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Extraterritorial Taxation of German-nexus Rights: ETT/ORIP

As a recent development in German tax law, German tax authorities are interpreting a provision that has been introduced into German tax law almost a century ago in a way that might result in an unpleasant surprise for foreign taxpayers. The extraterritorial taxation of certain IP related transactions that take place outside of Germany might be surprising but taxpayers nevertheless have to comply with current rules and should evaluate whether they are applicable in a given scenario.

What is ETT/ORIP?

ETT and ORIP are non-technical abbreviations that relate to a specific section in the German tax code covering the taxation of non-residents in the context of rights which are registered in a German public registry or exploited in a German PE where no German entity is involved in the transactions. ETT, or Extraterritorial Transfer Tax, refers to a tax on capital gains upon the alienation of such rights.

The alienation includes various types of transactions where at least economic ownership of the relevant rights is transferred against consideration. This can happen in e.g., Platform Contribution Transactions (PCTs) in the context of Cost-Sharing Arrangements (CSAs) or upon an onshoring-transaction.

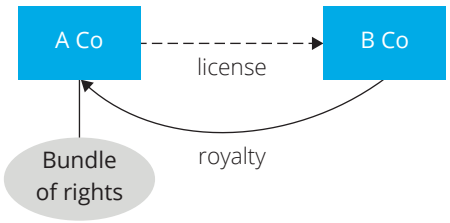
A case-by-case analysis is required to determine whether or not economic ownership in relevant rights has been transferred.

Potential ETT-exposure

ORIP, or Offshore Receipts in respect of Intangible Property, refers a withholding tax of 15.825% on the gross amount of royalties paid to non- residents for the use of such rights.

A case-by-case analysis is required to determine if rights have actually been licensed or those rights have been transferred (see ETT) or if in fact some other agreement (like a profit-split) existed.

Potential ORIP-exposure



What are relevant rights?

ETT and ORIP do not apply to "intangibles" in general, but only to **"rights"**, which are either **"registered"** in a domestic public register or **"exploited"** in a German permanent establishment or other facility ("German nexus IP").

A **"right"** enjoys legal protection (created either under the law or potentially under contract) related to intellectual property, it mainly includes Patents, Trademarks, Trade Secrets (potentially including Know-How) and Copyrights.

A right is **"registered"** in a German domestic register when it is entered into a public registry2 of intellectual property rights under which the licensor is granted legal protections related to the rights being licensed.

IMPORTANT NOTE: Not all rights which are listed at the register of the DPMA (Deutsches Patent und Markenamt) are registered in a domestic register. For example, a European Trademark itself might not be considered registered in a domestic register. There are different rules covering the registration process of Trademarks and Patents (registration processes can include steps at the DPMA as well as the EU Intellectual Property Office (EUIPO) and/or the World Intellectual Property Organization (WIPO)). A case-by-case analysis is required to determine the relevant rights, which are in scope of the rule.

The determination if a right is **"exploited"** in a German permanent establishment is an inherently factual question driven by where the rights are being utilized.

As the relevant rights (often referred to as "in-scope" or "German-nexus" IP) are usually part of a bundle of rights which is transferred/licensed. It is necessary to determine the relevant part of the overall consideration/royalty which is subject to German taxation. There are several ways to determine this amount which all require an in-depth economic analysis.

What is the relevant tax base?

In case of ETT the capital gain upon the alienation of German nexus IP and in case of ORIP the gross amount of license payments for German nexus IP or gross income resulting from the exploited IP in a German PE is the relevant tax base.

In most cases, however, the capital gain or the gross license payment/income comprise more than German nexus IP, e.g. rights registered in other countries or rights not registered at all, e.g. copyrights. To identify which amount of the capital gain or gross amounts have to be allocated to German nexus IP different economic approaches are available, but not limited to:

Cost Approach ("CA")
The CA uses the (incremental) value of the registration as such. That is why generally the costs of the registration plus a markup are deemed to represent the amount to be allocated to German nexus IP.

Bottom Up Approach ("BUA")
The BUA considers arm's length payments for the German nexus rights to determine the amount to be allocated to German nexus IP. Often, reference is made to database studies with comparable third party agreements.

Top Down Approach ("TDA")
The TDA starts with the overall capital gain/gross amount and allocates this amount proportionally to the German nexus IP based on an economic analysis.

