YPOG Article:
Ministry of Finance publishes letters on application of Royalty Limitation Rule

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Introduction

In order to avoid the abusive use of foreign preferential IP taxation regimes, the Ministry of Finance has implemented a provision that limits or denies the deduction of cross-border royalty expenses applicable for corporate income taxation, as well as regular income taxation (the Royalty Limitation Rule).[1]

The Royalty Limitation Rule, which applies to such taxation regimes from 2018, is generally applicable if:

- a German taxpayer records expenses for royalty fees
- payments are made to a related party
- the corresponding profit is subject to preferred and low taxation in the recipient's jurisdiction (a preferential taxation regime).

Applying Royalty Limitation Rule

On 5 January 2022 and 6 January 2022, the Ministry of Finance published two circular letters that contained guidance for the application of the Royalty Limitation Rule. The letters focus on guidance related to the so-called "nexus escape" and the distribution of the burden of proof between tax authorities and taxpayers.

The preferential taxation regime is applicable if the royalty-derived profit is taxed at a tax rate of below 25% (which also includes non-taxation) at the level of the foreign creditor. Taxation in this context is the actual taxation, including any subsequent refund claims, among other things. Besides the low taxation criterion, the preferential taxation regime requires a preferred taxation of royalty-derived profit. This means that there is a taxation regime applicable for such income deviating from the general income taxation regime in the respective foreign jurisdiction. Such preferred taxation may also be based on tax rulings.

If these conditions are met, the German taxpayer's royalty expense is non-deductible at a portion reflecting the shortfall from the 25% reference tax rate. However, if the recipient's taxation regime

[1] Section 4j of the German Income Tax Act.

is in accordance with the Organisation for Economic Co-operation and Development (OECD) nexus approach, which is defined within the concluding report of 2015 regarding OECD-Base Erosion and Profit Shifting Project Action Item 5, the Royalty Limitation Rule is not applicable for such royalty expense (ie, the nexus escape).

Most common preferential taxation regimes are the so-called "IP regimes". IP regimes are under continuous review by the OECD Forum on Harmful Tax Practices (FHTP), which evaluates their nexus conformity. The circular letter dated 5 January 2022 outlined that the conclusions made by the FHTP on the nexus (non-)conformity of particular IP regimes is decisive for the application of the nexus escape in Germany.

The circular letter dated 6 January 2022 comprises a non-exhaustive list of the most common non-nexus conforming IP regimes for the years 2018 to 2020.

Germany and all other EU member states have committed to abolish IP regimes that did not conform with the nexus approach by 30 June 2021. However, if an initially non-nexus conforming IP regime was revised and amended to achieve nexus conformity before 30 June 2021, the nexus escape will be applicable on royalty expenses relevant to the German taxpayer only after the amended IP regime became effective.

IP regimes that are not under review by the FHTP (eg, IP regimes subject to individual tax rulings) need to be assessed regarding their nexus conformity within the taxation procedure of the German taxpayer on a case-by-case basis.

The distribution of the burden of proof in this context follows the general rules. The tax authorities must provide abstract proof of income-increasing facts, meaning in this context that the tax authorities are obliged to prove the existence of a preferential taxation regime in the particular foreign jurisdiction in general. The taxpayer on the other hand must prove that the royalty payment in dispute is not subject to such preferential taxation regime at the level of the foreign royalty creditor. This is also true when applying the nexus escape. However, if the FHTP confirms the nexus conformity of an IP regime, there is no additional burden of proof for the German taxpayer.

German taxpayers should, therefore, have documentation prepared that sufficiently proves the application of the Royalty Limitation Rule in accordance with their respective tax filing position.

Comment

Due to the commitment by Germany and the other EU member states to abolish IP regimes that were non-nexus conforming by 30 June 2021, cases for applying the Royalty Limitation Rule in Germany are expected to decrease. For the remaining special cases, elevated documentation efforts may be required for German taxpayers. In some of such special cases, the involvement of foreign tax advisors might be required for assessing the actual taxation in the recipient's jurisdiction.

We are happy to support you and open for further exchange.

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