

Section 1 – Adjustment of income¹

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

(2) A party is related to the taxpayer if

1. the party

a) holds a stake in the taxpayer, or the taxpayer holds a stake in the party, of at least one quarter directly or indirectly in the subscribed capital, membership rights, participation rights, voting rights or company assets (substantial stake), or

b) is entitled to at least one quarter of the profits or liquidation proceeds from the taxpayer, or the taxpayer is entitled to at least one quarter of the profits or liquidation proceeds from the party; or

2. the party is able to exercise a controlling influence directly or indirectly on the taxpayer, or the taxpayer is able to exercise a controlling influence directly or indirectly on the party; or

3. a third party

a) holds a substantial stake in both the party and the taxpayer,

b) is entitled to at least one quarter of the profits or liquidation proceeds from both the party and the taxpayer, or

c) is able to exercise a controlling influence directly or indirectly on both the party and the taxpayer; or

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

The first sentence, no 3 (a) to (c), above also applies if, in the third party's relationship to the party and the taxpayer, one of the criteria specified in the first sentence, no 3 (a) to (c), above is fulfilled.

(3) When determining the transfer prices corresponding to the arm's length principle (arm's length prices) for business relations as described in subsection (1), first sentence, the actual circumstances underlying the transaction in question are applicable. In particular, it must be taken into account which business functions relating to the transaction are performed by which party involved in the

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

transaction, which risks are assumed in each case, and which assets are used for this purpose (functional and risk analysis). The circumstances as described in the first and second sentences above serve as the benchmark for determining the comparability of the transaction to be assessed with transactions between unrelated third parties (comparability analysis); insofar as possible, the circumstances underlying these transactions are applicable, by way of analogous application of sentences 1 and 2 above. The circumstances at the time when the transaction was agreed must be used as a basis. In principle, the arm's length price must be determined using the transfer pricing method that is most appropriate with regard to the comparability analysis and the availability of values relating to comparable transactions between unrelated third parties. Differences between the circumstances of transactions between unrelated third parties used for comparison purposes and the transaction to be assessed that could affect the application of the transfer pricing method must, insofar as possible, be removed by means of appropriate adjustments; this applies only if it improves comparability. If no comparable values can be determined, the arm's length price must be determined by establishing a hypothetical arm's length price, in compliance with subsection (1), third sentence, from the point of view of the supplier and that of the recipient, using economically recognised valuation methods.

(3a) The application of the arm's length principle frequently produces a range of values. This range must be narrowed down if, following application of subsection (3), sixth sentence, differences in comparability remain. If the values themselves do not provide any indications for a particular narrowing-down, the quartile containing the smallest values and the quartile containing the largest values within the range are not taken into account. If the value used by the taxpayer for the income determination falls outside the range specified in the first sentence above or the narrowed-down range, the median is applicable, unless the taxpayer plausibly demonstrates that a different value within the range better complies with the arm's length principle. When establishing the hypothetical arm's length price in accordance with subsection (3), seventh sentence, the result is frequently an arm's length range between the supplier's minimum price and the recipient's maximum price. In the cases set out in the fifth sentence above, the mean value within the arm's length range must be used as a basis, unless the taxpayer plausibly demonstrates that a different value within the arm's length range better complies with the arm's length principle.

(3b) If a business function is relocated, including the corresponding opportunities and risks as well as any assets or other benefits transferred or licensed along with it, and if subsection (3), seventh sentence, is applicable to the relocated business function because no comparable data can be determined for the relocation of the business function as a whole (transfer package), then the arm's length range must be determined on the basis of the transfer package. This may be disregarded if the taxpayer plausibly demonstrates that neither significant intangible assets nor other benefits were part of the business function relocation. This applies if the transferee enterprise performs the transferred business function exclusively in relation to the transferring enterprise and if the remuneration payable for performing the business function and for rendering the corresponding services must be determined by means of the cost-plus method.

(3c) The transfer or licensing of an intangible asset must be remunerated if it is based on business relations as described in subsection (4) and entails financial consequences for the transferee, the user, the transferor or the licensor. Intangible assets are assets

1. that are neither tangible assets or stakes nor financial assets,
2. that can be the object of a transaction without having to be individually transferable, and
3. that can confer on a party an actual or legal position with respect to that asset.

Determining the ownership or property of an intangible asset, including any rights derived therefrom, is the starting point for establishing which of the enterprises involved in a transaction is entitled to the proceeds from any kind of exploitation of the intangible asset. Insofar as a party related to the owner or proprietor of the intangible asset performs business functions in relation to the development or creation, enhancement, maintenance, protection or any kind of exploitation of the intangible asset, deploys assets for this purpose, and assumes risks, the owner or proprietor must remunerate the related party adequately for these business functions. The financing of the development or creation, maintenance, or protection of an intangible asset must be remunerated adequately and does not confer a right to the proceeds from the financed intangible asset.

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

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

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

b) that are not based on an agreement relating to articles of association; an agreement relating to articles of association is an agreement that directly results in a legal change in the shareholder status;

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

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

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

1. the enterprise's business functions that are performed by its staff (people functions),

2. the enterprise's assets that are needed to perform its designated business functions,

3. the enterprise's opportunities and risks that are assumed on the basis of the business functions performed and assets assigned to it, and

4. adequate equity (free capital).

In a second step, the type of business relations between the enterprise and its permanent establishment, together with the transfer prices for these business relations, must be determined on

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

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