



Steuerberatungsgesellschaft Wirtschaftsprüfungsgesellschaft
[Tax Consulting and Public Audit Company]
Frankfurt am Main (Germany)

„Transfer of Functions“

By Martin Thieslauk

Presentation held at Geneva Group International Regional Asian Conference
Beijing/China, 20 October 2010

■ Our name

- Combines the terms „benefit“ and „tax“
- Let us show you how to design a profitable symbiosis out of these “contradictory” terms.



■ Our Philosophy

- Using all legal means in taxation in order to obtain the maximum benefit for our clients!

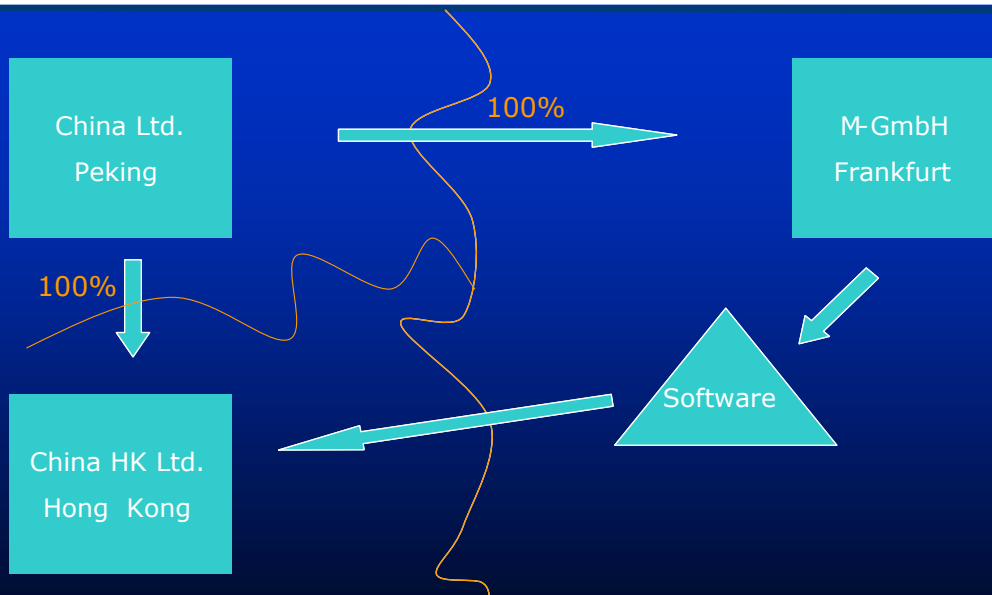
- Certified tax advisor
- Senior Manager
- Focuses
 - International Tax Law (country focuses: South Korea, Hongkong, Thailand, Singapore, Russia)
 - Preparation of annual financial statements
 - Consulting in company rating and controlling
 - Due Diligence
 - (Tax) law of private companies
 - Law of non-profit associations



The topic of my short presentation is “transfer of functions”. Most of you might wonder why “transfer of functions” is a subject of international taxation. There seems nothing more usual in daily business than to transfer a function from one agent to another.

But Germany is one of the fiscally most regulated countries in the world. And there is a special degree regulating the transfer abroad of business functions and processes inside companies or groups. It is thus a topic of daily interest for all companies which have some kind of branch or business outside Germany. And of course for those foreign companies investing in Germany.

What is Transfer of Functions?



Let me start my presentation with an example:

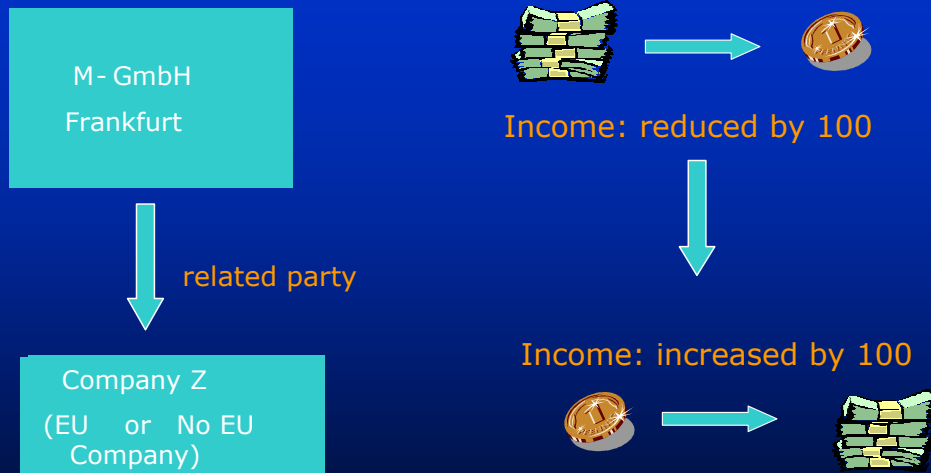
(Slide 1)

