Nexus Limitations on German-Source IP Taxation

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In this article, the authors discuss the potential taxation of German registered intellectual property and argue that neither German law nor customary international law allow taxation of granting or disposal of IP based solely on registration without further nexus in Germany.

During the first half of this year, many multinational enterprises were confronted with a peculiar interpretation of a provision in Germany's tax law that dates back to 1925 and was amended in 1934. The interpretation, which caught both the tax administration and taxpayers by surprise, stipulates that German income tax is payable for the granting or disposal of intellectual property rights if those rights were registered in a German public register. Literally translated, the relevant provision (section 49(1)(2)(f) of the German Income Tax Act (Einkommensteuergesetz, or EStG)) reads:

> [Subject to German income tax is] business income . . . generated by . . . leasing out or . . . the disposal of . . . rights which are registered with a domestic public book or register or whose exploitation is carried out through a domestic permanent establishment or other fixed base.[1]

The provision contains two alternative bases for taxation — the registration of rights in Germany (the registered rights rule) and the exploitation of rights in Germany (the exploitation rule) — that combine to form the German IP tax. The registered rights rule applies to trademarks, patents, design rights, and utility models that are registered at the German Patent and Trademark Office. Based on its literal wording, the registered rights rule does not encompass trademarks registered at the European Union Intellectual Property Office or patents registered at the European Patent Office.[2] The exploitation rule applies to the exploitation of any IP rights through a German PE of a group company or third party. The German IP tax covers both the granting of rights and the disposal of the beneficial ownership. For royalties, the tax is levied using a withholding based on the gross amounts paid in relation to German IP. For disposals, the tax is levied by way of tax assessment based on the net capital gain.

A question arose regarding whether the registered rights rule also applied to agreements within MNEs covering IP rights for multiple jurisdictions. In the cases at issue, neither of the contracting parties is tax resident in Germany, the payments are neither made into nor from Germany, and no connection to Germany exists other than the fact that a minor part (less than 10 percent) of the licensed or disposed rights involve

[1]Unless otherwise noted, all translations are the work of the authors.

[2]German tax literature shares this view. Walter Blümich, "Section 49 margin no. 286," *EStG* (2020); Carl Herrmann, Gerhard Heuer, and Arndt Raupach, "Section 49 EStG Margin no. 943," *EStG/KStG* (2019); and Paul Mirchhof, Hartmut Söhn, and Rudolf Mellinghoff, "Section 49, Margin no. I 107," *EStG* (2004).

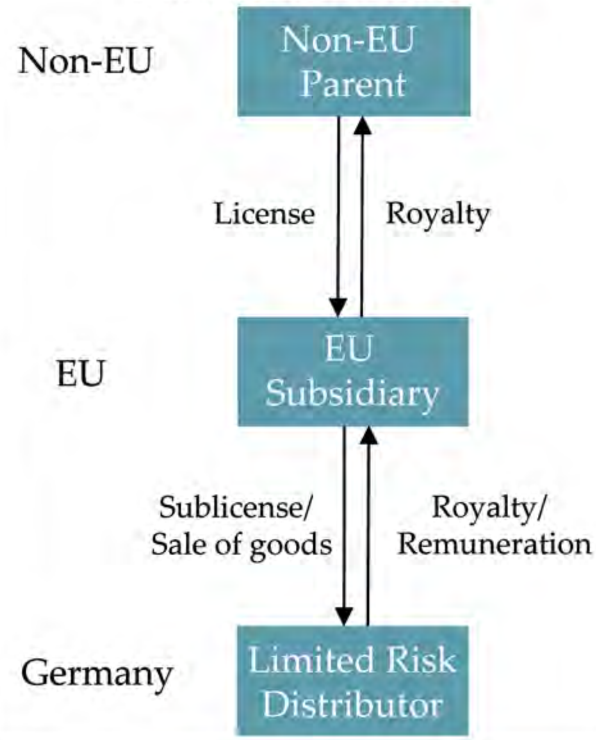
German registered IP. The following generalized hypothetical illustrates this scenario:

> Suppose a non-EU parent of an MNE is the legal and beneficial owner of a variety of registered and unregistered IP rights, such as copyrights, trademarks, patents, customer relationships, and distribution rights. The IP rights involve almost all countries around the world and include trademarks and patents registered in Germany. The non-EU parent licenses the worldwide IP to a European subsidiary. The EU subsidiary produces finished goods and sells them to limited risk distributors (LRDs) around the world, including a German LRD.[3]
>
> Alternatively, the EU subsidiary sublicenses IP rights, including the German registered IP, to a German manufacturer in return for remuneration. The German manufacturer uses the IP rights in its German manufacturing and distribution activities.

