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In this article, the authors consider a draft law that suggests the German government intends to retain a controversial rule permitting the extraterritorial taxation of intellectual property when the only nexus is the registration in a German IP register, a rule that the German Ministry of Finance previously proposed abolishing.

The German government no longer intends to abolish the infamous intellectual property registration tax. As previously reported,[1] the Ministry of Finance had proposed abolishing a nearly century-old provision. In early 2020, tax authorities, taxpayers, and their advisors were caught by surprise when it was suggested that such provision might apply to extraterritorial license agreements. The provision is outdated and does not fit in today's international tax environment, particularly in light of the OECD's pillar 1 proposal. Furthermore, it violates international customary law and German constitutional law.

German-Source IP Taxation

The pertinent provision in the German Income Tax Act dates back to 1925 and was amended to its present form in 1934. Under this provision, known as the registered rights rule, German income tax is payable for the granting or the disposal of rights that are registered in a German public register. This provision applies broadly to IP rights, such as trademarks or patents. During the first half of 2020, there was much discussion as to whether German taxation could even apply if neither the licensee nor the licensor is tax resident in Germany and neither has any other German nexus. A typical scenario would be a license that a non-German licensor granted to a non-German licensee covering IP rights that are registered in multiple jurisdictions, including Germany. Applying the German registered rights rule to such a case would effectively create a new kind of digital or IP tax with no expense deductions.[2]

Germany No Longer Pursues Abolishment

Contrary to an initial draft bill published November 19, 2020, the German government no

[1] *See* William Hoke, "Draft Law Lacks Proposal to End German Extraterritorial IP Tax," *Tax Notes Today Int'l*, Jan. 26, 2021; and Hoke, "German MOF Proposes Tax Exemption for Extraterritorial IP," *Tax Notes Int'l*, Nov. 30, 2020, p. 1228.

[2] See our previous discussion in Johannes Frey and Florian Schmid, "Nexus Limitations on German-Source IP Taxation," *Tax Notes Int'l*, Nov. 23, 2020, p. 1051.

longer proposes abolishing the registered rights rule. This reversal comes as a surprise given that the November draft explicitly stated that this tax was not appropriate and that the affected cases had no substantial nexus to Germany. The November draft also stipulated that abolishing the rule was necessary to prevent an unnecessary administrative burden. However, a draft recently released in January no longer includes the proposal and does not specify the reason for the government's recent change of mind.

A new administrative concession, which provides that withholding is not required in treaty cases for royalties up to €5,000 annually, will be of no relevance in the affected cases. Further, it will not mitigate the administrative burden for the taxpayers and for the tax authorities, and it was introduced by the legislature for cases in a completely different context. It is difficult to imagine how the German tax authorities expect to process all potential cases going forward in a timely manner and therefore unclear how they plan to treat all taxpayers equally.

The MOF published a circular on November 6, 2020, stating that the registered rights rule does not require any further nexus in addition to the mere registration of rights in a German register. The circular also announced the MOF's intention to actively apply the provision — a statement that preceded the now-withdrawn draft bill announcing the planned abolishment of the provision by only two weeks. It simply stated that a further nexus beyond the registration of the right in a German register was not required.

Registered Rights Rule and International Law

The registered rights rule violates both international public law and German constitutional law. Customary international law limits the taxing rights of states to transactions that have a sufficient nexus with the relevant state. This has been acknowledged in practice and international case law, particularly following the International Court of Justice's *Nottebohm*[3] decision in 1955, which acknowledged the so-called genuine link requirement.

Based on international customary law, the German Constitutional Court has set forth specific limitations under German constitutional law. In particular, to justify imposing tax on a nonresident, the court required either the realization of a taxable event within Germany or the presence ("causation") of a tax-significant transaction within Germany. Neither of these requirements is met when the only connection with Germany is the registration of IP in a German public register.[4]

The statements in the November draft suggested that MOF officials shared the view that Germany should not exercise taxing rights when there is no sufficient nexus with Germany. Typically, the transactions that fall under the registered rights rule involve a variety of different IP rights on a global level, and the portion of these rights allocable to Germany is extremely limited and of limited relevance. Unlike a permanent establishment or real property located in Germany, a registered right does not lead to income generated in Germany. Also, the tax authorities are likely to face significant obstacles in enforcing any claims against non-German parties of license agreements involving the relevant IP rights registered in Germany.

