TAXAND

Countering harmful tax practices in licensing of rights: The new license barrier rule in Sec. 4j of the German Income Tax Act

To encourage regional R&D activities, several countries have created preferential tax regimes in which income or profits from the exploitation of intangible assets are taxed at a favorable rate. In some countries, this also includes income from trademark rights, even if no particular R&D activities are involved. It is therefore no surprise that the OECD decided to zoom in on these 'license box' regimes under Action 5 of its Base Erosion and Profit Shifting (BEPS) project. Alongside this, Germany's new Act against Harmful Tax Practices with regard to Licensing of Rights of 2 June 2017 has resulted in the introduction of a new provision, Sec. 4j Income Tax Act (*hereafter: ITA*), that prohibits the tax deduction of license fees as business expenses if such payments are subject to a preferential tax regime and no substantial business activity is carried out.

I. Background

Among the main aims of the OECD/G20 BEPS project were to counter artificial profit shifting and to realign taxation with economic substance. Action 5, 'Countering Harmful Tax Practices More Effectively, Taking Into Account Transparency and Substance', focused on license boxes, or preferential tax regimes for IP companies. In the future, the OECD will no longer tolerate such regimes unless the tax benefits are granted in connection with 'substantial business activity' by the taxpayer. It will apply the 'Nexus Approach', which allows preferential tax treatment only for (license) fees for intangible assets for which the taxpayer either carried out the R&D itself or outsourced it to a third party ('qualified' R&D activities). However, a temporary grandfathering rule applies to regimes that were already in place in 2016 for the preferential taxation of income from licensing of rights to use intangible assets that do not follow the Nexus Approach. The countries affected now have until June 30, 2021 to abolish those regimes or to adapt them to the Nexus Approach.

This apparently does not go far enough for the German legislature. In fact, Sec. 4j ITA, which will apply to expenses incurred after 31 December 2017, undermines the OECD's grandfathering provisions by (partially) limiting the deduction of business expenses at the level of the licensee if the corresponding license fees are subject to a lower rate of taxation than standard and the licensee's country of residence does not follow the OECD's Nexus Approach in the context of this preferential tax treatment.

II. The new rule in detail

1. Prerequisites

According to the newly introduced Sec. 4j(1) sent. 1 ITA, deduction of expenses incurred in connection with the licensing of the use of or the right to use intellectual property is limited if the resulting income of the licensor is taxed at a rate lower than the standard rate (preferential treatment) and the recipient is a related party within the meaning of Sec. 1(2) of the Foreign Tax Act.

In order to deter the use of evasive constellations, Sec. 4j(1) sent. 2 ITA also covers cases in which royalties are routed from the first country to other countries with a preferential tax regime if the recipients of the payments in these countries are related parties of the licensee. Under Sec. 4j(1) sent. 3, licensees and licensors can also be permanent establishments that, for income tax purposes, are treated as beneficiaries of rights for granting the use or the right of use of rights.

According to Sec. 4j(2) ITA, a tax rate is low if royalty income is subject to a rate below 25%, in which case the effective tax rate is determinative. The law states that this threshold is based on the licensor's gross income from the licensing of the intangible assets. With this gross approach, low taxation can also result if the licensor's income is taxed at a nominal rate of 25% or more abroad, the licensor's country of residence permits the deduction of deemed business expenses, or the license fees abroad are partially tax-exempt. Actual tax-deductible expenses of the licensor (e.g. R&D costs, legal costs) have no impact on any low taxation. The following examples demonstrate how the tax burden is calculated pursuant to Sec. 4j(2) ITA:

Example 1:

A licensor, resident in country A, receives license fees of 100 from its subsidiary resident in Germany. The licensor incurs expenses of 20 in connection with the licensed assets. The applicable tax rate in country A is 30%. The licensor's tax burden is therefore 24 (80 × 30%). However, Sec. 4j(2) sent. 1 ITA is based on the tax burden of the gross income. As a result, the standard burden from income taxes remains at 30%. The license fees therefore do not qualify as low-taxed within the meaning of Sec. 4j(2) sent. 1 ITA.

