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Extraterritorial Taxation of IP Transactions in Germany – A Critical Analysis of the Statutory Requirements in the Context of the New Circular Letter of the German Federal Ministry of Finance Dated February 11, 2021

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1. Introduction

To be able to compete successfully in international markets, companies need to turn their R&D results fast and effectively into marketable products. Thus, besides the development (enhancement, maintenance, exploitation) of IP, its protection is of essential importance for companies. In order to ensure maximum legal protection, companies oftentimes formally register their IP assets (e.g., patents, trademarks) in many countries including Germany. In the context of the US tax reform, German tax experts started the controversial discussion whether the mere formal registration of IP in Germany could create a sufficient nexus for German taxation. The statutory provision that enables Germany to tax the income linked to German registered IP is part of the German tax law since 1925, but has actually never been applied in that way. After a deeper analysis of the statutory provision by the German Federal Ministry of Finance, it finally issued an official circular letter dated November 6, 2020. In this circular letter, it essentially argues that the mere registration is sufficient and that taxes must be declared and paid accordingly. Although the German Federal Ministry of Finance proposed the relaxation of the provision, the government has finally removed the relaxation from its draft law. Thus, both the statutory provision and the official circular letter of November 2020 put some pressure on taxpayers. On February 11, 2021 the Federal Ministry of Finance published another circular letter on this topic supplementing the circular letter of November 2020. It essentially contains some procedural simplifications and some statements about the determination of the relevant tax base. Against this background, we provide an in-depth analysis of the relevant domestic and treaty law provisions including the linked procedural requirements in this contribution. On this basis, we explain and critically discuss the content of the new circular letter of the German Federal Ministry of Finance of February 2021.

2. Domestic law perspective

According to German domestic tax law, a person with his tax residence abroad will become liable for taxes in Germany if he earned income from the sale or the licensing of rights provided that the rights are exploited in Germany or registered in a German public book or register (e.g., German patent register). The wording of the law seems to be clear: It does not require that a transaction

party, for instance, the licensor or the licensee, resides in Germany or that the income from the sale or the licensing of rights is paid out from Germany. The provision also does not distinguish between intra-group transactions or transactions between third parties. Thus, based on a literal interpretation of the statutory provision, the mere formal registration of the right in a German register may create a sufficient nexus for taxation regardless of whether the right is economically exploited in Germany or not. This actually means that this provision will also cover foreign-to-foreign transactions if they are related to German registered IP.

Example 1

Let us assume the following situation: Licensor A residing in China grants the limited right to use a patent that is inter alia registered in Germany to company B with tax residence in the US against an annual licensing fee. Based on a literal interpretation of the German statutory provisions, company A (China) may become liable for taxes in Germany with the income attributable to the IP registration in Germany.

However, according to the wording of the law, it is required that the right is registered in a "domestic public register". Domestic public registers specifically covered by the provision are the patent, utility model, trademark, design and topography registers kept at the German Patent and Trademark Office (DPMA). Patent applications with the European Patent and Trademark office must also be considered, if they have led to a registration in Germany. Non-German or international registers are generally not considered as domestic registers. Thus, transactions concerning rights that are not or cannot be registered in a German public register, such as copyrights or unprotected knowhow, should not be covered while, for instance, transactions with patents or trademarks registered with German public registers at the DPMA can be relevant. In this regard, it is worth mentioning that the German tax authorities can quite easily check the patent and trademark registrations at the DPMA since the abovementioned registers are public and can be accessed by everybody (https://register.dpma.de/DPMAregister/Uebersicht?lang=en). Further, the provision merely requires the *registration* of the right in a German public register. The person who has registered the right is not relevant to the provision. For instance, the right could also have been registered by the licensee (and does not need to be registered by the licensor).

