Transfer pricing regulations in Germany: Relocation of functions

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SUMMARY

The purpose of this article is to offer a brief summary of the methods foreseen under German tax law to enable the determination of adequate transfer pricing accepted by the tax administration. Special emphasis will be made on the new provisions regarding “functional relocation” introduced with the Corporate Tax Reform Act of 2008. This new law foresees a valuation of the portion of the company to be transferred (called the “relocation package”) aimed at the future cash-flow that could arise from the business function related to the relocated package.

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INTRODUCTION

Contents

Presently, globalized value chains are the norm in many economic sectors. Manufacturing and the services required in producing and distributing numerous products are disseminated over several countries. Frequently, the process of generating the value required in developing the end products is undertaken by related parties. Based on estimations, over 60% of worldwide trade is managed in consortia (refer to European Commission, 2001, p. 23). Therefore, the great influence that agreed transfer pricing policies exert on these transactions in the geographic distribution of the tax base, as determined within consortia, shall not be underestimated. Although conflicting interests may be assumed when two unrelated companies participate – this principle being the requirement of market prices' generation – this difference in interests does not apply in the case of two related companies. Therefore, consortia tend to define their internal prices (also) under tax criteria. This entails great efforts for the tax authorities in determining whether such transfer pricing policies are in line with the market or whether they require adjustments, as applicable. Individual transactions in a consortium, which lack comparable market prices hurdles this control procedure even more. The relocation of overall business functions in the framework of a restructuring process (for example, production and distribution of a given product in a given region), normally constitutes individual transactions of a consortium with a great potential for tax avoidance or tax evasion.

On such basis, this paper seeks to provide a brief summary of the methods enabling, pursuant to German tax law, to determine appropriate transfer pricing policies, with special focus on the new provisions regarding relocation of functions introduced by the Corporate Tax Reform Act of 2008.

To such end, the article is divided in two titles subsequent to this introduction. Firstly, we present a summary of the methods allowed in Germany to determine transfer pricing policies. The second title addresses provisions on the relocation of functions and focuses on the valuation of the relocated function. The paper ends with a brief overview of German regulations.

This article is largely based on a paper presented on 24 November of 2010 in the framework of a seminar on transfer pricing regulations in Latin America, organized by InWEnt (Capacity Building International, Germany), CIAT (Inter-American Center of Tax Administrations) and DIAN (National Tax and Customs Directorate, Colombia) in Bogota, Colombia.[1]

1 *All charts, unless otherwise stated, belong to the author.*

1. THE ARM´S LENGTH PRINCIPLE IN GERMANY

Fundamentals

Although the parties to a consortium may remain legally independent companies, they are normally under the headquarters' financial management. Frequently, this situation is correctly described with the term "business unit with legal diversity" (Sigloch, J., 2010, p. 465). Therefore, the transactions among companies belonging to the same consortium lack the conflicting interests that are a feature of the economically unrelated parties in the market.

Tax authorities address this type of situation based on two options (refer to Sigloch, J., 2010, p. 471):

(1) For tax purposes, they may treat the consortium as a single company. In this case, the internal transactions of the consortium and the transfer pricing policies defined for them bear no influence on the consortium tax base assessment. Currently, discussions are underway on the applicable solutions in the framework of a consolidated tax base for consortia in Europe. Nevertheless, to date, little progress has been made (refer to Spengel, Ch./Oestreicher, A., 2009, p. 773). The greatest difficulty in this case is the distribution of the tax base or revenue among the different countries where the members of the consortium are based.

(2) The different members of a consortium shall pay taxes as financially unrelated companies. This entails controlling and, eventually, correcting the transfer pricing amounts defined for internal consortium transactions, comparable with similar market prices. In other words, it requires taking as the basis a price that in similar conditions, would also have been agreed by external third-parties. This method is normally called, briefly, dealing at arm´s length principle. This is an internationally-applied principle, but the methods to determine transfer pricing policies differ from one country to another, to a given extent, in spite of the fact that many countries follow the OECD transfer pricing guidelines (OECD, 2010).

