taxnotes® international

Volume 90, Number 3 ■ April 9, 2018

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Reprinted from *Tax Notes International*, April 9, 2018, p. 339

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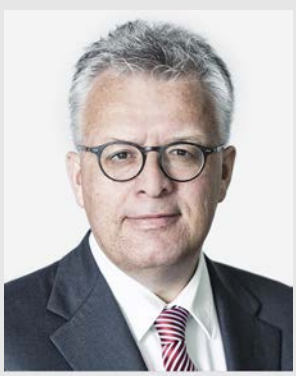

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In this article, the authors discuss Germany's early adoption of the OECD's nexus approach, focusing on how Germany's license barrier rule might apply to royalty payments from a German licensee to a related Swiss licensor that benefits from the special cantonal tax regimes available in Switzerland.

As of January 1, royalty payments from a German company to a foreign related party can no longer, under specified circumstances, be fully deducted as business expenses in Germany.[1] The new legislation was developed in the context of the OECD's work on preferential tax regimes (action 5 of the base erosion and profit-shifting action plan) and claims to close a potential taxation gap left behind after the implementation of the nexus approach, which is one of the minimum standards that all members of the BEPS inclusive framework have committed to implement. Since harmful preferential tax regimes that do not comply with the nexus approach must be abolished — but only by June 30, 2021 — Germany decided to take the matter into its own hands. Circumventing the OECD's grandfathering rule and essentially requiring that the nexus approach be implemented earlier, the new license barrier rule limits the deduction of license payments to a related licensor that is taxed under a harmful preferential tax regime that does not comply with the nexus approach.

As one of the most common jurisdictions for German cross-border business operations, Switzerland — including both the government and the business community — is no doubt watching closely as Germany moves ahead with this new regime. The interaction between the new German rule and the Swiss tax system, along with the ways businesses might respond to the change, provides a useful case study in the operation of Germany's law and the nexus approach in general.

[1] *See* Markus Greinert, Susann Karnath, and Theresa Siebing, "Limits on Royalty Payments: How Germany Wants to Fight IP Boxes," *Tax Notes Int'l*, Mar. 13, 2017, p. 997; and Jörg-Dietrich Kramer, "Germany's New Royalties Barrier Rule: Preventing Tax Evasion By Limiting Deductibility in Specified Cases," *Tax Notes Int'l*, Nov. 27, 2017, p. 879.

I. Germany's New Interest Barrier Rule

According to the new section 4j of the Income Tax Act (Einkommensteuergesetz, or EStG), a German licensor cannot deduct license payments as a business expense if the royalties are paid to a foreign related party (defined by a shareholding of at least 25 percent) and the royalty revenue is taxed under a harmful preferential tax regime. The rule also applies to licensing arrangements between a permanent establishment and another group company. A regime is considered harmful if the taxation of royalties differs from the general taxation of income in that jurisdiction, and the tax rate on royalty revenue is less than 25 percent. Notably, based on the wording of the rule, if a jurisdiction applies a low tax rate to all types of income — that is, not only for license payments — it would not be treated as a preferential tax regime.

When determining the tax rate on the royalty revenue in the other jurisdiction, all rules on the taxation of the royalty income must be considered, in particular any tax reductions, exemptions, or credits. Since the new rule does not set forth any further requirements as to taxation under a harmful preferential tax regime, it will apply regardless of whether the licensor can opt out of the regime.

Since the new rule is intended to implement the outcome of the OECD's work on preferential tax regimes (though through restrictions on the side of the licensee instead of the licensor, as the OECD intends), the deduction of license payments by the licensee will not be limited if the low taxation of the licensor results from a preferential tax regime that complies with the nexus approach of the OECD. Thus, license payments to a foreign licensor that are taxed under a nexus-compliant regime can still be deducted as business expenses in Germany.

In recent years, the OECD, and specifically the Forum on Harmful Tax Practices (FHTP), have been actively reviewing both the IP and non-IP taxation regimes of the OECD, the G-20, and all the members of the Inclusive Framework. In October 2017 the OECD published an update on the progress of the FHTP's review of regimes for compliance with the nexus approach.[2] Most of the existing preferential tax regimes in the OECD and G-20 member countries were deemed not harmful or were noted as being in the process of eliminating or amending harmful practices. Of particular note for our purposes, at the time the review was performed, the special cantonal tax regimes in Switzerland — as non-IP regimes — were deemed to be in the process of being eliminated by 2021. The OECD's report does not provide further details on whether the older Swiss regimes would have been considered harmful.