By taking into account the general purpose of the law and the historic intention of the legislator, the mere registration of the IP in Germany should likely not create a genuine link for German taxation, if the licensor did not economically exploit the IP registered in Germany. This interpretation of the law is discussed by various German tax experts. In our view, this position should be upheld. But it has to be analyzed on a case-by-case basis whether this view is applicable. Further, this interpretation also corresponds to the result in treaty cases and would mitigate any unnecessary administrative burden (see below). Nevertheless, the German tax authorities must apply the literal interpretation of the law in any case since they are bound by the circular letter issued by the German Federal Ministry of Finance dated November 6, 2020. The German tax courts will (probably) finally assess if and to what extent this position can be upheld. In the meanwhile, taxpayers are advised to consider the circular letters of the Federal Ministry of Finance, to check their transactions and potentially disclose them in order to mitigate serious adverse implications.

Given a limited tax liability of a licensor resulting from German registered IP based on a literal interpretation of the statutory provision, the licensee (not the licensor) is required to determine the tax base (based on the so called "inducement principle", see our blog contribution on the topic

published on January 25, 2021), calculate the taxes, withhold them (from the payment) and declare and remit them quarterly to the authorities. The current domestic withholding tax rate on royalties is 15% plus solidarity surcharge resulting in an aggregate tax rate of 15.83%. The licensee does not need to be domiciled for tax purposes in Germany. Thus, the obligation to withhold and declare taxes may also concern persons who are not personally liable for taxes in Germany. By contrast, given the limited tax liability of the seller of rights, the seller would be required to prepare and submit tax returns since the sale of rights is not covered by the domestic withholding tax regime. The authorities will issue a tax assessment notice and the seller must pay taxes accordingly.

3. Treaty law perspective

If Germany wants to tax income from the transactions explained above, it must further be ascertained whether the applicable Double Tax Treaty (DTT) allows Germany to tax this income. Germany has concluded DTTs with more than 90 countries. The Double Tax Treaty applicable in the specific case would generally be the DTT agreed between Germany and the residence state of the licensor or seller since the licensor or seller of German registered IP becomes liable for taxes in Germany according to the domestic tax law (see above). At one hand, the licensing of rights is typically covered by Art. 12 ("royalties") OECD Model Tax Convention (OECD MTC) or the respective article in the specific treaty.

On the other, the sale of rights is typically subject to Art. 13 OECD MTC ("capital gains") or the respective article in the specific treaty. For the application of Art. 13 OECD MTC, the relevant rights (patents, trademarks, etc.) would typically be regarded as "other" property (i.e. property "other" than, for instance, immovable property pursuant to Art. 6 para. 2 OECD MTC, etc.) so that the residence state of the seller would generally have an exclusive taxing right on this income (Art. 13 para. 5 OECD MTC). Thus, given that the wording in Art. 13 of the applicable DTT corresponds to the wording of Art. 13 OECD MTC, Germany would generally only be entitled to tax the income from the sale of German registered IP if it is the residence state of the seller.

Further, corresponding to Art. 12 OECD MTC, many German DTTs generally assign an exclusive taxing right to the residence state of the licensor. Thus, Germany would not obtain a taxing right on the income from the licensing of German registered IP unless it is the residence state of the licensor. Germany has however also concluded DTTs that assign a (limited) taxing right to the source state of the royalty income. For instance, the DTT with China generally allows the source country to apply a WHT rate of up to 10% on the gross amount of the royalty. Thus, in such cases, Germany could potentially try to claim a taxing right on this income. However, considering the specific circumstances in the case of foreign-to-foreign licensing, it can be asked whether Art. 12 OECD MTC or the specific article on royalty income, respectively, is applicable at all.

Although Art. 12 OECD MTC does not explicitly define *where* royalties are considered to arise; most states including Germany apply the principles of Art. 11 para. 5 OECD MTC. According to these principles, royalty payments should arise in the state, in which the debtor of the royalties has its residence. In the case of foreign-to-foreign licensing, Germany is not the state of residence of the debtor. Hence, Art. 12 OECD MTC is not applicable. Instead, Art. 21 OECD MTC will apply as shown in Example 2. In such case, Germany would have no taxing right at all.