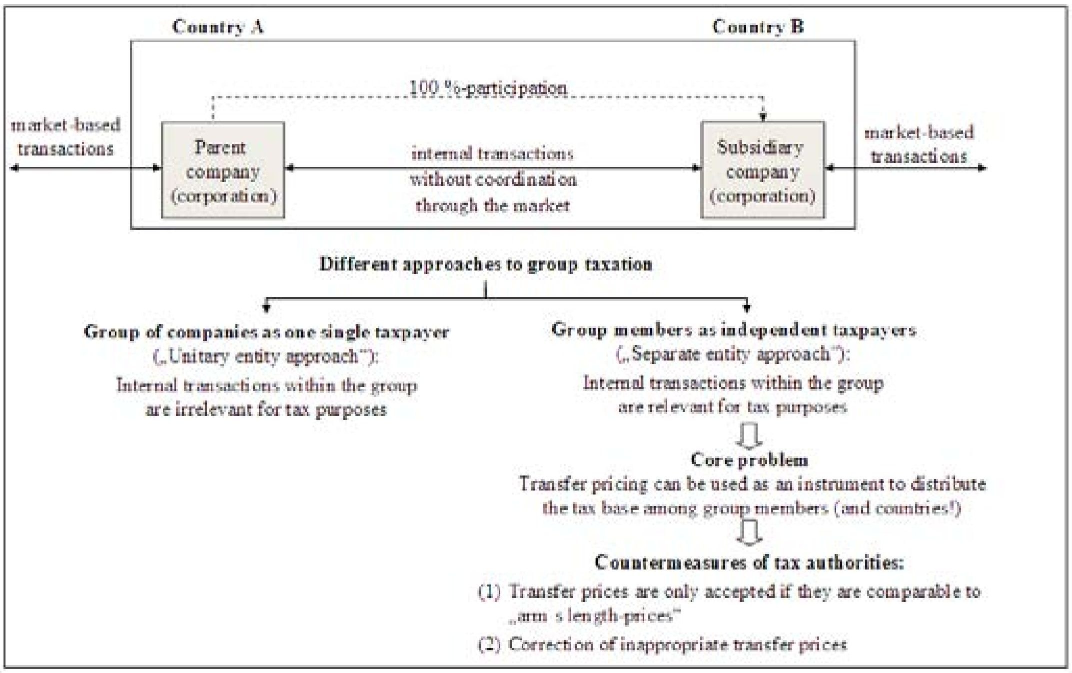
In Germany, the Arm´s length principle is defined in the International Taxation Act (AStG, Außensteuergesetz):

„When a taxpayer's income resulting from a cross-border commercial relation with a related individual is reduced by the fact that the income statement is based on different conditions, especially prices (transfer pricing), from those that would have been agreed under equal or similar conditions by unrelated third-parties (arm´s length principle), such income, regardless of other provisions, shall be determined as if it would have occurred in conditions agreed by unrelated third-parties."

Similarly, this principle also exists in certain provisions on national transactions exclusively (such as, concealed distribution of dividends).

The following chart (Chart 1) illustrates the two alternatives.

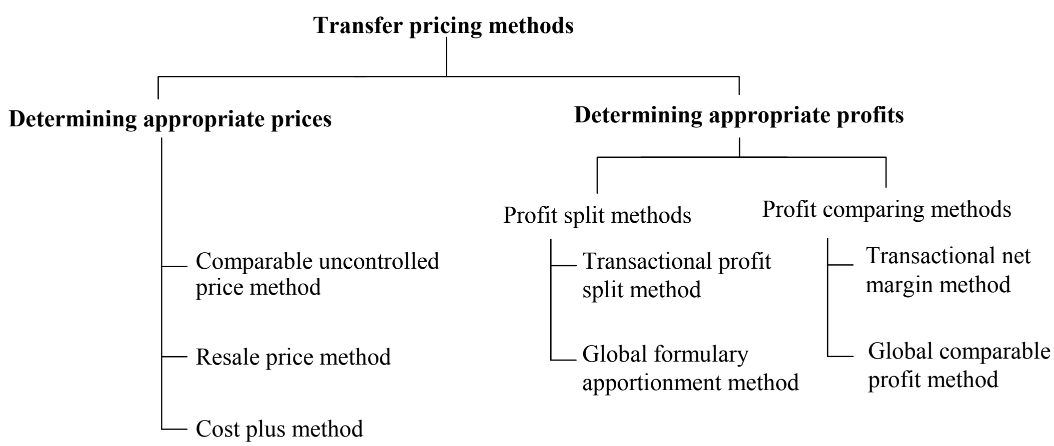
Graphic 1: Different approaches to group taxation



1.2 Methods to identify profits in the consortium

The following chart (Chart 2) presents a summary of the existing methods to define profits in a consortium (for a similar chart, refer to Schmidt, L./Sigloch, J./Henselmann, K., (2005), p. 378):

Graphic 2: Transfer pricing methods



By principle, a distinction is made between the transactional prices methods and the profit-based methods. The transactional prices methods (comparable uncontrolled price method, resale price method, cost plus method) are also called “standard methods”. The profit-based methods require distinguishing between the disaggregation (apportionment) of profits and the profit comparable methods. Both may refer to the individual transaction under analysis (transactional-profits methods) as well as the global business profit (global profits methods).

The applicable methods in determining price based on the Arm’s length principle depend on the relevant comparable transaction comparability with available comparable transactions. In order to determine the comparable basis, the following aspects shall be analyzed, among others:

- quantity and quality of the transaction’s assets/services,
- other contractual conditions (such as terms of payment, guarantees),
- functions and risks assumed by the companies involved (for example, companies with routine functions that do not assume significant market risks, companies who are strategic partners assuming considerable market risks),
- prevailing market conditions (such as, competition).

Based on the outcome of this comparability analysis, German tax law defines three categories for the arm's length principle:

(1) The unlimited arm's length principle: the comparable transactions are identical in their essential features or the comparable price may be adjusted without difficulties to the existing differences. In such cases, tax law provides for the application of the standard methods.

(2) The limited arm's length principle: the comparable transactions are not identical in their essential features, but by greater adjustments to the comparable prices, comparability is still possible. In this case, the standard methods as well as the transactional profits methods apply.

