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Global Tax Alert

German Ministry of Finance publishes draft law concerning the modernization of withholding tax relief and extraterritorial taxation of IP

Executive summary

On 20 November 2020, the German Ministry of Finance (MoF) issued a working draft law proposing a revision of certain withholding tax procedures with respect to income from capital investment and royalties in Germany. Within this draft, the information and certification requirements for withholding tax agents are revised and the anti-treaty shopping rules are aligned with current decisions of the European Court of Justice (ECJ).

Moreover, it is also proposed to eliminate the nonresident taxation of royalty income and capital gains relating to rights solely because these rights are registered in a public German book or register. This elimination would, according to the draft law proposal, have retroactive effect for all open cases.

Detailed discussion

The draft law tackles the issue of whether the German Sec. 49 (1) No. 2 f and No. 6 of the *Income Tax Act* (ITA), mandate German nonresident taxation of so-called "extraterritorial" intellectual property (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.

- 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 **registered in a German public register** (German-nexus IP), Germany can claim a taxing right under domestic law.
- 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. The MoF issued on 6 November 2020 a public letter confirming such German extraterritorial taxation of German-nexus-IP. For further explanation, see EY Global Tax Alert, *German Ministry of Finance publishes guidance on German taxation of extraterritorial intellectual property*, dated 6 November 2020.

Given today's globalized economy, IP is typically protected to the greatest possible extent and worldwide registration of IP is mandatory from an IP compliance perspective and also forms part of the "good IP law housekeeping" work. The application of these rules on transactions between nonresident parties solely because IP is registered in Germany could therefore affect almost any business worldwide and cause a multitude of issues and in particular significant efforts for both businesses and the German tax authorities. Given that under applicable tax treaties Germany should not have a taxing right, it is a positive development to avoid these significant efforts.

The 20 November 2020 draft proposes to delete the terms "registered in a German register" from the wording of the law, i.e., to remove the German taxation nexus for IP rights which are solely "registered" in a German public register or book.

This change would be effective for all open cases and therefore have retroactive effect. It is currently unclear whether and when the draft will become actual law, however the process is expected to proceed relatively fast and an enactment could likely occur by May 2021 if all legislative bodies agree.

The existing framework for refunds and exemption relating to withholding taxes on investment income will be improved by utilization of a higher level of digitalization and further centralization at the Federal Central Tax Office. A core component would be the implementation of a central digital database covering refund applications, tax certifications and other required information. Further, the draft addresses the German anti-treaty shopping rules in light of the current decisions of the ECJ in this regard, in particular including principles laid out in the "Danish" conduit cases of the ECJ (C 115/16 and C177/16). Other details pertain to the process of exemption from German withholding taxes in certain cases and to various additional items.

Implications

In summary, the proposal concerning extraterritorial taxation of IP is a positive development which would avoid significant and potentially misplaced efforts for all involved parties, including the German tax authorities, in a matter which was subject to recent controversial discussions. However, and in particular in light of the MoF letter issued on 6 November 2020, we need to caution that this is only a working draft law and it has yet to be seen how the process will develop further. Therefore, taxpayers that may be affected should continue to carefully evaluate their position and how this new proposal could impact their interaction with the German tax administration on this matter.

Regarding the other proposed changes, taxpayers should generally review their potential impact on the current withholding tax position and obligations in Germany.

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