

SINCE 2018, LICENCE PAYMENTS TO RELATED PARTIES ABROAD HAVE ONLY BEEN DEDUCTIBLE TO A LIMITED EXTENT.



With the introduction of the “Lizenzschranke” in Sec. 4j EStG there is a regulation which is directed against foreign preferential regulations for the taxation of income from usage transfer of rights. Some of the corresponding expenses can only be deducted to a limited extent.

1. BACKGROUND

The erosion of the tax base addressed in the OECD’s BEPS (Base Erosion and Profit Shifting) project takes place through, in addition to cross-border financing, the cross-border usage transfer of rights. In particular, regulations providing for preferential taxation of royalty income (–patent, licence, or IP boxes) without linking this advantage to active research and development activities contribute to harmful tax competition and have fallen into disrepute. At the OECD level (BEPS Action Point 5), it was decided that such regulations should be abolished or adapted by 30 June 2021.

In the future, preferential taxation should only be permissible if there is substantial business activity, in particular because active research and development takes place abroad (called the Nexus approach).

In addition to the OECD requirements, Germany has unilaterally decided to introduce a defensive measure until the end of the aforementioned transitional period. According to Sec. 4j EStG, expenses for the usage transfer of rights arising after 31 December 2017 are subject to a deduction ban if the corresponding income abroad was subject to preferential low taxation.

2. REGULATORY AREA OF SEC. 4J EStG

Sec. 4j EStG applies to all domestic taxpayers, regardless of whether their tax liability is unlimited or limited. The regulation also applies to both natural persons and corporations. Sec. 4j EStG covers “expenses for the granting of the use or the right to use rights, in particular copyrights and industrial property rights, of commercial, technical, scientific and similar experience, knowledge and skills, for example plans, designs and procedures”. The wording corresponds exactly to Sec. 50a para. 1 no. 3 EStG, which is why a comparable interpretation seems necessary in this respect. Thus, the provision applies in particular to rights protected under one of the following laws (Sec. 73a para. 2, para. 3 of The German Income Tax Act Enforcement Order (EStDV)):

- Copyright Act (Urhebergesetz)
- The Act on Designs (Designgesetz)
- Patent Act (Patentgesetz)
- The Act on Utility Models (Gebrauchsmustergesetz)
- Trademark Act (Markengesetz)

However, Sec. 4j EStG only covers licence expenses that are based on payments between related parties (Sec. 1 (2) of the German Foreign Tax Act (AStG)).

Note: In accordance with Sec. 4j (1) sentence 2 EStG, the scope of application is also extended to indirect licensing relationships. This is intended to prevent circumvention. Ultimately, the deduction prohibition also applies to licence payments from or to permanent establishments (PE) (Sec. 4j para. 1 sentence 3 EStG). In the case of assumed creditor/debtor relationships between several branches of a company (Sec. 1 para. 5 AStG, Sec. 16 of The German PE Profit Allocation Order (BsGaV)), however, the provision does not apply.

3. PREFERENTIAL LOW TAXATION

According to Sec. 4j para. 1 sentence 1 EStG, the deduction ban only applies “if the creditor’s income is subject to low taxation that deviates from the standard taxation in accordance with para. 2 (preference rule)”. This means that royalty income may be taxed at a low rate abroad as long as it is the generally applicable tax (standard taxation). At the same time, preferential taxation other than the standard taxation is harmless if it does not lead to low taxation within the meaning of section 4j (2) EStG. The “Lizenzschranke” only applies if preferential taxation other than the standard taxation is applied, resulting in low taxation. However, the known preferential regimes for income

from intangible assets generally have tax rates well below the 25% threshold, which is why the low taxation criteria will be fulfilled.

Preferential taxation is not defined by law. Given the legal purpose of combating harmful tax competition in the form of foreign patent, licence, or IP boxes, it should only address such rules that specifically favour revenues from the usage transfer of rights. Mere geographical advantages (e.g. special economic zones) are no more covered than domestic trade tax havens.

Note: The US has introduced a tax benefit in the form of Foreign Derived Intangible Income (FDII) as part of the recent tax reform. It is suspected – to a certain extent a widely held view – that this provision also falls within the scope of the “Lizenzschranke”. There are doubts, however, due to the fact that the benefit is linked to “deemed intangible income”, i.e. to a fictitious figure and therefore not to concrete income. Sec. 4j (1) sentence 1 EStG, on the other hand, requires a tax advantage for “income” abroad resulting from licence expenses in Germany. However, it remains to be seen how the administration will position itself on this.

According to Sec. 4j (2) EStG, low taxation exists if the creditor’s income is subject to income taxes of less than 25%. Please note the reference to “income”, i.e. a gross amount. The amount of operating expenses actually incurred is of no significance due to the revenue-based consideration. When determining the tax burden, however, benefits in the form of tax reductions, exemptions, credits, or reductions should be taken into account. The following examples are given in the explanatory statement to the law (Bundestag-Drucksache 18/11233, 15):

Example 1: The State A resident creditor generates royalty income of 100 and has related deductible operating expenses of 20. The lower tax rate in state A, which differs from the standard tax rate, is 10%.

Solution: The income tax burden pursuant to Sec. 4j (2) EStG amounts to 10%.

Example 2: The creditor resident in State B generates royalty income of 100. The standard tax rate applicable to royalty income in State B is 30%, but 50% of royalty income is tax-free.

Solution: The income tax burden pursuant to Sec. 4j (2) EStG is 15 % (50 % of 30 %).

Example 3: The creditor resident in State C generates royalty income of 100. The standard tax rate applicable to royalty income in State B is 30%, but State C allows the deduction of notional operating expenses amounting to 60% of the royalty income.