(3) The hypothetical arm's length principle: no transactions are available that may be made comparable with the transaction subject to control, even if greater adjustments were applied. In fact, the application of the hypothetical arm's length principle seeks to simulate the price negotiation and determination process among unrelated parties. To such end, a minimum price is defined, from the standpoint of the supplying company, and a maximum price from the standpoint of the company who is the beneficiary of the good or service. The applicable transfer price shall range between the minimum price and the maximum price in the so-called “transactional margin” (when applicable).

The global profit comparable method and the global profit apportionment method are not admissible in any case.

The following chart (Chart 3) presents a summary of the three categories and the applicability of the transfer pricing methods according to German tax law:

Graphic 3: Classes of comparability

Classes of comparability

	Unlimited comparability	**Limited comparability**	**Incomparability**
	Identical economic conditions or differences which can easily be taken into account with small adjustments (e.g. payment conditions) or differences which are not relevant for the transaction price	Economic conditions are not identical but differences can be taken into account with major adjustments	Economic conditions are not identical and differences cannot be taken into account even with major adjustments (e.g. intangible assets, “functions“)
Comparable uncontrolled price method	x	x	./.
Resale price method	x	x	./.
Cost plus method	x	x	./.
Transactional net margin method	./.	x	./.
Transactional profit split method	./.	x	./.
Global comparable profit method	./.	./.	./.
Global formulary apportionment method	./.	./.	./.

Hypothetical arm´s length principle

2. THE GERMAN RULES FOR RELOCATION OF FUNCTIONS

The following notions are exclusively centered on the so-called relocation of functions, in which the hypothetical arm’s length principle applies as a general rule.

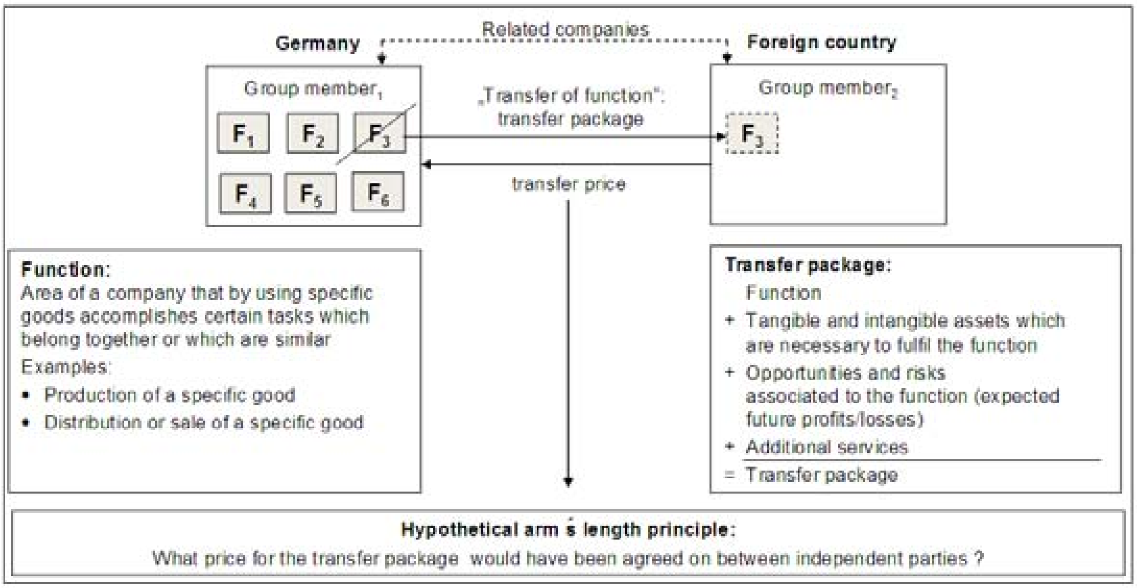
2.1 Fundamentals

The Corporate Tax Reform Act of 2008 introduced in Germany the legal fundamentals for the relocation of functions in the International Taxation Act. Pursuant to this law, relocation of functions shall apply when:

- a national corporation
- by relocating the use or transfer of tangible and intangible assets and services
- and the applicable opportunities and risks (implying the notion of future expected profits/losses)
- enables a foreign related company
- to perform a function until that moment performed by the relocating company
- and such function, upon completing the relocation, is discontinued or performed on a (very) limited basis.

