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By PwC Deutschland | 23 November 2011

EU royalty payments to be taxed net

The Supreme Tax Court has held that the withholding tax on royalty payments to licensors in other EU states should be on the net amount after deduction of direct costs.

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In 2006, the ECJ held that German rules on the taxation on the gross amount of income earned by residents of other EU member states were in breach of community law to the extent they did not allow a taxpayer the possibility of claiming a deduction for the directly related costs of earning the income (case C-290/04 *Scopio*, judgment of October 3, 2006). Since then, other judgments have been passed in the same vein and the Income Tax Act has been amended to allow for the directly related expenses of income earning for artists and athletes (*Scorpio* was a concert agency), those exploiting the broadcasting and other publication rights to German performances and to board members earning directors' fees. The Supreme Tax Court has now filled in a gap in the law by adding the one important missing item, royalties, to the list.

A local business acquired the exclusive right to operate proprietory pin-ball and similar games within a given area in return for a royalty of 28.5% of the takings. The royalty was paid to a Dutch B.V. that had acquired the licence from the owner of the technology in England on terms allowing sub-licensing in return for 93% of the fees received. The parties concerned insisted that the fee surrendered by the B.V. was a direct cost of its earning its licence fee income from Germany, and that its German tax liability should be based on the 7% net income remaining to it after settlement. The tax office and lower tax court insisted on following the letter of the law to the effect that the tax should be based on the gross amount.

The Supreme Tax Court has now held that the *Scorpio* precedent should be extended to the present case. The head licence fee paid by the B.V. was a direct cost of earning its sub-licence fee from Germany, and it should be taxed on the net in conformity with other EU residents earning income from German sources. This net taxation could be achieved by allowing the B.V. the right to claim a refund of the excess tax withheld, or by allowing the payer to base his withholding on the net amount. This latter was appropriate if the payer knew of the direct costs at issue and had access to the relevant documentation, in this case to the head licence agreement. The court went on to emphasise that the German payer must be satisfied that the costs claimed were plausible and in apparent agreement with the contract, but that he was not required to verify that the head licence had actually been paid or that it was at arm's length. He was also not required to investigate the shareholdings in the B.V.

Supreme Tax Court case I R 32/10, judgment of July 27, 2011 published on November 23

Keywords

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