Client Alert

July 2024

Germany: New tax audit focus - Application of Royalty Barrier Rule to Foreign-Derived Intangible Income (FDII)

In brief

Does your group have a German subsidiary or a German branch that pays royalties to a related party abroad under an intra-group license agreement? If so, a recent development in the German tax landscape could significantly affect you: The German Royalty Barrier Rule (RBR, Section 4j of the German Income Tax Act, (ITA)) is increasingly becoming relevant in German tax audits. Importantly, the German Tax Authorities (GTA) recently began expanding their scrutiny beyond traditional Patent/IP Box regimes. Now, they are also targeting payments made to U. S. licensors benefiting from the Foreign-Derived Intangible Income (FDII) regime. This broader interpretation of the RBR signals a new wave of controversies and potential challenges for businesses engaged in cross-border royalty transactions.

Contents

Key takeaways

- Increased Tax Audit Scrutiny: The GTA are broadening their audit focus beyond traditional Patent/IP Box regimes to also include intra-group payments to US licensors benefiting from the FDII regime.
- Proactive Compliance: Businesses with German subsidiaries or branches paying royalties to related parties abroad should review their intra-group licensing transactions and assess potential exposure to the RBR to ensure compliance and mitigate risks.
- Litigation Prospects: The RBR has been criticized for being overly broad and potentially disproportionate, which raises concerns about its constitutionality and compatibility with EU law. The prospects of success for taxpayers challenging the RBR before the German tax courts appear to be fairly promising.

In depth

The RBR, which came into effect on 1 January 2018, limits the deductibility of royalty expenses incurred by German businesses if the direct or (in the case of a back-to-back licensing structure) indirect licensor is a related party whose income is subject to a deviating low taxation (the "**Preferential Regime**"), unless such Preferential Regime complies with the Modified OECD Nexus Approach. The threshold for low taxation is 25% for royalty expenses that accrued until 31 December 2023 and 15% thereafter. The RBR applies irrespective of anti-discrimination clauses in Germany's Double Tax Treaties (DTTs).

Originally introduced by the German legislator with the intention to address the tax challenges posed by traditional Patent/IP Box regimes offering low tax rates and/or (partial) tax exemptions without requiring qualifying R&D activities in the country, the scope of the RBR could well extend beyond these specific regimes. In particular, its broad wording means that it could potentially also apply to preferential tax regimes that do not specifically target royalty income, as long as royalty income also benefits from such a regime.

Although the RBR has been in force for several years, its impact has been fairly limited in practice as the GTA have so far mainly focused on audit periods prior to the RBR's introduction in 2018. However, recent audit activity indicates a shift, with the GTA now increasingly scrutinizing cross-border royalty payments to related parties in 2018 and subsequent years for a potential application of the RBR.

Importantly, the GTA focuses not only on royalty payments to traditional Patent/IP Box jurisdictions. Other types of tax regimes such as the Swiss regime for cantonal special purpose vehicles (valid until 31 December 2019) are also considered by the GTA to be Preferential Regimes within the meaning of the RBR that do not comply with the Modified OECD's Nexus Approach. In addition, the GTA expressed their view in a 2022 circular on the RBR that even "tax rulings" can fulfil the requirements of a Preferential Regime in terms of the RBR.

Another rising hot topic in German tax audits is the application of the RBR to royalties paid to licensors in the US that benefit from the FDII regime. While the argument that FDII could be a Preferential Regime under the RBR is not new, the GTA's current focus on FDII comes unexpected for many observers, as FDII is still classified as a regime under further review by the OECD's Forum on Harmful Tax Practices as well as in the GTA's most recent circular. According to said circular, the GTA do (yet) not require taxpayers to apply the RBR in these situations.

At the same time, there are rumors that tax field auditors have been instructed by a decision of representatives of the Federal Ministry of Finance and the ministries of finance of the 16 federal states to take up all cases where payments are made to licensors who benefit from a regime under further review (such as FDII), if there is otherwise a risk that the tax claim could become time-barred or that the ability to amend the tax assessment could be forfeited. Both is usually the case following a tax audit, as the statute of limitations expires and the opportunity to amend the tax assessment usually is lost.