Example 2

Reference is made to the example in the previous section: Licensor A residing in China grants the

limited right to use a patent that is inter alia registered in Germany to company B with tax residence in the US against an annual licensing fee. As explained above, based on a literal interpretation of the German statutory provisions, company A (China) may become liable for taxes in Germany with the income attributable to the IP registration in Germany. The DTT with China would generally be applicable. As explained above, Art. 12 (para. 2) DTT with China allows the source country to apply a tax up to 10% of the gross amount of the payment. However, the source country, which is entitled to apply this tax, is the state in which the royalties "arise". The question therefore is whether Germany can be regarded as the state in which the royalties "arise" or have arisen. The answer to this question can be found in para. 5 of the same article: "Royalties shall be deemed to arise in a Contracting State when the payer is a resident of that Contracting State (…)." Hence, the principles of Art. 11 para. 5 OECD MTC are explicitly regulated in Art. 12 DTT China. The payer of the royalties, here company B, is tax resident in the US (and not in Germany). Thus, Germany cannot claim a taxing right on this income based on Art. 12 (para. 2) DTT China. From a German perspective, Art. 21 DTT China ("other income") should rather be applicable on it, which assigns an exclusive taxing right to the residence state of the person who has earned the income, i.e., China. Thus, Germany is generally not entitled to tax this income.

In a nutshell, in most DTT cases of extraterritorial taxation, Germany would likely not be entitled to tax the income. However, each case should be treated based on the specific treaty provisions. Further, it should be noted that Germany has not concluded a DTT with some important states such as Brazil or Hong Kong. In these cases, no treaty protection would be available and the domestic law will fully apply.

4. General procedural requirements in treaty cases

As explained above, in most DTT cases of extraterritorial taxation, Germany should not have a taxing right. However, in case of royalty income (subject to the domestic withholding tax regime), the German tax procedural law (see sec. 50d para. 1 ITA) nevertheless will require the licensee to withhold, declare and pay the taxes even if the DTT does not assign a taxing right to Germany. Thus, if the tax liability of the (foreign) licensor according to the domestic law provisions is given, the (foreign) licensee must generally withhold, declare and pay the taxes at the domestic tax rate. The taxpayer (i.e. licensor) generally has two options:

- He can apply for a refund of the taxes withheld at source if according to the applicable treaty, there is no or reduced withholding tax (refund procedure, sec. 50d para. 1 ITA) or, alternatively,
- he can apply for an exemption certificate that entitles the licensee to apply the reduced tax rate or to exempt the payment at source (exemption procedure, sec. 50d para. 2 ITA). The exemption certificate must be provided by the licensor to the licensee. Only if such a certificate granting the exemption from or reduction of withholding tax is available at the time of the payment of the royalty, the licensee can apply the reduced rate or refrain from any withholding in case of a full exemption. Thus, the exemption procedure is a future-oriented procedure and only comes into consideration when the licensor has not yet received the royalty payments in question. However, even in this case, the licensee must declare the income to the Federal Tax Office.

Given this procedural background, it is clear that the statutory provision together with the general procedural requirements causes serious troubles. On the one hand, as explained in the introductory section, the domestic law provision potentially entitling Germany to tax income connected to German registered IP is part of the German law since 1925. It is not a "new" provision. This means that it is generally applicable to all open cases and has thus relevance for past transactions. The

general statute of limitations is 4 years plus 3 years (7 years) if the taxes were not reported to the tax authorities by means of a tax return. The concrete period must actually be determined on a case-by-case basis and can even be longer under some circumstances. On the other hand, even if in most DTT cases, Germany should not be entitled to tax the income (see above). The exemption procedure will generally not be applicable on past transactions. Thus, the licensee would have the requirement to check past transactions and to declare and pay the taxes for all open years in order to mitigate serious adverse implications. Afterwards, the taxpayer, i.e., the licensor, could potentially ask for a refund. In a nutshell, the general procedural requirements do not only create an unnecessary administrative burden in the cases of extraterritorial taxation for all parties (including tax authorities). They could also cause serious harm to parties since, for instance, it is unsure how a licensee who discloses relevant transactions and pays taxes for the past could get any refund (for any taxes paid on behalf of the licensor) especially if the licensor is not willing to assist or does not exist anymore.

