Kluwer International Tax Blog

Foreign-to-foreign licensing subject to withholding tax in Germany?

Alexander Haller, Johannes Suttner, Leon Zimmermann (WTS Munich, Germany) · Monday, January 25th, 2021

Introduction

Let's assume the following situation: ParCo is the parent company of a multinational group with its residence in Switzerland and engaged in the automotive business. It developed an innovative battery technology. Due to the high density of competition and rivalry, ParCo is interested in having its innovative technology protected through a patent. For this purpose, ParCo applies, inter alia, for the registration with the German patent register. This creates costs in the amount of EUR 20k (patent lawyer fees, registration fees, etc.). ParCo further decides to establish the production (of the batteries) in China due to lower manufacturing costs. For this reason, ParCo grants the right to use the patent to its Chinese subsidiary, SubCo, against an annual licensing fee of EUR 500k. SubCo starts the production of the batteries and sells them to customers on the global market. The (global) annual turnover of the group earned from the battery business is EUR 10m (thereof EUR 10m with German automotive customers).

For the exemplary case at hand, in summer 2020 German tax experts started to discuss the following questions:

- Could the licensing arrangement between ParCo (Switzerland) and SubCo (China) create a limited tax liability of ParCo in Germany?
- Could SubCo (China) have the obligation to file a tax return and pay withholding taxes in Germany?
- If so, what would be the correct tax base on which the withholding tax is levied?

Relevant tax background

According to the wording of the German tax law, a licensor with its tax residence abroad would become liable for taxes in Germany if he earned income from the sale or the licensing of rights (e.g., copyrights, patents, utility models, trademarks, etc.) provided that the rights are exploited in Germany or registered in a domestic book or public register (e.g., patent register). Given the (limited) tax liability of the licensor, the licensee is obliged to withhold taxes from royalties paid to the licensor. The current withholding tax rate on royalties is 15% plus solidarity surcharge resulting in an aggregate tax rate of 15.83%. Only if a certificate by the German Federal Tax Office granting the exemption from or reduction of withholding tax is available, the licensee can

apply the reduced rate or refrain from any withholding in case of a full exemption. E.g., the lower or zero tax rate can be based on a bilateral tax agreement or within the EU on the EU Interest & Royalties Directive.

Registration of the right in a German register as sufficient genuine link for German taxation?

The literal wording of the law seems to be quite clear: The registration of the patent with the patent register would be sufficient for the licensor (ParCo, Switzerland) to become tax liable in Germany. However, this provision is part of the German tax law since 1925, but has actually never been applied in that way. I.e., neither German tax authorities nor taxpayers nor tax advisors practically considered or applied this provision as described. However, after the US tax reform (IP migration), the tax authorities started to deeper analyze the (IP) relevant provisions which finally resulted in an official circular letter of the German Federal Ministry of Finance dated November 6, 2020. In this circular letter, the German tax authorities argue that the wording of the law is clear and that withholding taxes must be withheld on purely foreign arrangements if the underlying IP is registered in a German book or register. Of course, this circular letter puts pressure on taxpayers (and tax advisors) as they were and still are required to check their foreign licensing arrangements and IP relevant transactions (e.g., the sale of German-registered IP).

The adverse implications of non-compliance with the obligations could be serious. Desisting from the payment of withholding tax can qualify as tax fraud and be subject to penalties. The topic is quite controversial and is being discussed quite intensively among German tax experts. One opinion is that the relevant provision must be interpreted in the context of the purpose of the law and the historical intention of the legislator. Therefore, following this interpretation, a limited tax liability (and withholding tax obligation) does not arise since the mere registration of the right in a German book or register is not considered being a sufficient nexus for German taxation. However, other experts conclude that the wording of the law is clear and that the mere registration of a right is sufficient nexus for taxation. In our opinion, the mere registration should not be sufficient as there is no direct income flow (linked to the IP) out of Germany. Therefore, the wording of the relevant provisions should be amended.

It seemed that the German Federal Ministry of Finance wanted to follow the “right” path. It published a draft law two weeks after the publication of the circular letter. The draft law contained an amendment of the statutory provision. As a consequence of the draft law, the payment of royalties would not have created a taxation nexus for Germany as the mere registration with a German book or register would not have been sufficient for this purpose. Further, the amendment should have been applied to all open cases with retroactive effect. The wording and reasoning of the draft law was quite surprising for all experts concerned by this topic. However, it was also clear that this draft law could likely be subject to further amendments in the course of the political discussions. Finally the Federal Government started the legislative procedure by striking off the relevant proposal from the Federal Ministry of Finance. Consequently, the current statutory provision will likely be kept, if the parliament does not amend the draft law during the legislative process.

