Observations on Germany's draft bill on application of the exit taxation rules

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In brief

The German Federal Ministry of Finance on July 5 published on its website the draft bill of a new Ordinance on the application of the arm's-length principle pursuant to Sec. 1 (1) of the German Foreign Tax Act in cases of cross-border transfer of functions (FVerlV 2022 - E). The new rules would be applicable for the first time for assessment periods beginning after December 31, 2021, and would replace the current FVerlV.

The Federal Ministry of Finance set a deadline of July 22 for public comments. It is now considering the feedback received, with an updated draft bill expected to be published in the European autumn/fall of 2022. This updated draft bill would then need to be approved by the upper house of the German parliament (Bundesrat) before becoming effective.

Previously, with the German Act to modernize the relief from withholding taxes and the certification of capital gains tax (Abzugsteuerentlastungsmodernisierungsgesetz – 'AbzStEntModG') published as of June 2, 2021 (Federal Law Gazette I p. 1259), the German transfer pricing regulations on cross-border transfer of functions were revised and moved to a new paragraph, 3b in Section 1 of the German Foreign Tax Act. In this context, the German Federal Ministry of Finance was authorized to issue a statutory order regulating details on the uniform application of the arm's-length principle within the meaning of Section 1 (3b) German Foreign Tax Act.

Takeaway: Taxpayers should review the changes in the draft bill and consider the potential impact to their business.

In detail

Background

The draft bill contains a total of 10 paragraphs, which are based on the structure of the current FVerlV. Two paragraphs of the current FVerlV covering price adjustments have been deleted in the draft as the new Section 1a German Foreign Tax Act contains general provisions on price adjustments.

In the opinion of the Federal Ministry of Finance, the FVerlV 2022 - E is intended to reflect the implemented provisions of Section 1 (3b) of the German Foreign Tax Act. As a result, FVerlV 2022 - E has been tightened for the taxpayer.

Observations

The proposed changes in FVerlV 2022 - E raise questions in light of the new statutory provision of Section 1 (3b) of the German Foreign Tax Act. For example, the provision of Section 4 (2) FVerlV (current version), which is important in practice, would be deleted without being replaced. This regulation provides that, at the request of the taxpayer, a transfer of use is to be assumed if it is doubtful whether the transfer package was transferred (i.e., one-time transfer) or provided for use. Since the tax effects of a one-time transfer are disproportionately higher than those of a transfer for use, discussions during a tax audit likely would intensify. In addition, some one-time payments abroad must be capitalized as goodwill and cannot be amortized, so the amendment to the provision could pose a risk of double taxation.

Despite the proposal to replace this provision in FVerlV 2022 - E, a transfer for use would still remain a possibility under Section 1 (3b) of the German Foreign Tax Act. As such, if a taxpayer can demonstrate that a transfer of use more accurately matches the factual situation than a one-off transfer, then the spreading of income over the relevant period of use should continue to be supportable. The law itself (and also the general income tax principles) should at least not exclude this possibility.

In addition, it appears there would be increased requirements for deviating from an unlimited capitalization period in the context of the transfer package valuation, as Section 5 FVerlV 2022 - E requires proof (and no longer only a "prima facie case," cf. Section 6 FVerlV 2022 - E) of reasons for a shorter (specific) period. The same applies to the use of statutory compensation claims for the valuation of a transfer of function. Here, too, the taxpayer would have to prove the lack of transfer of intangible assets; credible evidence will no longer be sufficient (cf. Section 8 FVerlV 2022 - E).

It remains to be seen to what extent the tax authorities will respond to the above-mentioned changes by revising the administrative principles on the transfer of functions.

Key individual regulations in the draft bill are discussed in more detail below.

Section 1 - General provisions

Section 1 FVerlV 2022 - E: General regulations

The definition of a "function" in paragraph 1 is unchanged from the current version of the FVerlV.

The definition of a "transfer of functions" in paragraph 2 largely has been left unchanged. The current provision — according to which a transfer of functions also can exist if the acquiring company temporarily takes over the function (cf. Section 1 (2) sentence 2 FVerlV current version) — has been deleted. As before, however, business transactions that are realized within five fiscal years are to be combined as a single transfer of function if the requirements for a transfer of functions are met in an overall view.

