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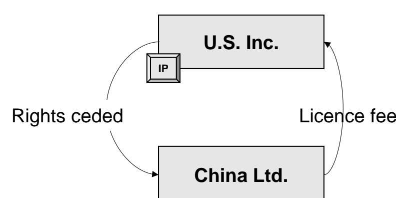
Rights granted abroad – Withholding tax due in Germany?

Draft bill published on 19 November 2020 offers hope that an unnecessary tax discussion may be brought to an end

A German tax issue has been causing great uncertainty among international corporates since spring 2020: Are licence fees received under licence agreements concluded between foreign companies taxable in Germany if the right granted is listed in a public register in Germany, but no other links to Germany exist? In times dictated by the pandemic, German tax authorities appeared to have identified a (new) source of tax income, and despite strong criticism from across the legal press, they were unwilling to surrender it. In a Circular issued by the Federal Ministry of Finance (*Bundesfinanzministerium*; **BMF**) on 6 November 2020, the tax authorities still upheld their belief that the income was taxable in Germany. Shortly afterwards, however, the BMF made a surprising U-turn. In a draft bill (*Referentenentwurf*) published on 19 November 2020[1], the BMF now proposes amending the relevant tax provisions set out in section 49 (1) no. 2 f) and section 49 (1) no. 6 of the German Income Tax Act (*Einkommensteuergesetz*; **EStG**) in terms of the contentious points such that the fact that a right is merely registered in Germany does not automatically lead to it being subject to the German tax regime. The amendment is to be applied to all open cases.

BMF, 6 November 2020: Taxability where a right is merely registered in Germany

The following example aims to illustrate the current discussion: A US parent company, as trademark owner, concludes a licence agreement with a Chinese company governing the temporary use of this trademark for marketing purposes in return for a fee. The trademark is registered in the German trademark register. The Chinese company does not actually use the trademark in Germany.



Variation: According to the terms of the licence agreement, the licensee's right of use is expressly limited to the Chinese market.

The US parent, as recipient of the fee, is not subject to unlimited tax liability in Germany, since neither its registered office nor its principal place of management is located in Germany. It may, at most, be subject to limited tax liability. The only link to Germany in this context is that the trademark is listed in the German trademark register. Pursuant to section 49 (1) no. 2 f) EStG (income from commercial operations) and section 49 (1) no. 6 EStG (for non-commercial income), income generated in Germany that is subject to limited tax liability will be deemed to exist if a right that has been included in a public list or register in Germany is granted for use in return for a fee. The same apparently applies if such a right is sold. In this context, the question of whether these provisions also (at least) require the *de facto* possibility of using the registered right above and beyond their mere wording is the subject of debate.

With the BMF Circular dated 6 November 2020, the tax authorities confirmed their opinion previously expressed that limited tax liability under these provisions also exists,

[1] Draft Bill for an Act to Modernise Relief from and Issue Certification for Withholding Taxes (*Referentenentwurf für ein Gesetz zur Modernisierung der Entlastung von Abzugssteuern und der Bescheinigung von Kapitalertragsteuer*) dated 19 November 2020.

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even if the rights granted were not exploited in Germany at all. Merely being listed in a German register is sufficient to trigger limited tax liability; the Circular expressly states that no further-reaching or additional link to Germany is required. The rights registered in Germany also include patents, for instance, which were registered in Germany in line with the European Patent Convention having been filed with the European Patent Office.

In the above sample case, the US parent would generally be subject to limited tax liability in Germany in the form of withholding tax. Due to the tax authorities' strict interpretation of the wording, the same may well apply in the case of the variation described above, although in this case the licensee was not even granted an abstract right of use for Germany.

In case of German tax liability: Consequences for affected companies

For the affected companies, the tax authorities' view as described in the BMF Circular issued on 6 November 2020 triggers different consequences, depending on whether or not a double tax treaty is in place with Germany.

In cases where no double tax treaty applies, the company is definitely subject to tax liability. In cases where such treaty applies, the right to apply German tax provisions assumed by the tax authorities is frequently limited in practice where rights are ceded temporarily, but here too, comprehensive compliance duties apply, which are both costly and time-consuming for the companies affected:

- Due to the fact that companies were not previously aware of being subject to limited tax liability in Germany, they will generally not have obtained an exemption certificate at the time of payment, which would absolve them of having to retain withholding tax.

- Thus, the party owing the fees is obliged to retain the withholding tax due on the respective payments (e.g licence fees) and remit such amounts to the German tax authorities, while also filing a tax return. According to the BMF Circular dated 6 November 2020, the German Federal Central Tax Office (*Bundeszentralamt für Steuern*) is generally responsible in this context. The relevant tax return relating to any payments received by the payee on or before 31 December 2013, however, is to be filed with and taxes remitted to the competent tax authority. Should the party owing the fees fail to meet its obligations to retain withholding tax, claims could be brought against the payee instead.

- The payee will be referred to the procedure for refunding withholding tax, for which an application must be made.

- Comprehensive contract reviews or screenings are often required in connection with the obligations to remit and declare withholding tax.

This process is costly and time-consuming for both the companies and the tax authorities, although no tax income is ultimately generated.

Moreover, in such cases questions, inter alia, relating to liability arise and the risk of being suspected of tax evasion cannot be completely ruled out, even where the latter can generally be rejected due to the fact that the company had no knowledge of its tax liability.

Draft bill dated 19 November 2020: Abandonment of German tax liability in cases without further links to Germany

Against this background the draft bill for an Act to Modernise Relief from and Issue Certification for Withholding Taxes was published on 19 November 2020, with the explanatory memorandum initially confirming the BMF's view as set out in the Circular dated 6 November 2020. At the same time, the explanatory memorandum also includes an acceptance that this is "not appropriate" and does not align with the legislature's intention. It thereby confirms the concerns previously expressed relating to the BMF's interpretation of the provisions of section 49 (1) no. 2 f) and section 49 (1) no. 6 EStG which is, in our opinion, too broad.

Following the planned redrafting of these provisions, mere registration in Germany should no longer trigger tax liability here. The words "or included in a public list or register in Germany" in section 49 (1) no. 2 f) sentence 1 EStG and the words "or included in a public list or register in Germany" in section 49 (1) no. 6 EStG are to be deleted. According to the draft bill published on 19 November 2020, a "substantial link to Germany" will in future be required if tax liability is to be triggered. This will relate in particular to whether or not the rights in question are being used in Germany, for instance at a permanent establishment of the licensee in Germany.

According to the current draft, the new legislation will also apply to all open cases.

What do affected companies now need to observe?

While the planned amendment is very welcome, it is not yet clear whether or when it will be adopted. Companies

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cannot rely on the current draft bill having a protective effect in respect of their actions.

Moreover, the BMF Circular of 6 November 2020 also is still effective. Although as an administrative order it does not have the same status as legislation, tax authorities are bound to observe it until such time as it is revoked. This means that from the point of view of the authorities the duties of compliance as set out above generally continue to apply for the affected companies. Such companies should certainly actively approach the tax authorities in order to discuss further action. At the same time, they should keep an eye on the developments in terms of the planned legislation.

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