In contrast to royalty payments, Germany does not impose withholding tax on the alienation of rights. Thus, there is no refund or exemption procedure for the taxation of such capital gain. Nevertheless, if such capital gain arises from IP registered in Germany, the vendor will generally have to file an electronic tax declaration to the German tax authorities for the respective tax year. Based on the tax declaration, the tax authorities will assess the German tax.

5. Procedural simplifications as provided by circular letter of the Federal Ministry of Finance dated February 11, 2021

As explained in the introductory section, the German Federal Ministry of Finance published another circular letter on February 11, 2021, which supplements the circular letter of November 2020. It essentially contains some procedural simplifications for royalty payments already made or made until September 30, 2021. It further contains some statements how the relevant tax base should be determined and, additionally, requires the (foreign) seller of (German registered) rights to prepare and submit a tax return even if the applicable DTT does not grant a taxing right to Germany. The circular letter is generally applicable to all open cases. For royalty payments already made or made until September 30, 2021, the tax authorities do not require to withhold, pay and declare the taxes if specific substantial and formal requirements are fulfilled.

Substantial requirements

The substantial requirements concern the tax residence of the licensee and the entitlement of the licensor to obtain the exemption from withholding taxes according to the treaty. They can be summarized as follows:

- **The licensee must not be tax resident in Germany.** This specifically means that (foreign) corporations (as licensees) must neither have their place of management (sec. 10 General Tax Code, “GTC”) nor their registered office (sec. 11 GTC) in Germany. Foreign natural persons (as licensees) must neither have their residence (sec. 8 GTC) nor their habitual abode (sec. 9 GTC) in Germany.
- **The licensor must be entitled to treaty benefits.** This requires that the licensor has or had his tax residence in a state which has concluded a DTT with Germany that was applicable at the time when the royalty payment was made. Further, the licensor must personally be entitled to the treaty and the royalty must be attributable to him according to the specific treaty. Additionally, it is required that the licensor is entitled to the exemption (from withholding taxes) under

consideration of some specific domestic provisions, namely sec. 50d para. 1 sent. 11 and para. 3 ITA. The first provision (sec. 50d para. 1 sent. 11 ITA) refers to cases where there is a conflict of qualification (e.g. hybrid companies) or the licensor is a partnership. Hence, this provision assigns the entitlement to apply for a refund (only) to the person who earns the income and is liable for taxes according to the laws of the other state. Thus, for instance, a (foreign) partnership which earns German source income would be entitled to a refund claim (and not the partners) if the partnership is taxed in its residence state like a corporation. By contrast, the second provision (sec. 50d para. 3 ITA) is an anti-treaty-shopping-rule. The application of this provision essentially intends to exclude functionally weak or non-functional companies from a tax relief. This provision targets tax structures that are employed in an attempt to gain withholding tax relief by exploiting treaties (or directives). This rule is currently subject to amendments since the Court of Justice of the EU ruled in more than on case that it infringes EU law.

Formal requirements

Besides the substantial requirements, applicants also have to fulfil certain formal requirements. The requirements concern the application for an exemption certificate and some disclosure and transparency obligations. They can be summarized as follows:

- **Application for an exemption certificate (sec. 50d para. 2 ITA) until December 31, 2021:** The licensor (or the licensee if the licensor has granted a power of attorney) must apply for an exemption certificate with the German Federal Tax Office until December 31, 2021. The licensee can file an application without power of attorney if the contractual relationship with the licensor does not exist anymore or if the licensee can prove that the licensor could not or is not willing to apply for an exemption certificate. The applicant has to send a copy of the application to the relevant local tax office if the application refers to payments made before December 31, 2013.
- **Disclosure of relevant contractual relationships and agreements:** The taxpayers must disclose the relevant contractual relationships and agreements. In addition, the authorities require that also agreements with other related parties being affected by this IP must be disclosed (e.g., sublicensing arrangements).
- **Translation of relevant parts of the licensing arrangement:** The relevant parts of the underlying licensing agreement (regulating the transfer of rights, ownership of rights, payment conditions) must be translated into German and disclosed to the Federal Tax Office together with the documents in the language of the contract.