The definition of "transfer package" currently contained in paragraph 3 of the "transfer package" is moved to paragraph 2. Further, Section 1 (2) sentence 1 FVerlV 2022 - E clarifies that a two-sided assessment of the transfer package is required if a function is transferred to a company that already performs this function or if a loss-making function is transferred. ***Observation:*** With respect to both cases, Section 1 (2) FVerlV (current version) leaves room for different interpretations.

The definition of "material intangible assets" has been adopted in unchanged form (except for minor editorial adjustments) and now is in paragraph 3 (currently in paragraph 5). Accordingly, materiality is to be assumed if the intangible assets are necessary for the transferred function and their arm's-length price in total amounts to more than 25% of the sum of the individual prices of all assets and other benefits of the transfer package. This is particularly relevant for the question of whether a transfer package valuation can be dispensed with, as Section 1 (3b) sentence 2 of the German Foreign Tax Act requires that no significant intangible assets were the subject of the transfer of function.

Paragraph 4 contains a provision for cases in which, after the transfer, the acquiring company independently provides the services — currently provided exclusively to the transferring company — to other companies at prices that are higher than the remuneration according to the cost-plus method. In such arrangements, an arm's-length price must be recognized for assets and other benefits previously provided free of charge by the transferring company for the provision of services. ***Observation:*** This provision appears to be aimed at functional expansion of companies formerly operating as "cost-plus service providers" and essentially corresponds to Section 2 (2) sentence 2 FVerlV (current version), according to which, in cases where the acquiring company undertakes the transferred services exclusively for the transferring company on the basis of the cost-plus method, it is to be assumed that no significant intangible assets are transferred with the transfer package.

Unchanged from the current legal situation, according to paragraph 5, a transfer of functions still will not be deemed to have taken place if there is no restriction of the relevant function at the transferring company within five years of the function being taken up by the acquiring company (so-called "duplication of functions"). The current paragraph 7, however, is not included in the new bill. According to this provision, a transfer of functions also should not exist if only assets are sold or transferred for use, or if only services are provided, or if personnel are seconded within the group without a function being transferred at the same time.

Section 2 - Value of the transfer package

Section 2 FVerlV 2022 - E: Value of the transfer package

The priority of the general transfer pricing methods in cases of transfer of functions, in which the price for the transfer package as a whole can be determined on the basis of unrestricted or restricted comparable values (cf. Section 2 para. 1 sentence 1 FVerlV current version), has not been included in the draft bill. ***Observation:*** This exclusion is presumably a consequence of the new wording of Section 1 para. 3 German Foreign Tax Act, which no longer explicitly refers to the general transfer pricing methods. Nevertheless, in our view, these should still be considered as the primary transfer pricing methods (e.g., in accordance with international principles, such as in the OECD TP Guidelines), even if not the case in practice in the case of transfer of functions (due to their high degree of individuality), so that the "hypothetical arm's-length comparison" must be used.

Section 2 addresses how the area of agreement is to be determined when carrying out a hypothetical arm's-length comparison or a transfer package assessment is to be determined. Accordingly, a functional and risk analysis must be carried out before and after the transfer. Furthermore, in addition to actually existing alternatives for action, location advantages or disadvantages, synergy effects and tax effects also should be taken into account. ***Observation:*** This section goes beyond the current wording of the FVerlV, which does not explicitly include tax effects. However, there were regulations for the consideration of tax effects in the administrative principles on the transfer of functions of October 13, 2010.

Furthermore, Section 2 states that a capital value-oriented valuation method is to be used for the calculation of the area of agreement, whereby the expectations of the financial surpluses of the companies involved are to be taken into account. Currently, "net income after taxes" is defined as the relevant figure in this context. The new wording is intended to take greater account of cash flows, which are customary in business valuations, although according to the explanatory memorandum in the draft bill, this wording does not involve any substantive changes.

Section 3 FVerlV 2022 - E: Components of the transfer package

Section 3 FVerlV 2022 - E contains regulations on the components of the transfer package and largely corresponds to the current version Section 4 FVerlV.

