

Comment on the OECD Discussion Draft regarding Transfer Pricing Aspects of Business Restructurings

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The German approach to meeting the arm's length principle in business restructuring transactions

Germany is one of the first OECD countries to have introduced extensive legal regulations for the taxation of cross-border business restructurings. In 2007 Germany amended its provisions on the arm's length principle with respect to business restructurings under the heading "*Funktionsverlagerung*" (transfer of functions). In view of the fact that the issue of business restructuring is highly important for the tax revenue potential of Germany, it comes as no surprise that Germany chose not to wait until the OECD Working Group had presented its findings. Germany is still a high tax country, its combined corporate tax levies amounting to some 30 percent, with high labour costs and high costs of social security systems. Since the break-up of the former Soviet bloc, Germany has had at its eastern border neighbouring countries with low tax levels (around 20 percent) and, in addition, with low labour and social security costs. On the other hand these countries also display efficient labour forces, reliable legal systems and good infrastructure. It is, therefore, not amazing that German enterprises are tempted to transfer business functions to these middle and eastern European countries, with the effect of weakening the German tax base where such transfers are not compensated at arm's length.

Whereas the concerns of the German government regarding the transfer of tax base from Germany to low-cost countries are well founded and the attempt to introduce rules to enforce arm's-length remunerations for these transfers is legitimate, some specific rules in the German legislation go beyond internationally accepted standards for allocation of taxing rights therefore inevitably causing double taxation conflicts. Hereinafter we will outline the specific provisions that concern us, compare them with the draft OECD report and give our comments. It is the objective of this paper to draw the attention of the Working Group to these issues in the hope that the Working Group is able to find a solution commonly acceptable to tax authorities of the OECD countries and to enterprises.

Outline of the German legislation on business restructuring

In principle, the German Foreign Tax Act requires the transfer price for intra-group cross-border business transactions to be determined primarily according to the comparable uncontrolled price method, the resale price method, or the cost plus method.

If no third party values of at least limited comparability can be found, the taxpayer is to base his income determination on a hypothetical third-party comparison. Where a function including the related opportunities and risks is transferred accompanied by assets and other

advantages transferred or lent, the taxpayer shall determine the arm's-length-price on the basis of the transfer of the function as a whole (transfer package). For this he is to estimate the lowest price for the seller and the highest price for the buyer, each price based on the profit expectations (profit potential) of each party, internal planning calculation and on capitalisation at adequate interest rates. If no other value is plausibly put forward, the mean of the price range between lowest price acceptable to the seller and highest price acceptable to the buyer is to be taken.

Valuation of “transfer package” vs valuation of individual assets

A major difference of these rules compared with the approach taken in the OECD draft report is the valuation of a “transfer package”. Using this package concept the German interpretation of the arm's length principle departs from a strictly transactional approach to pricing of assets and other advantages. Although the transfer package is not in itself an asset, the expectation of the German authorities is that in most cases the value of the transfer package may prove to be higher than the sum of the values of the individual assets involved.

The OECD, however, focuses on the pricing of individual assets, taking account of the goodwill in cases where an ongoing concern (possibly including contractual rights or a workforce in place) is transferred. The German approach to valuing the “transfer package” always as a whole may frequently, therefore, result in higher prices than those allowed under the OECD approach.

Treatment of location advantages including tax incentives

Another critical issue is the treatment of location advantages and tax incentives available only in the country of the buyer.

According to the German rule, calculating the price range on the basis of the profit potentials of both the seller and the buyer, economies of scale and scope as well as any location advantages and tax incentives may influence the highest price acceptable to the buyer, the price range, and therefore the relevant transfer price. Since in the absence of other plausible values under the German rules the mean of the price range is to be taken, half of these location advantages are automatically transferred to the Transferor. In our view, the critical issue is whether it is in line with the arm's length principle to attribute to the transferor half of all advantages which may accrue to the transferee, even if these advantages were not apparent at the outset.

There are certainly cases where, in an arm's length situation, the transferor may negotiate a substantial part of the benefits accruing to the transferee when transferring business functions. That may be the case if only the production of semi-finished products is transferred to the transferee putting the latter in the situation of a mere toll manufacturer, where the products are tailor-made to the needs of the transferor and no other customers exist for these products other than the transferor. However, in other cases it may be

inappropriate to transfer a part of these benefits to the transferor. As a base case for the discussion we want to use the following example:

Within a group of companies a certain product is produced by a plant in Country A (country of transferor). The products are sold to Group owned sales companies and independent distributors in all European and a number of overseas countries. The plant is not competitive due to high costs, old machinery and/ or other reasons. The plant in country A is therefore closed down and the production is transferred to the transferee in country B (country of the transferee) offering lower cost levels, specific investment incentives and lower taxes. After the transfer, the sale of the products now manufactured in country B continues to be effected through the marketing companies and the distributors.

