Germany

Dr. Alexander Voegele and Chunyu Zhang,
NERA, Frankfurt

I. Issue One

Are there any specific tax regulations on business restructurings (in terms of moving activities) in Germany?

Germany has played an important role in the international debate over the taxation of business restructurings, particularly after the codification of the arm's length principle in connection with the transfer of function legislation in § 1(3) of the *Aussensteuergesetz* ("AStG").

As part of its tax reform package in 2008, Germany enacted tax legislation that contains provisions applicable to business restructurings. § 1 of the AStG was amended and paragraph 3 of § 1 now contains general transfer pricing principles, a specific provision on transfer pricing aspects in cases where functions are transferred cross-border, a price adjustment clause, and finally the empowerment for the Federal Ministry of Finance to issue further decrees to this law.

In August 2008, the German Federal Ministry of Finance issued a decree on transfer of functions ("FVerlV")[1]. A detailed draft of the Administrative Guidelines ("VGrS")[2] was released in July 2009, which explains the tax authorities' view on transfer of functions based on case examples and further addresses issues not contained in the AStG and the FVerlV.

According to this new tax regime, if companies choose to relocate business functions from Germany to a related party abroad, considerable exit charges may become payable.

II. Issue Two

If not, then are business restructurings covered by general, transfer pricing, or intangible property regulations? Are arrangements involving cross-border redeployment of functions, assets, and/or risks covered by such regulations?

In light of the response to the above question this issue is not applicable to business restructurings in Germany.

III. Issue Three

Does Germany impute a compensation/exit charge upon business conversion, say from a full-risk marketing distributor to a limited/low risk distributor or agent, only when there is a transfer of intangibles (say marketing intangibles in the form of customer lists, distribution networks, etc.) along with flight of functions; or even if there is mere flight of functions without any transfer of intangibles attached to the functions?

The exit tax could be applicable if operative functions, such as production or distribution, are transferred out of Germany, or where such functions are reduced, as in the case of transforming a German full-fledged production entity into a contract manufacturer.

Since the German regulation provides a broad definition of the "transfer of function," the taxpayer should understand two important definitions—"function" and "transfer of function"—introduced in the regulation before determining if they will be subject to the exit tax.

According to § 1 paragraph 1(1) of the FVerlV, a function is defined as an aggregation of operational tasks of the same kind that are performed by certain units or departments of a company. It is an organic part of a company, but need not constitute a branch of activity for tax purposes. A transfer of function occurs when a business function, including related business opportunities and risks, as well as any other benefits associated with the transferred or licensed assets, is moved to a different location. A transfer of function can also occur where the receiving company assumes the function only for a limited period of time.

However, this rather broad definition of the "transfer of function" is narrowed by several exceptions. For example, the new regulation does not apply to the following cases[3]:

- Where the receiving company performs the functions exclusively for the transferring company and is remunerated with a cost plus method, and no material intangibles have been transferred;
- Where only assets are transferred or services are performed that are not considered as economically belonging to a function and its relocation; or
- Where employees are seconded, as long as the secondment cannot be considered as economically belonging to transfer of functions.

Furthermore, no transfer of function takes place if the transfer of intangibles is not "material." The VGrS specify that no material transfer occurs if the revenue of the transferring company does not decrease more

than EUR1,000,000 or 10 percent of the last turnover within a time period of five years (§ 2.1.6.2.4 of the VGrS).

In addition, if the receiving company expands its role without a direct reduction of the functions of the transferring company, i.e., the expansion of the receiving company has no effect on the future earnings of the transferring company, then the transaction is defined as duplication and no transfer has taken place.

The German tax authorities impute a compensation/exit charge upon business conversion, such as from a full-risk marketing distributor to a limited/low risk distributor or agent, when there is a transfer of intangibles (e.g., marketing intangibles in the form of customer list, distribution network, etc.), along with the flight of function. In the case of a transfer of function without any transfer of intangibles attached to the function, an exit charge could also be applicable as far as the function of a full service provider is shifted to a foreign principal. This view of the tax authorities may be not covered by the legislation.

