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By PwC Deutschland | 08 February 2022

German Federal Ministry of Finance (MoF) published two circulars in relation to the royalty limitation rules

On January 27, 2022, the German Federal Ministry of Finance (MoF) published two circulars in relation to the royalty limitation rules.

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The first deals with general questions of application of the rules, including, in particular, commentary in relation to "preferential regimes", an examination of what constitutes conformity to the nexus approach and remarks on the allocation of the burden of proof. In the second circular, the MoF lists which international regimes will fall short of the necessary requirements in the 2018, 2019 and 2020 tax years.

In addition the second circular also comments for the first time on special cantonal companies in Switzerland. Furthermore, it indicates that US FDII regime continues to be listed as a preferential regime the review of which is still ongoing.

The rules in brief

The royalty limitation rules (Section 4j Income Tax Act), which were introduced in 2017, restrict the deductibility of royalty expenses/licence payments where, the recipient of the income is a related party vis-à-vis the debtor and the income in the hands of the recipient is subject to a special **preferential regime**. A regime will be considered as preferential, where the tax treatment under it differs from the standard tax treatment and the income is taxed at a rate less 25 %. Where, however, the relevant regime is considered to correspond to **OECD Modified Nexus Approach,** a full deduction will be possible.

Preferential regimes

A preferential regime is considered to exist where the tax treatment applied differs from the standard treatment. According to the first circular this "difference" is established by comparing the treatment applied to the relevant income to the treatment of other income in the same state. In this regard:

- The benchmark for "standard taxation" is the standard tax rate that would be applied to the income of taxpayer with a legal personality comparable to that of the relevant creditor;
- It is irrelevant whether the taxpayer must make an application to participate in the regime;
- It is not necessary for the regime only to apply to royalty income nor must it be limited to so-called "intellectual property" (IP) regimes such as license boxes, IP boxes or patent boxes.
- So-called "tax rulings", i.e. individual agreements between foreign tax authorities and recipients of royalty payments, can also fall within the royalty limitation rules.
- With regard to what constitutes low taxation, the amount of tax legally owed tax, will not be relevant but rather the tax actually levied and paid. Any subsequent refund claims will also be taken into account. Furthermore, refunds available to other taxpayers may also be considered in calculating the tax rate. This will be the case where the shareholder of the royalty recipient is entitled to a tax refund following a dividend receipt.
- A general low rate of taxation in the creditor's country of tax residence will not per se lead to the assumption that a preferential regime exists. Rather, the low level of taxation must constitute a deviation from standard taxation;
- Where the royalty income is attributed in whole or in part to a person other than the creditor or where tax is (also) levied on another, the total tax burden will be considered.

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Nexus conformity

The circular refers to the analyses of international preferential regimes performed by the Forum on Harmful Tax Practices (FHTP) of OECD. These are split into two categories, namely the analysis of IP-Regimes and the analysis of other preferential regimes. Only regimes in the former category will be examined by the FHTP for their nexus conformity. The second circular issued by the MoF in connection with the royalty limitation rules on 6 January 2022 contains the FHTP's non-exhaustive list of preferential regimes not considered to have adopted the nexus approach in the years of assessment 2018 to 2020.

Where the FHTP has not performed a nexus-conformity analysis, e.g. where the regime is in the category of "other preferential regime" or where the royalty payment forms part of a "tax arrangement," the question of nexus-conformity will be investigated as part of the normal tax assessment process.

Burden of proof

Finally, the circular comments on the burden of proof. General principles will apply, namely that the tax authorities bear the burden of proof for facts which increase the tax burden whereas the taxpayer bears the burden of proof for facts which reduce it. This means that the tax office must prove the existence of a preferential arrangement or lower taxation, although the use of the FHTP analyses may be sufficient for this purpose.

The taxpayer is not only required to prove that the license expenses are deductible as a business expense and that any preferential regime is nexus-compliant, but also has additional obligations to cooperate and provide evidence under the provisions of the General Tax Code due to the international element.

It is, however, open to the taxpayer to prove that an existing preferential regulation does not apply or to provide evidence for standard taxation, e.g. by means of a foreign tax assessment notice and the calculations on which it is based, a confirmation of the foreign tax authority, etc. Where the FHTP has confirmed that a regime is nexus-compliant, the taxpayer will not be obliged to provide further evidence.

Keywords

IP box, Patent Boxes, nexus approach, royalties, royalty limitation rules