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Germany

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Federal Council approves new law limiting royalty deductions

On June 2, 2017, the German Federal Council approved a new law introducing a so-called royalty barrier (Lizenzschranke). Accordingly, as of January 1, 2018, German-based licensees will be unable to deduct royalties paid to affiliates to the extent that the licensor's royalty income is not subject to the regular tax regime (e.g. IP box regime) and taxed at a low rate within the meaning of the royalty barrier (effective tax rate of < 25 %). This prohibition on deduction does not apply, however, if the royalty income benefits from a preferential arrangement under the OECD's so-called Nexus Approach.

As compared to the draft bill submitted in December 2016, which we discussed in our December 2016 Client Alert ("German government plans to limit royalty deductions as from 2018"), the new law contains in particular two new elements:

1. While the draft bill left it open whether the licensor's net or gross income was relevant for determining whether the licensor was taxed at a low rate, the law's final wording makes it clear that the gross income is relevant. Any actually incurred operating expenses of the licensor (e.g. depreciations after on-shoring) that reduce the effective tax burden below 25 % do not constitute a low taxation within the meaning of the royalty barrier.
2. According to the draft bill, the royalty barrier was not to be applied if the licensed rights were connected with "substantial business activities". In this manner, the legislator intended to include the OECD's Nexus Approach into the general wording of the regulation. In the final wording, the escape is slightly more specific. According to the wording of the new law, the royalty barrier shall not apply if the respective preferential arrangement "is in line with the Nexus Approach pursuant to Chapter 4 of the final report 2015 on the OECD's BEPS Action Item 5 (2016)". In terms of substance, however, this should not result in any changes.

From a legal perspective, the royalty barrier is controversial for several reasons:

1. Generally speaking, the royalty barrier also applies in cases where the royalty income is subject to the regular tax regime at the level of the licensor itself and where the rights are licensed to the licensor by a group company (back-to-back) which benefits from a preferential arrangement that is not in line with the OECD's approach and which is taxed at a low rate. Where both the licensor and the other group company benefit from a preferential arrangement, the lowest tax rate shall be relevant. In practice, the licensee in an intra-group back-to-back structure will, hence, have to prove that the requirements for the application of

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the royalty barrier are not fulfilled at any level. The problem is, that the licensee is usually unaware of the tax situation of its sister and parent companies both at a legal and factual level.

2. The fact that the burden of proof to the German licensee is shifted to the German licensee even though the licensee is often neither aware of the low taxation abroad nor able to exert any influence in this respect may not be in accordance with the German Constitution on only benefits the German tax administration. In addition, there is the question whether the new rule might violate the so-called net income taxation principle (Nettoprinzip) and the principle of taxation according to the ability to pay (Leistungsfähigkeitsprinzip). From a constitutional law perspective, it is furthermore questionable whether the mere reference to the final report of the OECD is sufficiently specific and clear to comply with the requirements of a general and abstract act of parliament. Finally, the new rule might also violate the principle of proportionality (Verhältnismäßigkeitsgrundsatz) because it also applies if the regular tax regime is below 25 % (e.g. 16 %) and the benefit derived from the preferential arrangement (e.g. 15 %) is marginal.

3. Last but not least, the new rule clearly discriminates cross-border services and interferes with the freedom to provide services under EU law. It also favors transactions between unrelated entities over transactions between affiliated companies and could, thus, raise state aid rule concerns.

Against this backdrop, affected companies should consider taking legal action against the new law. As a matter of precaution, taxpayers procuring licenses from abroad should now start reviewing their structures in order to assess whether the royalty barrier applies and, if necessary, implement defense measures already at this point.

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