Whether Germany will use the FHTP's list as a reference for its license barrier rule or whether it will perform its own review of the IP regimes worldwide is not clear. As of this writing, Germany has not published any further guidance on the application of the license barrier rule. In particular, it has not published a list of harmful preferential tax regimes.

II. Applying Germany's Rule to Switzerland

Based on the new license barrier rule, license payments from a German licensee to a related Swiss licensor cannot be deducted as business expenses in Germany if the (low) taxation of the license payments in Switzerland (a) deviates from the general taxation of income, and (b) does not result from a nexus-compliant tax regime. Neither the rule itself nor the explanatory statement provides further guidance on the reference point for the term "general taxation," that is, whether it refers to the taxation of all taxpayers in the jurisdiction or the taxation of the other income of the specific licensor-taxpayer.

If the general taxation referred to the general taxation of all taxpayers in a country (here, Switzerland) with respect to all types of income, then the preferential tax system referenced would not only include specific IP regimes, but also special tax regimes for corporate income in general. Irrespective of whether specific income is always taxed at a lower tax rate or whether the specific tax regime is optimal for the taxpayer, it would be treated as preferential if it provides for a lower tax rate compared to other income or other taxpayers. This result would contradict the object and purpose of the new rule — to specifically target licensing structures. Thus, the reference system must be the general taxation of the specific licensor for all other types of income.

[2] OECD, "Harmful Tax Practices — 2017 Progress Report on Preferential Regimes" (2017).

Thus, a preferential tax regime that falls under the new license barrier rule would have to grant a low taxation specifically for IP. In contrast, an overall low rate of taxation on the licensor's total income would not lead to the application of the license barrier rule. Tax consultants[3] and at least one former member of the German tax administration[4] share this interpretation.

A. Swiss Tax Regimes

In Switzerland, corporate income tax is levied at three levels. At the federal level, corporate income tax is levied at a flat rate of 8.5 percent on profit after taxes (approximately a pretax rate of 7.8 percent). The ordinary cantonal and municipal corporate income tax rates vary by location. Special tax regimes exist at the cantonal and municipal levels. The effective tax rate on companies subject to ordinary taxation is between 11.2 percent and 24.4 percent, depending on the location of the company.

The special cantonal tax regimes can result in no or significantly lower cantonal and municipal income taxation for specific types of businesses. Some of the most common regimes, and their key features, include:

- The holding company regime provides a complete exemption from cantonal and municipal income taxes when a company qualifies as a holding company, meaning its purpose is to carry out the long-term holding of affiliated share companies. To qualify, at least two-thirds of the company's total assets must be holding assets (the definition of which differs slightly by canton) or two-thirds of the company's total income must be holding income (that is, dividends). A holding company may not engage in commercial activities. Non-holding income is generally restricted to interest income and royalty income from trademark-related IP. Any royalty income must be ancillary to the holding income.
- The domiciliary or administrative company regime provides significantly reduced tax rates on foreign-source income (income from non-Swiss counterparties), while income from Swiss counterparties is taxed at ordinary rates. A domiciliary company can only engage in administrative or auxiliary functions, not commercial activity. Notably, the company can receive royalty income.
- The mixed company regime also provides for reduced taxation at the cantonal and municipal level on foreign-source income, while Swiss-source income is subject to ordinary taxation. To qualify for mixed company taxation, the business activity of the company must be predominantly focused outside of Switzerland. This means that at least 80 to 85 percent of the income and expense, depending on the specific canton, must involve non-Swiss counterparties. The effective tax rate for mixed companies lies between 9 and 11 percent. Mixed companies may also receive royalty income.

None of these tax regimes grants a low tax rate specifically for IP. Thus, the regimes would not fall under the new license barrier rule. This interpretation makes sense based on the wording and official objective of the new rule. However, the German Ministry of Finance has not provided any official guidance on the application of the license barrier rule to license payments made to Swiss companies taxed under one of the special cantonal tax regimes, creating significant uncertainty for German licensees.

B. Consequences

If the Swiss special cantonal tax regimes do not create a harmful preferential tax regime under the license barrier rule because the regimes apply to all kinds of income — not specifically to license income — license payments of a German licensee to a related Swiss licensor should be fully deductible in Germany.