The application of the simplified procedure generally requires that all abovementioned requirements are fulfilled. At one hand, the circular letter leaves it in the discretion of the tax authorities to decide whether the simplified procedure is applicable or not. If the entitlement of the licensor to treaty benefits is “doubtful” (e.g., due to qualification conflicts, hybrid or double-resident companies), the simplified procedure will not be applicable. The authorities are especially not required to conduct an in-depth analysis of a single case. On the other, if the authorities reject the application, the taxpayers must prepare tax returns and pay taxes within one month after the issuance of the rejection notice. Thus, the circular letter grants the taxpayers only a very short time window. Concerning the determination of the relevant tax base the circular letter states that the so called “inducement principle” (Veranlassungsprinzip) must be applied starting from the gross amount of the royalty payment and that cost-based approaches or so called “bottom up” approaches would not be acceptable (see our blog contribution on the topic published on January 25, 2021 for more details).

As explained above, the simplified procedure is only applicable on royalty payments already made or made until September 30, 2021. For royalty payments made after this period, the general procedural law will be applicable and no simplification procedure will be available. This essentially means that the licensees must generally withhold, declare and pay the taxes. The licensor can apply for a refund of the taxes paid afterwards, if the applicable DTT grants a relief. Alternatively, the licensor can apply for an exemption certificate with the Federal Tax Office and could forward the exemption certificate to the licensee. In this case, the licensee can refrain from withholding taxes at source. However, it should be noted that the licensee must physically have the exemption certificate at the time of the payment of the royalty. He cannot refrain from withholding taxes if the licensor has only filed the application for an exemption certificate with the Federal Tax Office. Thus, it is necessary to start the application for an exemption certificate for relevant cases as soon as possible since the completion of the application procedure could take up to 3 months or even longer.

6. Conclusions

Considering the content of the circular letter of February 11, 2021, the German Federal Ministry of Finance could have acknowledged that the "normal" procedure according to the procedural law (see sec. 4 of this contribution) would not be enforceable in cases of extraterritorial taxation. Nevertheless, the application of the simplified procedure, as regulated in the circular letter, requires the fulfillment of very strict conditions. Especially, the application of the sec. 50d para. 3 ITA (anti-treaty-shopping regulations) on cases of extraterritorial taxation could bring a considerable additional compliance burden and could create a complexity that can neither be administered by the taxpayers nor by the tax authorities. Further, the circular letter leaves it in the discretion of the tax authorities to decide about the applications without the requirement to analyze properly the facts and circumstances of the single case. This together with the requirement for taxpayers to determine the tax base, to declare and pay the taxes within one month after the issuance of the rejection notice, will bring each taxpayer in a very difficult situation. This is not justified since each taxpayer who submits an application shows that he wants to comply with the disputable literal interpretation of statutory provisions as confirmed by the German Federal Ministry of Finance. Additionally, in our view, we do not expect that this "new" interpretation of the statutory provisions leads to significantly increasing tax revenues, since in many cases Germany should generally not have a taxing right. We think that the German government should rather ask if this measure creates any residual benefit from a cost-benefit perspective since also the administrative burden for the tax authorities, especially the Federal Tax Office, is considerable. As a consequence the costs could likely increase any minor additional tax revenues. Indeed, the German legislator should examine whether the statutory provision could be amended as already proposed in the draft law published in November 2020. Nevertheless, the law will continue to apply and the circular letters of the Federal Ministry of Finance remind the taxpayers to comply with its interpretation of the law. Each taxpayer is advised to identify and check potentially relevant transactions and to develop a strategy as soon as possible. As of now, the simplified procedure will only be available for payments made until September 30, 2021. However, the Ministry of Finance has already proposed to extend the simplification procedure for payments made until June 30, 2022. The final decision on the extension is still outstanding.

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