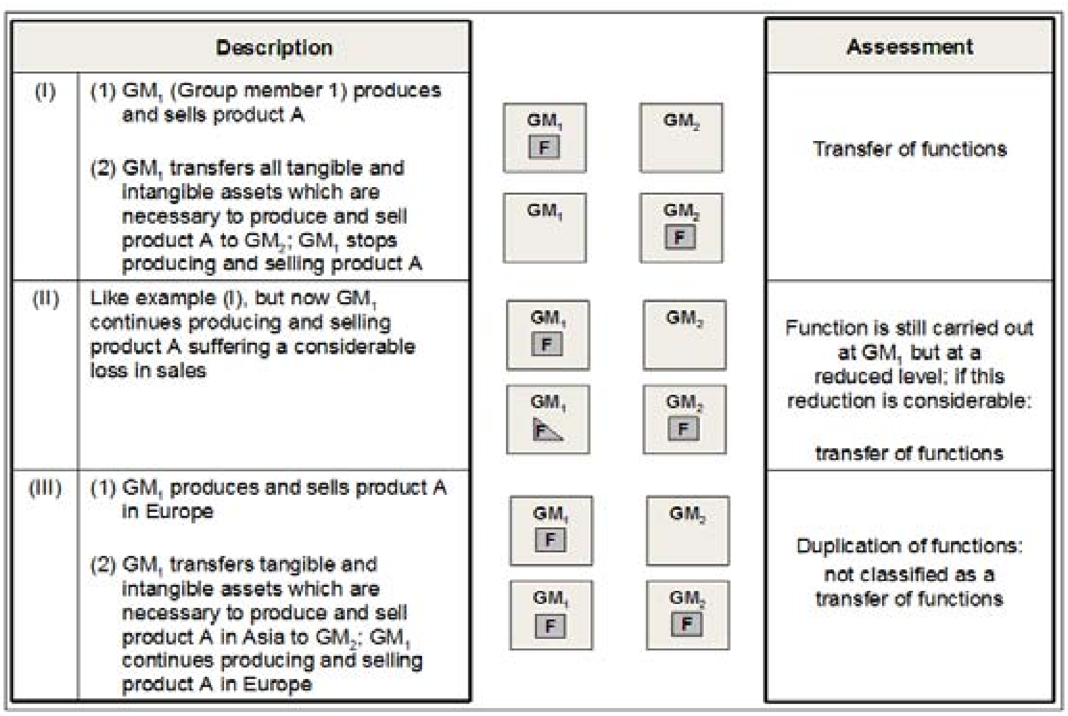
The overall relocated financial assets and the applicable risks and opportunities are called the relocation package. The following chart (Chart 4) illustrates the rule.

Graphic 4: Business restructuring – “Transfer of functions”

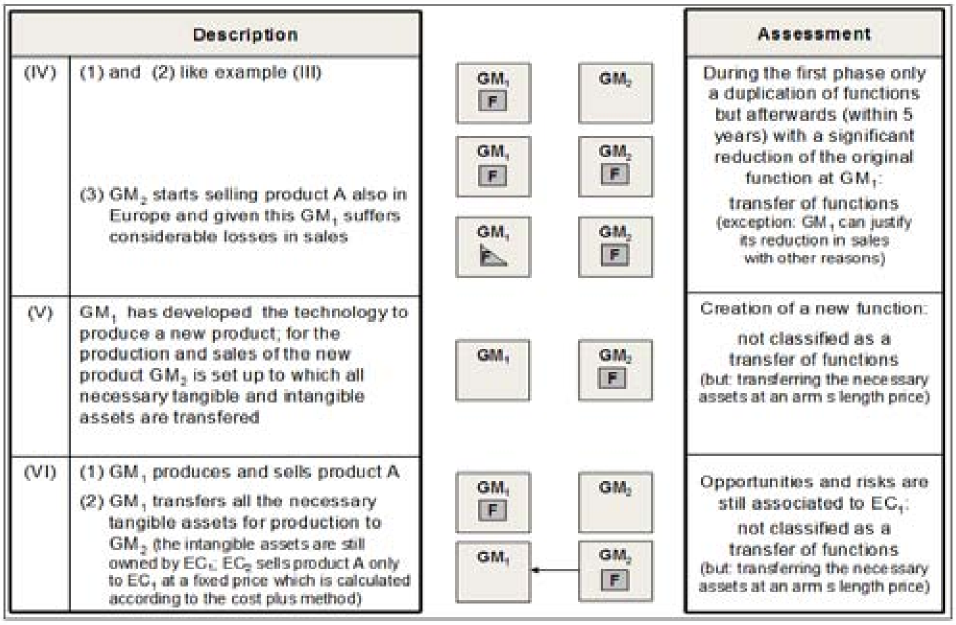


The legal definition allows for extensive interpretation. In order to explain when the relocation of functions applies, a number of examples are provided (Charts 5 and 6)