On the contrary, it seems that the tax authorities are currently well preparing for the taxation of German-registered IP of non-German residents. According to rumours, they set up a task force to identify relevant cases and are working on additional guidance which could be published soon. Such guidance could provide for simplification rules for current royalty payments in case the licensor is entitled for an exemption based on a double taxation agreement. This would have the

effect that the licensee is currently relieved from filing tax returns on withholding tax. Nevertheless, the licensor needs to provide sufficient evidence to prove its entitlement to the exemption. Based on the expected guidance, the vendor of German-registered IP has to file a tax return even if Germany has no right of taxation according to the applicable double taxation agreement.

What could be the "correct" tax base?

Let us assume the case that SubCo resides in Germany and pays license fees to its Swiss parent ParCo. In such a case, it is quite clear that the gross amount of the agreed royalty would be the tax base for the withholding tax that SubCo must pay to the German tax authority. However, in the exemplary case at hand, SubCo is resident in China and ParCo earns royalty income from a Chinese source. Nevertheless, ParCo becomes tax liable in Germany due to the registration of its innovative battery technology with the German patent register. What would be the "correct" tax base in such a case?

As a starting point, it should be quite clear that the (source) income attributable to the German registration needs to be attributed according to the so-called "inducement principle" ("Veranlassungsprinzip") (or by the arm's length principle that can also be seen as a concretization of the so-called "inducement principle" for intra-group transactions). The German tax literature is discussing various approaches to determine the tax base leading to significantly differing results. An approach could be to determine the tax base based on the so-called "DEMPE" functions concept as outlined in chapter VI of the OECD Transfer Pricing Guidelines. In a nutshell, the mere registration of the IP could be attributed to "P" (protection function) which likely does not entitle to more than a routine return determined on a cost-plus basis. In the case at hand, the cost for the registration of the IP (EUR 20k) would serve as cost basis. However, it is not clear if the German tax authorities will accept such an approach. By contrast, representatives of the German tax authorities who published their (non-official) opinions believe that such (cost-based) approach does not result in a correct determination of the German source income connected to the registration. Another approach could be to determine the tax base based on market or income factors (e.g. turnover-based allocation keys). Considering the very simplified example above, this would mean that the entire royalty payments paid by SubCo to ParCo (EUR 500k) should be subject to withholding tax in Germany since the group generated its entire turnover from the battery business with German customers. In our opinion, a cost-based approach should be upheld since the costs can directly be linked to the registration. For this reason, it should not be justified to determine the tax base on the basis of income or market factors since the mere registration of the IP (in Germany) does not generate any relevant amounts of income that can directly be linked to the licensing arrangement. Nevertheless, the tax base should be determined by taking into account all relevant facts and circumstances of the single case.

According to unofficial sources, it seems that the tax authorities plan to follow the top-down approach. That means that the royalty income of the licensor is the starting point and is allocated according to the "inducement principle" in a second step. If the tax base could not be determined in this way, the tax authority could estimate the tax base by applying a turnover-based allocation key. In our example, this would result in a tax base of EUR 500k.

Conclusions

Considering that there is no direct income flow out of Germany, in our opinion, the relevant

provision should be amended to avoid adverse tax implications for foreign residents. Additionally, it is not yet clear how the tax base should be determined and if any taxes withheld in Germany could be credited in the residence state of the licensor. This will cause numerous uncertainties for all parties concerned, including the tax authorities. Moreover, any taxes withheld in Germany that could not be refunded or credited can potentially lead to definitive double taxation for taxpayers. Owners of German-registered IP are advised to check their arrangements with a German tax lawyer or tax advisor and to approach the German tax authorities in order to mitigate serious adverse implications for the past and the future.

The authors would like to thank Dr. Gabriele Rautenstrauch (WTS) for reviewing the draft version of this blog.

This entry was posted on Monday, January 25th, 2021 at 6:00 pm and is filed under Germany, Withholding Taxes
You can follow any responses to this entry through the Comments (RSS) feed. You can leave a response, or trackback from your own site.