Transfer of German functions and tax deductibility in China

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A discussion of tax treatments in China

As part of its tax reform package in 2008, Germany enacted tax legislation that contains provisions applicable to the relocation of business ("FVerlV").[1] It applies to all "transfer of functions" out of Germany. In July 2009, the German Federal Ministry of Finance released draft administrative guidelines ("VGrS")[2] that explain the tax authorities' view on the transfer of functions on the basis of case examples and addresses issues not contained in the Auszersteuergesetz ("AStG") and the FVerlV.

The implementation of the new regulation raises challenges for German multinational companies that seek to expand their presence in the global marketplace. Along with an increased administrative burden due to additional documentation standards, the companies may face uncertainty over tax treatments in the receiving countries while the risk of disputes between tax authorities will be increased on an international level.

While pursuing China as both a growth market and a market for low-cost labour, more and more German companies conduct an increasing number of cross-border transfers of business functions from Germany to China. Germany's new tax regime undoubtedly raises the question of how to address the issues related to the tax treatments of transferred functions in Germany and China. In addition to uncertainty about the amount of tax, the companies may have to face non-deductibility of the payments in China. Any disagreement between tax authorities will lead to double taxation. In addition, any other potential tax exposures, e.g., withholding tax, business tax, and customs duties need to be taken into account by taxpayers in relocating their business.

I. Transfer of functions

The German regulation provides a broad definition of a "business function" transferred out of Germany to a related party. A transfer of functions occurs when business functions, including related business opportunities and risks, as well as any other benefits associated with the transferred or licensed assets, are moved to a different location.[3] A transfer of functions can also occur where the receiving company assumes the function only for a limited period of time.

Anytime business functions are transferred, a compensation payment has to be made. The transferred function has to be valued based on its total value (a so-called "transfer package"). The prices may be determined for individual assets rather then for the transfer package if the transferred function does not include the transfer of essential intangible assets and benefits, if the overall result of the individual assets transferred complies with the arm's length principle, or if any embedded intellectual property can be defined and valued separately ("Escape Clauses"). The valuation should be based on the discounted value of the transferred earning potentials. The function – including all tangible and intangible assets as well as opportunities and risks – has to be valued. Each individual asset, as well as the underlying benefits re-

sulting from the transfer itself, form part of the function and are considered when determining the tax basis.

II. Transaction forms

Generally, there are five types of transaction or remuneration forms if the functions are transferred from Germany to China:

- sale
- licensing
- leasing
- integrated transfer pricing system
- transferring functions to a contract manufacturer or contract services provider.

A sale is the transfer of ownership, which leads to immediate exit taxation. Alternatively, the transferring company may enter into a license agreement or a lease agreement with the receiving company. Under the license agreement, the licensor authorises the licensee to use such rights in return for an agreed payment (royalty). The right to use the intangibles is normally granted only for a limited time, and the licensor remains the owner of the intangibles. Some functions may be leased.

In addition to these three transaction forms where the function will be remunerated on a separate basis, the taxpayer can integrate the compensation in its transfer pricing setting. That means the taxpayer can appropriately adjust the transfer prices of goods and services transferred between the transferring company and the receiving company so that an arm's length compensation for the transferred function can be properly reflected in its daily intercompany transactions.

Finally, the taxpayer can transfer manufacturing functions to a contract manufacturer, or shift the specific services to a contract service provider. In this case, such actions do not lead to a transfer of intangibles and no exit tax for the transfer of functions should be applicable.

Principally, the taxpayer is free to decide to structure their transactions.[4] In the absence of contractual terms on transfers, the tax authority's decision as to whether the transaction is a sale or another form should be based on the original intention of the parties at the beginning of the transaction (e.g., based on the meeting minutes, internal memorandums, etc.).

Although companies can freely choose the form of their transactions, it is not always an easy task to decide which form is best suited to their circumstances. Understanding the tax consequences is therefore a critical step in the planning stage. When deciding upon a transfer of function from Germany to China, the following issues have to be taken into account by taxpayers:

- tax deductibility of the remuneration for corporate income tax purposes
- the time of recognition of income in Germany and that of deductions in China
- other tax exposures, e.g., withholding taxes, business taxes, as well as customs duty issues.

In the following paragraphs, these issues will be discussed in detail for each form from a Chinese tax perspective.

III. Possible tax treatments of the remuneration in china

A. Sale

If the transaction is structured as a sale, the purchase price of the function may need to be allocated to certain assets based on their respective fair value. Allocating the purchase price to the various assets being purchased can affect the amount of taxes the transferee will have to pay each year for the next several years. Therefore, allocation of tangible and intangible assets for accounting purposes should also take into account tax considerations in such cases.