Graphic 5: Tansfer of functions – examples I



Graphic 6: Tansfer of functions – examples II



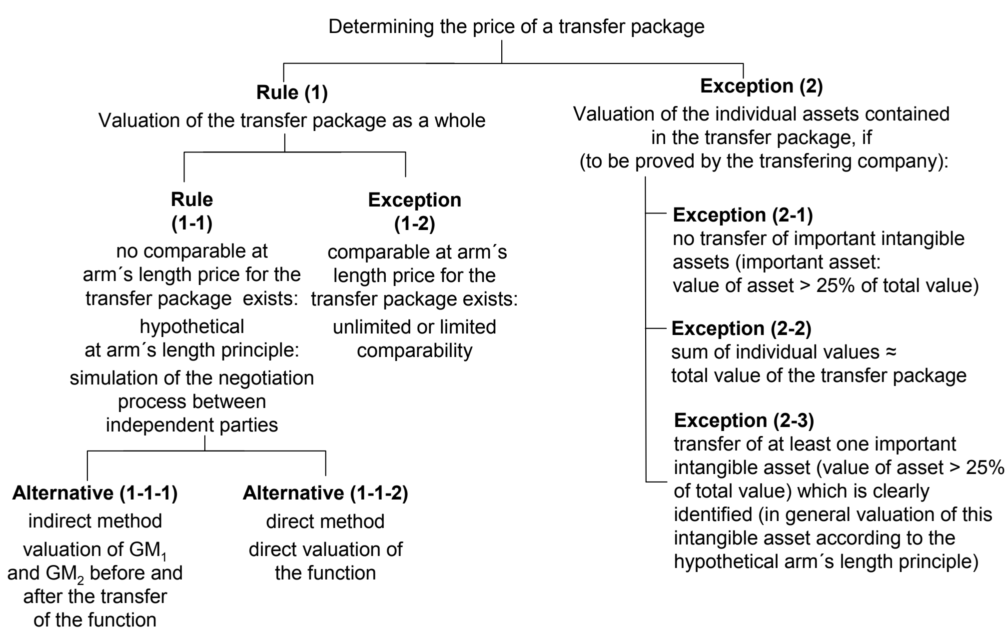
	Description	Assessment
(IV)	(1) and (2) like example (III) (3) GM_2 starts selling product A also in Europe and given this GM_1 suffers considerable losses in sales	During the first phase only a duplication of functions but afterwards (within 5 years) with a significant reduction of the original function at GM_1: transfer of functions (exception: GM_1 can justify its reduction in sales with other reasons)
(V)	GM_1 has developed the technology to produce a new product; for the production and sales of the new product GM_2 is set up to which all necessary tangible and intangible assets are transfered	Creation of a new function: not classified as a transfer of functions (but: transferring the necessary assets at an arm s length price)
(VI)	(1) GM_1 produces and sells product A (2) GM_1 transfers all the necessary tangible assets for production to GM_2 (the intangible assets are still owned by EC_1; EC_2 sells product A only to EC_1 at a fixed price which is calculated according to the cost plus method)	Opportunities and risks are still associated to EC_1: not classified as a transfer of functions (but: transferring the necessary assets at an arm s length price)

2.2 Determining the function price

2.2.1 Methods to calculate the function relocation price

The following chart (Chart 7) presents a summary of the rules and exceptions applicable in the assessment of relocation packages in the framework of relocations of functions:

