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By PwC Deutschland | 14 March 2017

Plans to restrict the deduction of royalty expenses to combat tax planning by international groups

On 25 January 2017 the federal government approved a draft of the Act to Combat Harmful Tax Practices in connection with the Licensing of Rights. The intention is to prevent multinational businesses from transferring their royalty income to countries, which offer such income preferential treatment. Such preferential tax regimes (so-called Licence Boxes, Patent Boxes or IP-Boxes) are considered not to meet the demands of the OECD and G20 BEPS Project. A new provision is to be introduced to the Income Tax Act (ITA) for this purpose; the new provision should be applied to expenses arising after 31 December 2017.

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In Action 5 of the Final Report of the BEPS Project, the participating countries agreed upon a framework for measures, according to which the states might provide for a preferential tax treatment (Licence Boxes, Patent Boxes or IP-Boxes) to certain income resulting from qualifying intellectual property (“IP”). The so-called “nexus” approach examines, whether such a preferential treatment is dependent upon the amount of research and development (“R&D”) activities of the taxpayer benefitting from the scheme. It is based on general principles, which apply to tax benefits for R&D and similar expense-orientated tax rules. Under these expense-orientated tax rules, expenses and tax benefits are directly related to one another, because the expenses will be applied to the calculation of the tax benefit.

The nexus approach extends this general principle to tax provisions, which apply to income realised after the creation and utilisation of IP. With regard to the value of the IP, the ratio of the taxpayer’s own costs (i.e. the expenses incurred through the taxpayer’s own R&D activities and R&D activities performed by a third party on behalf of the taxpayer) are put into proportion to the overall costs of development, which include additional acquisition costs for IP and expenses for contract research by related parties. The total income arising from the value of the IP is deductible in this proportion. To the extent that the income deemed to benefit from the preferential regime does not exceed this amount, the regime meets the substantial activity requirement. With effect from 1.7.2016, no new IP or taxpayers may be admitted to preferential regimes which do not apply the nexus approach. In existing cases, such (non-compliant) preferential regimes may continue to apply until 30.06.2021 at the latest.

Introduction of a royalty expense capping as a defence measure

As the existence of preferential regimes, which do not apply the nexus approach, cannot be excluded in the future and as a large number of German tax treaties apply a zero tax rate on royalty payments, it is still conceivable that businesses will shift their royalty income to the relevant countries. In order to avoid this, the government has introduced a new section in to the ITA with the new bill. “We will no longer tolerate international groups shifting their royalty income to tax havens, unless there is a connection to R&D there”, stated Wolfgang Schäuble, the Minister of Finance, in the cabinet resolution. The Bundesrat also recently demanded such defence measures in a resolution and requested that, at the very least, a workable solution should be introduced in the current legislative period.

The new section in the ITA provides that expenses incurred for the licensing of rights by a related party (within the meaning of Section1 (2) of the Foreign Transactions Act (“FTA”)) are non-deductible or only partially deductible, to the extent that the payment - in the hands of the recipient - is subject to a low tax rate (income tax rate of <25%) and the low tax rate is not a result of the standard tax rate in the country in question but rather arises from a special preferential regime (e.g. a Licence Box).

To stop any further avoidance, the provision also applies to situations under which further related parties are inserted in between. Furthermore branch undertakings are also considered to be payers and recipients within the meaning of the provision. Insofar as the conditions apply, only that proportion of the expenses will be deductible that corresponds to the ratio that the income tax rate borne by the recipient bears to a tax rate of 25%. This means that the higher the tax burden on the recipient the greater the deductible proportion by

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the payer.

However, there should be no restrictions to the deduction, where the low rate of taxation of the income in the creditor's hands is the result of a preferential regime, which only applies to rights which underlie a substantial activity. According to the draft this will only be the case where the creditor has, to a greater extent, developed the right within the parameters of his own business activity. This exception does not apply where the preferential regime benefits trade mark royalties.

An exception to the general rule is also to be applied where the income arising from the royalty payments is treated and taxed as deemed income under CFC rules (Sec. 10 FTA). This exception is intended to avoid a double taxation which would arise through a denial of the royalty expense with a parallel taxation of the related royalty income under CFC rules.

Note: In February 2017 the government responded to parliamentary questions regarding the names of EU Member States which – according to its understanding –operate such a preferential tax regime for so-called Licence Boxes and the extent to which these countries are introducing checks. The Parliamentary State Secretary Dr. Michael Meister stated (verbatim): "The following European Member States have a so-called Licence Box: Belgium, France, Great Britain, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Spain, Hungary, Cyprus. With effect from 1 March 2014 Austria introduced a restriction to the deduction of interest and royalty payments in §12 No. 10 of the Austrian Corporate Income Tax Act. The Austrian rule provides for a complete disallowance of the expense, where the income in the hands of the recipient is not subjected to a CIT rate of at least 10 per cent. To the extent that there is taxation of at least at the rate of 10 per cent, a full deduction of the expenses is allowed." *Source:* Deutscher Bundestag – Drucksache (printed matter) 18/11220 from 17 February 2017

Keywords

IP-Boxes, Patent Boxes, licence box, royalties