In both scenarios, the question arises whether the royalties paid by the EU subsidiary to the non-EU parent are subject to German withholding tax. If the non-EU parent sells its worldwide IP, the question arises whether that sale is subject to German-source taxation.[4] (See figure.)

There are a variety of reasons why transactions between two non-German tax-resident entities are not subject to German-source taxation. In mixed agreements — that is, agreements that include the worldwide IP and in which the German registered or exploited IP amounts to less than 10 percent of the overall consideration — case law and a recent administrative decree on the taxation of software licenses suggest that no German-source taxation is payable on the granting or disposal of the German registered or exploited IP.[5] This approach is also in line with the commentary to article 12 of the OECD model income tax treaty.[6]

Hypothetical Involving German Limited Risk Distributor



Furthermore, German constitutional law forbids the application of tax provisions that lead to an enforcement deficit. A structural deficit in equal enforcement arises when there is not a sufficient likelihood that German tax authorities would investigate undeclared taxable events.[7] In our view, the hypothetical scenarios would give rise to a structural enforcement deficit. The German tax authorities would not have sufficient rights under existing tax treaties to investigate

[3] In this scenario, no German trademark would be granted. The trademark right would be exhausted following the sale in the member state where the EU subsidiary is tax resident.

[4] It is uncontroversial that a royalty that the German LRD pays for German registered rights granted by the EU subsidiary through a sublicense could be subject to German-source and withholding tax.

[5] Federal Fiscal Court (Bundesfinanzhof) I R 73/02 (Jan. 28, 2004), Federal Tax Gazette II 2005, 550; and Federal Finance Ministry, IV C 5 — S 2300/12/10003: 004 (Oct. 27, 2017). This approach is also shared in German literature. *See, e.g.*, Blümich, "Section 50a, Margin no. 41," *EStG* (2020).

[6] *See* OECD commentary to the model tax treaty 2017, article 12, at 11.6.

[7] *See* Federal Constitutional Court, 2 BvL 17/02 (Mar. 9, 2004). According to this decision, enforcement must generally be possible without substantial investigations by the tax authorities.

and enforce a German tax in either case. In a case involving a tax on dividends to be withheld by foreign debtors, the German tax authorities acknowledged that the withholding could not be enforced and refrained from imposing the withholding tax altogether, thus indirectly acknowledging an enforcement deficit in that situation.[8] The same rationale would apply to our hypothetical situations. This is supported by the fact that the German tax authorities have never investigated the facts in a case that applied the IP tax in that manner. Furthermore, the tax authorities could only find out about those facts through an illegal fishing expedition.

The international community expects the German tax authorities to comply with German law, while also adhering to the principles of customary international law. Germany's approach to the taxation of German registered or exploited IP should also be consistent with expectations based on its membership in the OECD.

This article focuses on how customary international law limits Germany's taxing rights. The German constitutional court (Bundesverfassungsgericht) has provided specific guidance in this respect: Germany must follow the principles of international law that restrict its taxing rights. In compliance with customary international law, a specific nexus must exist for German-source taxation. In Section I, we look at the background, development, and rationale of the German IP tax law provision. Sections II and III analyze the specific nexus requirements.

I. The IP Tax Rule: German Context

As originally enacted in 1925, the pertinent provision provided that Germany could only impose income tax on income derived from within Germany ("*aus dem Inland bezogen*").[9] It was based on the equivalence or benefit principle — that is, the idea that Germany should benefit from business activities within Germany because the taxpayers who undertake that activity derived advantages from the benefits granted by the German state.[10] The original provision only included the registered rights rule. In 1931 a regulation added the exploitation rule to "protect the economy and the finances" as a "measure against capital and tax flight."[11]

The type of multinational license and IP agreements described in our hypotheticals are used by many MNEs today, but they were not common in 1925. The German legislature did not intend to tax transactions between two entities if neither was tax resident in Germany and they did not undertake business activities in Germany.[12]

