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German Tax and Legal News

Draft law published to limit deductibility of royalty payments

Limit would apply to royalty payments made to recipients benefiting from non-nexus-based, low-taxed IP regime

On December 19, 2016, the German Ministry of Finance (MOF) published a first draft of a law that would limit the deductibility of related party royalty payments that would result in the low taxation of the royalty income at the level of the recipient as a result of the application of an IP regime (IP box, patent box, license box, etc.) in situations where the IP regime is not based on the “nexus approach” as described in action 5 of the OECD BEPS project. If approved, the proposed rule would apply to royalty payments that become due after December 31, 2017.

The draft law targets beneficial “non-nexus”-based IP regimes; low taxation (or non-taxation) of royalty income based on the general taxation of the recipient would not be within the scope of the law. The restriction on the deductibility would apply only to royalty payments between related parties, i.e. payments made to unrelated parties would not be affected.

The draft law also targets payments to indirect recipients that benefit from a non-nexus-based IP regime resulting in low taxation. This approach would disallow deductions in back-to-back royalty structures where only an indirect recipient benefits from such a regime.

“Low taxation” for purposes of the draft law generally means an effective tax rate of less than 25%. However, low taxation would not automatically result in a full disallowance of a deduction of the royalty payment - the percentage of the disallowed royalty payment would have to 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).

“Nexus-based” preferential tax regimes that would fall outside the scope of the proposed rule are those regimes whose benefits depend on a substantial economic activity. The draft law provides that a substantial economic activity would not exist where the recipient of the royalty payment did not fully or predominantly develop the underlying IP in its own business operations (e.g. if the IP was developed by related parties or acquired).

The draft law provides an exception from the restrictions for payments regarding trademark rights.

The MOF has asked interested parties to provide comments on the draft by January 11, 2017; the government is expected to make a decision on whether to move forward with this initiative on January 25.

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