A foreign company, let us call it „China Ltd.“, seated in Beijing, buys the German machine building company „M-GmbH“, seated in Frankfurt. A software engineer working for M-GmbH develops a new programme which in a first instance is used inside the German company for own purposes.

The new software could be merchandised as a new business field of M-GmbH. The company expects development costs around 1 million Euros and additional yearly costs for customer care and advanced development of the programme of about 200.000 Euros.

It is expected that the sale of the software will generate a yearly turnover of 1 million Euros. The launch of the product is scheduled for the following year. The company supposes that the software can be sold during a period of 5 years before it will need a new launch due to technical progress.

China Ltd. decides to pass the further development of the software to “China Hong Kong Ltd.”, the related party seated in Hong Kong. There, the process until obtaining market quality will cost them only 500.000 Euros. The additional annual costs are calculated around 100.000 Euros only. One of the employees of the German company will therefore be switched to the Hong Kong company.

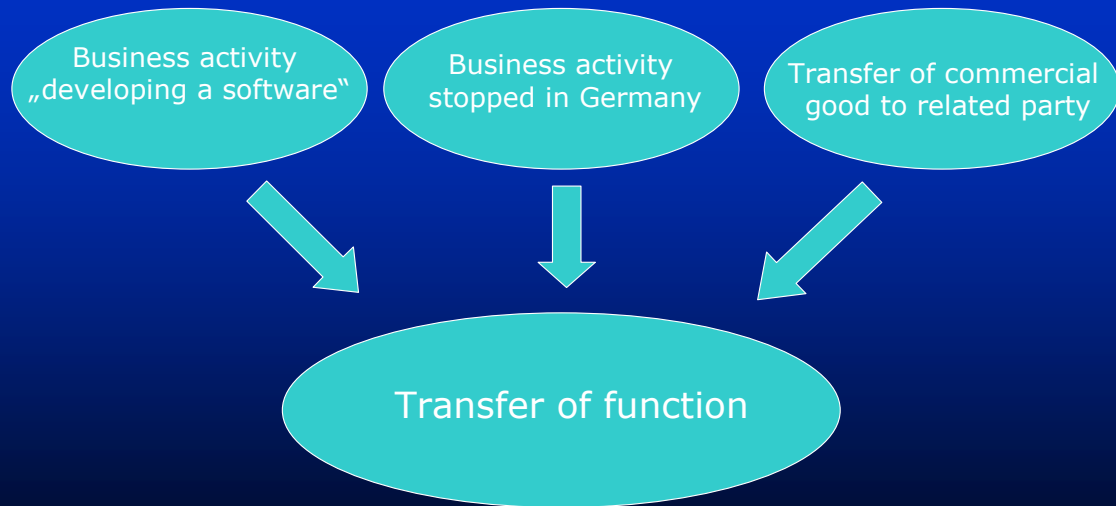


The rules for classifying subjects with cross-border relations between German companies and foreign related parties are regulated in the German Foreign Tax Act (AStG). The central statement of this legal norm is:

(Slide 2)

If the taxable income of a tax liable person in Germany resulting from a business relation with a foreign related party is reduced, the taxable national income in Germany will have to be increased accordingly (Section 1, paragraph 1 Foreign Tax Act).

I would like to ask your comprehension that the figure of the “related party” cannot be considered in this presentation. I would rather like to demonstrate the German Foreign Tax Act’s intentions and effects in connection with the “transfer of functions” by means of the case described before.



