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tax notes international

Volume 48, Number 1 ■ October 1, 2007

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by Wolfgang Kessler and Rolf Eicke

Reprinted from *Tax Notes Int'l*, October 1, 2007, p. 53

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Featured Perspectives

Out of Germany: The New Function Shifting Regime

by Wolfgang Kessler and Rolf Eicke

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This is a short tale of those who play the game and those who don't. The name of the game is "function shifting," often played moderately, sometimes aggressively, by multinational corporations, but always under the alert eyes of the tax authorities. Those who play the game argue that function shifting (that is, moving production and know-how abroad) is necessary in a global market environment to build up market volume abroad. Frequently, it is simply used to cut costs. Those who do not participate in this game are small and midsize companies, which are subject to lifelong taxation on any asset they purchase or develop, with no chance of relief or at least a lower tax rate.

Function shifting has a bad reputation, as it is widely classified as a tool for aggressive tax planning, sharing this fate with excessive interest payments and transfer pricing "management." For the last two tax planning measures, the German tax regime offers new thin capitalization rules, the *Zinsschranke,*[1] as well as a fairly new and elaborate transfer pricing regime. However, lawmakers haven't addressed function shifting as such until now. Historically, this subject matter was dealt with in regulations and by case law.

As part of the 2008 corporate tax reform package, the German government will codify strict rules that apply to those who shift functions out of Germany. Germany then will join Brazil as the only two countries in the world that have enacted specific function shifting provisions. Other countries like the U.S. address these issues by general tax or transfer pricing rules.[2]

The new legal framework will be embedded in a so-called *trias solution*. First, the legislative statute will enter into force on January 1, 2008, followed by an administrative regulation and a circular. The tax authorities, who have been struggling with this topic for years, will issue the regulation and circular. The upcoming circular has a long history. In 2001 and 2002, two draft versions were halted because of new developments in case law.

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[1]*See* Kessler and Eicke, "New German Thin Cap Rules — Too Thin the Cap," *Tax Notes Int'l*, July 16, 2007, p. 263.

[2]IRC section 482, Treas. reg. section 1.482.

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The time of inaction is over; the reasons why the German government and the tax authorities are eager to gain an edge on this issue are twofold:

- first, to help finance the corporate tax rate cut, with the estimated extra revenue of €1.77 billion per year; and
- second, to keep the German tax base from eroding as German multinational companies keep expanding and transferring both business and know-how abroad.

To pursue this goal, the legal framework regarding transfer pricing plays a key role when taxing multinational companies. Confirming what tax professionals already know, Bernd Niess, tax director of DaimlerChrysler AG (to be renamed Daimler AG in fall), says that "transfer pricing is the tax issue of the millennium." The shifting of intangible assets turns out to be one of the most sensitive and high-stakes issues in modern international tax law. The tax authorities watch the shifting of intangible assets very closely. The reasoning goes as follows: After supporting the development with tax deductions, the tax authorities do not want to miss out on their share when the very same assets generate high yields abroad.

Legal Framework

The main purpose of the new regime is to tax the value of the hidden reserves embedded in the function that is moved abroad. This includes both the current value and the future value.

According to the new statute, a function is an "aggregation of similar business tasks including the associated chances and risks, which are performed by specific positions or branches of a company." Examples are production, distribution, services, and research and development activities. A function shift in the sense of section 1(3) (sent. 9) AStG (*Aussensteuergesetz*, or the Foreign Tax Act) occurs if a function that used to be performed by and attributed to a domestic company is given away to a related company.

There are different kinds of function shifting:

- a complete transfer of a function, including all profit chances and risks as well as the decision-making power (function outsourcing);
- the transfer of a part of a function, including the associated chances and risks (function meltdown);
- the transfer of the possibility to physically perform a function by retaining the profit chances and risks as well as the decision-making power (function separation); and
- a transfer of an extended function (function extension).

Valuation and Method Hierarchy

As a rule, the valuation will be conducted on the basis that the function is transferred in total with all its associated chances and risks ("transfer package"). The determination of the value equals the discounted value of the current and future earnings potential for both the transferring company and the receiving company. Thereby, the impact and consequences of the function shift must be assessed applying a function and risk analysis that encompasses goodwill, location advantages and disadvantages, and synergy effects, among other things.

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With the introduction of the transfer package, the German legislature abandons its concept of an individual asset valuation. In only two instances can the taxpayer rely on a different price than the earnings potential of the transfer package ("escape clause"):

- if no essential intangible assets and benefits are transferred, meaning less than 5 percent of the total value of the transfer package; or
- if the total amount of aggregated single-priced transferred assets and services equals the arm's-length price when compared with the computation as a transfer package.

The escape clause makes the already difficult computation even more so, since the taxpayer is forced to calculate the price of the transfer package in any case before proving that another price is more probable than the arm's-length price.

The new regime establishes a strict hierarchy between the applicable methods that is in contrast to the previous opinion of the tax authorities.

First, the taxpayer has to provide for a comparable arm's-length price when comparables are available. If necessary, the price must be adjusted in accordance with a function and risk analysis. Methods of choice are the comparable uncontrolled price method, the resale price method, or the cost-plus method. Yet comparable uncontrolled prices are rare, and in practice, the method applies in only 5 percent of the cases. If, however, several comparable prices are obtainable, the taxpayer can choose the most favorable within a range of prices.