On the other hand, if the special cantonal tax regimes are found to create a harmful preferential tax regime for license payments, then the

[3] *See, e.g.*, Claus Ritzer, Ingo Stangl, and Susann Karnath, "Update zur Lizenzschranke," 9 *Der Konzern* 401 (September 2017); Xaver Ditz and Carsten Quilitzsch, "Countering Harmful Tax Practices in Licensing of Rights: The New License Barrier Rule in Section 4j of the German Income Tax Act," 45(12) *Intertax* 822 (2017); and Sebastian Benz and Julian Böhmer, "Der RegE eines paragraf 4j EStG zur Beschränkung der Abziehbarkeit von Lizenzzahlungen (Lizenzschranke)," 5 *Der Betrieb* 206 (February 2017).

[4] Kramer, "Germany's New Royalties Barrier Rule: Preventing Tax Evasion by Limiting Deductibility in Specified Cases," *Tax Notes Int'l*, Nov. 27, 2017, p. 879.

deductibility of the license payments in Germany depends on whether the tax regime is deemed to be nexus-compliant. If the preferential regimes are nexus-compliant, then the license payments could be fully deducted in Germany. Otherwise, the license payments could not be (fully) deducted as business expenses in Germany. In that case, the deductible share of the license payments would depend on the income tax rate applied to the license income at the licensor's level. The nondeductible share would be calculated as follows:

$$\frac{25\% - \textit{income tax burden } \%}{25\%}$$

If the license income is taxed at a rate of 10 percent at the level of the licensor, then 60 percent (that is, 15 divided by 25) of the license payments cannot be deducted by the licensee anymore. Notably, the application of the license barrier rule does not depend on any arm's-length considerations. Whether the license payments comply with the arm's-length principle is irrelevant for the purpose of this new rule.

Thus, if the Swiss special cantonal tax regimes are deemed partly or fully harmful preferential tax regimes — that is, not (fully) compliant with the nexus approach — the license payments would not (fully) be deductible as business expenses in Germany anymore. The taxation of the license income in Switzerland and the nondeduction of the license payments in Germany would lead to economic double taxation that could not be eliminated via the German-Swiss double tax treaty, because the new license barrier rule specifically states that it applies irrespective of an existing double tax treaty (section 4j, para. 1, sentence 1, EStG). Any German company that makes license payments to any Swiss company taxed under a special cantonal tax regime should, therefore, examine tax strategies that might limit the effect of a double taxation of license payments should this result unfold.

III. Potential Business Strategies

A. Binding Ruling

In response to the uncertainty regarding the treatment of Switzerland's special cantonal tax regimes and given the significant tax risks involved, one might consider applying for a binding ruling in Germany to clarify the impact of the license barrier rule to these regimes. The German tax administration may — in its own discretion — grant a binding ruling under section 89(2) of the German fiscal code (Abgabenordnung, or AO) at a taxpayer's request. These rulings are usually limited to situations that have not yet been realized or that may have an effect in the future. However, a binding ruling will not be granted if the taxpayer intends to use the planned structure to realize tax benefits. Since the new license barrier rule explicitly targets licensing structures that lead to tax benefits abroad, it is hard to imagine the German tax administration would grant a ruling in favor of a structure that it suspects may lead to tax avoidance based on a provision that tries to combat those very structures.

B. Transfer of IP to a Nexus-Compliant Regime

Alternatively, one might consider shifting the IP of the Swiss licensor to another group company located in a jurisdiction with a nexus-compliant preferential tax regime. Under the nexus approach, however, the acquisition cost would not be a qualifying expenditure that can be used to determine the portion of IP income eligible for tax benefits. A nexus-compliant tax regime would thus exclude the acquired IP from the tax benefits. The IP would, therefore, be taxed under the general taxation regime applicable to the potential buyer.

Further, license income that does not result from an entity's own research and development activities would generally be considered passive income under Germany's controlled foreign corporation rule. Thus, if the IP is transferred to a low-taxed group company controlled by one or more German shareholders, the license income would fall under the German CFC rule, specifically sections 7 and 8 of the Foreign Tax Act (Aussensteuergesetz, or AStG), and would be added to the income of the German shareholders. The only time the CFC rule would not apply is when the low-taxed group company is located in the EU or European Economic Area and it performs effective economic activities.[5]

[5] Section 8, para. 2, of the ASTG. *See also Cadbury Schweppes PLC and CSO Ltd. v. Commissioners of Inland Revenue*, C-196/04 (CJEU 2006).