In 1934 the legislature deleted the requirement that income be "derived from within Germany." Thereafter, only the registered rights rule and the exploited rights rule applied. However, there is no indication that the legislature actually intended to abandon the additional requirement. In contrast, the legislative notes state that the change simply summarized the previous provisions — that is, they intended for the rules to remain substantially the same.[13] Since 1934 the German legislature has made additions to the German IP tax, but the core provision and its wording remain unchanged. Interestingly, in a 2011 decision, the Federal Fiscal Court also explicitly referred to the requirement that income be "derived from within Germany," thus indirectly confirming that such requirement still exists.[14]

To date, there are no known cases in which the German tax authorities levied taxes on IP transactions like those in our hypotheticals. The common understanding appeared to be that the German IP tax only applies when there is an activity in Germany or a payment out of Germany — that is, when a specific nexus exists. Consequently, no court has ever touched upon the question of to what extent international law restricts the scope of applying the IP tax to

[8] Federal Finance Ministry (Bundesministerium der Finanzen, or BMF), Circular (May 21, 2019), margin no. 6.13.

[9] The legislative history states that Germany can tax all income that is earned from within or within Germany. *See* Blümich, *EStG*, at 108 (1925); and Imperial Fiscal Court, I A 56/32 (June 28, 1932), Imperial Tax Gazette 1932, 742.

[10] See Johanna Hey, *IWB No. 1* (Jan. 1, 2014), on the conceptual link between the equivalence principle and the territorial allocation of taxing rights. *See also* Peter Hongler, *Justice in International Tax Law* (2019), at 11.5.2.1.

[11] *See* Imperial Gazette I 1931, 736.

[12] *Supra* note 9 and related text.

[13] Legislative notes to the introduction of the EStG 1934, Imperial Tax Gazette 1934, at 59.

[14] Federal Fiscal Court (Bundesfinanzhof), I R 32/10, Federal Tax Gazette II 2014, 513 (July 27, 2011).

nonresidents. In fact, there are few statements in international jurisprudential literature that cover this specific issue.

Nonetheless, in a brief decree released on November 6, the German tax authorities state their intention to apply the German IP tax to cases like our hypotheticals. Despite this being the first time they have taken this stance, they have not provided any further explanations or specific guidance on the matter.[15]

II. Nexus and Customary International Law

A. The Concept and Taxing Rights Generally

In addition to the strong arguments under German law suggesting that the German IP tax should not apply to our hypotheticals, customary international law also restricts Germany's taxation rights. Article 25 of the German Constitution of 1949 (Grundgesetz) stipulates that customary international law prevails over domestic federal law.[16] Therefore, any nexus restrictions under customary international law prevail over the German registered rights rule, and the key question becomes: Does the German IP tax involve a nexus that is sufficient to allow Germany to impose tax based on customary international law? Generally, a rule can only qualify as customary international law if both of the following criteria are fulfilled: (1) the rule is shown to be uniform and consistent in the states' practice (objective element); and (2) the states adhere to that practice because they believe they are legally obliged to do so (*opinio juris sive necessitatis*, the subjective element).[17]

As Bernard Oxman explains, "a State must be able to identify a sufficient nexus between itself and the object of its assertion of jurisdiction."[18] The International Court of Justice (ICJ) provided important guidance on the nexus requirement in *Nottebohm* (*Liechtenstein v. Guatemala*), 1955 ICJ 4 (Apr. 6), when it held that states' jurisdiction to prescribe rules applicable outside their own territory is limited. In so stating, the ICJ introduced the so-called *genuine link* requirement.[19] In that case, the court ruled that a state's decision to grant diplomatic protection requires a "genuine connection of existence, interests and sentiments, together with the existence of reciprocal rights and duties."

Because it is customary international law, the genuine link requirement also applies to a state's ability to impose tax on nonresidents.[20] A nonresident cannot be taxed unless a sufficient nexus exists.[21] For these purposes, residence is determined based on actual residence or citizenship. Source taxation, by contrast, relies on the idea of taxation "by the state within whose territory the value is created."[22] Thus the power to tax is traditionally based on business being conducted or real property being located in the territory or on "transactions that occur, originate, or terminate in that state or have some other substantial connection to that state."[23] This fits with the concept of an economic allegiance that F.A. Mann noted can be based on "domicile or residence, property, and economic activity within the taxing state."[24] Writing in 1964, Mann concluded: "Although the terminology is not

[15] Federal Finance Ministry, Circular — IV C 5 - S 2300/19/10016 :006 (November 6, 2020).

