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German Tax and Legal News

MOF publishes two decrees detailing the application of the royalty barrier rule

Decrees include an updated list of non-nexus compliant preferential tax regimes and guidance for the application of the rules.

On 27 January 2022, the German Ministry of Finance (MOF) published two decrees dated, respectfully, 5 and 6 January 2022 regarding the application of the limitation on the deductibility of certain related party royalty payments ("royalty barrier rule") of section 4j of the Income Tax Code (ITC). The first decree dated 5 January 2022 includes interpretative guidance regarding the definition of a preferential tax regime, nexus-conformity in terms of action 5 of the OECD BEPS project, and the burden of proof regarding the application of the royalty barrier rule. The second decree dated 6 January 2022 includes an (updated) non-exclusive list of foreign tax regimes that are considered to be harmful tax regimes by the tax authorities for calendar years 2018 to 2020 for purposes of the royalty barrier rule. The MoF, on 20 February 2020, published a non-exclusive list of foreign tax regimes for 2018 only (see GTLN dated 02/25/20), which is now updated. In line with the 2020 list, the updated list is coordinated with the list of preferential tax regimes for intellectual property (IP) that are not nexus-based and that have been identified by the Forum on Harmful Tax Practices (FHTP) of the OECD. The decree also includes a list of preferential tax regimes that currently are under review, which still 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 (e.g., 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 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 is not 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 is not affected. The rule also targets payments to indirect recipients that benefit from a non-nexus-based IP regime resulting in low taxation. This approach disallows 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, which may only result in partial non-deductibility instead of full non-deductibility based on the applicable effective tax rate at the level of the recipient.

First decree dated 5 January 2022
The 5 January 2022 decree in its first part provides the view of the tax authorities regarding the definition of a preferential tax regime and low taxation in terms of section 4j ITC. In order to determine whether a preferential tax regime exists, the actual taxtion of the royalty income must be benchmarked against the taxation of other income under the general tax regime in the same country. "General tax regime" in this regard means the application of the general tax rate on income of the same type of taxpayer without taking into account any sort of benefits (in particular, benefits related to the legal type of entity, tax residence of the licensor, or specific types or sources of income). Whether a taxpayer must file a specific application to deviate from the general tax regime should not be of relevance. In order to qualify as a preferential tax regime, a tax regime does not necessarily have to be limited to income from royalties or IP but can be much broader. Based on the decree, so-called "tax rulings" (which are only granted to specific licensors by foreign tax authorities on a case-by-case basis) also could qualify as preferential tax regimes in terms of the royalty barrier rule.

Low taxation in terms of the royalty barrier rule exists in case the actual taxation of the royalty income is less than 25%. Whether other income of the licensor also is low-taxed should not be of relevance. The decree also refers to the provisions of the Foreign Tax Act and its principles for determining the existence of low taxation that could be applied in the same way for purposes of the royalty barrier rule. It is confirmed that the existence of a general low tax rate at the level of the licensor should not trigger the royalty barrier rule.

The second part of the decree describes the view of the tax authorities with regard to "nexus-conformity" in terms of the royalty barrier rule. The decree refers to the FHTP list and the 6 January 2020 decree (see below) and how to apply the various FHTP lists. It also confirms that in case no nexus-conformity review has been undertaken for a specific regime by the FHTP at the OECD level, a domestic (German) review and analysis must be applied. This might, in particular, be the case in the following scenarios:

- The preferential tax regime in question was classified as an "other regime" by the FHTP, and, therefore, no analysis of the nexus conformity was being done at the OECD level;
- The preferential tax regime was terminated or adapted to nexus-conformity during the grandfathering period (through 30 June 2021), and, therefore, the regime was not reviewed further by the FHTP; or
- An individual tax ruling qualified as a pereferential tax regime in terms of the royalty barrier rule.

In the third and last part of the decree, the MoF discusses the burden of proof that applies in case of the royalty barrier rule and highlights that the general rules should be applicable. Based on these general rules, the tax authorities have the burden of proof with regard to facts that result in an increase of the tax burden, and the taxpayer bears the burden of proof for facts that support a decrease of any tax burden. The tax authorities describe their view that the tax authorities must prove the existence of a harmful preferential tax regime; the tax authorities should in this regard be able to make use of the FHTP list as mentioned above. It also is highlighted that the taxpayer must comply with the general, increased compliance obligations for cross-border transactions for purposes of the royalty barrier rule. In addition, it states that as a general presumption it is assumed that in case of the existence of a preferential tax regime in a foreign country, such regime applies to royalty income of a taxpayer.

Such presumption, however, can be rebutted by the taxpayer if sufficient evidence/documentation proving the contrary is provided. In order to successfully rebut the presumption, the German licensee must provide documentation regarding the accounting treatment of the royalty income at the level of the foreign licensor and tax assessment notices (including workpapers) for the calculation of the tax base. The specific information that must be included in this documentation is specified further in the decree. Nexus-conformity of a tax regime generally must be established by the taxpayer. In case the FHTP list provides for nexus-conformity, it is generally assumed that this should apply for purposes of the royalty barrier rule as well. No further evidence must be provided by the taxpayer in this case. The MoF highlights that the nexus conformity of a preferential tax regime must be reviewed on an abstract-general basis and must not be done on a case-by-case analysis for each taxpayer separately.

Second decree dated 6 January 2020
The 6 January 2022 decree reiterates that the list provided by the MoF for the years 2018 to 2020 is non-exclusive and only serves as a guideline. It also repeats that "grandfathering" rules that were permitted by the OECD (through 30 June 2021) are considered irrelevant for purposes of the application of the royalty barrier rule.

The decree again includes a second list of preferential tax regimes that are under review to determine whether they are in line with the nexus approach for the relevant years. The decree (in line with previous guidance) states that 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 (e.g., in a tax audit). Royalties should, however, be treated as being fully tax deductible for purposes of the royalty barrier rule in the preliminary tax assessment.

The FDII regime in the US is still included on the list of preferential tax regimes that currently are under review. In this regard, it might be worth mentioning that the most recent list of the FHTP at the OECD (which was published after its November 2021 meeting) also shows the FDII regime still under review but with the added comments "In the process of being eliminated" and "The United States has committed to abolish this regime." Whether these statements hold true in light of the most recent version of the Build-Back-Better Act in the US and the stalled legislative process can be questioned but might indicate that the review process of the FHTP is currently paused (and might not be resumed in case the FDII regime is changed to the satisfaction of the FHTP).

The decree in this regard confirms the view of the tax authorities that the FDII regime qualifies as a preferential tax regime; however, whether it should be considered as a harmful preferential tax regime still remains to be seen.

Comments

The two decrees from the German tax authorities provide welcome additional guidance for assessing the risk that royalty payments could fall under the interest barrier rule and be classified as being (partially) nondeductible. The still non-exhaustive nature of the lists provided by the MoF in its 6 January 2022 decree, however, results in remaining uncertainty for taxpayers. The question how FDII qualifies for purposes of the royalty barrier rule is still open and has not been decided yet. Due to the significant number of license arrangements between German licensees and US resident licensors, this results in a significant uncertainty for many taxpayers and multinational enterprises. It would be in the interest of affected taxpayers if this issues is resolved sooner rather than later.