Example 2:

A licensor, resident in country A, receives license fees of 100 from its subsidiary resident in Germany. The licensor does not want to incur any expenses. The applicable tax rate for license fees received in country A is 30%, but 50% of the license fees are tax-exempt. The licensor's tax burden is therefore 15 (50 × 30%). The income tax burden relevant for Sec. 4j ITA is then 15% (15/100) and the income is classified as low-taxed within the meaning of Sec. 4j(2) sentence 1 ITA.

Example 3:

A licensor, resident in country A, receives license fees of 100 from its subsidiary resident in Germany. Again, the licensor does not want to incur expenses. The applicable tax rate for license fees received in country A is 30%, but country A allows deemed business expenses in the amount of 60% of the license fees to be deducted. The licensor's tax burden is therefore 12 (40 x 30%). The income tax burden relevant for Sec. 4j ITA is then 12% (12/100) and the income is classified as low-taxed within the meaning of Sec. 4j(2) sent. 1 ITA.

In addition, the low tax rate must also result from a preferential tax regime that differs from the standard rate. Since the amount of the licensee's expenses pursuant to Sec. 4j(1) sent. 1 ITA must correlate with the licensor's income, a tax rule should not qualify as 'preferential' unless it explicitly refers to the taxation for the fees mentioned in Sec. 4j(1) sent. 1 ITA for granting the use or the right of use of intangible assets. Contrary to the general principles of taxation, the tax rule may not be of a general nature, but must give preferential treatment to the income from the licensing of rights.

More comprehensive preferential regimes that are not tailored specifically to income from licensing the use of intangible assets, but nevertheless give preferential treatment to license fees in individual cases, should not meet the definition in Sec. 4j ITA.

2. Legal consequences

The legal consequence of Sec. 4j ITA that the share of the royalties subject to a lower tax rate in the country of the recipient will not be deductible as business expenses at the level of the licensee. Pursuant to Sec. 4j(3) ITA, the non-deductible share is equal to the difference between a standard tax rate of 25% and the effective tax rate applied divided by 25%. If royalties are, for example, subject to income tax in the amount of only 5% at the level of the licensor, 80% of the royalties paid will not be deductible as operating expenses at the level of the licensee (20% ÷ 25 %). Notwithstanding provisions to the contrary contained in the DTA (treaty override), this follows from the wording of the legislation (Sec. 4j(1) sent. 1 ITA) and will be implemented below the line as are the German provision limiting the deduction of interest contained in Sec. 4h ITA and the new provision on the deduction of special operating expenses contained in Sec. 4i ITA.

3. Exception when the OECD Nexus Approach is implemented

Sec. 4(1) sent. 4 ITA states that a preferential tax rule is harmless if the requirements of the Nexus Approach defined in chapter 4 of the OECD 2015 Final Report on Action 5 are met. As a result, spending on marketing-related intangible assets (e.g. brands) has always been omitted from this provision on exceptions by the direct reference, enshrined in Sec. 4j(1) sent. 4 ITA, to the OECD Final Report on BEPS Action Point 5. The reason for this is that these assets can never meet the prerequisites for a harmless tax-privilege regime under the OECD Nexus Approach. Therefore, if a foreign privilege favors license fees for the licensing of trademarks, the prohibition on deducting business expenses will always apply without exception under Sec. 4j ITA – subject to its prerequisites otherwise being met. This view must be described as extremely questionable: On the one hand, no plausible arguments emerge as to why spending on patent R&D is supposed to validly indicate any business activity of substance. On the other, this interpretation of spending is supposed not hold true for the creation of marketing-related intangible values.

III. Summary

The newly introduced license barrier rule in Sec. 4j ITA will entail substantial difficulties of application and interpretation. In particular, doubts also exist as to whether the provision complies with constitutional and European law. Not least because of the relatively low additional revenues of EUR 30 million p.a. that the government hopes to generate from applying the provision, the necessity of Sec. 4j ITA can arguably be described as extremely questionable.