[16] *See also* German Constitutional Court, 2 BvH 1/52, BVerfGE 1, 208 (Apr. 5, 1952).

[17] *Continental Shelf* (Libyan Arab Jamahiriya/Malta), 1985 ICJ 13 (June 3); German Constitutional Court, 2 BvR 1170/83, NJW 1988, 1462 (May 21, 1987); and Hongler, *supra* note 10, at 4.3.2.

[18] *See* Oxman, *Max Planck Encyclopedia of International Law* (1987), *cited in* Hongler, *supra* note 10, at 4.1.2.2.2.

[19] According to Hongler, *supra* note 10, at 4.1.1.2, the genuine link requirement originates from states' fiscal authority. When a state levies tax on nonresidents without sufficient nexus, it infringes on another state's sovereignty. *See also* Karl Neumeyer, *Internationales Verwaltungsrecht* 436 (1936).

[20] Wolfgang Schön, "Neutrality and Territoriality — Competing or Converging Concepts in European Tax Law?" 69 *Bull. Int'l Tax'n* 271, at 3.2 (Apr./May 2015); Hongler and Pasquale Pistone, "Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy," IBFD Working Paper, at 3.2 (2015); and Hongler, *supra* note 10, at 4.1.1.2.3.

[21] *See* Klaus Vogel and Morris Lehner, "Grundlagen des Abkommensrechts, Margin no. 11," *DBA* (2015); and Joachim Englisch and Christiane Krüger, "Zur Völkerrechtswidrigkeit extraterritorialer Effekte der Französischen Finanztransaktionssteuer," 14 *IStR* 513 (2013). See also *Vodafone International Holdings v. Union of India & Anr*, Civil Appeal No. 733 of 2012, in which the Supreme Court of India stated: "In the present case, the transaction was between two non-resident entities through a contract executed outside India. Consideration was also passed outside India. That transaction has no nexus with the underlying assets in India."

[22] Juliane Kokott, "Chapter 2: The 'Genuine Link' Requirement for Source Taxation in Public International Law," in *Tax and the Digital Economy* 2.03 (2019); and Hongler, *supra* note 10, at 9.

[23] Kokott, *supra* note 22.

[24] F.A. Mann, *The Doctrine of Jurisdiction in International Law* 110 (1964). See also note 28, *infra*, and related text.

always the same, this principle is now widely accepted."

B. Application to the Hypotheticals

The taxation of IP royalties and disposals based solely on a registration in Germany does not fall under any of the situations that provide nexus. In other words, no economic activity or value creation occurs in Germany when two non-German resident entities enter into a worldwide license or disposal agreement in which German registered IP only constitutes a small portion of the IP granted.

Returning to the objective test for qualifying as customary international law, the OECD model tax treaty is a useful starting point because it reflects the shared views of the member states on taxing rights.[25] Articles 12 and 21 of the OECD model treaty provide that only the residence state has a right to tax royalties and disposals of IP. The rules regarding the taxation of royalties under article 12 of the OECD model treaty do not distinguish between registered and unregistered rights. Neither the OECD model treaty nor any of the reports from the base erosion and profit-shifting project refers to the registration of IP as a sufficient (or even relevant) nexus for taxing the disposal of or granting of rights in IP. Notably, Germany was one of the main proponents of the nexus approach in BEPS action 5, which provides that preferential IP regimes can only apply when an entity engages in research and development — that is, conducts significant activities — in the jurisdiction. The final report on action 5 requires "substantial activity" in the respective state to support the taxation of IP, and it refers to expenditures "as a proxy for substantial activities."[26] Similarly, the 2017 U.N. model treaty does not mention registration as a sufficient nexus for source taxation.

Taken together, these sources indicate that mere registration does not supply a sufficient nexus for the taxation of IP. There is no generally accepted "registration principle" under customary international law. Consequently, registration should not be a factor in determining nexus.

III. German Constitutional Court

The German Constitutional Court has also provided guidance — derived from public international law standards — on the general limitations that apply to the taxation of nonresidents. The court has confirmed that the imposition of taxes on nonresidents requires sufficient and appropriate contact with the taxing state (that is, nexus). According to the court, these requirements protect the taxpayer and compensate for the taxed nonresident's inability to participate in the democratic procedure and implementation of the tax law.[27] Looking at the specific facts of the underlying case, the court stated that Austria had sufficient nexus to allow it to impose taxes on a German citizen who caused a "tax-significant" outcome in the Austrian territory.