The basic idea of the German Foreign Tax Act is that the state of Germany shall not lose tax substance. On the one hand, it shall be guaranteed that the profits obtained from business relations with related parties persons shall be taxed in the same way as such relations between non-related third parties inside Germany. On the other hand, at the moment of moving out of Germany, transferring the seat, those future potential benefits shall be taxed which would have been created inside Germany in case the business activity – the function – had been carried out in Germany

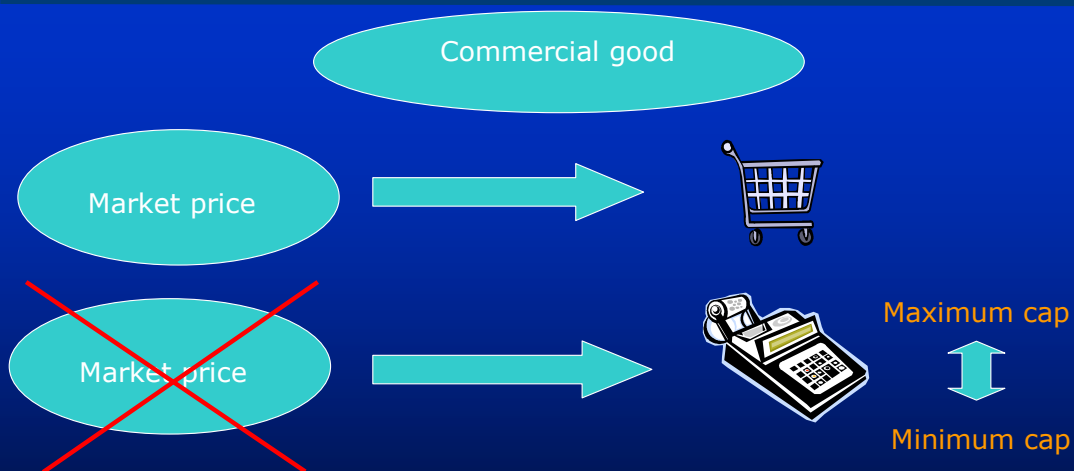
(Slide 3)

The term „transfer of functions“ means that one or several business activities shall be transferred to a place outside Germany and at the same time the same activity or activities shall be given up inside Germany. “Transfer of functions” also includes the fact of handing over or letting commercial goods to the foreign related party.

Our example reflects the following items:

- Firstly, the business activity of “developing a software” is started abroad.
- At the same time a business activity is stopped in Germany because the only software engineer is expatriated to the foreign company.
- Finally, the software as a commercial good is handed over to the related party in Hong Kong. There this good will be explored in the future being developing and merchandising by the related party.

Comparison with the Market Price

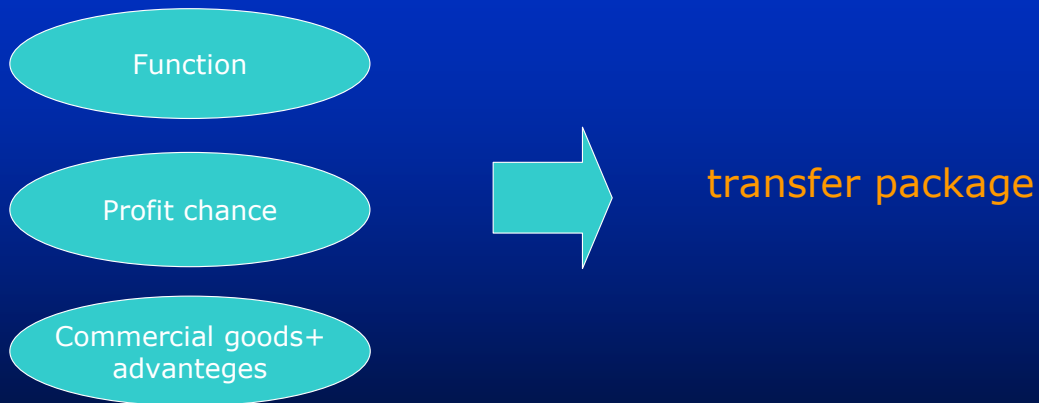


As we can prove by means of this example, the after achieving market quality and having borne corresponding development costs, a yearly turnover of 1 million Euros will be generated by selling this software. If this turnover was generated inside Germany, in the following years additional taxes would arise. This is the reason why an virtual profit will be added to the real profit of the German company in the year in which the “function” will be transferred to Hong Kong.