Graphic 7: Determining the price of a transfer package

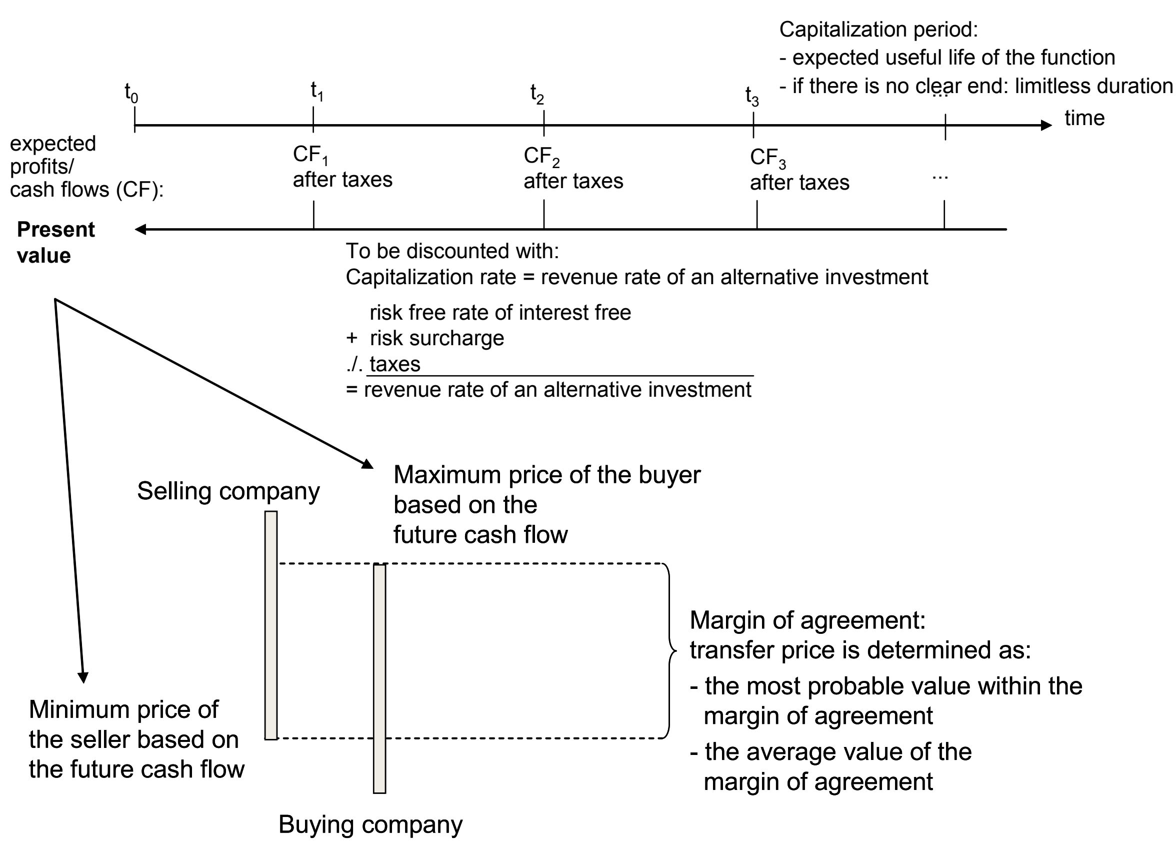


In order to value a relocation package, in general, a global evaluation is required (also see Oestreicher, A./Hundeshagen, Ch., 2009, p. 145). Since it may be impossible to determine comparable, or to a certain extent comparable, market values for the relocated functions (alternative 1-2 of the foregoing chart), the hypothetical arm's length principle is normally applied (alternative 1-1). It shall be calculated according to the cut-off prices' calculation, known in the theory of business valuations. The company relocating the function determines the minimum price to be requested; while the function beneficiary company calculates the maximum price it is willing to pay for the relocation package. The maximum price indicates the maximum value that the beneficiary company is able to pay without impairing its situation should it never acquire the relocation package. If the maximum price of the beneficiary company exceeds the minimum price of the company relocating the function, a positive transactional margin is created, according to which both parties would reach, through their negotiations, the transaction price. Therefore, the transfer pricing applicable shall also stand in the range of this transactional margin. The key evaluation parameters in calculating the respective cut off prices are:

- future profits and cash-flows expected from the performance of the function after tax (the law mentions only profits; nevertheless, a company valuation must be based on cash-flows),
- life of the relocation function as a capitalization period,
- capitalization rate adjusted to risk after tax.

The following chart (Chart 8) presents a summary of the procedure:

Graphic 8: Calculating the maximum and minimum price – valuation steps



Since it shall be frequently difficult to directly forecast future profits (cash-flows) from an individual function (alternative 1-1-2), many times only the indirect method applies to value the relocation package (alternative 1-1-1). In this case, the value of the relocation package is defined as the difference in company values before and after the relocation of functions. Given the fact that this shall be performed by the company relocating the function as well as the beneficiary company, four (!) business valuations are required.
In exceptional cases, it is possible to depart the principle of global valuation of the relocation package and conduct an individual evaluation of the relocated financial assets (alternatives 2-1, 2-2 and 2-3 on Chart 7) (also see Greil, S., 2010, p. 479):

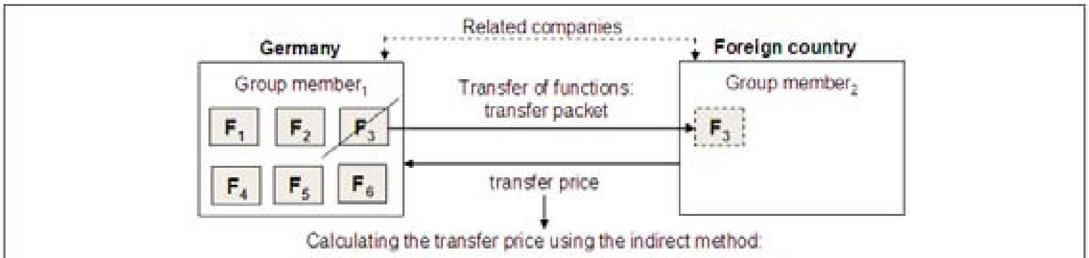
- No transfers of intangible assets (exception 2-1): an intangible asset is considered essential if its value exceeds 25% of the total relocation package value. If no intangible asset is relocated or if its value is under 25% of the total value, an individual valuation of the relocated assets may be performed (for example, the relocation of a company's accounting shall be covered in this exception). Should several intangible assets be relocated in the framework of the relocation of functions, its value shall be added to determine whether the amount exceeds the 25% cap or not.
- The sum of the individual values of the relocated assets equals the value of the relocation package (exception 2-2): if the sum of the individual relocated values ranges within the transactional margin applicable in a global valuation, the sum of the individually valued assets may be used as transfer pricing. Nevertheless, this exception does not entail laxer rules for taxpayers, since overall, an individual valuation and a global valuation shall be required.
- Transfer of at least one essential intangible asset that is accurately described (exception 2-3): when at least one essential intangible asset forms part of the relocation package (value > 25%) and is accurately described by the taxpayer, it is also possible to forego a global valuation of the relocation package. Nevertheless, on many occasions, it shall be necessary to apply the hypothetical arm's length principle for the accurately described intangible asset. Contrary to exception 2-1, this exception does not require adding the values from several intangible financial assets. In particular, this third exception generates many questions that still remained unanswered.

