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German Tax and Legal News

MOF publishes nonexclusive list of non-nexus-based tax regimes for purposes of royalty barrier rule

List includes noncompliant tax regimes and regimes that are under review.

On 20 February 2020, the German Ministry of Finance (MOF) published a decree regarding the application of the limitation on the deductibility of certain related party royalty payments ("royalty barrier rule") that was introduced to the Income Tax Code (section 4j) with effect as from 1 January 2018. The decree includes a nonexclusive list of foreign tax regimes that are considered to be harmful tax regimes by the German tax authorities for calendar year 2018 for purposes of the royalty barrier rule. Based on comments provided by the tax authorities, the list is in line with the list of preferential tax regimes for intellectual property (IP) that are not nexus-based that have been identified by the OECD. In addition, the decree includes a list of preferential tax regimes that currently are under review. This list includes the foreign-derived intangible income (FDII) regime that was introduced in the US as a result of the tax reform effective from 2018.

The royalty barrier rule that has been effective since 2018 limits the deductibility of related party royalty payments that result in the "low taxation" of the royalty income at the level of the recipient as a result of the application of a preferential tax regime (IP box, patent box, license box, etc.) in situations where the preferential regime is not based on the "nexus approach" as described under action 5 of the OECD BEPS project. The royalty barrier rule applies to royalty payments that became due after 31 December 2017 (for a more detailed description of the royalty barrier rule, see GTLN dated 02/08/2017 and GTLN dated 05/02/2017).

The royalty barrier rule primarily targets beneficial "non-nexus"-based IP regimes; low taxation (or non-taxation) of royalty income based on the general tax regime applicable to the recipient should not be within the scope of the rule. The restriction on deductibility applies only to royalty payments between related parties, i.e., payments made to unrelated parties should not be affected. The rule also targets payments to indirect recipients that benefit from a non-nexus-based IP regime resulting in low taxation. This approach should disallow deductions in back-to-back royalty structures where only an indirect recipient benefits from such a regime.

"Low taxation" for purposes of the royalty barrier rule generally means an effective tax rate of less than 25% at the level of the recipient. However, low taxation does not automatically result in a full disallowance of a deduction of the royalty payment—the percentage of the disallowed royalty payment must 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),

The decree states that royalty payments that result in low taxation at the level of the recipient due to the application of one of the preferential tax regimes that is listed as being noncompliant must be treated as being (partially) nondeductible. The MOF explicitly limits the application of the list to calendar year 2018 and does not present the list as being exhaustive (rather, it describes the list as a "guideline"). The decree also mentions that several countries either already have abolished noncompliant preferential tax regimes or have replaced these regimes with compliant regimes. However, "grandfathering" rules that are permitted by the OECD (until 2021) should be considered irrelevant for purposes of the application of the German royalty barrier rule, based on the decree.

The decree includes a second list of preferential tax regimes that currently are under review to determine whether they are in line with the nexus approach for calendar year 2018. The decree states that German tax returns where a deduction for such royalty payments is claimed should be assessed on a preliminary basis, subject to review at a later point in time/in a tax audit. However, the decree states that such royalties should be treated as

being fully tax deductible for purposes of the royalty barrier rule in the preliminary tax assessment.

The most prominent tax regime that is included on the list of preferential tax regimes that currently are under review is the FDII regime in the US. The FDII regime provides a tax incentive to US domestic corporations in the form of a lower tax rate on income derived from tangible and intangible goods and services in markets outside of the US. As a result, a US corporation may claim a specific deduction that results in reduced taxation of such income. The question whether the FDII regime should be considered as a preferential tax regime for purposes of the German interest barrier rule is disputed by German tax practitioners. The decree seems to indicate that the German tax authorities are of the opinion that the FDII regime qualifies as a preferential tax regime; however, whether it should be considered as a harmful preferential tax regime still is being analyzed.

The decree from the German tax authorities should be a helpful tool in assessing the risk that royalty payments could fall under the interest barrier rule and be classified as being (partially) nondeductible. However, due to the nonexhaustive nature of the two lists that are included in the decree and the limitation of their applicability to calendar year 2018, the value of the lists may be limited.

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