Solution: The income tax burden pursuant to Sec. 4j (2) EStG amounts to 12% (40% of 30%).

In all examples, the actual operating expenses are irrelevant.

4. LEGAL CONSEQUENCE

As a legal consequence, the expenses are only partially deductible in accordance with Sec. 4j (3) sentence 1 EStG. The non-deductible portion is determined as follows (Sec. 4j (3) sentence 2 EStG):

$(25\% - \text{burden of income taxes in \%}) / (25\%)$

Example: The domestic tax liable debtor has licence expenses of 100. The corresponding royalty income abroad is subject to preferential taxation for royalty income and a tax rate of 5%. The other requirements of Sec. 4j EStG are fulfilled.

Solution: The non-deductible portion of royalty expenses is 80% $([25\% - 5\%] / 25\%)$. Applying the "Lizenzschranke" to a corporation in Germany thus results in an effective additional tax burden of 24% (assumed total tax burden of 30% multiplied by 80%).

The regulatory mechanism can easily lead to an additional burden on licence expenditure in Germany, which goes beyond the advantages obtained abroad in the taxation of licence income. Thus, Sec. 4j EStG can have excess legal consequences.

Note: In order to avoid additional charges, the "Lizenzschranke" pursuant to Sec. 4j (1) sentence 5 EStG does not apply insofar as a CFC tax amount within the meaning of Sec. 10 (1) sentence 1 AStG is to be recognized on the basis of the corresponding license income. Since CFC tax concerns a net amount, but the exception is based on the recording of the gross amount "revenue", a parallel application of Sec. 4j EStG and the CFC tax may nevertheless occur.

5. EXCEPTION ACCORDING TO SEC. 4J PARA. 1 SENTENCE 4 EStG

Sec. 4j EStG pursues the goal of combating harmful tax competition and ensuring fair taxation of royalties (Bundestag-Drucksache 18/11233, 9). Accordingly, the provision is not intended to nullify every advantage abroad. Where foreign regulations stipulate that the benefits are linked to compliance with the requirements of the "Nexus Approach", there should be no limitation on deductions. This is to be achieved by Sec. 4 (1) sentence 4 EStG. Accordingly, the deduction ban does not apply if the low taxation of the creditor's income results from a preferential arrangement "which corresponds to the Nexus approach under Chapter 4 of the 2015 Final Report on Action Point 5, OECD (2016), Countering Harmful Tax Practices More Effectively Taking into Account Transparency and Substance, OECD/G20 Base Erosion and Profit Shifting Project".

The OECD's Nexus approach aims to ensure that tax incentives related to IP regulations are only granted to taxpayers who actually carry out research and development activities (OECD, Countering Harmful Tax Practices More Effectively, 2015, marginal 28). To determine a degree of benefit, qualified expenditure is set in relation to total expenditure. Details of implementation will be left to the States. As far as can be seen, only a few of the existing preferential arrangements have currently been brought in line with the Nexus approach (e.g. in the Netherlands and Ireland).

Note: According to the OECD report to which this legislation refers, marketing-related intangible assets are never entitled to preferential treatment. As a result, if trademarks or similar rights abroad are taxed at a preferential rate, Sec. 4j EStG should always apply, because the exception in Sec. 4j para. 1 sentence 4 EStG never applies in this respect.

6. INCOMPATIBILITY WITH EU LAW

Another notable aspect of the exception described above is its focus – alone and in abstract terms – on the design of the foreign regulation and its synchronisation with the OECD-Nexus approach. The actual activity abroad, on the other hand, is irrelevant. This means that the partial deduction ban should also intervene if the license creditor conducts substantial business activities abroad, but the foreign preferential arrangement does not link the preferential treatment to this activity. This seems questionable under EU law in view of the recent rulings of the European Court of Justice, according to which a national standard can only justify intervention on the basis of this justification ground if it specifically targets wholly artificial arrangements, which do not reflect economic reality, with the goal of unjustly benefiting from a tax advantage. (ECJ, decision dated 20.12.2017 – C-504/16 and C-613/16, Deister Holding AG/ Juhler Holding A/S). In view of the lump-sum structure of Sec. 4j EStG, compliance with this requirement is not possible.

Note: In addition, there may be a violation of the Interest and Royalties Directive. Although the ECJ (decision dated 21 July 2011 – C-397/09 – Scheuten Solar) ruled that the Interest and Royalties Directive only protects creditors from legal double taxation, the “Lizenzschranke” results in economic double taxation for debtors. However, Sec. 4j EStG links the ban on deduction for the debtor with the tax burden of the creditor. Since Sec. 4j EStG – just like the directive – specifically concerns licensing relationships between related parties, the standard contradicts the objective of the directive. The latter may have significance in relation to Switzerland: while the freedom to provide services does not provide any protection there, the Interest and Royalties Directive does so very well (see also Sec. 50g para. 6 EStG).

7. PRACTICAL NOTE



Existing licensing relationships must be checked urgently. In addition to the provisions of Sec. 4j EStG, the requirements of the foreign preferential regulation must be included in this examination. It must also be examined whether the waiver of the foreign preferential arrangement is preferable due to the excessive legal consequences of the German regulation. Consideration should also be given to relocating IP holding companies.

In view of the considerable doubts about Sec. 4j EStG under EU law, appeal procedures remain a credible option for action in EU/EEA cases. In view of the strict guidelines of the European Court of Justice rulings and the imprecise structure of Sec. 4j EStG, the provision is problematic against the background of fundamental freedoms.

In practice, however, not only the debtor but also the creditor should have his legal position clarified for tax purposes, as the latter is subject to taxation under Sec. 50a (1) No. 3 EStG, and in the EU and EEA context, the high requirements for granting the advantages of agreements and directives also raise concerns.

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