

Lower House passes bill to limit tax deductibility of royalty payments

On 27 April 2017, the German lower house of parliament (Bundestag) passed the bill that would limit the deductibility of certain related party royalty payments. The bill (which would introduce a new section 4j in the Income Tax Code) generally is based on a draft law published by the federal ministry of finance on 19 December 2016 (for prior coverage, see [GTLN dated 20 December 2016](#) and [GTLN dated 8 February 2017](#)).

The draft law targets royalty payments made to a nonresident that result in “low taxation” of the royalty income at the level of the recipient due to the application of an intellectual property (IP) regime (i.e. IP box, patent box, license box, etc.), where the IP regime is not based on the “nexus approach” as described in action 5 of the OECD’s BEPS project (“Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance”).

The draft law passed by the Lower House is identical to the December 2016 version, but includes the following updates:

- Clarification that if the direct recipient of the royalty payment is a transparent entity for local tax purposes, the rule would be applied at the level of the shareholders that are finally subject to tax. This clarification has been introduced to ensure that the rule would apply in such cases.
- Introduction of a reference to chapter 4 of the BEPS action 5 report with respect to the definition of the nexus approach, including the formula in paragraph 30 and all other criteria described in chapter 4, II. (“Substantial activity requirement in the context of IP regimes”). The grandfathering rules in paragraphs 62-66, however, are excluded.
- When determining whether a preferential tax regime exists when there are several creditors and different tax regimes, the lowest tax rate would be the relevant rate.
- As described in the initial draft, the royalty deduction limitation rule would apply to payments made after 31 December 2017.

In addition to the rule on royalty payments, the lower house passed a new rule that would introduce a beneficial tax regime for certain restructuring profits. A “restructuring profit” would arise when a creditor waives (in whole or in part) its debt claims against a distressed business entity to enable a successful restructuring of the business. In a decision dated 28 November 2016 (see [GTLN dated 29 March 2017](#)), the Federal Tax Court rejected the “restructuring decree” issued by the Federal Ministry of Finance, concluding that the tax benefits granted by the decree with respect to the treatment of restructuring profits violate a constitutional principle for administrative actions. The decree granted a general exemption from tax that otherwise would be payable on a restructuring profit in certain cases. The legislator intends to reinstate the beneficial tax treatment for restructuring profits, albeit with certain modifications, as compared to the restructuring decree. The European Commission will need to be notified for Germany to obtain clearance from an EU state aid perspective.

The upper house of parliament (Bundesrat) now must vote on the draft, which is expected to take place on 2 June 2017—approval of the upper house is likely

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