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Global Tax Alert

Germany publishes draft bill to restrict deduction of royalties to affiliated foreign entities that benefit from IP regimes without substantial local R&D activities

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Executive summary

On 19 December 2016, the German Ministry of Finance (MoF) published a first technical draft of an *Act against Harmful Tax Practices with regard to Licensing of Rights*. The purpose of the draft legislation is to introduce a new section in the *German Income Tax Act* (Sec. 4j ITA) restricting the tax deduction of royalties and similar payments made to related parties if such payments are subject to a non-Organisation for Economic Co-operation and Development (OECD) compliant preferential tax regime (IP Box) in the jurisdiction of the recipient, and are effectively taxed at a rate below 25%.

In line with the so-called "nexus approach" of Action 5 of the OCED Base Erosion and Profit Shifting (BEPS) project to *counter harmful tax practices more effectively, taking into account transparency and substance*,[1] the draft intends to restrict the tax deduction only in cases where the licensed intellectual property (IP) subject to the preferential tax regime is not derived from substantial research and development (R&D) activities carried out by the licensor (except for the licensing of trademarks where no such exception based on substance is possible). Moreover, royalty payments that are low taxed however, not because of a preferential IP Box regime but because of the fact that the recipient's jurisdiction is a general low tax jurisdiction, are not covered by the proposal.

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Since the restriction is limited to royalties and similar payments made to related parties, payments made to unaffiliated third parties would not be covered by the rule.

In summary, the tax deduction of cross-border royalties or similar payments made to related parties may be wholly or partially denied if the following conditions are cumulatively met:

- The (direct or indirect) recipient of the royalty benefits from a preferential tax regime related to the royalty income.
- The preferential tax regime is not limited to income for which sufficient underlying economic activities are required, i.e., the exploitation of self IP creation (unqualified preferential IP regime); hence, a fully OECD-compliant IP regime should not be caught by the deduction limitation.
- The effective taxation of the royalty income is less than 25%.

If these conditions are fulfilled, the percentage of nondeductible royalties is calculated as follows:

$$\frac{25\% - \textit{effective tax rate at recipient's level in }\%}{25\%}$$

For example, if the effective tax rate of the recipient was 5%, then 80% of the licensor's expenses would be nondeductible.

The draft foresees that the new rules would apply to any royalty expenses that "arise" after 31 December 2017. This definition seems to indicate that it affects expenses incurred as of 1 January 2018 and later, as determined by general German tax accounting rules. However, it is expected that the draft will be subject to intense discussions, and it is therefore difficult to assess if and when the proposed rules will become final law.

Detailed discussion

Type of license expenses caught by the new rule

The draft rule applies to expenses made for the utilization or the right to utilize (intangible) rights, in particular copyrights and intellectual property rights, including the right to utilize business, technical or scientific know-how and skills. Insofar, the wording is equivalent to the existing rule in the German domestic ITA that defines the type of royalty income that is subject to withholding tax if received by a foreign tax payer.

Only payments made to related parties effected

Only payments made to a recipient that qualifies as a related party of the licensee are supposed to be subject to the restricted deduction. The term "related party" is defined in the *German Foreign Tax Act*, according to which a party is related to another person if, e.g., it owns a direct or indirect equity participation of at least 25% or can exercise a dominating influence over that other person, or if a third person owns a direct or indirect equity participation of at least 25% in both relevant parties.

Interposition of related party intermediaries covered

The draft rule expands the limitation on "indirect" license arrangements where payments are in essence routed through a recipient towards another related party which benefits from an unqualified preferential regime. That is if (i) the recipient of the payments or (ii) another party related to the German payer incurs in turn expenses for license rights, from which the rights derive that are licensed to the German payer, and (iii) the recipient of those payments (the "indirect recipient") benefits from an unqualified IP regime, then the deduction of the German licensee's payments will still be restricted.

Permanent establishments to which the licensing rights or obligations are attributed for income tax purposes are treated as regarded payers or debtors, as the case may be, for purposes of the rule.

Unqualified preferential tax regime

As an exception to the rule, the tax deduction of license payments is not limited if the low taxation in the jurisdiction of the recipient is caused by a preferential IP tax regime that only applies to rights which are based on substantial business activities (nexus approach). Substantial business activities are not deemed to exist if the recipient of the payments did not or did not predominantly develop the right in the course of its ordinary business activities. In particular, no substantial business activities shall exist if the right was acquired or if it was developed by another related party. Moreover, with reference to the OECD BEPS report on Action 5, the substantial business activities exception does not apply to licensing of trademarks; hence, such activities would not be covered by the nexus approach.

Definition of low taxation and relative amount of non-deductibility

The unqualified preferential tax regime must provide for the taxation of the royalty income at an effective rate of less than 25%. Whether or not such rate is present has to be determined on the basis of German tax accounting principles, and follows in general the determination rules of "low taxed income" under the German controlled foreign company rules. If the requirements for a restricted deduction of license payments are met, the percentage of nondeductible expenses is defined as follows:

$$\frac{25\% - \textit{effective tax rate at recipient's level in }\%}{25\%}$$

Hence, in a case where the effective tax rate under the harmful preferential tax regime in the jurisdiction of the recipient would, e.g., be 10%, then 60% (= 25% – 10% / 25%) of the license payments may be nondeductible, whereas 40% of the license payments would generally still be tax deductible. If there was no taxation at the recipient's level at all, the deductibility would be completely denied.

According to the wording of the draft, the application of the rule shall not be limited by any existing double tax treaties.

Next steps

The MoF has asked public interest groups and other stakeholders for submission of comments and the draft is expected to become subject to intense discussions over the coming weeks and months. As of today, it is therefore difficult to assess whether any changes to the draft might still be introduced during the course of the legislative process, and if and when the draft will become final law. Also, it remains to be seen if the new rule would be in line with European Union law, in particular with the freedom of establishment principle.

The draft foresees that it would only apply for any royalties that "arise" after 31 December 2017. German taxpayers that currently incur (or expect to incur) license payments made to related parties that are directly or indirectly subject to low taxation under a preferential tax regime are advised to carefully monitor the developments of this legislative process and to assess whether the new law may result in any adverse future German tax implications.

Endnote

1. http://www.oecd-ilibrary.org/taxation/countering-harmful-tax-practices-more-effectively-taking-into-account-transparency-and-substance-action-5-2015-final-report_9789264241190-en.

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