financing relationships. The new rules aim to combat profit shifting through inappropriate financing arrangements, by refining the application of the arm's length principle to cross-border financing transactions.

On 14 August 2024, the Federal Ministry of Finance (BMF) published a draft revision of the administrative regulations on TP principles (BMF draft regulations) to deal with the new rules. While the administrative regulations are binding only on tax authorities, not taxpayers, it presents the German tax administration's interpretation of the new rules, making them highly relevant for the TP practice in Germany.

The new rules are effective for the tax assessment period 2024 and onward. Especially, the provisions on interest deduction (Section 1 (3d) AStG) do not apply to expenses of financing relationships agreed and implemented before 1 January 2024, unless the continuing transaction is substantially amended after 31 December 2023 or continued beyond 31 December 2024.

Key take-ways

Limiting the interest deduction in German inbound cases

Section 1(3d) AStG stipulates financing expenses for a German domestic taxpayer arising from cross-border intra-group loans can only be deducted, if the taxpayer can credibly demonstrate that:

Debt Service Capacity

the taxpayer was able to meet the debt service obligations (interest and principal repayment) for the entire loan term from the outset. This shifts the burden of proof to the taxpayer, requiring detailed financial forecasts and documentation to demonstrate the borrower's ability to repay the loan. A follow-up financing can be considered in the forecast calculation.

Economic Necessity and Alignment with Business Purpose

the loan was economically necessary and used for the taxpayer's business purpose. Investments like parking funds in savings accounts or cash pools, for example, are considered generally not compatible with the core business of the company. The goal is to ensure that intra-group loans are used for legitimate business purposes, not as a tool for profit shifting.

In addition, the provision emphasizes the principle of conformity of the (publicly) available group ratings: the financing expenses are only deductible to the extent the applied interest rate is equal or below the interest rate that would be granted by an external third party to the borrower based on the group credit rating.

While there is an escape clause for individual cases, whereby the taxpayer can prove that a different rating derived from the group rating is aligned with the arm's length principle, the taxpayer must reliably present the creditworthiness assessment, according to the explanatory memorandum of the law. This includes the arm's length quantitative and qualitative factors, as well as the effects of the group's belonging (implicit support).

Classification of routine financial services

Section 1(3e) AStG classifies intra-group finance activities – such as a pure brokerage service, forwarding of a financing transaction, and a typical treasury function – as low-risk routine functions. According to BMF, if a group financing company lacks the ability and authority to control, or bear the risk associated with a financing transaction, it is only entitled to a risk-free return as compensation. Based on the German practice (not stipulated in the regulations, though), these companies' compensation would be calculated using the cost-plus method. Financing functions typically serve as support functions for the core value-adding activities of a business. However, the situation differs when the financing function is a primary activity and a central component of the value creation model, such as in the banking or insurance sectors.

However, taxpayers can provide evidence that the financing company is performing non-routine activities, such as managing substantial financial risks (mainly the credit risks). In such cases, higher margins may be justified. This escape clause requires detailed functional and risk analyses to prove that the company takes on risks beyond the routine scope.

What is the problem?

The reliance on group rating contrasts with OECD's recommendation to apply a stand-alone rating, potentially leading to significant documentation challenges and an increase in tax disputes. A key area of concern is how German groups that both grant and take out loans should deal with this new rule. The wording of section 1 (3d) AStG clearly focuses solely on inbound loans. This should logically also apply in the case of outbound loans. If that happens, outbound loans to foreign companies would become cheaper, resulting in German groups receiving less interest incomes when they grant loans.

In essence, §1 AStG is designed to safeguard Germany's tax base in cross-border transactions involving related parties. A possible application of a stand-alone rating in outbound cases by the German tax authorities is feasible through the escape clause, where the burden of proof would lie with the tax authorities. Additionally, the draft BMF regulations introduce the "Notch-Guide", offering a middle ground between group rating and stand-alone rating.

Actions needed

The new rules in Sections 1(3d) and 1(3e) AStG introduce tighter compliance requirements for intercompany financing relationships.

As these rules apply retroactively from 2024, multinational groups should review and adjust existing financing arrangements to ensure compliance, especially considering the potential for increased scrutiny and disputes with tax authorities. The following working approaches may be inspiring:

1

§ 1 paragraph 3d, no. 2 AStG is a "to the extent" regulation. Therefore, it is recommended to check whether the stand-alone rating might even be better than the group rating. In that case, the more favorable rating applies. This is unlikely to occur in practice very often, but this work still needs to be done.

2

A transactional-based functional and risks analysis is needed for intercompany financial transactions. This analysis is even more critical in case a deviation is applied, e.g. the group rating is not applied, or certain financial activities are qualified as non-routine nature.

3

A detailed transfer pricing documentation should be prepared at the timing of determining the interest, covering the following aspects:

- Whether and how the debt service can be fulfilled (e.g., through a forecast calculation, which may include follow-up financing. The borrower must have expected returns on their financed investment that at least cover the financing costs).

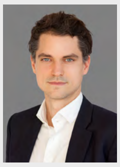
- That the debt service will be provided as agreed, including a fixed repayment date, clear obligations for interest payments, the right to enforce repayment, and other contractual terms.

- The purpose of the provided capital and how it will be used, taking into account the options realistically available to the borrower.

How A&M can help

Taxpayers need to stay alert and monitor German transfer pricing audit practices as they continue to evolve. If you would like to receive more information or discuss the impact of the above, please get in touch with **Clemens Petersen** and **Cheng Qiu**.

CONTACTS



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