IV. Issue Four

Does Germany recognise "workforce-in-place" as constituting an intangible, thus requiring payment of compensation on its movement in the course of a business conversion?

The German regulations on transfer of function do not specify whether "workforce-in-place" itself can constitute an intangible and whether its movement triggers a requirement of compensation payment. Actually, as discussed above, the German legislation introduces a broad and ambiguous definition of the terms used in the cases of transfer of function.

According to § 1 paragraph 3(9) of the AStG, a transfer of function is assumed if "a function including . . . the transferred or leased assets and other benefits" is transferred. § 1 paragraph 2 of the FVerlV provides a further detailed definition of when a transfer of function takes place: "A transfer of function . . . occurs when a company conveys assets and other benefits . . . to another related company or allows it to make use of such assets and other benefits. . ." From this explanation it can be understood that without a transfer or license of assets and other benefits, a transfer of function does not apply, even if business opportunities and risks are transferred.[4]

In order to determine whether "workforce-in-place" can constitute an intangible, we need to start with the definition of intangibles under the German laws. Regarding what is actually meant by "intangible asset", the German legislations and case law provide, however, no universal and abstract definition. Under section 266.II.A of the German Commercial Code ("HGB"), "intangible asset" is identified as concessions, industrial property, and similar rights and assets, as well as licenses for such rights and assets. Under § 3.1.2.3 of the 1983 Administrative Guidelines[5], industrial property rights, design patent rights, copyrights, non-protected inventions, plant variety rights, business or trade secrets, or similar rights or benefits are listed as examples of intangible assets. In most cases, the Federal Tax Court only gave examples without providing a more general definition.

In addition to intangible assets, another important term used in the German legislation that could be linked to "workforce-in-place" is "other benefits". So far there is no legal definition of what "other benefits" actually means. But clearly they should be neither business opportunities nor assets, as "other benefits" are termed here as a key criterion in a separate manner. Taking into account that the objective of a transfer of function is that the receiving company can exercise the transferred function in the future, the "other benefits" could therefore be understood as practical benefits that can be valued separately as part of the total value, but without being able to constitute an independent asset[6].

In short, there is no general rule to determine whether "workforce-in-place" itself constitutes intangibles or other benefits within the scope of the German regulations. In practice, it should be analysed case-by-case to what extent know-how is transferred abroad. Knowledge of the expatriate is not subject to the exit tax. But any knowledge, which can be transferred separately from the persons who have developed this knowledge, has to be qualified as know-how and therefore has to be taxed.

Furthermore, one has to segregate between the know-how which is transferred and the knowledge of how to transfer this IP. For example, the manufacturing know-how or marketing know-how of a company can be transferred by external consultants with their own know-how of transfers, as well as by internal restructuring units with their restructuring know-how. While the former, i.e., the know-how of transfers, can be charged on the basis of the CUP or cost-plus methods, the transferred know-how should, however, be taxed on the basis of future income or cash flows of the recipient.

Therefore, in such cases the only criteria to judge whether a movement of "workforce-in-place" triggers an extra compensation requirement are the shift of IP. It is actually irrelevant if a group of expatriates is sent abroad or if only single persons are sent. Nevertheless, the transfer of a group of expatriates may be an indication for further analysis to find out if know-how is transferred.

V. Issue Five

Does Germany disregard business restructuring, which is driven entirely by tax savings, without having any other commercial justification or rationale?

Germany does not disregard business restructuring, which is driven entirely by tax savings, without having any other commercial justification or rationale, but will assume deemed dividend distribution, deemed contributions, or a correction based on § 1 of the AStG. The existing law on actions, which are driven entirely by tax savings, without having any other commercial justification or rationale (§ 5 of the German general tax code ("AO")), has not been applicable for more than a half century.