Second, if a comparable arm's-length price cannot be provided for, function- and risk-adjusted limited comparables like cost-plus rates or gross profit margins must be used. The data can either be derived

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from own accounts or from databank research. The range must be narrowed if several prices are available.

In the absence of a comparable price or a limited comparable price, the taxpayer must compute a hypothetical arm's-length price. This first-time codification of the hypothetical arm's-length price is based on the case law on hidden profit distributions. Thereby, the regime simulates a situation with mutually complete information between a hypothetical buyer and a hypothetical seller and applies the "doubled diligent and conscientious businessman test." The so-called scope of consent between the two parties is created by the maximum price a diligent and conscientious buyer would pay and the minimum price for which a diligent and conscientious seller would offer the asset. Each price is based on a discounted cash flow computation. Within that scope, the most probable price is relevant. If the taxpayer does not provide for a most probable price, the median of the scope of consent is applicable. The legal presumption that the median is the acceptable price is a major disadvantage for taxpayers and is internationally unusual, as it is common sense that any price within the range is an acceptable price.

Price Adjustment Clause

Furthermore, the regime deems that unrelated third parties would include a price adjustment clause in their contracts if future profits are uncertain (section 1(3) (sent. 11) AStG). If the parties have not agreed on a price adjustment clause, the German tax authorities can correct the price once within 10 years in case of a fundamental divergence. This clause is similar to the United States' commensurate with income standard, which requires taxpayers to assess all future benefits and enables the U.S. tax authorities to adjust the profit assessment if the figure diverges more than 20 percent from the actual result in the future.

The problem with the price adjustment clause is that the frequency of that kind of clause in today's contract practice is declining, following the economic theory to minimize risks by not concluding contracts that generate potential additional costs in one or two decades. Risk aversion is one of the major reasons

for the process of group building. The new function shifting regime's legal presumption that unrelated third parties would agree on a price adjustment clause contradicts both the economic theory and the practice of group building.

Obstacle One: Doubling of Functions

In practice, there will be two major obstacles for multinational companies. The first applies to the doubling of functions. This measure hinders any company attempting to expand its international activities. For example, licensing the production of goods for a foreign subsidiary will trigger the new function shifting regime. Moreover, using domestic know-how and other intangible assets abroad with a subsidiary or branch means running the risk of double taxation.

Lawmakers claim that this harsh step is necessary to prevent abuse; otherwise it would be easy to declare an actual function shift as a doubling of functions to escape the tax consequences. Because the current draft version is under attack from multinational companies fearing a genuine double taxation in this matter, there is little hope that the tax authorities will change their mind.

Obstacle Two: Expatriates

The new regime is not applicable to the deployment of employees abroad. Yet according to the draft version of the upcoming regulation, the regime also applies when an employee performs an entire function for a group member, for instance, when the employee takes along his field of responsibility.

OECD and EC Law Conformity

The new regime introduces a new interpretation of arm's-length prices with a far-reaching interpretation of the underlying earnings potential. Further, the German hierarchy of methods and the valuation itself as well as the concept of a price adjustment clause contradict the current OECD guidelines, and will most likely diverge from the upcoming 2008 OECD guidelines on business restructurings. Moreover, the new regime is not in line with article 9 of the OECD model treaty and will therefore cause uncertainties and distortions in the international arena. Taken together, the new regime collides with 95 percent of Germany's double tax treaties. Moreover, it violates EC law in different ways:

- first, it violates the freedom of permanent establishment, since it treats domestic and cross-border cases unequally without justification, as it is pointless to claim that the rules comply with the strict antiabuse case law of the ECJ; and
- second, it collides with several fundamental principles of the EC Arbitration Convention, which will spark a series of conflicts.

Taxpayer Actions

Instead of a transfer of functions, the taxpayer might consider concluding a timely limited licensing agreement. Despite the fact that a transfer price has to be assessed and the profits taxed, there will not be an immediate taxation of the hidden reserves, but there will instead be a favorable timing effect.

Conclusion

Even though the OECD is planning to issue guidelines for business restructurings in 2008, Germany is committed to enacting specific function shifting rules that will enter into force on January 1, 2008. The need for the rules is undisputed and they will enhance legal certainty and prevent erosion of the tax base. However, the means and principles will spark many domestic and international discussions.

At the core of the new regime is the taxation of transfer packages based on current and future earnings potential, instead of assessing the individual tangible or intangible assets separately. Such a far-reaching scope of taxation is unique in the international arena. Only the U.S. tax law on the shifting of intangible assets has a similarly broad scope.

Also, the new set of rules establishes a hierarchy of methods to assess the transfer price of a function when shifted abroad. These provisions will likely not be in line with the OECD rules. Moreover, the "doubled diligent and conscientious businessman test" as the basis for the computation of the hypothetical arm's-length price, transfer packages, earnings potential, and price adjustment clauses is internationally unknown. For this reason, the new German way of taxing function shifting will likely spark a number of mutual agreement, EC arbitration, and arbitration procedures.

Moreover, the regime also applies to the doubling of functions, for instance when a German parent supplies its foreign subsidiary with know-how. German tax authorities will scrutinize principal structures in which most of the intangible assets of a group and much of the group's risk are held by a single principal company, for instance, in Switzerland. Any shift in this direction must be carefully planned.

In a nutshell, multinational companies will run the risk of being taxed twice. Accordingly, shifting functions out of Germany might turn out to be a costly adventure. ◆

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