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Global Tax Alert

German Ministry of Finance publishes guidance on German taxation of extraterritorial intellectual property

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Executive summary

On 6 November 2020, the German Ministry of Finance (MoF) issued letter guidance concerning the German nonresident taxation of income from rights which are registered in a German public register. The letter briefly states that the registration of intellectual property (IP) rights in a German register is sufficient to trigger nonresident taxation of license or capital gains income derived from such rights, and that it is not required for any of the parties involved to be a German tax resident.

According to the Ministry, the payor of royalties derived from the licensing of such rights has to deduct and pay withholding tax and file a tax return with the German Central Tax Office for payments made after 31 December 2013. For payments made preceding 31 December 2013, withholding tax payments and tax filings have to be made with the competent local tax office. Also, the payee of licensing fees has to file a tax return with the competent local tax office, if the registered IP rights were licensed over an indefinite period of time, resulting in a sale of rights transaction which is not subject to withholding, but potentially to capital gains taxation.

The letter guidance abstains from discussing any other technical aspects which arise in the context of German nonresident taxation of IP rights, including the reach of any tax treaty protections.

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Detailed discussion

The question at issue is whether the German Sec. 49 (1) No. 2f and No. 6 of the *Income Tax Act* (ITA), mandate German nonresident taxation of so-called "extraterritorial" IP rights transactions. "Extraterritorial" IP transactions include the licensing or sale of IP rights between, or in the case of a sale by, German nonresident parties.

It is important to note that both statute provisions have existed in their current format in the German ITA for many years.

The following addresses the key issues related to the question at issue.

- Based on the wording of the German statute provisions (Sec. 49 (1) No. 2f and No. 6 ITA), where a non-German resident person licenses or sells IP that is either **registered in a German public register** or where IP is **exploited in a German permanent establishment** (PE), Germany can claim under domestic law a taxing right. Both categories are referred to as "German-nexus IP."
- Under the plain language of the statute, a German taxation right may cover German-nexus IP right licensing or sale transactions which take place solely between, or in the case of a sale by, German nonresident parties. The statute also does not differ between transactions which occur between related or unrelated parties. However, in the past, the taxation of such extraterritorial IP right transactions was never enforced or addressed by German tax authorities, and until now, no administrative pronouncements, court cases or other authorities existed which would have addressed this area.
- Although there are a number of overarching fundamental positions, which could be brought forward against the plain language application of the statute, including the constitutional law argument of unequal enforcement, it is unclear whether such fundamental positions will be accepted by German courts in ensuing litigation, which is expected to occur in the future.
- The definition of a right "registered in a German public register" encompasses primarily patent rights and trademarks, but also so-called utility models and designs registered by the German Patent and Trademark Office in Munich (DPMA). Given the complex various registration methods under international patent and trademark law, it must be ascertained, which international registrations and EU registrations actually also qualify as registrations in a "German" public register. The guidance is not conclusive on this point.
- The determination of the presence of a sale transaction will also in most cases present difficult tax technical issues, such as whether a specific transaction constitutes an indefinite transfer and thus a sale for German tax purposes and whether a transferor of rights is indeed the economic owner of German-nexus IP rights, in particular where the legal owner is a different party.
- Complex allocation questions arise in the event that – as is frequently the case – the German-nexus IP is included in a bundle of worldwide IP rights, which are licensed between nonresident parties in one transaction, and a fractional amount of the consideration must be apportioned to the German nexus IP.
- In the case of IP licensing, the tax would be levied via withholding tax (WHT) at a rate of 15.825%, according to the tax authorities to be withheld by the royalty payor even if that person is not a German tax resident. Under general German procedural WHT rules, the royalty payor may only refrain from WHT if the royalty recipient has provided the payor with a valid WHT exemption certificate issued by the German Federal Tax Office. This WHT exemption certificate would only be granted upon application and prospectively. It would not be granted to persons not entitled to German treaty benefits, that is, any IP licensor resident in an offshore jurisdiction which did not conclude a tax treaty with Germany. The certificate would also not be granted to entities resident in a treaty jurisdiction, which do not pass stringent German domestic anti-treaty shopping rules. If WHT had been withheld, and the royalty recipient is entitled to treaty benefits, a refund to the treaty rate can be applied for with the German Federal Tax Office.
- In the case of a sale of German-nexus IP, the German taxing right would mean that a non-treaty protected IP owner would have to declare a capital gain on such sale to the German tax authorities via a tax return filing. Such gain would be taxable at 15.825% corporate income tax/solidarity levy for a corporate seller. Generally, a treaty-protected IP-owner should not be impacted by this extraterritorial taxation as the gain should be covered by the capital gains article. The tax authorities nevertheless also expect a treaty protected transferor to file a capital gains tax return in such cases.

The analysis of the relevant fact patterns and hence conclusion on the best approach for dealing with the current uncertainty is complex, but necessary and urgent. Taxpayers may conclude that a disclosure of relevant transactions and payments is required for all open years (which generally are 2013 and following years). The hope was, that the German tax authorities would issue guidance at least on the most pressing technical questions surrounding the German extraterritorial taxation of IP for treaty protected licensors. The now published guidance does not distinguish between treaty protected or non-treaty protected licensors or sellers. In particular it would have been and still is important to find an appropriate solution for taxpayers who ultimately do not owe a tax in Germany, which avoids back-and-forth payments. However, the MoF letter published on 6 November includes only minimalistic content by addressing the following points:

- The letter, which includes five short paragraphs, holds that Sec. 49 (1) No. 2f and 6 ITA encompass the taxation of rights which are registered in a German domestic register, and that no other German domestic nexus is required to trigger the German taxing rights.
- Concerning international and EU registrations, the letter only briefly states that a "German registered right" also includes patents, which are registered by the DPMA on the basis of a registration with the "European Patent and Trade Mark Office" (Apparently, the MoF means the European Patent Office, as a European Patent and Trade Mark Office does not exist).
- The letter plainly states that in licensing transactions over a "limited period of time" the licensee has to withhold and pay the WHT to the Central Tax Office and file a corresponding WHT return. The letter does not discuss any tax treaty questions or positions, or technicalities of the exemption certificate procedure. For licensing payments made prior to 31 December 2013, the letter states that such payments and filings have to be made with "the competent local tax office" (without stating which office that should be – note that the different procedural competencies arose from a 2013 law change).
- For licensing transaction which have been entered into over "an unlimited period of time," resulting in sale characterization, the licensor has to file a nonresident tax return with the local competent tax office.

Implications

In summary, the 6 November 2020 MoF letter does not discuss any of the complex questions which may surround a German nexus IP transaction, but is limited to a public statement that nonresident taxpayers have to come forward and comply with their tax payment obligations concerning transactions involving German registered IP rights under Sec. 49 (1) No. 2f and 6 ITA. It is anticipated that the MoF may issue more detailed guidance in the future, in particular concerning the German rights transfer pricing allocation methodology. However, it is unclear, when further guidance can be expected, and the level of detail that such guidance would encompass. The analysis of the relevant fact patterns and hence conclusion on the best approach for dealing with the current uncertainty is complex, but necessary and urgent. In light of this official announcement, taxpayers that may be affected should carefully evaluate their position and in particular whether a disclosure or filing of tax returns and payments for relevant transactions is required for any open years (which generally are 2013 and following years).

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