Let us see how this additional profit is calculated:

(Slide 4)

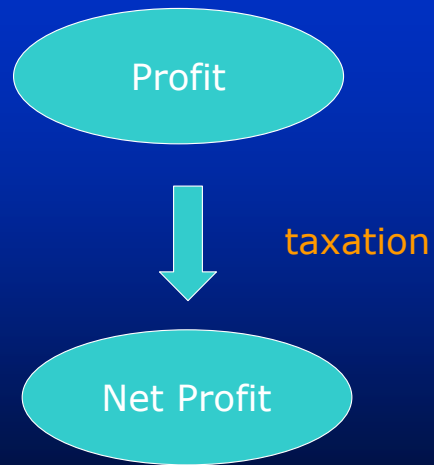
The most important principle of the German Foreign Tax Act is the comparison with the market price. If there is NO comparable market price, one will try to obtain a “price” by applying calculation and comparison methods. The German authorities suppose that there is a minimum and a maximum cap which define the margin in which the price can be established.



As the matter of fact, the comparable market price usually does not exist. The price to be established shall be agreed basing on a “transfer package”, taking into consideration the interest rates which can be obtained by a capitalisation in accordance with their function and risk.

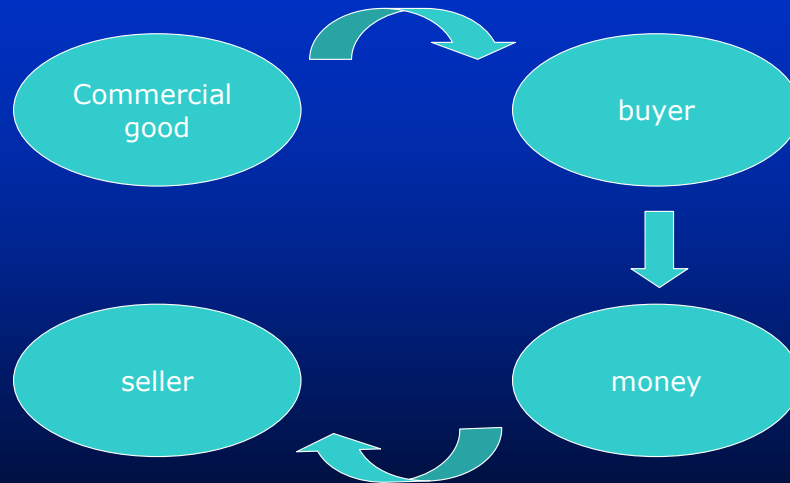
(Slide 5)

A „transfer package“ consists of the „function“ and the opportunities and risks adherent to this function – the profit chance. It also contains the commercial goods and advantages which the transferring company passes to the assuming company together with the function. And finally it includes the services rendered in connection with the transfer.



(Slide 6)

The „profit chance“ in the meaning of the German Foreign Tax Act are the net profits expected to be obtained after tax.



(Slide 7)

A decent and prudent director of the transferring company would not abstain from these profits without any other compensation. On the other hand, the director of the assuming company would be willing to pay a compensation for.

The value of the „transfer package“ can therefore consist of the individual prices of the transferred commercial goods, of the hypothetical profit chance or of a combination of both.

