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German Tax and Legal News

MOF publishes decree on extraterritorial taxation of royalty payments and IP transfers

Decree provides procedural relief for certain taxpayers subject to German extraterritorial tax.

The German Ministry of Finance (MOF) published a decree on 11 February 2021 regarding the tax compliance obligations of nonresident taxpayers that are subject to German extraterritorial taxation on royalties and/or transfers of certain intellectual property (IP). The decree provides some procedural relief relating to royalty withholding tax (WHT) filings and payments in relation to certain nonresidents that qualify for benefits under an applicable tax treaty with Germany; the relief is available for 2013 and subsequent years. However, the decree also provides that where there is a transfer of German-registered IP, a nonresident is required to file a German tax return even in a case where the transfer is not taxable in Germany based on the provisions of an applicable tax treaty (which would be a "nil return" in this case).

Draft legislation published by the MOF on 19 November 2020 had previously raised expectations that the potential German tax exposure for royalty payments between two non-German entities and IP transfers related to rights that are registered in a German public book or register would be abolished; however, the government-approved draft legislation published on 20 January 2021 no longer includes these provisions (see GTLN dated 11/23/20 and GTLN dated 01/20/21). As noted above, the decree published by the MOF on 11 February 2021 provides certain administrative filing relief in situations where the German extraterritorial taxation rules apply.

Under the German rules for limited liability taxpayers, the transfer of rights that are being exploited in a German permanent establishment or other German facility, together with royalty payments for such rights, are subject to German taxation. In addition, rights registered in a German public book or register may give rise to a German limited tax liability. This tax is often referred to as ETT (extraterritorial transfer tax) or ORIP (offshore receipts in respect of intangible property), although these terms are not used in the legislation. In the case of ETT (i.e., on the alienation of the IP), the tax must be declared via the German tax return filed by the non-German transferor. In the case of royalty payments (ORIP), the tax must be withheld at the time of payment and remitted quarterly by the licensee even if the WHT obligation may be mitigated under a relevant tax treaty, unless the licensor provides the licensee with a valid German WHT exemption certificate as required under Germany's domestic WHT rules, allowing the application of a reduced or zero percent royalty WHT rate.

The new decree refers to a prior MOF decree published on 6 November 2020 in which the MOF confirmed its view that a mere registration of rights is sufficient nexus for German taxation, and that tax return filings or WHT declarations are required in such cases (see GTLN dated 11/09/20). In the new decree, the MOF deals with the procedural aspects of addressing unexpected tax exposure for years since 2013 and provides relief for certain cases in which it is clear that a relevant tax treaty applies.

For cases where it is clear that a nonresident taxpayer is eligible for treaty benefits in relation to royalty payments that relate to German-registered rights, the decree waives the obligations to file WHT returns and make WHT payments, provided all of the following conditions are met:

- The licensee is not a German tax resident at the time the payment is made;
- The licensor is tax resident in a country with which Germany has an applicable tax treaty in place at the time the payment is made; and
  - The licensor is entitled to treaty benefits under the tax treaty;
  - The licensor qualifies as the beneficial owner of the payment; and
  - The conditions of the German anti-treaty shopping rules are fulfilled;
- An application for a royalty WHT exemption certificate is filed with the federal tax

office by the licensor (or, under certain conditions, by the licensee) by 31 December 2021. If the application covers the year 2013, a copy of the application must be sent to the local responsible tax office as well;
- A copy of the relevant contractual license agreement is submitted, together with the application for an exemption certificate. In the case of transactions between related persons, all additional agreements regarding the licensing of the same rights to other related persons must be disclosed as well; and
- The most relevant and important provisions in the relevant license agreement are translated into German (if the agreement is in a foreign language) and provided to the German tax authorities. Based on the guidance, this would, in particular, apply to the provisions governing the ownership of the rights, the payment terms, and the content and definition of the rights that are granted.

Where it is uncertain whether a nonresident is eligible for treaty benefits (e.g., due to the anti-treaty shopping rules or because of hybrid elements or dual resident companies in the structure), the relief would not apply. It is currently unclear if this means that it is not possible to use the procedures provided by the decree, or if it means only that the tax authorities could reject the application for a retroactive WHT exemption certificate in complex cases. Where the tax authorities reject the application for an exemption certificate, the relevant filings must be made within one month after the rejection.

Where an exemption certificate is denied, as well as in cases where the royalty recipient is not resident in a tax treaty country or otherwise is not eligible for treaty benefits, the relevant filings need to be made and the tax base must be determined. The decree includes guidance regarding the determination of the tax base. In this respect, the MOF rejects the use of cost-based and "bottom-up" valuation methods and requires the determination to be based on a revenue-based approach ("top-down" approach).

For transfers of German-registered IP, as noted above, the decree requires tax returns (nil returns) to be filed even in a case where the transfer is not taxable in Germany based on the provisions of an applicable tax treaty. Filings can be made by submitting a "paper return" and do not need to be made electronically if the tax return is filed with the responsible tax office no later than 30 September 2021 and the full fact pattern is disclosed (unless the tax office already has requested a tax return filing). The relevant contractual transfer agreements dealing with registration-nexus IP will need to be disclosed and supported by copies of the relevant provisions (original version) and with a German translation (if the agreement is in a foreign language). Based on the wording of the guidance, it seems to be unclear whether the obligation to provide the underlying agreements applies only in cases where the return that is being filed is not a nil return.

The new decree is the first guidance from the tax authorities that sets forth an obligation for a nonresident taxpayer to file a German tax return in a capital gains situation where German taxation would not apply based on an applicable tax treaty (even though this would be a nil return). The position of the tax authorities in this regard appears questionable. It should be noted that the conditions of the German anti-treaty shopping rules would not be applicable in a capital gains situation, as the anti-treaty shopping rules apply only in WHT situations (however, the provisions of specific tax treaties, such as the limitation-on-benefits provisions of the Germany-US tax treaty, may need to be considered).

Taxpayers potentially affected by the German extraterritorial taxation rules should carefully re-evaluate their filing obligations and approach, considering the implications of the decree. The application of the rules—in particular, the identification of the relevant rights and payments, and the determination of the tax base—can be highly complex. The relaxation of filing requirements in cases where it is clear that a nonresident qualifies for treaty benefits in relation to royalty payments may simplify the compliance burden, but the preparation of the disclosure filings and applications for an exemption certificate for the relevant payment flows still requires proper diligence. A rejection by the tax authorities of the application for an exemption certificate will result in a tight one-month deadline to fully comply with the regular filing obligations, so taxpayers should plan ahead to avoid being put in this situation without adequate preparation. In cases where there is no applicable tax treaty, individual approaches should be evaluated as to how to address the valuation requirements set forth by the decree regarding the determination of the tax base for royalty payments.

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