2.2.2 Function valuation example

Explanation on the indirect global valuation of a relocation package with a simplified example:

A consortium company (CC_1) relocates a specific function with all the tangible and intangible assets required in performing the function of another consortium company (CC_2). The latter also assumes all the inherent risks and opportunities in the future performance of the function. In order to simplify the example, we assume that the function shall only be performed for an additional three years. In order to determine the cap prices for the relocation package of CC_1 and CC_2, the values of companies before and after the relocation of functions shall be determined. To such end, future cash-flows (and profits) shall be estimated before and after the relocation of functions. It is assumed that the interest rate for the alternative investment adjusted by risk (capitalization rate), is 10% before tax in both countries and it shall be reduced by the tax burden applicable. The capitalization rate after tax is determined as the capitalization rate before tax multiplied by the factor of one less the tax base. (Such assumptions on the capitalization rate and the tax consideration have been greatly simplified. Nevertheless, they are necessary in order to explain the principles of the procedure). For simplification purposes, risk surcharges, normally different according to the company, are identical for both companies and shall not change as a consequence of the relocation of functions. The calculations are presented on the following chart (Chart 9):

Graphic 9: Determining the price of the transfer package – example I



Value GM_1 before transferring the function	t_0	t_1	t_2	t_3
CF before taxes		150	150	150
Taxes (30%)		-45	-45	-45
CF after taxes		105	105	105
Present value (7%)	275			

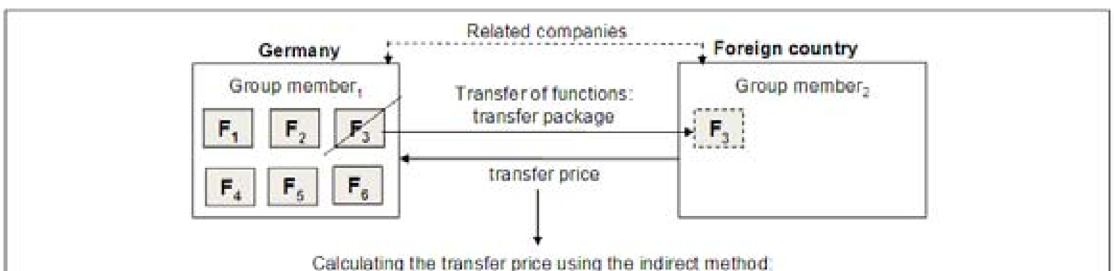
Value GM_2 before receiving the function	t_0	t_1	t_2	t_3
CF before taxes		40	40	40
Taxes (20%)		-8	-8	-8
CF after taxes		32	32	32
Present value (8%)	82			

Value GM_1 after transferring the function	t_0	t_1	t_2	t_3
CF before taxes		104,0	104,0	104,0
Taxes (30%)		- 31.2	-31.2	-31.2
CF after taxes		72.8	72.8	72.8
Present value (7%)	191			

Value GM_2 after receiving the funcion	t_0	t_1	t_2	t_3
CF before taxes		110	110	110
Taxes(20%)		-22	-22	-22
CF after taxes		88	88	88
Present value (8%)	227			

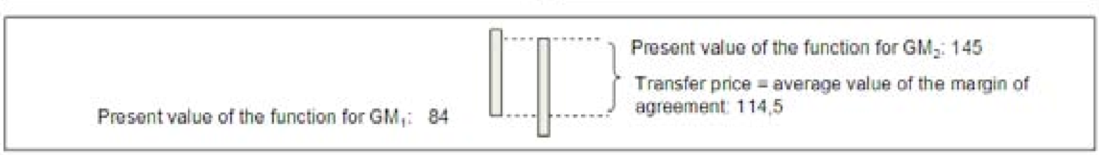
In the case of CC_1, the difference between the company value before the function relocation (275) and the company value after the relocation (191) equals the minimum price for the relocation package. The maximum price from the standpoint of CC_2 is formed as the difference between the value of the company after the function relocation (227) and the value of the company before relocation (82) as defined in the following chart (Chart 10):

Graphic 10: Determining the price of the transfer package – example II



Present value of GM_1 before transferring the function	275
./. Present value of GM_1 after transferring the funcion	191
= Present value of the function for GM_1	84

Present value of GM_2 after receiving the function	227
./. Present value of GM_2 before receiving the function	82
= Present value of the function for GM_2	145