The nexus principle has been decisive in numerous tax cases in a variety of jurisdictions. India encountered the principle in the famous 2012 *Vodafone*[5] decision. In that decision, the Supreme Court of India required nexus for the taxation of offshore companies. The court found that nexus did not exist in the case because neither the property being transferred nor the parties to the transaction were situated in India.[6]

Further Constraints

The taxation of transactions with no connection to Germany could also lead to

[3] *Liechtenstein v. Guatemala*, 1955 ICJ 4 (Apr. 6).

[4] *See* Frey and Schmid, *supra* note 2.

[5] *Vodafone International Holdings v. Union of India & Anr*, Civil Appeal No. 733 of 2012.

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

infringements of EU freedoms. German-source IP taxation generally leads to a withholding tax of 15.825 percent on the gross amount of royalties, without deductions for expenses. The taxation of gross amounts is similar to a digital services tax, but it operates without any threshold, credits, or allowances. This taxation of an arbitrary gross amount contradicts the specific income allocation concepts that the OECD has developed as part of its pillar 1 proposal. Germany actively participated in the development of these concepts.

Enforcement of the registered rights rule would also violate German constitutional law. According to long-standing case law, provisions that cannot be equally applied to all taxpayers infringe the principle of equal treatment because of structurally deficient enforcement. Such deficit can arise when the set of rules that is intended to enforce a tax provision is in contrast to the tax provision itself, so that the rules do not enable the tax authorities to safeguard an equal application of the tax rule to all taxpayers. The Federal Constitutional Court noted that such a deficient enforcement structure may exist if the tax authorities need to audit extensively in order to achieve an equal enforcement at all. It would be practically impossible for the German tax authorities to undertake the efforts that equal enforcement of the registered rights rule would require — they would not be capable of investigating potential cases of infringement given the high number of domestic IP registrations. Instead, the tax authorities would depend on reporting by taxpayers. A review of all potential cases across the globe that an extensive interpretation of the registered rights rule would require is simply not possible. This would render any taxation under the rule entirely arbitrary. Thus, the registered rights rule violates the principle of equal treatment because the structural deficit renders it unenforceable in practice.

In any event, the German portion of the royalty payment in many of the multijurisdictional agreements would be de minimis and therefore not subject to German-source taxation. The registered rights rule would involve mixed IP agreements — that is, agreements covering IP from various jurisdictions and potentially including different types of rights. If the portion of the consideration allocable to German-registered IP amounts to 10 percent or less of the overall consideration under the relevant multijurisdictional agreement, no German-source taxation applies. The underlying rationale is that in these mixed agreements, the minimal German part is of minor importance, and it is the predominant part that causes the whole transaction to occur. The tax treatment of the whole transaction should follow the tax treatment of the predominant part (causation principle). This rule is based on case law and a recent administrative decree on the taxation of software licenses.[7] Because of the paramount character of the rights to use non-German-registered IP and the nature of these mixed agreements, splitting the remuneration between the German and the non-German pieces is not permissible. There is also case law stating that a retrospective bifurcation based on an estimate is not permitted.

Facilitation by a New Decree?

On February 11 the German government issued an application decree simplifying the procedure for cases that are, in the government's view, subject to withholding tax solely as a result of the registration of rights and that do not result in a tax liability because of a double tax agreement.

In this application decree, the procedure for treaty cases is simplified. In cases considered to be clear treaty cases by the MOF, filings of withholding tax returns may not be required for periods ending on or before September 30. However, the new application decree does not address the substantive issue of whether and in which cases the registered rights rule would apply.

The decree also addresses questions of income determination in the case of mixed agreements. According to the decree, the tax authorities have chosen a top-down approach. Methods that try to calculate the German portion of a royalty on a stand-alone basis are disfavored. Rather, the German tax authorities seem to prefer allocation based on the so-called causation principle, which would include only royalties that are caused by

[7] *See* Frey and Schmid, *supra* note 2.

the granting of the right to use the German-registered IP (for example, based on revenues). However, this causation principle would also seem to support excluding de minimis German income. In any event, the question of correct allocation will likely become a subject of intense debate if the German tax authorities actually try to apply extraterritorial IP taxation.

Outlook

It seems likely that the latest draft law will become effective by May. It has to pass both chambers of Parliament. Whether a proposal to abolish the registered rights rule might be reintroduced remains to be seen.

Without abolition, intense administrative efforts and lengthy litigations may follow. This would be highly inefficient for both the government and taxpayers holding German-registered IP. It would be a long time until the German Federal Fiscal Court, the German Federal Constitutional Court, the Court of Justice of the European Union, or the arbitration tribunals reach a final decision on the issues. The levying of withholding taxes may also be subject to mutual agreement procedures based on the respective DTAs. It remains to be seen whether the reactions of the international community as well as the substantial litigation risks could induce the German government to make another U-turn. ■