The choice of the method and its application depends on the facts and circumstances of the individual case. A comprehensive economic analysis typically includes an analysis of the industry, the business model and the relevant value chain of the taxpayer. It is also important to understand which German nexus rights are actually used, whether additional protection rights exist (e.g. EU trademarks) and the specific value contribution of the German nexus IP.

What information is required?

In order to further analyze the existence and impact of German nexus rights, the following information is of importance:

- License/royalty agreements;
- Cost-sharing agreements;
- IP-transfer/sale agreements;
- OrgCharts of group structure;
- Address, legal representatives, legal successor and authorized recipients of all payment creditors & debtors;
- Residency certificates + certificates of incorporation of all payment creditors & debtors;
- Quarterly history of royalty payments;
- IP purchase payments;
- Sales amounts, which contribute to license/royalty payments or IP purchase payments;
- Segmentation of sales amounts in line with legal protection of relevant German nexus rights (distinction between manufacturing and distribution where applicable);
- Cost related to registration and litigation of German nexus rights and Group WACC;
- IP valuation reports for IP transfers;
- Treatment of in-scope royalty payments in jurisdiction of licensor and licensee.

What are the recommended actions?

On 19 November 2020, a draft law proposal was published by the German Ministry of Finance (MOF) which would (inter alia) have eliminated the ETT/ORIP exposure if nexus exists because of the mere registration of rights in a German public register. The "exploitation alternative" would have continued to create a tax exposure. However, this relaxation of the extraterritorial taxation rules was no longer included in the government approved version. Additional guidance has been issued by the MOF before and after this legislative back and forth: on 6 November 2020, a decree was issued by the MOF which confirmed the application of the rules and reminded taxpayers about their compliance obligations. On 11 February 2021, another decree was issued by the MOF which tries to reduce the compliance burden for taxpayers which are clearly covered by a tax treaty which would prevent Germany from taxing relevant royalty payments or capital gains under the registration nexus (i.e. no changes in case of exploitation nexus).

Considering the above, the following actions should be taken, depending on the specific fact pattern:

1. Identification of the potential ETT/ORIP exposure. This includes at a minimum the following points:
   - Identify potential transfers of rights
   - Identify royalty streams (payments per quarter)
   - Identify German nexus IP (based on exploitation or registration)
   - Determine if treaty protection is available
   - If treaty protection is not available or would appear doubtful: Determine relevant part of consideration/royalty allocable to German-nexus IP

In principle, this exposure would need to be identified for the last seven years (assuming the taxpayer previously was unaware of the issue). We usually would recommend to go back to 2013 considering the increased attention the issue got in 2020.

2. If a relevant ETT-exposure is identified and no treaty protection is available, a tax return (including a determination of the tax base) should be filed making appropriate disclosures. If treaty protection is available, the guidance still requests a filing to be made, but would allow a filing of a nil-return with appropriate disclosures.

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   If a relevant ORIP-exposure is identified, WHT-declarations for each quarter need to be filed and payments need to be made. WHT-declarations need to be filed on the 10th of each month following the end of a quarter. Under general rules, WHT-filings have to be made irrespective of treaty protection unless/until a WHT exemption certificate is available. The tax paid could be refunded to the recipient of the royalties in a refund procedure if treaty protection exists (specific considerations apply in case of back-to-back royalty payments). According to the simplification provided under the decree issued 11 February 2021, if the taxpayer is able to demonstrate clearly that treaty protection applies, it would be sufficient to apply for an exemption certificate by 31 December 2021 for all relevant royalties paid for registered rights until 30 September 2021 together with appropriate disclosures (including contracts and relevant elements of these contracts translated into German). While this would alleviate the need to go through the process of determining a tax base, paying the WHT and applying for a refund, the necessary disclosures would still require a detailed assessment of all facts and circumstances.

   Especially where no treaty protection exists, this protection is doubtful or where an exploitation nexus exists, tax return filings should include all relevant facts that would allow the tax authorities to make their own determination of the tax amounts due to mitigate certain non-tax risks. While the decree states that tax authorities seem to accept only revenue-based royalty/purchase price allocations (top-down approach, see above), many aspects of the fact pattern should be considered to determine the appropriate allocation.

Individual filing strategies to take into account the various aspects of the rules and the individual situation will need to be identified. Contact our dedicated team to discuss your specific situation and to determine a suitable course of action.

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