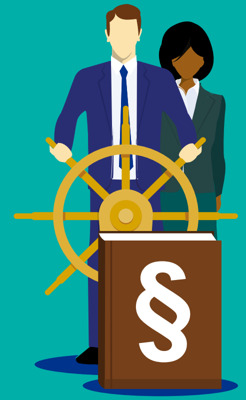
Non-resident taxation in Germany for foreign-to-foreign licence payments and IP transfers

Draft bill proposes tighter anti-treaty/directive shopping rules



German non-resident taxation for foreign tax residents with certain IP structures and a proposed tightening of German anti-treaty/directive shopping rules entail major tax challenges for multinationals. Take advantage of our expertise to assess and reduce your potential tax exposure.

Background
In the recent past, the German tax authorities have started applying rules that subject foreign-to-foreign royalty payments or income from the transfer of IP rights to German non-resident taxation when the respective IP is either exploited in German territory or registered in a German register. Greater attention followed the decree of the German Federal Ministry of Finance ("BMF") dated 6 November 2020 confirming that such cases may lead to a domestic tax liability for foreign companies and an obligation to file tax returns.

In addition, according to a draft bill published by BMF on 20 January 2021, a significant tightening of the German anti-treaty/directive shopping rules under Section 50d (3) of the German Income Tax Act (ITA) is proposed.

Limited tax liability in Germany regarding certain IP structures
According to Section 49 (1) no. 2 f) ITA in its current version, royalties or capital gains from transfers associated with IP that is either exploited in Germany or registered in a German register can give rise to German non-resident taxation, even if no obvious German nexus exists. As a result, capital gains derived outside of Germany from the transfer of domestically registered or exploited IP rights may be subject to ordinary German taxation (but not German withholding tax). For ongoing royalty payments, a withholding tax obligation might apply. These tax obligations may not only affect German tax resident companies or German PEs, but also arise at the level of foreign companies that are part of the licensing structure.

Besides the review to determine whether IP transfers relating to German registered IP are at hand, "domestic exploitation" entails a series of critical constellations in which the existence of a German tax liability may be viewed differently by the German tax authorities, as the term "exploitation" as used in Section 49 (1) no. 2 f) ITA is not specified by law.

For treaty protected transactions, tax relief under an applicable tax treaty should, in principle, be available. However careful analysis is required with respect to the application of a treaty, and a potential withholding tax relief is subject to strict German anti-treaty shopping rules (Section 50d (3) ITA). To the extent that a German (withholding) tax liability existed without sufficient tax being paid in Germany in the past, potential tax evasion risks may arise if taxpayers do not declare themselves.

Revision of anti-treaty/directive shopping rules
Withholding tax reductions for dividends and royalties can either be claimed by way of an exemption procedure or through a tax refund. Such withholding tax relief is, however, subject to strict German anti-treaty/directive shopping rules (Section 50d (3) ITA). In a nutshell, no withholding tax reduction shall be granted if a company with insufficient business substance is interposed between the shareholder and the distributing or paying domestic company.

According to the revised draft provision, the foreign company is entitled to withholding tax relief from a tax treaty or EU directive only to the extent that

- persons hold shares in the foreign company who would be entitled to the relief if they earned the income directly (so-called personal entitlement to relief) and
- the source of income has a substantial nexus to an economic activity of that foreign company (so-called factual entitlement to relief).

Overall, the draft revision represents a significant tightening of the current provision regarding, inter alia, the following:

In contrast to the currently applicable provision, for personal entitlement to relief the shareholder would need to be entitled to relief under the same provision as the foreign company itself. This would not be fulfilled even if the shareholder was entitled to claim the equivalent amount of relief, but the entitlement resulted from another tax treaty.

For factual entitlement to relief, a "substantial nexus" of the income stemming from the German paying company to the economic activity of the foreign company shall henceforth be required, whereas the currently applicable provision is based on "gross income from own economic activity" of the foreign company. As a result, the entitlement to relief in the future could be refused despite full economic activity of the foreign company if the above-mentioned substantial nexus does not exist. A company simply forwarding income received to its shareholder ("Durchleitungsgesellschaft") as well as any activity of the foreign company without a properly equipped business operation shall expressly be excluded from being an economic activity.

According to the revised version, the anti-treaty/directive shopping rules shall not be applicable if it can be shown that none of the main purposes for the interposition of the foreign company constitutes a tax advantage (so called "Motive Test"), whereas in the currently applicable version, the interposition of the foreign company is considered abusive if there are no economic or other valid reasons.

In addition, the stock exchange exemption shall only be applicable to the foreign company itself. The listing of its shareholders on a stock exchange, however, shall not suffice.

With regards to the first-time-application of the revision it is stipulated in the draft bill that the new rule shall have retroactive effect on all open cases, unless the applicable rule at the moment in time of the payment would not prevent a respective relief.

Some or all of the services described herein may not be permissible for KPMG audit clients and their affiliates or related entities.

Our services

With respect to extraterritorial IP taxation

- Review existing IP structures for a German nexus that has not yet been considered.
- Preparation/filing of WHT returns/declarations for historic/future payments.
- Claiming (withholding) tax relief if a reduction under EU law/tax treaty is available, i.e. assisting with refund procedures and/or applying for exemption certificates to avoid future German WHT.
- Adapting/modifying existing IP structures.

With respect to the draft tightening of anti-treaty/directive shopping rules:

- Review whether to conduct dividend distributions and/or payments under the currently applicable anti-treaty/directive shopping rules before the revision is passed.
- Review of withholding tax risks of existing structures in light of the draft provision.
- Assistance with regard to refund procedures and applying for exemption certificates under the stricter requirements of the draft.
- Examining existing exemption certificates with regard to their validity should the draft bill be enacted.
- Considering alternative structuring measures.

Contact

KPMG AG
Wirtschaftsprüfungsgesellschaft

Dr Markus Gsödl
Partner, International Corporate Tax
T +49 69 9587-3910
mgsoedl@kpmg.com

Christian Schiessl
Partner, International Corporate Tax
T +49 89 9282-1527
cschiessl@kpmg.com

Dr Anne Schäfer
Partner, Corporate Tax Services
T +49 30 2068-4608
anneschaefer@kpmg.com

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