

Germany: Recent case law regarding transfer of functions (ToF)

ToF is a hot topic in German tax audits leading to controversial debates between taxpayers and the German tax authorities. The German regulations on ToF are very comprehensive and go far beyond the OECD regulations stipulated in Chapter IX of OECD Transfer Pricing Guidelines. Starting with the corporate tax reform 2008, the tax treatment of a ToF is explicitly regulated by the German law. The German regulations foresee that a significant portion of the entire profit potential of the transferred function is taxed in Germany, i.e. the expected loss in profit potential in Germany but also typically half of the expected gain in profit potential in the receiving country.

Due to a change in the German law, the definition of a ToF was tightened and the threshold for the requirements of a ToF was lowered. This change applies to all completed ToF taking place in assessment periods beginning after December 31, 2021.¹

Recent case law has shown that German taxpayers may successfully defend themselves against an increased tax burden due to the assessment of a ToF by the German tax authorities:

- **Judgment 10 K 310/19: Fiscal Court Lower Saxony, March 16, 2023 (pending at Federal Fiscal Court):** The German tax authorities claimed the termination of the production function at the German subsidiary X, which has been performed exclusively for affiliated entities, and the subsequent takeover of this function by another subsidiary Y being a ToF and calculated a transfer package. X sold the production facilities to affiliated companies and the closure costs were borne by Y, no further compensation was paid. The court ruled that the transfer of a production function being performed exclusively

for affiliated companies is not regarded a ToF respectively a transfer of a business opportunity due to the lack of a contractual right to certain purchase quantities. Additionally, no material assets like production facilities, a customer base, or specific know-how were transferred to the receiving entity.

- **Judgment 10 K 117/20: Fiscal Court Lower Saxony, August 03, 2023 (pending at Federal Fiscal Court):** This case addressed the restructuring of a German license manufacturer into a contract manufacturer and low risk distributor for a European principal structure which in the view of the German tax authorities fulfilled the criteria of a ToF. The Fiscal Court stated that no transfer of business opportunities took place, since the production and distribution function was continued. Crucially, the main strategic decisions were not made by the German entity before or after the restructuring. Furthermore, no assets were transferred since they were either still in use or not owned by the German entity. The premature waiver of the use of the license agreement was compensated in isolation by a straight forward arm's length indemnification payment.
- **Judgment I R 54/19: Federal Fiscal Court, August 09, 2023 (referred back to the Fiscal Court):** In this case, the outsourcing of a production and subsequent conversion of sales to a specific customer were examined. The court ruled that the production for just one customer does not fulfil the factual requirement for a function due to a lack of stand-alone status. However, the court emphasizes that the transfer of a customer relationship to an associated company must be remunerated at arm's length.

¹ Regulation on the Application of the Arm's Length Principle pursuant to § 1 Paragraph 1 of the Foreign Tax Act in Cases of Cross-Border Transfer of Functions (Function Transfer Regulation - FVerlV), published on October 18, 2022 (BGBl. I p. 1803)

These judgments underscore the nuanced approach of German tax law in evaluating ToF. It is important to note that these court decisions refer to previous versions of the German tax code which were applicable to ToFs for assessment periods beginning before January 01, 2022. Whereas the old legal basis referred to “assets and other benefits” as a criterion of a ToF, the new regulations read “assets or other benefits”, thus relaxing the old requirement. In addition, according to the new regulations, it is sufficient that a function is transferred only in part.

It remains to be seen how the stricter legal framework will affect the discussions of the German taxpayers with the German tax authorities and how it will affect future court decisions.

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