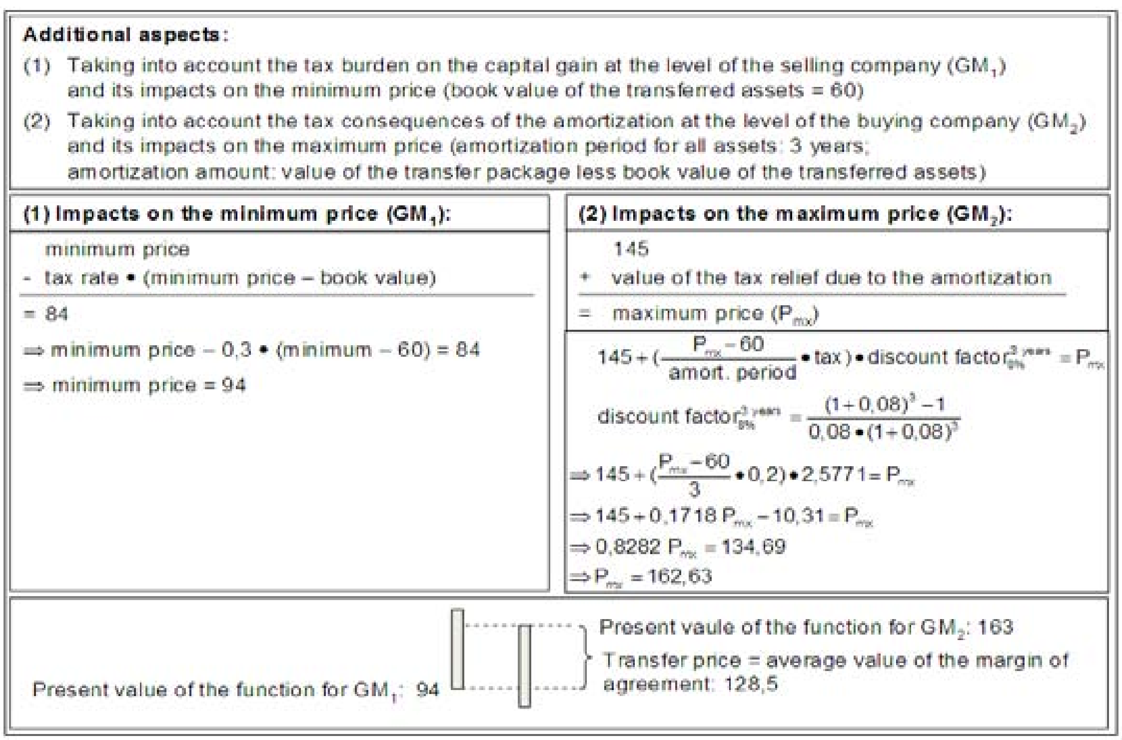
Upon comparing the cap prices, we obtain a positive transactional margin between 84 (minimum price CC_1) and 145 (maximum price CC_2). By principle, admissible transfer pricing is deemed to be any value within the transactional margin, provided it meets the arm's length principle. When in doubt, the average value of the transactional margin is taken (114.5) as the relocation package transfer pricing admitted from the tax standpoint.

A factor that is not taken into consideration in the calculations is taxation of a possible profit from the sale in CC_1 and the tax effects of the amortization of the assets acquired in CC_2. Should these tax consequences be included in the considerations, new cut-off prices shall apply for CC_1 and CC_2 and, therefore, a new transactional margin as well:

- Owing to the taxation of the sales profit, CC1 should increase the minimum price required for the sale of the relocation package not to produce impairment of their financial status. Therefore, the minimum price of CC1 increases from 84 to 94 (for the calculation, see Chart 11).
- Should CC2 apply the total price paid for the relocation package as purchase expenses for the assets purchased (an infrequent case), an additional amortization potential arises and a tax discharge effect that increases the purchase cap price for CC2. In a simple example, the maximum price would increase from 145 to 163 (see Chart 11 for the calculation 11).
- Therefore, the new transactional margin goes from 94 to 163 with an average value of 128.5.

The following chart (Chart 11) illustrates the calculations applicable:

Graphic 11: Determining the price of the transfer package – example III



3. CONCLUSIONS

With the new regulation on the determination of fiscally approved transfer pricing policies for the relocation of functions, another highly complex regulation was introduced in German tax law. For its theoretical evaluation – we still do not rely on many practical experiences – the following items may be mentioned:

- The valuation of assets or sections of companies (relocation packages) centered on future cash-flow is in line with the valuation theory.
- A global indirect valuation of the relocation packages requires four company valuations. In order to deduct the relevant cash-flows for valuation and the relevant profits as the tax base, it is necessary to draft, on a case by case basis, planned balance sheets, planned profits and losses accounts and planned financial calculations, all of which shall be concerted. This is very onerous for the taxpayer and implies, based on the estimations required, significant legal uncertainty with respect to the approval of transfer pricing by the tax administration.
- Determining a capitalization rate adjusted by risk and taxes is highly complicated. The risk surcharge also depends, among others, on the capital structure that may be modified with the relocation of a function. Even without modifying the capital structure, the individual risk of each company may vary before and after the relocation of functions. In fact, this would be the rule, since the relocation of the function also entails relocation of the opportunities and risks inherent in the performance of the function. This requires determining a number of risk-adjusted capitalization rates.
- German tax authorities determine applicable taxes on the future foreign profits generated as of the date of the function relocation. This could be interpreted as a very broad taxation power of the German tax authorities and, eventually, deemed a violation of the European law of freedom of establishment. A negative argument may be the fact that, as of the function relocation date, only the sale price that would have been agreed between two rationally behaving unrelated parties was considered for taxation purposes. In general, the tax authority of the country of the seller headquarters is entitled to levy the sale profits.
- If the tax authority of the country of the headquarters for company acquiring the function does not accept transfer pricing as determined by the German tax authority, the parties are faced with the risk of double taxation on future profits. The German tax authority levies such profits as of the date of the function relocation, and the foreign tax authority levies them as of the date of realization of the profits based on the amortization potential that is not generated at the time of acquisition.
- From the standpoint of economic policy, we may argue that many companies decide early on against headquarters in Germany, basing such decision on the fact that the tax barriers for subsequent relocation of functions from Germany to a foreign jurisdiction are very high.

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