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By PwC Deutschland | 08 July 2022

Limited tax liability and tax withholding in case of indefinite transfer of know-how

The transfer of know-how by a foreign creditor for an unlimited period may lead to limited income tax liability in Germany by way of tax withholding. The fact that the know-how must be used domestically in order to trigger German withholding tax does, according to the Supreme Tax Court, not require that the know-how also had the specified scope, substance and quality to fulfill the purposes pursued in the domestic market.

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Background

In 2007, the plaintiff, a limited liability company (GmbH), concluded a technology transfer agreement with the Hungarian company P Kft (P). In the preamble, the contracting parties assumed that P had developed, optimized and implemented a process to produce a pharmaceutical substance since July 2005. The technology transfer agreement stated that the right of P to exclusively manufacture the product X would be transferred to the plaintiff. Under this agreement, the plaintiff acquired the unrestricted right to use the know-how developed by P for the manufacture of two active ingredients Y and X. A lump sum amount was agreed as remuneration for the transfer of the exclusive rights to use the technology, for compensation of the costs of the work performed to date, for the preparation of the documentation including the rights associated with it and for the work concerning the technology transfer.

Following disagreements between the plaintiff and P about the quality of the active substances produced by P the contractual relationship was terminated in 2009. According to the invoice, the services provided by P up to September 2009 were to be covered by the payments made by the plaintiff. The plaintiff did not claim any back payments. After termination of the contractual relationship, insolvency proceedings were filed against P.

The tax office issued a notice of liability against plaintiff. The view of the plaintiff in the appeal proceedings was that the transfer for an unlimited period is not (anymore) covered by the limited tax liability if the previous owner of the know-how not only transferred it to a third party for use, but also sold it ("sale of a right"). However, the Munich Tax Court dismissed the appeal as unfounded.

Decision

The Supreme Tax Court also rejected the action submitted by the plaintiff and held that the Munich Tax Court had correctly interpreted the technology transfer agreement between the plaintiff and P insofar as there was a transfer of know-how for an unlimited period, but at the same time there were no indications whatsoever that P intended to dispose of its know-how definitively and in its entirety.

Section 49 (1) no. 9 of the German Income Tax Act (ITA) requires that the know-how be used or must have been used in Germany. This, according to the Supreme Tax Court, presupposes that the know-how is used for its designated purpose in Germany; the know-how must have been used or deployed in Germany by the party liable for the remuneration (the plaintiff) or indirectly enabled by it.

However, this does not imply that the use of the know-how necessarily must have yielded the success intended by the parties from the outset. Irrespective of an actual utilization in Germany, the limited tax liability cannot be waived solely because the know-how transferred does not meet the expectations of the party liable to pay the remuneration or was not suitable for the purposes pursued by it in the first place.

Pursuant to Sec. 50a (5) Sentence 1 ITA, the withholding tax is due at the time the remuneration is received by the creditor. However, the tax also arises if advance payments are made, or in cases of a credit, or if - as in the case in dispute - payments for the transfer of know-how are due at the time the contract is concluded

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and thus possibly even before the know-how is used in Germany.

In order to ensure tax deduction in any case, it is therefore adequate for tax withholding if the actual use in Germany was planned by the creditor at the time the fee is paid. In the opinion of the Supreme Tax Court, it is therefore irrelevant that ultimately there was no transfer of the know-how due to the termination of the contractual relationship or, for example, in the light of the subsequent insolvency proceedings.

Source:

Supreme Tax Court, decision of 13 October 2021 (I R 18/18), published on 14 April 2022.

Keywords

limited tax liability, withholding tax