According to the court, sufficient nexus was a given in case of citizenship, residence, residual abode, or presence. Apart from these obvious criteria, the court also referred to the following criteria:

- the realization of a taxable event within Germany (the taxable event test); or
- the causation of a tax-significant outcome within Germany (the tax-significant outcome test).[28]

These criteria comply with the generally accepted principle of territoriality. Territoriality principles require a significant (physical) presence in the taxing country. The right of a state to tax generally requires domicile, residence, property, or economic activity within the taxing country.[29] Numerous courts from around the world have recognized this principle. In 2007 the Supreme Court of India, *Ishikawajma-Harima*

[25] *See* Stjepan Gadžo, *Nexus Requirements for Taxation of Non-Residents' Business Income* 2.25 (2018).

[26] The recent debate regarding a new international nexus by the OECD working group on pillar 1 shows the limitations of the existing nexus concept. *See* Stephanie Soong Johnston, "OECD Now Aiming for Global Corporate Tax Reform Deal by Mid-2021," *Tax Notes Int'l*, Oct. 19, 2020, p. 344.

[27] Federal Constitutional Court, 2 BvR 475/78, BVerfGE 63, 343 (Mar. 22, 1983).

[28] Federal Constitutional Court, 2 BvR 475/78, BVerfGE 63, 343 (Mar. 22, 1983) (referring to Mann, *supra* note 24).

[29] *See, e.g.*, Kokott, *Das Steuerrecht der Europäischen Union* 143 (2018); Kokott, *supra* note 22, at 2.03; Lehner, *supra* note 21, at 11; and Mann, *supra* note 24, at 115.

Heavy Industries Ltd. v. Director of Income Tax, Mumbai, [2007] 288 ITR 408, explained that "territorial nexus for the purpose of determining the tax liability is an internationally accepted principle." Likewise, Mann cites the Supreme Court of Pakistan's 1958 decision *Imperial Tobacco Co. of India Ltd. v. Commissioners of Income Tax*, 1958 PLD-Supreme-Court 125, for "the rule of International Law that a legislature has authority to tax . . . foreigners only if they earn or receive income in the country for which that legislature has the authority to make laws."[30]

The following subsections take a closer look at the two additional criteria identified by the German Constitutional Court in the context of German IP taxation.

A. The Taxable Event Test

1. General Scope

The German Constitutional Court did not further define the phrase "realization of a taxable event within Germany" when it set out the taxable event test.

First, it should be noted that the taxable event must be a physical or actual event. Without a physical or actual event, the reference to territoriality (the phrase "within Germany") would be superfluous. A mere fiction or deemed event would also undermine the whole nexus requirement. This interpretation is in line with the rationale of source taxation, that is, the taxing right held by the state in which value is created, activity is performed, or income originates.[31] Value creation or income origination in the territory requires activity within the territory that is attributable to the taxpayer itself. This interpretation adheres to the rationale behind the genuine link requirement as well as the allocation of taxing rights under the OECD model treaty.[32]

In the 2012 *Vodafone* decision, the Supreme Court of India applied a similar nexus requirement for the taxation of offshore companies.[33] The court denied a nexus in that specific case because neither the property being transferred nor the parties to the transaction were situated in India. Referencing the general provision on deducting tax at the source, the court said:

> Section 195, in our view, would apply only if payments made from a resident to another non-resident and not between two non-residents situated outside India. In the present case, the transaction was between two non-resident entities through a contract executed outside India. Consideration was also passed outside India. That transaction has no nexus with the underlying assets in India. In order to establish a nexus, the legal nature of the transaction has to be examined and not the indirect transfer of rights and entitlements in India.

2. Application to the Hypotheticals

The taxable event test is not fulfilled in our hypotheticals. Both parties are tax resident outside Germany; they are not conducting activities within Germany; and the consideration is not paid out of, or into, Germany.