In the absence of comparable third party prices the German regulations would ask for a valuation of the profit potential of transferor (which, due to the assumptions, would be low or even zero) and the profit potential of the transferee, which, again according to the assumptions, would be high, due to low costs, investment incentives and low tax levels. The low profit potential of the transferor forms the lower end of the price range, and the high profit potential the high end of the price range. Under the German legislation the transfer price for the transfer has to be set as the mean of this price range. As an effect, 50 percent of the benefit from lower cost, lower tax rates and investment incentives in country B would be transferred to country A.

The OECD requires both the transferor and the transferee to assess the benefit they reasonably can expect having regard to other options realistically available to each of them. It is not clear, however, how to treat advantages resulting from a beneficial tax system (favourable depreciation allowances, tax credits or low tax rates) accruing to the relocated activity. The draft OECD report is silent on whether or not those advantages would have to be distributed among the parties.

It is commonly agreed that the arm's length principle is to be applied to intra-group transactions, and that each country has a justified claim to that part of the tax base that was created in its territory through use of local infrastructure. In the case of restructuring, however, the issue is how to apply the arm's length principle in a consistent manner.

In principle, different types of profit potentials can be addressed in a business restructuring project:

1. The profit potential existing at the outset for the enterprise transferring business functions and that of the affiliated enterprise to which the business function is transferred;
2. The profit potential arising from the restructuring itself, such as synergies, economies of scale etc;
3. The profit potential arising because the economic and legal environment in the country of the transferee allows for a lower cost structure (i.e. lower labour costs, lower tax costs, investment incentives etc).

Existing profit potential

There is little doubt that the transfer of profit potential which is carried by some rights or other assets owned by the transferor requires remuneration to the transferor, thus compensating for any loss in net assets. The option available to the transferor is to carry on with his business. The minimum arm's length price for the transfer of the business is therefore the value of the continued operations.

Economies of integration

Potential profits arising from economies of integration may in a sense be independent of the country where the operations of the enterprise are realised. Rather, such profits are a consequence of scale, scope and the reduction of transaction costs. Therefore, in principle, they could be realised in each of the countries involved. To give an example: As a matter of principle, economies of scale can be achieved irrespective of whether production in country A is transferred to country B or vice versa, leaving aside for the moment special circumstances of the case such as technical availability of plant and machinery. The option of achieving advantages of this sort and of realising the profit potential connected with them is in principle open both to the transferor and the transferee.

In an arm's length scenario it may be assumed that both transferor and transferee have made a contribution to the generation of this type of profit potential. Therefore, from an arm's length perspective it would be fair to distribute potential economies of integration between the parties involved. If no better measure is available the assumption is reasonable that the relevant tax base may be apportioned equally among the countries involved. In a group context more than two entities may benefit from a restructuring of an enterprise. In this case the tax base may be allocated according to the benefits received.

Location savings

It is this type of profit potential which raises our particular concern because in our view the German legislation may not be in line with the arm's length principle. This type of profit potential is connected with one of the countries involved only, normally with the country of the transferee (otherwise the functions would not have been transferred to this country). These economies of location should be allocated among the parties depending on what independent parties would reasonably have agreed at arm's length in similar circumstances taking into account the options available to them. Location savings are only realisable by the resident transferee as they require investment in this country. On the other hand, from a tax perspective this option is not open to the transferor. Under no circumstances can he achieve these benefits and the profit potential connected with them by investment in his own country. Since the option to achieve these benefits is open to the transferee only there is in our view no legitimate reason for the country of the transferor to tax part of these benefits. Where, in a group context, only one sole transfer of functions takes place, i.e. no comparable transaction exists between third parties, whether or not a transferee would be prepared to incorporate location savings and, especially, tax advantages into his maximum

price is not obvious. He may realise this sort of savings in any alternative investment available to him.

As the German rules require that, as a matter of principle, all advantages or savings are to be distributed equally among the parties involved there is an inherent assumption that location savings may never rest with the transferee and therefore must also be distributed accordingly between the parties. We do not see this view as being in line with the arm's length principle.

In our view, the country of the transferee can hardly be expected to accept a tax rule according to which location savings are cancelled out by way of taxation. Under such a system the country of the transferor would in a sense "highjack" a significant part of the benefits resulting from the policy and economic environment of the transferee's country (e.g. significant tax incentives, investment incentives).

Conclusion

It is the objective of this paper to draw the particular attention of the Working Group to the issue of location savings. Beyond this it highlights differences between the OECD draft and existing German rules regarding the taxation of a transfer package. If no consensus can be achieved in these areas an increase in the number of cases of double taxation is unavoidable. Possible positions may be that either the German view is inconsistent with the arm's length principle or, on the other hand, that this German legislation is applicable as the OECD standard. The unambiguous adoption of either of these positions could help to avoid double taxation. In any case, this issue has to be clearly addressed by the Working Group and it is, therefore, our hope that in its review, the Working Group will deliver a clear statement in this context.