NATIONAL FOREIGN TRADE COUNCIL, INC.

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August 16, 2007

The Finance Minister
Mrs. Birgit Diezel
Free State of Thuringia
Ministry of Finance
Ludwig-Erhard-Ring 7
99099 Erfurt
Federal Republic of Germany

Dear Minister,

The National Foreign Trade Council, organized in 1914, is an association of some 300 U.S. business enterprises engaged in all aspects of international trade and investment. Our membership covers the full spectrum of industrial, commercial, financial, and service activities, and our members have for many years been substantial investors in many countries. U.S.-based multinational companies have a long history of robust investment in the German economy in particular, presently employing approximately 800,000 Germans.

We welcome Germany's interest in attracting and retaining investment and the German tax rate reductions recently enacted to that end. Our member companies are concerned, however, that investments from the United States into Germany will be adversely affected by the recent German legislation on "transfer of functions," as interpreted by the draft regulations now under discussion (§1 AStG, Entwurf einer Funktionsverlagerungs-Verordnung). We fear that these transfer of functions rules will have the unfortunate effect of forcing U.S. companies to limit future investments in Germany and, in some cases, terminate or reduce existing investments, notwithstanding the new tax rates. Indeed, we understand that German tax advisors are already receiving requests for advice on plant closures.

We appreciate the obvious care with which the transfer of functions rules were developed and the acknowledgement, during the legislative process, of the importance of following international norms and avoiding double taxation. However, the new German rules depart from U.S. laws and OECD principles in several important respects, which makes relief from double taxation uncertain.

A key difference between the new German rules and U.S. laws is that U.S. laws do not tax transfers of *functions*. U.S. transfer pricing rules tax transfers only when an asset that is the property of the transferor is transferred and that transfer is covered by the rules. Only specified types of intangible property are taxed on transfer; transfers of other intellectual property are not taxed, even if they may have some value.

The proposal, in the draft German regulations, to tax the "*doubling of functions*" in the absence of an asset transfer is particularly novel from a U.S. perspective. Unlike the new German rules, U.S. transfer pricing rules do not attempt to tax the location savings associated with functions performed in other countries by affiliates of U.S. companies. Location savings do not constitute intangible property under U.S. transfer pricing rules, and the cost reduction from location savings normally does not increase the profits of the foreign affiliate. Only if the cost advantage (and resulting product price reduction) is unique to the foreign affiliate, and cannot be enjoyed by its competitors in the same country or another country, would the profits of the foreign affiliate be increased. Even if the profits of the foreign affiliate are increased, they may not be taxed currently under U.S. controlled foreign company rules, and the United States would allow a credit against U.S. tax for income taxes imposed by the host country in any event.

Nor do U.S. laws tax transfers of *profit potential*. U.S. case law specifically confirms, in the leading 1983 case of *Hospital Corporation of America*, that even a particular "business opportunity" may be transferred to an affiliate without compensation. Profit potential is taken into account under U.S. laws only if it is relevant for the valuation of an asset that has been transferred in an otherwise taxable transaction, and only for valuation purposes. Unlike under the new German rules, a transfer of profit potential alone is never taxed under U.S. law.

Under U.S. transfer pricing rules, then, tax is imposed only on transfers of certain assets that are the property of the transferor. Only specified types of intangible property are taxed on transfer. Transfers of functions or profit potential alone, or transactions involving the "doubling of functions," are not taxed. Current OECD guidelines on transfer pricing take the same approach, defining "intangible property" narrowly (in pararaph 6.2) and cautioning against more expansive definitions (in paragraph 6.6). The current OECD guidelines do not contemplate the taxation of transfers of functions or profit potential or of the doubling of functions.

It is true that the OECD has formed a working group of technical experts to study transfer pricing aspects of "business restructurings." The OECD working group is actively debating a number of issues raised by delegates from some member countries, including the extent to which transfers of functions or profit potential should be taxable (although the doubling of functions is not, to our knowledge, under consideration). However, the OECD working group has not yet reached any conclusions and the OECD does not plan to issue even its initial discussion draft until the end of 2008, at which time public comments will be invited and a formal dialogue with business regarding the proposals will commence. In the meantime, the outcome of the OECD project remains entirely uncertain, as recent public comments by officials of several OECD member countries have indicated substantial differences in position.

The new German rules on transfers of functions differ in some very important respects, therefore, from current U.S. transfer pricing rules and OECD transfer pricing principles. We understand that a number of German experts have also questioned whether the new German rules are consistent with the provisions of EU law. Given the unique features of the new German rules, and the active debate currently underway at the OECD on many of the same issues, it is quite unlikely, in our view, that German tax authorities will be able to persuade U.S. or other foreign authorities to cede taxing jurisdiction over affected companies to prevent double taxation. This increased risk of double taxation is a matter of grave concern to our member companies.

The foregoing considerations clearly call for the draft regulations currently under discussion to adopt the narrowest possible interpretation of the recent legislative changes. For example, it is important for the regulations to clarify, among other points, that the new tax does not apply to the "doubling of functions," to the profits earned in perpetuity on a function, or to foreign location savings. As a practical matter, it is also important for the regulations to confirm that a reasonable level of detail and evidence will suffice to rebut the new legal presumptions of taxation.

Our members would be happy to work with you and your colleagues to help further develop an approach that would be less harmful to inbound investment. We are sending a similar letter extending the same offer to the Federal Minister of Finance and to the Finance Minister of each of the *Länder*. Please let us know how we can contribute towards a solution.

Sincerely,

William A. Reinsch
President