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Bundesrat approves legislation introducing restrictions on the deduction of royalty payments

In its sitting on 2 June 2017 the Bundesrat (the Upper House) approved the Act to Combat Harmful Tax Practices in connection with the Licensing of Rights.

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The new legislation is intended 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. The new provision should be applied to expenses arising after 31 December 2017 and is to be introduced by way of a new provision in the Income Tax Act (ITA).

The new section (Section 4 j ITA) provides that expenses incurred through licensing rights from 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, Patent Box). Where there is more than one creditor, the lowest tax charge will be relevant.

The provision also applies to situations under which additional related parties are inserted in between. Furthermore branch undertakings may also be considered as 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 the payer.

Under the provision, a foreign partnership treated as a transparent entity, e.g. a check-the-box transparent corporation will also be considered to be a creditor.

The restrictions will not apply if the foreign preferential regime follows the nexus approach of the OECD (see Chapter 4 of Action 5 the Final Report of the BEPS Project).

Keywords

International Tax, Patent Boxes, Royalty expenses