The EU's Anti-Tax Avoidance Directive (Council Directive (EU) 2016/1164) requires that all member states implement a CFC provision by 2019. Under the EU's CFC rules, member states will be required to treat license income as passive income that will generally be added back to the tax base of the controlling company.[6] The license income of a low-taxed licensor that is controlled by one or more foreign companies located in the EU would fall under this new CFC provision.

C. Transfer of IP to an Ordinary Tax Regime

Another strategy one might consider is transferring the IP from the Swiss licensor — at fair market value — to a group company that is subject to ordinary taxation in Switzerland (or elsewhere), that is, a company that enjoys no special tax privileges. When, for example, a Swiss company acquires the IP and receives royalty income from Germany, it will be subject to ordinary Swiss taxation at the federal, cantonal, and municipal levels. The acquired IP can be amortized, usually over five to 10 years depending on its value. Thus, the Swiss acquiring company might be able to offset future royalty income against future IP amortization expenses.

The Swiss seller will be subject to ordinary income taxation on the capital gain because the sale is made to a Swiss company subject to ordinary taxation. If the IP is sold to a non-Swiss counterparty, the corresponding capital gain would benefit from mixed company taxation — that is, a lower effective tax rate.

After the transfer, the IP would no longer qualify for a preferential regime after the transfer, so the German license barrier rule would not apply. Also, if the new IP holder is controlled by a German company and taxed at a rate of at least 25 percent, the foreign license income would not be subject to the German CFC rules. However, since the highest ordinary effective tax rate in Switzerland is 24.4 percent, it would not be possible to avoid the German CFC rules using a Swiss licensor.

[6]The EU's CFC rule will not apply when the CFC carries on substantive economic activity supported by staff, equipment, assets, and premises, as evidenced by relevant facts and circumstances. However, EU member states may opt not to apply this escape clause for CFCs resident in a third country.

D. Voluntary Transition to Ordinary Taxation

A Swiss company operating under a special cantonal tax regime may give up that treatment. The tax consequences from doing so will only concern cantonal and municipal taxes since the federal income tax was always levied based on the general rules. In principle, the company can obtain a step-up of the surplus value created under the tax regime at the effective tax rate applicable to the company. For a holding company, this would mean a tax-free step-up. For a mixed company, however, a portion would be subject to cantonal and municipal income tax. Depending on the cantonal practice, the company may be able to defer actual taxation until the realization of the corresponding capital gain.

Thus, a Swiss licensor that owns IP and receives royalty income from Germany might consider opting for a voluntary transition from privileged taxation to ordinary taxation, assuming the tax practices of the relevant canton are not disadvantageous for the company. After this transition, the Swiss licensor would be subject to ordinary taxation at federal, cantonal, and municipal levels on its royalty income from Germany. Because of the step-up, the company could offset future royalty income against future IP amortization expenses at the cantonal and municipal levels.

Pending Swiss tax reform efforts, which will abolish the special cantonal tax regimes, provide for a special transitional regime that follows a slightly different approach: The surplus value created under the tax regime will be determined when the tax regime is abolished. For the next five years, any realized surplus value will be taxed separately at a lower rate. This part of the Swiss reform is expected to enter into force on January 1, 2020.

While the taxation under the ordinary tax regime in Switzerland should not trigger Germany's license barrier rule, taxation during the step-up period might be covered by the rule. The result depends on the exact structure of each canton's step-up system. If the step-up period is designed as a transition phase until regular taxation of the license income applies, then the taxation of the license income during that period would deviate from the general taxation. As the tax rate would likely be below 25 percent, the transition regime might qualify as a harmful preferential tax regime.

IV. Other Considerations

If a Swiss licensor plans to adopt one of the strategies discussed above, it would typically apply for an advance tax ruling with the competent cantonal tax authority to obtain legal certainty about the tax treatment of the contemplated transaction. Because Switzerland has signed the Multilateral Convention on Mutual Administrative Assistance in Tax Matters and introduced corresponding domestic legislation, any tax ruling on these transactions would be subject to the spontaneous exchange of information on tax rulings with other concerned jurisdictions.

When transferring the ownership of IP with the intent to shift the corresponding royalty income to another company, the transfer of legal ownership alone is not sufficient from a transfer pricing perspective. To be recognized by the concerned jurisdictions, the transfer must include at least some of the economically significant activities. When transferring IP or other intangibles, particular attention should be paid to the decision-making and control functions associated with the development, enhancement, maintenance, protection, and exploitation of the intangibles that drive value creation. Any transfer of IP to another Swiss or foreign entity must also be reviewed from a transfer pricing perspective. ■