Note: Section 4 para. 2 FVerlV (current version), which is important in practice, has been deleted without being replaced. Accordingly, in case of doubt as to whether a transfer or a transfer of use was to be assumed with regard to the transfer package or individual parts, a transfer of use is currently to be assumed at the request of the taxpayer. ***Observation:*** The question arises under the draft bill changes whether this assumption still would be

possible; the law itself (and also general income tax principles) should at least not exclude this option. We are hopeful that the tax authorities will continue to recognize so-called "business lease" models in the future, even if we expect more discussions in tax audits as a result of the deletion.

Section 4 FVerlV 2022 - E: Capitalization interest rate

According to both Section 4 FVerlV 2022 - E and Section 5 FVerlV (current version), the appropriate capitalization interest rate is to be determined on the basis of a risk-free interest rate plus an adequate risk premium. ***Observation:*** The new references to the equivalence principle and to the conduct of third parties in Section 4 FVerlV 2022 - E should not lead to any substantive changes. The same applies to the suggestion that the capitalization interest rate should have a transaction reference.

Section 5 FVerlV 2022 - E: Capitalization period

According to Section 6 FVerlV (current version), it is sufficient for the taxpayer to make a credible case for a shorter than unlimited capitalization period in order to use it as a basis for the valuation. Section 5 FVerlV 2022 - E instead requires the taxpayer to prove that a shorter capitalization period is appropriate. ***Observation:*** From the comparison of the phrases "make credible" and "prove," it appears that the requirements for counter-evidence on the part of the taxpayer have been increased by Section 5 FVerlV 2022 - E.

Section 6 FVerlV 2022 - E: Determination of the area of agreement

Section 6 FVerlV 2022 - E is largely based on Section 7 FVerlV (current version). Furthermore, the minimum price for the transfer of a function is determined by the change in the profit (Section 6 FVerlV 2022 - E refers to financial surpluses) of the transferring company, taking into account any closure costs. The reference in Section 6 FVerlV 2022 - E to the relevance of the present value of the financial surpluses is solely of a clarifying nature. Thus, the explanatory memorandum to the draft bill states that Section 6 FVerlV 2022 - E corresponds to the current Section 7 FVerlV (old version) with subsequent editorial adjustments and clarifications.

Section 6 para. 2 FVerlV 2022 - E corresponds to Section 7 para. 2 FVerlV (current version) without any changes. Thus, the minimum price of a function, which the selling company cannot continue, corresponds to its liquidation value.

Pursuant to Section 7 (3) Sentence 1 FVerlV (current version), the minimum price for a loss-making function corresponds either to the present value of the expected losses or to the closing costs. In addition, Section 6 FVerlV 2022 - E and Section 6 para. 3 FVerlV (old version) correspond to each other. Further, no substantial changes can be found in Section 6 FVerlV 2022 – E with regard to the determination of the maximum price. Section 6 para. 5 FVerlV 2022 - E corresponds to Section 7 para. 5 FVerlV (current version) without any changes, and the adjustments in para. 4 of Section 6 FVerlV 2022 - E are solely of an editorial nature.

Section 7 FVerlV 2022 - E: Claims for damages, compensation and indemnification

Section 7 FVerlV 2022 - E corresponds almost word for word to Section 8 FVerlV (current version). However, as in Section 5 FVerlV 2022 - E, the burden of proof is tightened to the disadvantage of the taxpayer. While Section 8 FVerlV (current version) required the taxpayer to demonstrate credibly that no material intangible assets were transferred in order to limit the determination of a compensation payment to claims for damages, compensation, and indemnification, the taxpayer now must prove this assertion.

Section 3 - Final provisions

Section 8 FVerlV 2022 - E clarifies that the regulations on the transfer of functions also are applicable to transactions between a company and its permanent establishment.

Pursuant to Section 9 FVerlV 2022 - E, the revised relocation of functions regulations are to apply to assessment periods beginning after December 31, 2021, thereby repealing the current version of FVerlV (Section 10).

Let's talk

For a deeper discussion of how this draft bill could impact your business, please contact:

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