In calculating the Chinese transferee's taxable income, the taxpayer can deduct depreciation and amortisation expenses on their acquired tangibles and intangible assets if such charges are calculated in accordance with the relevant stipulations including:

- use of a straight-line method for depreciation and amortisation,
- the intangible assets serve taxpayer's business activities,
- the purchased intangible assets are amortised over their useful life prescribed under relevant laws or contracts. If no useful life or benefit period is specified, the amortisation shall be no less than 10 years.

One issue raised by structuring the transaction as a sale is that it requires the amortisation of intangible assets and the depreciation of fixed assets over several years. This results in an asymmetry between immediate recognition of taxable income in Germany in the case of a lump sum payment for the function and the deferral of deductions caused by amortisation and depreciation in China. Because of this significant tax disadvantage, structuring the transfer of function as a sale is seldom in practice. It may make sense in cases of immediate loss utilisation in Germany.

B. Licensing and leasing

Licensing and leasing are other ways for German companies to structure their transactions, especially in order to overcome the asymmetry problem mentioned above. The type of licensing agreement or leasing agreement will leave the transferring company in a position to realise a profit in the future rather than generate immediate revenue. Additionally, a royalty payment assessed on licensee's revenue or profits can be considered as a valid form of an adjustment clause

defined in the FVerlV, which effectively increases the flexibility of the taxpayers.

According to the Chinese Corporate Income Tax (CIT) Law, in principle, the Chinese transferee can deduct reasonable expenses (including royalties and rentals paid to its related party), which are actually incurred and are related to the generation of income for CIT purposes.

When considering the tax treatments of royalties and lease rentals, the first step is always to clearly understand their definitions under the Chinese tax regulations. Under some Double Tax Agreements (DTA), including the DTA between China and Germany, income received as consideration for the use of industrial, commercial, or scientific equipment is also defined as royalty.[5] Additionally, the royalties also include the payment for information concerning industrial, commercial, or scientific experience. A recent circular of the State Administration of Taxation, Circular 507, further elaborates on the definition of this type of information, which should be interpreted as "proprietary technology," which generally refers to the undivulged technical information or data that is necessary for the industrial reproduction of a product or process.[6] The key attributes of proprietary technology include:

- the licensor agrees to provide technology to the licensee and neither participates in the implementation of the technology nor guarantees the outcome or result, and
- the licensed technology normally already exists, or is developed at the request of the licensee and licensed under agreements that restrict the use of the technology.

Obviously, this definition is more consistent with the explanation of proprietary technology in the Commentary on Article 12 of the OECD Model Tax Convention. To avoid misunderstandings and disputes with the tax authorities, the taxpayer needs to clearly explain the characteristics and scope of the royalties. This should reduce the potential risk of double taxation.

In general, royalties or rentals derived from China by non-tax residents shall be subject to 10 percent withholding income tax (WHT) and five percent business tax (BT) under the Chinese tax law and the tax treaty. Since 2008, the BT is no longer allowed to be deducted from the gross income when computing WHT on royalties or rentals.[7]

In circumstances where a lessee leases equipment from outside of China, the lessee is also required to pay customs duty and import VAT on the equipment leased. In addition, royalties may also be subject to customs duty. According to the General Administration of Customs [2006] No. 148, royalties satisfying the following conditions should be included in the imported goods' dutiable value:

- royalty is related to the imported goods
- royalty payments are a precondition for the seller to export and sell the goods inside China's customs border

Under these conditions, the duty basis might be increased inadvertently if the royalty is deemed a "condition of sale". However, there should be no major impediment to structuring the relocation of functions in a way that avoids customs duties. First of all, it is important to ensure that any royalty agreement is carefully scrutinised from a customs perspective before it is introduced. The elements covered under the royalties and their relation to the imported goods should be clearly identified and defined to minimise the potential dispute with Chinese customs.

C. Integrated transfer pricing systems

Integrating the compensation in the taxpayer's current transfer pricing system is another alternative. In practice, this alternative is actually more preferable than the previous three forms where the function needs to be separately remunerated. This remuneration form is especially suitable to highly vertically integrated businesses, e.g., the automotive industry. The automotive industry usually adopts vertically integrated strategies by technical developing, manufacturing, and marketing, and its supply chain spreads over multiple countries and tax jurisdictions.

