

German Ministry of Finance publishes guidance on royalty deduction limitation rule

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On 19 February 2020, the German Ministry of Finance (MoF) issued guidance concerning harmful preferential regimes in connection with the German royalty deduction limitation rule. The decree identifies and lists harmful preferential tax regimes in a non-exhaustive list, which should fall under the German royalty deduction limitation rule beginning with the 2018 assessment period. The status of the United States (US) Foreign Derived Intangible Income (FDII) deduction is, however, still under review.

The German royalty deduction limitation rule (Section 4j of the Income Tax Code) partially disallows the deduction of royalty payments made to recipients in jurisdictions, which are subject to a non-OECD¹ (non-nexus) compliant harmful preferential tax regime which taxes the royalty income at an effective rate below 25%.

The MoF decree lists numerous identified, non-nexus compliant harmful preferential regimes which are generally subject to the German royalty deduction limitation rule for the 2018 assessment period. Although the decree applies procedurally only to the 2018 tax assessment period, it reveals some of the underlying fundamental technical positions of the MoF on the subject matter. Essentially, the decree has two parts: Part 1 lists all harmful preferential regimes identified by the tax authorities to date. The full list of the identified harmful preferential regimes (the majority of them already being phased out or being phased out in the near future) can be found [here](#).

Part 2 lists preferential regimes which are still under review; those are certain preferential regimes of Brunei Darussalam, Cook Islands, Dominica, Jordan, Lithuania, Paraguay, Qatar and the US FDII deduction.

According to the decree, the deduction of a royalty paid to a recipient in a preferential regime jurisdiction which is currently listed as under review, that is, including all royalty payments made to a US recipient, is allowed, provided that no other reasons for a disallowance are present (e.g., a transfer pricing adjustment). The relevant taxable years must be kept open for those taxpayers until the review procedure is finalized, followed by a retroactive reassessment of taxable income, if the MoF would qualify the regime as harmful.

Even though the decree does not contain any specific details or explanations regarding the US FDII deduction, the technical reference made in the decree appears to indicate that the MoF views the FDII deduction as a preferential regime within the meaning of the rule for which it has yet to determine

whether it is compliant with the OECD nexus approach and, therefore, should not be covered by the rule. This also seems to imply that the MoF dismissed other arguments which held that the FDII deduction should, absent any nexus considerations, already in principle not qualify as a preferential regime because it applies not only to royalty income, but also to a broader set of income items.

The decree states that the FDII deduction results in royalty taxation at a 13.125% effective rate and does not address the fact that the FDII deduction is, in essence, a lump-sum deduction which is applied to the overall taxable income of the recipient.

It is currently unknown when the MoF will finalize its review of the FDII deduction. As the FDII deduction is currently under review by the OECD's Forum on Harmful Tax Practices (FHTP), it seems likely that the MoF will wait for the outcome of this review prior to making any decision in this regard.

Endnote

1. Organisation for Economic Co-operation and Development.

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