New German Regulation: Transfer of Functions
Executive Order

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With the German 2008 Business Tax Reform Act, detailed transfer pricing regulations concerning the cross-border transfer of functions were incorporated into § 1 of the Foreign Tax Law. By way of an executive order, the Federal Ministry of Finance has now further regulated the terms and conditions for the application of the arm’s length principle under this new regulation. The Executive Order was approved by the Federal Cabinet on May 21, 2008 and on July 4, 2008 by the Upper House.

The Executive Order essentially defines terms like “function”, “transfer of functions”, “transfer package”, etc, and provides further details on the new legal regulations regarding cross-border shifts of functions.

Key terms of the new regulation

The term “function” is defined as a business activity that is the aggregate of similar operational tasks performed by certain areas or departments within an enterprise.

The Executive Order defines the term “transfer of functions” (“transfer” hereafter) as standardised in § 1, subsection 3, clause 9 of the Foreign Tax Act. It further specifies that a transfer has occurred if a transferring company (transferor) shifts or assigns assets and other advantages, including associated risks and opportunities, cross border to a related company (transferee), thereby restricting the transferor’s ability to perform the function in question.

A transfer may also occur if a function is only partially transferred. The provisions of the Executive Order then apply to the transferred part. Business transactions carried out within a period of five fiscal years shall be collectively considered a single transfer if the transactions are economically linked to each other.

Exemptions

Transferring functions to a “cost-plus-entity”

Functions shifted cross border shall be exempted if these functions are performed by the transferee solely for the purpose of the transferor and if the remuneration of the transferee is calculated by applying the cost plus method under the arm’s length principle. The remuneration must be limited to payments for the services rendered by the transferee. This most likely concerns transfers to contract manufacturers and/or contract service providers.

Duplication of functions

Furthermore the duplication of functions is not considered to be a transfer if there is no reduction of the functions performed by the transferor within a period of five years while the other prerequisites of a cross-border transfer are fulfilled. However, if there is a reduction within a five year period, the complete process shall be regarded as a transfer.

Furthermore, functions are not supposed to be transferred if

• only assets are sold or assigned, or
• only services are provided, or
• the transaction would not be considered a sale or purchase of a function between unrelated third parties, or
• if personnel are seconded without actually shifting a function.

The above-mentioned transactions are thus subject to the regular arm’s length pricing standards. However, if these transactions form part of a single transfer from an economic point of view, they are subject to the transfer of functions regulations.

Transfer pricing on the basis of the transfer package

The applicable arm’s length price shall be determined on the basis of the so-called “transfer package”. The transfer package contains all risks and opportunities as well as assets and advantages associated with the transferred or assigned function.

The remuneration shall be calculated on the basis of the profit potential from the point of view of the transferor but also the transferee. The profit potential from the perspective of the transferor is equivalent to the net present value of the net profit a prudent and diligent business manager would not forego without an appropriate remuneration. From the perspective of the transferee, the net profit is equivalent to the net profit a prudent and diligent business manager would be prepared to compensate.

Basically it is necessary to evaluate the transfer package in its entirety. The determination of individual transfer prices for the specific parts is also possible if no significant intangibles or opportunities (the value of the intangibles does not exceed 25% of the entire transfer package) are transferred. However, the sum of the value of each part of the transfer package must then correspond to the value of the transfer package in its entirety. The overall result of the individual transfer prices, measured on the basis of the price for the whole transfer package, should be in accordance with the arm’s length principle.

The price of the transfer package shall commensurate with the profits that can be attributed to the function and which could be expected from performing the function at the time of the transfer when estimated in its entirety.

The determination of the profit potential for each function relating to the transfer package has to take into account all the circumstances of each individual case based on functional analyses performed prior to and after the transfer. The profit potential calculations should also take into consideration the alternative courses of action available to the transferor and transferee, including location advantages and disadvantages as well as effects of synergy. Documentation on the decision making process on whether or not to transfer a function have to be used as the basis for calculating the profit potentials.

Valuation of the profit potential

Three factors must be considered in determining the profit potential:

1. Determining an appropriate discount rate and establishing a discount period,
2. Determining the profit expectations;
3. Discounting these profit expectations by applying the discount rate.

The estimation of an appropriate discount rate is to be based on the rate of interest for a risk-free investment with an unlimited discount period, if no definite period is sustained by the taxpayer. The interest rate must be increased by a surcharge commensurate to function and risk, which shall be calculated taking into account both the transferor and transferee entities’ functional and risk assessments in comparable situations.

The determination of the price of the transfer differs depending on whether the function is expected to realize profits (profits) or permanent losses (losses).

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<th>Profits</th>
<th>Losses</th>
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<td><strong>Lower limit</strong></td>
<td>Compensation for loss of or decrease in profit potential plus any accumulated costs of closure</td>
<td>Lower absolute amount derived from expected losses or accumulated closure costs</td>
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<tr>
<td><strong>Upper limit</strong></td>
<td>Profit potential from the assumed function</td>
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If the transferor is in a loss situation, the expected losses may be higher than the closure costs. In such cases it may be considered characteristic of a prudent and diligent business manager to agree on a remuneration that only covers a portion of the accumulated closure costs, or make a compensation payment to the transferee for assuming the source of loss.

If the transferor’s minimum price is zero or below zero, the question whether or not an unrelated third party would pay a price for assuming the function in a similar situation, has to be examined.

Claim for damages and compensation as a basis for taxation

Generally, third parties would be entitled to legal or contractual claims for damages, indemnity and compensation claims, and other claims which
might arise if possible courses of action open to them were ruled out either contractually or effectively. Such cases may arise where functions are transferred by removing or reducing a function. In order to reflect such third party behaviour, similar claims and compensations may qualify as a basis for taxation of the transfer of functions if the following criteria are met:

- proof of the agreement on comparable regulations among unrelated third parties and, additionally,
- substantiation that no significant intangibles and opportunities have been transferred or assigned for use (exception: transfer or assignation as a mandatory consequence of the regulation).

Adjustments
The tax authority is permitted to retroactively adjust the original transfer prices within a ten years period after the transfer if the actual profit deviates substantially from the original profit expectation.

A "substantial deviation" exists if

1. the actual transfer price lies outside the original area of negotiation or
2. the recalculated maximum price is lower than the transferor’s original minimum price.

The transferee’s recalculated maximum price and the original minimum price shall form the boundaries of the area of negotiation.

Appropriate adjustment
An “appropriate adjustment” of the original transfer price is to be recorded in the fiscal year subsequent to the fiscal year in which the deviation occurred. In case the transfer price based on actual earnings lies outside the original area of negotiation, the adjustment shall be considered appropriate if it corresponds to the difference between the original and the recalculated transfer price. In case the recalculated maximum price is lower than the transferor’s original minimum price, the adjustment shall be considered appropriate if the adjustment corresponds to the difference between the original transfer price and the mean value of the transferee’s recalculated maximum price and the transferor’s original minimum price.