Because of its high level of vertical integration between and within different functions and locations, there are many intercompany transactions of products and services between the transferring company and the receiving company. By applying the residual profit split method, the taxpayer can combine the compensation for the transferred function in the pricing of the products or services transferred between the related parties, e.g., adjusting the transfer prices downward for the products delivered from China to Germany or upward for the products delivered from Germany. In this case, the taxation of the remuneration is based on the regular operating income from the transfer prices, and the withholding tax and business tax imposed on passive incomes can be avoided.

One important point in this context is that the discount rate and other risk factors associated with the development and amortisation of the transferred intangibles should be correctly taken into account in planning and determining the transfer prices. Furthermore, in order to justify the arm's length nature of the intercompany transactions, the taxpayer needs to perform a sound economic analysis of their transfer pricing system.

In summary, integrating the compensation for the function in the taxpayer's transfer pricing system is easier and more flexible than an isolated remuneration. Different from adjusting the transfer prices downward, the most significant problems associated

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with adjusting the transfer prices upward are the customs duty issues. If the products delivered from the German company to its Chinese related company are subject to high Chinese customs duties, integrating the compensation in the transfer prices of products can create a high customs duty burden for the taxpayer.

In addition to daily issues, year-end adjustments could be another main challenge faced by the taxpayer. Retroactive year-end adjustments of the intercompany transfer prices (both upward and downward) is allowable for transfer pricing purpose; post-transaction downward retroactive adjustment of the customs duties is, however, generally impossible in practice.

To mitigate these problems and to provide more flexibility from a customs perspective, taxpayers can sometimes combine two or three transactions and remuneration forms depending on the tangible and intangible assets transferred. For example, taxpayers can develop a system in which the function is valued through downward adjustments of the prices for products imported from China and retroactive year-end adjustments are made in the form of royalties. While the royalties provide taxpayers more flexibility in making compensation adjustments, the former enables the taxpayer to easily price the intercompany transactions between related parties and reduce the withholding and business tax exposures to some extent.

D. Transfer functions to a contract manufacturer or contract services provider

As discussed previously, no exit tax will be applied if a routine function, such as contract manufacturing, is opened in China that performs its activities towards a German principal and that will be compensated on an arm's length cost-plus basis. This is also applicable for the cases in which a Chinese commissionaire or sales agent is established.

However, their contract characteristics could be challenged by the Chinese tax authorities, who are questioning if the functions performed and risks assumed by the Chinese contract manufacturer or distributor are actually only limited to a routine nature. If the entity is finally identified as a non-contract manufacturer and the tax authorities require more profit allocated in China, it will simultaneously trigger an exit tax in Germany. Correspondingly, the German tax authorities will conclude that, in addition to tangibles, some intangibles have also been transferred to China. This will make the situation more complex and therefore require the taxpayer to make careful preparations before discussing and negotiating with the tax authorities in both countries.

IV. Conclusions and practical recommendations

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. One difference between these rules and the approach taken in the OECD draft report is the valuation of a "transfer package". Compared to the German regulation, the OECD draft focuses on the pricing of individual assets.

In China, there are no specific rules or circulars relating to taxation of cross-border business restructuring. It can be expected that Chinese tax authorities' understanding will be closer to the guidance presented in the OECD draft. However, 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. When planning a transfer of functions from Germany to China, the taxpayers should take the following into consideration:

- Clearly classify and define the functions and the associated intangibles that are transferred from Germany to China.
- Define a sound and sophisticated compensation system.
- Include an adjustment clause in the agreement to increase the flexibility to a potential downward adjustment of the transfer value.

In the midst of these uncertainties, taxpayers may consider approaching tax authorities in Germany and China for a bilateral advance pricing agreement (APA). The APA is an excellent tool for taxpayers to manage their transfer pricing risk and eliminate double taxation. It also benefits the Chinese and German tax authorities, as they provide upfront clarity and certainty on a company's transfer pricing arrangements, helping to secure future tax revenues via a collaborative approach rather than an adversarial tax audit approach.

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NOTES

[1] The Funktionsverlagerungsverordnung (FVerlV) was published on August 12, 2008.
[2] Grundsätze der Verwaltung für die Prüfung der Einkunftsabgrenzung zwischen nahe stehenden Personen in Fällen von grenzüberschreitenden Funktionsverlagerungen.
[3] § 1 (3) sentence 9 of the Foreign Transactions Tax Law.
[4] § 2.4.1 of the VGrS.
[5] Article 12 of the Agreement Between the People's Republic of China and The Federal Republic of Germany for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital, concluded in 1985.
[6] Article 2 of Guoshuihan [2009] No. 507.
[7] According to Guoshuifa [2009] No.3 released by the Chinese State Administration of Taxation in January 2009 and Caishui [2008] No.130.