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Germany tax alert
Bill to limit tax deductibility of royalty payments undergoing legislative process

On 25 January 2017, the German government decided to introduce a bill into the legislative process that would limit the deductibility of certain related party royalty payments. The bill (which would introduce a new section 4j in the Income Tax Code) generally is based on a draft law that was published by the federal ministry of finance on 19 December 2016 (for prior coverage, see *World Tax Advisor* **article dated 13 January 2017**).

The draft law would target royalty payments that result in the "low taxation" of the royalty income at the level of the recipient due to the application of an intellectual property (IP) regime (i.e. IP box, patent box, license box, etc.), in situations where the IP regime is not based on the "nexus approach" described in action 5 of the OECD's BEPS project. If approved, the proposed rule would apply to royalty payments that become due after 31 December 2017.

The explanatory statement to the draft refers to the OECD Forum on Harmful Tax Practices for purposes of analyzing preferential tax regimes and determining their features.

The draft law is directed at beneficial "non-nexus"-based IP regimes—low taxation (or nontaxation) of royalty income based on the general taxation of the recipient would not fall within the scope of the proposed rules. The restriction on deductibility would apply only to royalty payments made between related parties; payments made to unrelated parties would not be affected. Related parties for these purposes would be parties that are deemed to be related under the Foreign Tax Act, i.e. where a party holds directly or indirectly at least 25% of another party or can exercise control over another party or where another party holds directly or indirectly at least 25% of both parties.

The draft law also targets payments made to indirect recipients that benefit from a preferential non-nexus-based IP regime resulting in low taxation. This approach would result in the disallowance of deductions in back-to-back royalty structures where only an indirect recipient benefits from the regime.

"Low taxation" under the draft law generally would mean an effective tax rate of less than 25%. The determination of whether the income is low-taxed would be made in accordance with the rules in the Foreign Tax Act. However, low taxation would not automatically result in a full disallowance of the deduction of the royalty payment. The percentage of the disallowed payment would be calculated based on the applicable tax benefit at the level of the recipient (i.e. the difference between the applicable tax rate and a 25% tax rate), using the following formula:

$$\frac{25\% - \text{recipient's effective tax rate (ETR)}}{25\%}$$

For example, if the tax rate at the level of the recipient is 10%, 60% of the royalty payment would be nondeductible for German tax purposes, and if the non-nexus based IP-regime provided for a 0% tax rate, the full amount of the royalty payment would be nondeductible.

Examples

The explanatory statement to the draft law contains three examples that illustrate how the ETR would be determined at the level of the recipient:

Example 1: Licensor A receives a royalty payment of 100 and has related business expenses of 20. The preferential tax rate for royalty income is 10%. The ETR would be 10%. The amount of the actual business expenses related to the royalty income would be irrelevant since the ETR would be calculated based on revenue.

Example 2: Licensor B receives a royalty payment of 100. The general tax rate applicable to royalty income is 30%, although royalty income is only taxed at 50% of the full rate. The ETR would be 15% (50% of 30%). The amount of the actual business expenses related to the royalty income would not be relevant.

Example 3: Licensor C receives a royalty payment of 100. The general tax rate applicable for royalty income is 30%. A notional business expense deduction of 60% applies to royalty income. The ETR would be 12% (40% of 30%).

Exceptions

The draft law contains an exception to the deduction limitation for royalty payments made to subsidiaries of the German licensee and that trigger the German controlled foreign company (CFC) rules at the level of the subsidiary so as to prevent double taxation (denial of deduction and inclusion under the CFC rules).

"Nexus-based" preferential tax regimes that would fall outside the scope of the proposed rule include regimes whose benefits depend on a substantial economic activity (e.g. R&D). The draft law provides that a substantial economic activity would not exist where the recipient of the royalty payment did not fully or predominantly develop the underlying IP in its own business operations (e.g. if the IP was developed by related parties or acquired).

Payments regarding trademark rights based on the definition in the Trademark Act that are made to low-taxed IP-regimes generally are (partially) nondeductible, since based on the wording of the draft law, the nature of the IP-regime should not be of relevance for such payments.

Germany's existing tax treaties should not affect the limited deductibility of royalty payments.

Comments

The outcome of the legislative process is unclear, although because the draft law is supported by the governing coalition at the federal level, chances that the draft law will be enacted seem high. Affected taxpayers should carefully monitor the legislative process.

Contacts

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