The only link to Germany is the registration of IP rights in a German public register. However, this does not lead to any activity or physical presence within Germany. The registration only enables the owner of the rights to prevent others from using specified rights. A registered right — for example, a trademark — enjoys the same level of protection in Germany as other rights that cannot be registered — for example, copyrights or other contractual intangible rights, such as distribution rights. It is therefore arbitrary and inadequate to refer to IP registered in Germany as a source of taxing nexus. Taxpayers could register trademarks in the European Trademark Register, which would provide the same protection as a domestic trademark. Certainly, registration in the

[30] Mann, *supra* note 24, at 110. *See also Rewe Zentralfinanz eG v. Finanzamt Köln-Mitte*, C-347/04 (CJEU 2007); and *Futura Participations SA and Singer v. Administration des contributions*, C-250/95 (CJEU 1997).

[31] Kokott, *supra* note 22, at 2.03; and Hongler, *supra* note 10, at 11.5.1. *See also* Section II.A, *supra*.

[32] *See* Section II.B, *supra*.

[33] *Vodafone*, Civil Appeal No. 733 of 2012. In September 2020 an international arbitration tribunal in The Hague constituted under the India-Netherlands bilateral investment treaty held that India's retroactive alteration of its Income Tax Act and the imposition of a retroactive withholding tax obligation on Vodafone despite the Indian Supreme Court's judgment was in breach of both the investment treaty and international law. Permanent Court of Arbitration, No. 2016-35 (2020).

European Trademark Register would not lead to German-source tax since such register is not a German domestic register.

Registration — even in a German registry — does not constitute a taxable event within Germany, nor does it provide a sufficient nexus to justify a German taxing right.

B. The Tax-Significant Outcome Test

1. General Scope

The German Constitutional Court also referred to another route for creating nexus: the tax-significant outcome test.

The reference to "outcome" as opposed to "realization of a taxable event" shows a recognition that tax consequences with other persons could also lead to such nexus. The typical example would be a license granted by a non-German resident to a German licensee. Those activities could lead to tax-deductible expenses for the German licensee and therefore involves an outcome that has tax significance within Germany.

Likewise, when intangible property is acquired through a PE in Germany, a tax-significant outcome would occur. In those cases, the acquirer would generally deduct the acquisition costs as depreciation from its taxable income. As a result, the significant outcome test covers activities that lead to tax deductions for a German PE.

2. Application to the Hypotheticals

In our hypothetical scenarios, the significant outcome test is not fulfilled. As noted in relation to the taxable event test in Section III.A.2, both entities are tax resident outside Germany, and they are not conducting business within Germany. The consideration is not paid out of, or into, Germany, and it is not attributable to a German PE. If a non-German licensee without a German PE is granted a right to use IP, the licensee has no tax-deductible expenses in Germany.

Even if the non-German licensee sublicenses the portion of the total IP that is registered in Germany to a German sublicensee, the non-German licensee/sublicensor would not be able to deduct its own license fees for German tax purposes. If the non-German licensee/sublicensor was an EU resident, Germany would not have the right to tax the royalties that entity received. If the non-German licensee/sublicensor is tax resident outside the EU, its expenses would not be tax deductible in Germany (section 50a(3), sentence 2 EStG); the German sublicensee would in particular be required to withhold tax on the gross amount of the license fees in case the sublicensee had not withheld taxes; and no deduction would be permitted. In any event, the mere fact that the IP is registered in Germany does not lead to any tax-significant outcome in Germany. Notably, the registration itself may not even change (that is, the parties may not need to update the information in the registry) if only the beneficial ownership is transferred or the German registered IP is simply licensed.

IV. Conclusion

The hypotheticals discussed above do not lead to German-source taxation. German and international taxation principles, including the principle of equal enforcement and the de minimis rule, preclude levying such taxation. Further, customary international law generally and the German Constitutional Court's interpretation thereof more specifically establish that Germany does not have a taxing right in the hypotheticals because because of a lack of sufficient nexus. No genuine link results from simply registering IP in a German public register absent either a further activity by the taxpayer in Germany or income being derived from within Germany under the relevant license agreement. Once again, customary international law prevails over German law.

This result complies with the way the German authorities interpreted the situation from the passage of the 1934 amendment until 2020. If, after adhering to the same principles for nearly a century, German tax authorities change their administrative practice in a way that focuses specifically on non-German taxpayers, that change in practice itself may be an infringement of international agreements, including, *inter alia*, the nondiscrimination clause found in the 1954 Germany-U.S. treaty of friendship. If the licensee is an EU resident company, the same change may be an infringement of fundamental freedoms under EU law. ■