

BMF publishes draft on new business function relocation ordinance

On July 5, 2022, the German Federal Ministry of Finance ("BMF") published a draft bill for the amendment of the Ordinance on the Relocation of Functions ("FVerlV-RE"). This is intended to incorporate legislative changes made by the German Withholding Tax Relief Modernization Act ("AbzStEntModG").

Background

In 2021, the AbzStEntModG revised the regulations on the arm's length principle and aligned them with the current OECD transfer pricing guidelines. As part of this, the rules in relation to relocations of functions were also revised and moved into the newly implemented section 1 (3b) of the German Foreign Tax Act ("ASTG"). As a result, the provisions of the current Ordinance on the Relocation of Functions no longer refer to the current version of the law and have become partially obsolete due to their incorporation directly into the law.

The new provisions relate to the cross-border relocation of functions between affiliated companies, as well as between permanent establishments or between a permanent establishment and its headquarters. The provisions should be applied to relocations of functions in assessment periods beginning after December 31, 2021. As the amended provisions are expected to apply from beginning of the assessment period, the new version is also relevant for restructurings already carried out prior to the adoption of the new Ordinance, meaning that it would de facto have retroactive effect.

According to the explanations in the draft bill, it is essentially aimed at closing the gaps that arose from the reorganization of section 1 of the German Foreign Tax Act and it is therefore heavily based on the current version of the Ordinance. To the extent that provisions of the original Ordinance have been incorporated into section 1 of the German Foreign Tax Act by the AbzStEntModG, they are no longer included in the new version of the Ordinance. However, the draft clearly goes beyond purely editorial amendments, making it worthwhile to take a closer look at the main changes. We anticipate that an updated BMF letter on the relocation of functions will be published shortly after the new Ordinance comes into effect, in which the position of the tax authorities will be further specified.

Overview of significant changes

As explained above, the new Ordinance is based on the previous version published on August 12, 2008 and aims to close gaps arising from the reorganization of section 1 of the German Foreign Tax Act. To the extent that provisions of the original Ordinance have been incorporated into section 1 of the German Foreign Tax Act by the AbzStEntModG, they are no longer included in the new version of the Ordinance, and the resulting blind references have been amended. In addition, editorial changes have been made and terminology has been adapted to more common formulations. For example, in the regulations on the value of the transfer package in the new section 2 of the Ordinance, instead of "profit potential", the term "financial surplus" is used, which is more common in the context of business valuations.

Nevertheless, the draft goes far beyond purely editorial adjustments. The following changes are particularly noteworthy:

- Definition of a relocation of functions (FVerlV-RE, s 1(2)): The first sentence contains an adjusted definition of a relocation of functions, which reads as follows (relevant changes were highlighted by the authors):

"A relocation of functions within the meaning of section 1 (3b) of the German Foreign Tax Act occurs if a function, including the corresponding opportunities and risks as well as any assets and other benefits that may have been transferred or provided, is relocated in whole or in part, such that the acquiring company is able to perform this function or expand an existing function."

In this regard, it should be noted that now, due to the addition of the words "may have been", the transfer or provision of assets is no longer a determining factor. Also, a transfer/relocation of a function as a whole is no longer necessary and a "partial" transfer/relocation will already be sufficient to realize a relocation of functions. Furthermore, the reduction of a function at the transferring company is no longer a determining factor for a relocation of functions.

This significantly tightens the regulations and substantially expands the circumstances in which relocations of functions are to be assumed. Particularly in cases of permanent establishments or personnel secondments, this results in a series of unresolved questions or potential problem areas. It is questionable whether this is covered by the enabling legislation.

- Valuation (FVerIV-RE, s 2): From now on, tax effects are also to be considered in the valuation of the transfer package. This notion from the German tax authorities has already been stated in the Administrative Principles on Relocations of Functions in 2010, however no international consensus has been reached on this issue. With its inclusion in the draft bill, this concept now has force as law in Germany. However, the regulation does not clarify how exactly these tax effects are to be considered.
- Capitalization interest rate (FVerIV-RE, s 4): For the determination of the capitalization interest rate, a mandatory capital market reference has been introduced and explicit reference has been made to the third-party comparison. Therefore, simplified approaches will no longer be possible in the future, which may lead to considerable additional work in determining the capitalization interest rates.
- Capitalization period (FVerIV-RE, s 5): While the previous version only required a credible demonstration for a limited capitalization period, the taxpayer is now required to provide evidence on this. This results in a tightening of the burden of proof, which in practice cannot routinely be fulfilled by a taxpayer. Furthermore, a similar increase in the burden of proof is to be expected for the assumption of a duplication of functions, as well as the recognition of claims for damages, compensation and indemnification for the value of function transfers.

Conclusion and implications

Following the adoption of the AbzStEntModG, the ongoing tightening of the legal environment is now also reflected in the planned amendments to the Ordinance on the Relocation of Functions. The new version considerably restricts the legal options for German taxpayers to avoid the holistic transfer package valuation. Additionally, the tendency towards a considerable extension of the burden of proof is highly problematic. In the future, it is likely as a minimum to result in a significant additional effort for companies and tax consultants, provided that satisfying the burden is factually possible at all.

The effect of the draft regulation on the valuation, and thus also the tax amount, can be described very briefly as being to the benefit of the tax authorities for many cases. In this context, revised administrative principles on the relocation of functions are necessary in order to be able to act with legal certainty if the ambiguities rising from the current draft are not eliminated in the final version, or if the existing questions remain unanswered.

With its provisions on the legally certain and uniform application of the arm's length principle to relocations of functions under section 1 (3b) of the German Foreign Tax Act, the new Ordinance is intended to be authoritative and applicable for relocations of functions in assessment periods beginning after December 31, 2021. Therefore, the new version would also be retroactively relevant for restructurings that were already carried out after this date, but prior to its adoption.

With the publication of the draft, associations were given the opportunity to comment on it. After finalization by the BMF, the Bundesrat must still approve the Ordinance.

Fundstelle

Federal Ministry of Finance, draft bill of 25 May 2022, published on 05 July 2022

[Ordinance on the application of the arm's length principle according to section 1 \(1\) of the German Foreign Tax Act in cases of cross-border relocations of functions \(Business Function](#)

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