

The new objective of tax audits

Segmentation of loss-making activities within a company

By **Oliver Biernat**

One of the common transfer pricing rules in German law is that German subsidiaries or permanent establishments of a foreign group are expected to make a reasonable profit that meets the arm's length principle. Losses or small profits that are far below the average profits of comparable companies will not be accepted, unless the company is still in the starting phase, which must not exceed 3-5 years, or faces a very difficult situation other comparable companies do not face. The logic behind this is that a third party would close down a loss-making entity after some years. Consequently, it is assumed that the reasons for

continuing a loss-making subsidiary must originate in the relationship between the two parties and therefore transfer prices must be incorrect.

Adjustments by the tax authorities are then usually calculated by applying an average return on investment that represents the average yield of the business sector the company is doing business in, on the turnover. This may lead to substantial additional payments for a company, especially if applied retroactively for several years. Interest and fines will be on top.

In recent times, tax auditors have increasingly started to ask for a segmentation within the audited company. The background is that the economically independent loss-

making activities will be qualified as hobby businesses and not regarded for the tax base. Another idea is that they don't accept loss-making segments and correct their transfer prices, although the company as a whole is profitable.

The German Federal Fiscal Court demonstrated that they follow that view within narrow limits in several fundamental decisions. In the event that you are affected by such actions of the German tax authorities, the disputes should be kept open with regard to an open revision at the German Federal Fiscal court no. AZ X R 27/16. Furthermore, you should keep an eye on the P&L situation of the various segments within your company.

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Advisory, Auditing & Accounting,

Corporate Finance, Fiduciary

& Estate Planning, Tax

Frankfurt am Main, Germany

T: +49 69 256 227 60

W: www.benefitax.de

Oliver Biernat

E: o.biernat@benefitax.de

Benefitax GmbH

Steuerberatungsgesellschaft

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Oliver Biernat

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Oliver Biernat is Founder and Managing Partner of Benefitax. He is a



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German Chartered Accountant, Certified Tax Advisor and Specialist Advisor for International Taxation with more than 25 years of experience. Since 2008, he has chaired GGI's International Taxation Practice Group (ITPG), increasing its size to more than 550 experts from 90 countries in the process.