VI. Issue Six

Do the German tax authorities view risks as only transferring with the relevant people/risk managers? What do the German tax authorities place more reliance on, ex-

amination of contractual terms or actual behaviour/conduct of the parties?

First, two situations regarding the risk have to be distinguished:

- Risk as an element of a function, e.g., distribution or manufacturing; and
- Taking over risk of other parties, e.g., insurance functions.

When risk is only an element of a function, it is only important for comparability purposes. That means the function (e.g., distribution) can only be compared with comparables bearing the same risks.

Under the second situation, where risk is taken over without transferring the relevant people/risk managers, it could be acceptable as far as sufficient capital is transferred to this location accompanying the risk and can be used effectively. In such a case the risk of capital has to be remunerated adequately. If relevant people/risk managers are also transferred, then their function has to be remunerated in addition to the risk of capital. These aspects need to be considered by adjusting the comparable data.

A full remuneration, such as for an insurance or re-insurance company, is generally based on the premise of a transfer of relevant people/risk managers. For instance, when a foreign unit (e.g., a captive) is taking over risks of other group companies, significant people should also be transferred. If not, only the risk of capital can be charged by the captive. In the case where only capital is transferred, a split of the remuneration between the place of capital and the place of labour would be necessary.

§ 1 paragraph 3 (9) of the AStG states that a transfer of function occurs when "a function, including the associated opportunities and risks" is transferred. As a result, opportunities and risks are regarded here as a part of the function, and the transfer of risks is recognised as a criterion for the existence of a transfer of function. However, the risks discussed here may only lead to exit taxation, if the function can and should be remunerated due to the assumption of risk. In other words, if the transferred function (e.g., distribution) is getting a higher remuneration due to higher associated risk, the exit taxation of the function increases correspondingly.

In practice, during the course of administration, the German tax authorities place reliance on actual behaviour and conduct of the involved parties as well as on contractual terms, no matter which is more problematic for the taxpayer. Contracts, which lead to German profits, should be fulfilled, irrespective of the actual behaviour. In contrary, contracts leading to high profits in tax havens will lead to add-backs by tax authorities or to corrections if the actual behaviour is different.

In general, when functions and risks are transferred to other countries, actual behaviour and conduct of the parties, instead of contractual terms, are more important in the eyes of the German tax authorities.

VII. Issue Seven

Are there any special/contemporaneous documentation/reporting requirements for extraordinary transactions and business restructurings, including justifying the rationale for business restructuring, expected benefits, testing of the compensation paid/received, etc.?

While the OECD discussion draft on business restructuring simply requires the application of the arm's length principle on a general basis without giving specific guidance, the German regulations on transfer of functions specify the detailed application of the arm's length principle including a hypothetical arm's length method and the related calculation schemes.

A. Transfer package

In cases where a transfer of function applies, the taxpayer has to determine the range of agreement based on the transferred function as a total value (a so-called "transfer package"). The transfer package should be based on the discounted value of the transferred earning potentials. This implies that instead of valuing each asset individually, the function, including all tangible and intangible assets as well as opportunities and risks, has to be valued as a whole. Not only each individual asset but also the underlying benefits resulting from the transfer itself form part of the transfer package and are considered when determining the tax basis of the function[7]. However, an escape clause allows the valuation of individual assets in cases when the following conditions are met:

- Intangibles are not "essential" for the transferred function ("qualitative measure", § 2.1.5 of the VGrS);
- The intangibles or benefits constitute less than 25 percent of the overall value ("quantitative measure", § 2.1.5 of the VGrS); and
- A material intangible will be valued separately.[8]

Furthermore, a valuation of individual assets is also permitted if the taxpayer presents *prima facie* evidence that, compared to the transfer package, the total value of the individual assets accurately reflects the arm's length principle (§ 2.2.3 of the VGrS), i.e., is in the range of values for the transfer package described below.

