



## LIMITED TAX LIABILITY APPLIES TO ROYALTY PAYMENTS BETWEEN NON-RESIDENTS

In a letter dated 6 November 2020, the Federal Ministry of Finance (BMF) made initial comments on an interpretation of German limited tax liability on royalty payments, an issue that has emerged as controversial in the recent past. The BMF's legal position may have significant consequences for internationally operating groups of companies. The easing of the legal requirement that had been originally planned is no longer on the cards. An initially envisaged easing of the legal requirement is no longer expected. In a further letter dated 11 February 2021, the BMF provides for a simplification rule for payments received by 30 September 2021. However, the tax authorities are sticking to their previous legal interpretation.

### KEY ASPECTS

The BMF takes the following legal view:

- › Persons receiving royalty payments who are not resident in Germany are subject to limited tax liability in Germany if they receive royalty payments for rights entered in a German register, regardless of whether there is any other nexus with Germany.
- › Consequently, companies that owe royalty payments must check whether they are required to withhold and pay withholding tax.

- › With the simplification rule for payments received or accruing by 30 September 2021, withholding tax is waived. Nevertheless, companies must submit an application for exemption to the Federal Central Tax Office (BZSt).

### BACKGROUND AND LEGAL BASIS

According to the wording of sections 49(1) no. 2(f) and no. 6 of the German Income Tax Act (Einkommensteuergesetz, EStG), companies receiving payments that are not resident in Germany and lease or rent (li-

cense) intellectual property rights entered in a public book or register in Germany (e.g. a patent or trade mark register) have limited tax liability in Germany. The tax must be levied either by charging a deduction (section 50a(1) no. 3 of the EStG if rights are transferred) or by an assessment procedure (section 25(3) of the EStG if rights are sold). The BMF takes the view that no further domestic nexus (beyond registration in Germany) is required. Consequently, royalty payments between persons resident outside Germany who do not exploit the rights in Germany can also give rise to a limited tax liability based on the current legal situation, as long as they are attributable to rights registered in Germany. The legal interpretation by the BMF in its letter of 6 November 2020 is likely to be covered by the wording of the law, even though it is difficult to reconcile it with the spirit and purpose of the provision.

In its ministerial draft of 19 November 2020, the BMF proposed amending the requirements referred to above by deleting the words 'or entered in a domestic public book or register' as a nexus for limited tax liability in Germany. However, this amendment is no longer contained in the bill resolved by the Federal Government on 20 January 2021. Since the BMF has in the meantime published another letter (on 11 February 2021) providing a simplified transition rule, any change in the legislation appears to be out of the question in the short term.

## **ILLUSTRATIVE PRACTICAL SCENARIO**

The parent company of an internationally operating group of companies is in the USA ('US parent'). The US parent owns the group's intangible assets, including patents that are registered in the European Patent Office and thus also registered in the German patent register. Production for the European market is handled by a Polish subsidiary ('Polish subsidiary'). The Polish subsidiary pays monthly royalties to the US parent for the exploitation of the patent rights in the production process. The BMF takes the view that the part of the royalties that is (proportionately) attributable to the patents registered in Germany results in limited tax liability for the US parent company in Germany, based on the current legal position. In principle, the Polish subsidiary would therefore be required to deduct and withhold German withholding tax.

## **THE SIMPLIFICATION RULE**

In its letter of 11 February 2021, the BMF once again addresses the issue of the limited tax liability on royalty payments and makes it clear that it still adheres to its interpretation of the law. For reasons of simplification, however, the tax withholding can be waived for royalties that accrue or have accrued to the royalty recipient by 30 September 2021 if the following conditions are met:

- › The party paying the royalty is not resident in Germany.
- › The party receiving the royalty is relieved of withholding taxes levied in Germany upon receipt of the payment by virtue of a double taxation agreement between Germany and its country of residence.
- › The party receiving the royalty submits an application for exemption from tax deduction to the BZSt by 31 December 2021, in which the contractual relationships must be disclosed, in a German translation, if applicable.

As a result, this means that investment income tax need not be withheld in the cases covered by the simplification rule, but the cases must nevertheless be reported to the Federal Central Tax Office.

## **PRACTICAL EFFECTS**

Numerous possible scenarios are affected by the problem. For example, inbound cases may arise in which an international group with subsidiaries holds rights that are entered in a register in Germany, but are owned by the respective foreign companies. Domestic companies with a foreign subsidiary may also be affected, for example, if the foreign subsidiary has rights entered in a German register.

Under the simplification rule, it should often be possible to avoid tax withholding on royalty payments accruing until 30 September 2021 in purely foreign situations. Nevertheless, verifying the requirements and proving them to the tax office will lead to a significant additional administrative burden on companies.

If the requirements of the simplification rule are not met, e.g. because the party paying the royalty is resident in Germany or royalty payments are received after 30 September 2021, the question of withholding tax becomes acute. It is possible that the effective tax burden can also be reduced to 'zero' in these cases by actively seeking a withholding tax reduction in advance via the exemption procedure or the withholding tax retention and refund procedure, provided that there are provisions to this effect in the applicable DTA. This gives rise to a number of practical questions and hurdles, ranging from the identification of the relevant fact patterns, to the derivation of the tax basis (proportionately attributable to German rights), down to procedural questions, including the examination of any entitlement to claim relief under the DTA (applicability of the DTA and DTA restrictions such as section 50d(3) of the EStG). By contrast, cases in which there is no DTA protection can lead to effective tax burdens.

Cases where, in contrast to the illustrative scenario, the underlying rights are not transferred for a limited period, but rather for an indefinite period (sale of rights), are not subject to German tax deduction in the opinion of the BMF; however, they result in the non-resident seller being required to file a tax return in Germany.

## **WHAT YOU NEED TO DO**

In its letter of 11 February 2021, the BMF increased pressure on companies with cross-border operations to carefully review royalty payments, assess any limited tax liability and make royalty payments by 30 September 2021, if applicable, and file an application for exemption from tax withholding by year end. In cases

not covered by the simplification rule, they must determine whether they should file tax returns and pay taxes. Corresponding cases that crystallised in assessment periods 2014 and thereafter should not yet normally be subject to the time limit on assessments, and would therefore in principle have to be addressed. However, the tax authorities have left many questions unanswered (e.g. about the derivation of the tax basis or the application of simplifications in zero tax cases), although the letter of 11 February 2021 contains guidance on determining the tax basis.

Since a change in the law and any easing of the withholding tax obligation or the tax filing obligation is not currently expected, affected companies should identify corresponding scenarios and verify whether the simplification rule applies, or if necessary, file corresponding tax returns and make tax payments.

## CONTACT



Your designated contact persons are available to discuss the issues and identify potential cases.

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