GERMANY

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Relocations of functions and adjustment payments

Germany has been an early indicator of how the OECD's new rules on so-called 'hard-to-value intangibles' may look when implemented at the national level. Already in 2010 Germany enacted rules on 'relocations of functions' (*Funktionsverlagerung*). These rules have given rise to many disputes in the field of tax audits throughout Germany, and many lessons have been learned which are pertinent in light of the new OECD rules.

Similarities between the new OECD rules to the existing German ones

In essence, German tax law prescribes that whenever a – loosely defined – 'function' is relocated within a multinational company from Germany to another country, the net present value of the income of the functional income transferred needs to be taxed in Germany. Importantly, the rules stipulate that independent enterprises would agree on a 'adjustment clause'. If the tax payer does not present an arm's-length adjustment clause, the rules stipulate that effectively there would need to be a revaluation of the overall transfer within 10 years, and potentially an adjustment if a significant deviation is found.

Both the very loose definition of 'functions' as any commercial activity, (not necessarily tied to an organisational unit of the company), and the stipulation of the adjustment clause are also cornerstones to the OECD rules on hard-to-value intangibles. By the OECD's definition, an intangible is anything that is neither a financial nor tangible asset, but which would be remunerated between independent parties. This is quite a loose definition. Furthermore, the OECD stipulates that when an intangible is transferred that was "hard to value" (and, almost by definition, many intangibles fall in this category), there should be an automatic price adjustment after 10 years.

The trouble with loose definitions

Germany's example shows the problem that the OECD's loose definition of intangibles can entail: If almost anything could be an intangible, it becomes very hard for taxpayers to decide whether or not one has been transferred in even very small and simple changes to intercompany transactions.

For example, while the German regulations were originally aimed at whole factories being transferred with their underlying IP, the loose definition meant that today even the production of individual goods might be considered to fall under these rules. We have seen cases where the tax payer had manufacturing activities in Germany and France, and initiated a program such that both plants would share the production of some goods to better capacity utilisation. The German tax authorities claimed that the production of these goods constituted a function that was now partially transferred and calculated a significant adjustment.

In another case, a German company expanded their business by opening a distribution entity in Austria. The company previously had no dedicated sales activity for that market, but some deliveries were made to customers from Austria who had approached the company themselves. To the company's astonishment, the German tax authorities thus stipulated the existence of an export.

As these examples show, a loose definition unsurprisingly increases the scope for disputes. In either case, the taxpayer is well advised to very clearly present arguments about what does or does not constitute a transferred function or intangible in advance. It was possible to clarify these things in the audit, but only with considerable effort.

The problem with adjustment clauses

What will the OECD's stipulation of adjustment clauses for hard-to-value intangibles mean for taxpayers? Germany offers some rather bleak lessons regarding actual adjustment clauses. On the other hand, appropriate use of valuation techniques can help to reduce the issues somewhat.

In practice, adjustment clauses are hugely impractical: The valuation of an intangible (or a function) is generally based on expectations of future income, which is inherently uncertain. When a valuation is based on a single projection of income, and a check is made after ten years against the actuals, this often results in a very significant deviation, and therefore adjustment. But additional payments 10 years after the fact often prove to be very difficult in practice. What happens if an internal reorganisation meant one of the parties was sold to a different holding in the group in the meantime? Would the purchase price need to be adjusted? What if there had been a profit participating loan? What if there had been a profit participation by employees? In practice, adjustments for the income of up to 10 years ago leads to many problems.

However, there is silver lining in the lessons from the German relation of functions as well: The need for adjustment payments can be significantly curtailed when using appropriate economic tools for the valuation of the function – or intangibles. Mostly importantly, the valuation should not just take a single projection into accounts, but also reflect known risks and variations. Specifically, valuation techniques that are based on a variety of different future profit projects are much more robust, as better or worse cases are already reflected in the determined value.

We have used a number of different economic valuation methods, most importantly 'Monte Carlo' simulations that are based on appropriately reflected business scenarios. While these methods require more economic input than a plain vanilla discounted cash flow analysis, it does significantly reduce the uncertainty that is introduced by the adjustment clauses of the OECD and the German legislation alike.

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