Example: value of transfer package



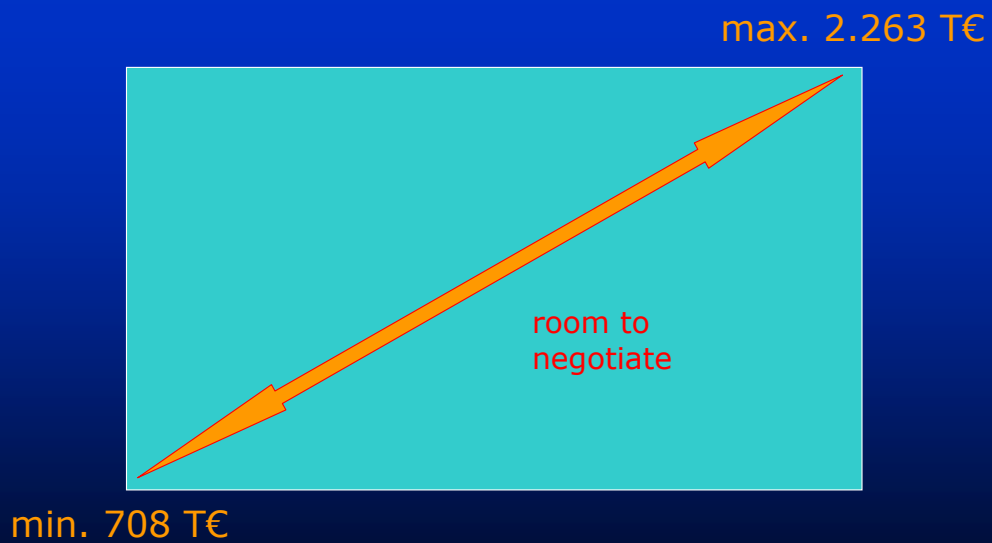
<u>For the transferring German company</u>	Year 1 (in T€)	Year 2 (in T€)	Year 3 (in T€)	Year 4 (in T€)	Year 5 (in T€)	Year 6 (in T€)
Turnover from software sale	0	1.000	1.000	1.000	1.000	1.000
Less development costs	- 1.000	0	0	0	0	0
Less operating costs	0	- 200	- 200	- 200	- 200	200
Profit	- 1.000	800	800	800	800	800
./.. Loss carried forward	0	- 800	- 200	0	0	0
Profit before tax	- 1.000	0	600	800	800	800
Profit taxes approx. 30%	0	0	- 180	- 240	- 240	- 240
Profit after tax	- 1.000	0	420	560	560	560
Cash value at the transfer date	- 1.000	0	367	467	447	427
Additional profit according to German Foreign Tax Act						708

Example: value of transfer package



<u>For the assuming foreign company</u>	Year 1 (in T€)	Year 2 (in T€)	Year 3 (in T€)	Year 4 (in T€)	Year 5 (in T€)	Year 6 (in T€)
Turnover from software sale	0	1.000	1.000	1.000	1.000	1.000
Less development costs	- 500	0	0	0	0	0
Less operating costs	0	- 100	- 100	100	- 100	- 100
Profit	500	900	900	900	900	900
./.. Loss carried forward	0	- 500	0	0	0	0
Profit before tax	- 500	400	900	900	900	900
Profit taxes approx. 30%	0	- 66	- 149	- 149	- 149	- 149
Profit after tax	- 500	334	752	752	752	752
Cash value at the transfer date	- 500	305	657	628	600	573
Additional profit according to German Foreign Tax Act						2.263

Margin of Additional Profit



(Slide 11)

As you can see, there is a significant margin between 708.000 Euros and 2.263 million Euros.



additional
tax

2010



2020

10 years

(Slide 12)

What has to be considered additionally are the future insecurities and risks. If there is no regulation for an adjustment and significant deviations are produced within the ten following years after the transfer of the function, an adequate adjustment amount has to be assumed. This amount will be calculated on the base of the initial transfer price of the commercial good which has been the base of taxation in the year following the year in which the deviation has occurred.

If there is no adjustment regulation, this will mean in our present case that the German fiscal authorities will require the presentation of the results during the ten years following the transfer.

The German tax law does not contain a final definition of the items covered by the term „function“. However, the German fiscal authorities and their lively fantasy do not seem to have any restrictions. We can thus sincerely recommend that the parties of such operations do previously consult their expert advisors.

■ **Contact us:**

Benefitax GmbH

Steuerberatungsgesellschaft Wirtschaftsprüfungsgesellschaft

Darmstädter Landstraße 125

60598 Frankfurt am Main

Tel. 069 – 25 62 27 60

Fax 069 – 25 62 27 611

info@benefitax.de

www.benefitax.de

Nevertheless, there are serious reasons which motivated the German fiscal authorities to adopt such „creative“ means. Let me describe a real story which occurred in the not too far past:

A multinational group with worldwide activities wanted to close a production plant in a economically weak German region. In order to avoid losing many workplaces, the multinational group received high subventions from the German authorities. The company on its behalf guaranteed to maintain the workplaces during a certain period.

Immediately after finishing this period, the production was transferred abroad and Germany lost both: the subventions and the workplaces. The idea of the fiscal regulations for transfer of functions – which have been established two years ago – was to complicate occurrences like these. Perhaps, it is now to understand why the taxation of such processes in connection with the transfer of function has been established.

Thank you for your attention!

Thank you for your attention!

