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Limited taxpayers: withholding tax on cross-border licensing of software

At the beginning of November 2017 the Federal Finance Ministry published the long-awaited circular on its intended application of the rules (Section 50a Income Tax Act)applying to limited taxpayers and withholding tax on cross-border licensing of software and databanks.

The Federal Finance Ministry circular provides a detailed evaluation of software and databank licences supplied by non-resident provider to resident customers and the potentially resultant limited liability to German tax under Section 50a (1) No. 3 Income Tax Act (“ITA”) by way of withholding. The limited liability to German tax arises where income is realised from licensing rights, which are exploited in a domestic branch or other establishment.

Starting point: Limited liability to German tax

This liability arises where the user is given extensive rights to (economically) exploit the software (this could for example be the right to duplicate, to adapt, to disseminate or to publish) and that this exploitation occurs in a domestic branch or other establishment. The term “exploitation” means targeted activities intended to achieve an economic benefit from the licensed rights. No limited tax liability will arise for example where the licence of the software functions is the prime purpose of the contract.

Result: Withholding Tax

Tax will only be withheld under Section 50a (1) No. 3 ITA where the non-resident provider of the cross-border software licence is a limited taxpayer.

Example

A German resident company obtains a licence from “Software Ltd.”, a Singapore resident company, containing the right to disseminate, duplicate, publish and adapt a special photo software in order to make it suitable for the German market and to incorporate it in software package containing separate programme features, which package the German company markets. The royalties paid by the Germany company constitute the domestic income of a limited taxpayer in the hands of Software Ltd, to the extent the latter company does not have a domestic branch or a permanent representative in Germany.

Withholding tax under Section 50a (1) No. 3 ITA only applies to temporary licences. A licensing of patented software is generally to be viewed as a temporary licence of rights, as a full transfer of patented rights is not permissible.

Provision of extensive rights for economic exploitation

Income from the licensing of rights will be subject to a limited tax liability where extensive rights are granted which allow for further economic exploitation. This would be the case, for example, where a foreign entity, which had neither a domestic branch nor a permanent representative in Germany, allowed its German resident subsidiary to further develop and commercially market the parent’s original software products in Germany and for the payment of a royalty granted the German company extensive rights (duplication adaptation and dissemination rights). In such a case the German subsidiary would not only be entitled to use of the software in a conventional manner but also to the exploit it through development and dissemination of the adapted form.

Licensing of software for conventional use.

Domestic income does not arise where the licence simply allows a conventional use of the software. This evaluation applies regardless of whether the relevant software is so-called “standard software” or whether it is specially developed “individual” software. Conventional use also includes adaptations and duplications which are necessary for conventional use in so far as no economic exploitation is involved. No domestic income will arise where the cross-border licence is limited to the onward transfer of the software and its conventional use within a group of companies within the meaning of Section 18 of the Stock Corporation Act; this will apply whether or not the onward transfer is on a cost-covering basis or whether an additional payment is made.

The circular also addressed some other issues:

Internet-based software licences: In addition to the transfer of software through disk or download, the use of software can be facilitated over the internet server of the supplier. This applies particularly to Application Service Providing (“ASP”) and Software as a Service (“SaaS”). In addition to the transfer of software, the end-user is regularly supplied with further technical services (data retention, data processing, support, maintenance and advice). Again in this situation, domestic income will only arise to the extent that extensive rights for economic exploitation are granted.

Transfer of software copies to intermediary suppliers: no taxable transfer will arise, where the licence is limited to the domestic dissemination of certain copies (reproductions) of software, without the intermediary supplier being granted extensive rights in the software itself. The transfer by the foreign software provider can occur through the provision of a disk or by way of a download (provision of a licence key for the download of the software).

Mixed contracts: No tax liability will arise where the transfer of rights is insignificant (i.e. no more than 10%) compared to the supply as a whole or where the consideration cannot be allocated where an apportionment is required.

Use of the Read/Print function of a databank: According to the Finance Ministry’s interpretation, no domestic income should arise where the licensee uses the Host Access Functionality or the Read- Print-Functions of a databank in a standard (conventional) manner. This is in contrast to the commercial use of the databank or of information contained in the databank (for example rights to public reproduction, the right to sub-license to a third party or the right to publish patented analyses).

No economic exploitation of data use in higher education institutes and in public libraries: As mentioned above domestic income will only arise where the rights are…. exploited in a domestic branch or other establishment. According to the Finance Ministry the expression “other establishment” also includes universities and public authorities. However, it cannot be assumed that an institute of higher education or a library can carry on a targeted activity (“exploitation”) within the framework of its public duties. Hence foreign suppliers who license the use of their academic databanks to institutes of higher education or a libraries are not subject to the limited tax liability where the commercial use of the databank is excluded in the contract between the institute of higher education/ library and the databank supplier.

The circular is to be applied to all open cases.

Source:

Federal Ministry of Finance circular of 27 October 2017 (IV C 5 S 2300/12/10003: 004) published on 2 November 2017.

Keywords

Income Tax Act, International Tax, Licensing of software, Licensing rights, administrative principles, databanks