B. Hypothetical arm's length method

With respect to the transfer pricing methods, § 1 paragraph 3 of the AStG differentiates between fully comparable third party data and partially comparable third party data. That means if fully comparable data is available for the transaction, the traditional OECD methods are preferred (§ 1 paragraph 3(1) of the AStG). For cases where only data with limited comparability is available, an appropriate method should be used (§ 1 paragraph 3(2) of the AStG).

In cases where neither fully nor partially comparable data can be identified, which is usually the case in practice, the taxpayer has to use a so-called "hypothetical arm's length method" to determine the arm's length price of the transaction (§ 1 paragraph 3(5) of the AStG).

Using this method, the arm's length range for a transfer of function is determined by the minimum price of the transferring company and the maximum price of the receiving company. The minimum price is equal to the profit potential of the transfer package that the transferring company intends to achieve for a certain period in the future, plus closing costs. And

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the maximum price is equal to the profit potential of the transfer package that the receiving company intends to achieve for a certain period of future years.

For the profit potential, according to the FVerlV, net (cash) flows after tax should be considered. Because of different production costs, labour costs, synergy effects, and tax rates, the profit potential of the transferring company and the receiving party differs in practice, and mostly depends on the assets, chances, risks, and other advantages of a transfer package. The following factors are generally relevant and need to be taken into account in evaluating a fair minimum as well as the maximum price:

- Legal and economic ownership of the transfer package;
- Useful life of the transfer package;
- The contributions of both parties; and
- Other elements such as the market development, the economic situation, gestation lags, closing costs, and appropriate amortisation rates.

In addition, synergy effects and location savings are also of special importance and should be reflected in the analysis.

C. Bargaining value

After having calculated the minimum price of the transferring company and the maximum price of the receiving company, the German regulation assumes that the fair market value of such a transaction is the mean of the minimum and maximum price if no better evidence can be shown. It is principally up to the taxpayer to prove that another price than the mean better reflects the arm's length principle. Better evidence can be illustrated based on the individual bargaining power of both parties.

VIII. Summary

Apart from the USA, Germany is one of the first OECD countries to have introduced extensive legal regulations for the taxation of cross-border business restructurings. In the meantime, Working Party No.6 of the OECD's Committee on Fiscal Affairs has published a draft paper analysing the effects of restructuring on transfer pricing issues. Although there is still a great debate about whether the Germen regulations conflict with the internationally agreed principles, the taxpayers that transfer the functions out of Germany will still have to live with the reality of the new German rules and prepare themselves as well as possible.

Alexander Voegele is Chairman of the advisory board of NERA Economic Consulting GmbH in Frankfurt. He can be contacted by email at: alexander.voegele@nera.com
Chunyu Zhang is a former economic analyst at NERA Frankfurt. She can be contacted by email at: chunyu_zhang2001@hotmail.com

NOTES

[1] The *Funktionsverlagerungsverordnung*, published on August 12, 2008.
[2] *Grundsätze der Verwaltung für die Prüfung der Einkunftsabgrenzung zwischen nahe stehenden Personen in Fällen von grenzüberschreitenden Funktionsverlagerungen*, published on July 17, 2009.
[3] Förster, H., "Germany's Transfer Pricing Provisions: A Conflict with Internationally Agreed Principles?", *BNA Tax Management 18 Transfer Pricing Report* S-3, 01/28/2010.
[4] Borstell, T and Wehnert, O.,Chapter Q: Funktions- und Geschätsverlagerung, in Voegele, A./Borstell, T./Engler, G.: *Handbuch der Verrechnungspreise,* 3rd version, Beck Munich, 2010.
[5] *Grundsätze für die Prüfung der Einkunftsabgrenzung bei international verbundenen Unternehmen – Verwaltungsgrundsätze*. Fral Tax Office, February 23, 1983, BStBl. I at 218
[6] Brüninghaus, D. and Bodenmüller, R., *Tatbestandsvoraussetzungen der Funktionsverlagerung*, DStR 2009.
[7] Voegele. A., *Bewertung von Transferpaketen bei der Funktionsverlagerung*, DStR 2010.
[8] Legislation proposed in March 2010