To help you navigate through this complex landscape, we prepared a detailed Q&A that outlines the scope and implications of the RBR, incorporating the latest guidance from the GTA dated 5 January 2022 and 6 January 2022. We encourage you to use this information to assess the potential impact on your business and to ensure compliance with the current regulations.

German Royalty Barrier Rule - Questions & Answers ("Q&A")

1. What royalties are in scope of the German RBR?
2. Is it possible to avoid the RBR by interposing another party (back-to-back license)?
3. What is a Preferential Regime for the purpose of the RBR?
4. What is the threshold for low taxation?
5. Can withholding taxes be taken into account when determining whether the royalty income is subject to low taxation?
6. Given that the threshold for low taxation is 15% as from the start of 2024, will the RBR lose its relevance with the implementation of Pillar 2?
7. How does the escape for nexus-compliant regimes work?
8. Does the circular of the GTA classify certain tax regimes as Preferential Regimes in terms of the RBR?
9. What are the consequences of a tax regime being blacklisted as opposed to being grey-listed by the GTA?
10. Which tax regimes are included in the GTA's Black List?
11. Is FDII listed as a Preferential Regime on the Black List or the Grey List?
12. What is the consequence of a tax regime (e.g., FDII) being included in the Grey List?
13. What is the prevailing view in the German tax literature as to whether the FDII qualifies as a Preferential Regime?
14. Do you expect that FDII will be put on the GTA's Black List?
15. Given that the deduction for FDII income will be reduced from 37.5% to 21.875% in 2026, will the RBR lose its relevance for FDII?
16. Could the RBR be triggered by a check-the-box election?
17. What should taxpayers do if they make royalty payments to licensors benefiting from FDII or other tax regimes on the Grey List?
18. How is the portion of non-deductible expense determined?
19. What cases are we currently seeing in ongoing tax field audits?
20. Are there already any pending court cases?
21. Will it be possible to draw conclusions from these court rulings for other regimes (e.g., FDII)?
22. What can taxpayers do in preparation of a tax audit?
23. What should taxpayers do if a tax audit has already been initiated?
24. What should taxpayers do if they received amended tax assessment notices after a tax audit?
25. What are the taxpayers' chances of success before the German tax courts?

Should you have any questions or require further assistance, please do not hesitate to contact us.

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German Royalty Barrier Rule - Questions & Answers ("Q&A")

This Q&A aims to address the most frequently asked questions regarding the German RBR. For your convenience, a translated version of the RBR is attached hereto.

1. **What royalties are in scope of the German RBR?**

   The RBR defines royalty expenses as expenses incurred by a business for the right to use:

   a. Rights, in particular copyrights and industrial property rights (IPs), or

   b. Industrial, technical, scientific and similar experience, knowledge and skills, plans, samples and processes ("**Know-how**").

   A typical example in which the RBR may apply is where a German enterprise pays royalties to a foreign affiliate under a manufacturing and distribution license for the granting of the right to commercially exploit the IP in Germany.

   Another example is that of a German software reseller that distributes limited-term licenses to customers and therefore requires the copyright use right to "rent" the software as well as the copyright use right to reproduce the software.

   In addition, the RBR may also apply to a SaaS reseller, but only if the SaaS reseller is involved in the distribution of the SaaS service in such a way that it requires the copyright use right to reproduce the software and the copyright right use right to make the software available to third parties. In most cases, however, such rights are not required.

   Furthermore, it is important to note that cross-border payments for software development services can also fall within the scope of the RBR if the payments were made prior to 7 June 2021 or if the service provider retains certain use rights in the developed software under the software development agreement. In these cases, the GTA is of the view that the service fee includes a royalty portion.

   Moreover, since the RBR does not explicitly require that royalties be paid for commercial exploitation rights, even intra group royalties paid under a group-internal software license agreement for internal use only (e.g., ERP license) might fall within the scope of the RBR if the foreign tax regime provides for a preferential treatment of such income.

   In contrast, the RBR should not limit the deductibility of expenses from the amortization of acquired IP (e.g., patents). Furthermore, the RBR should also not apply to expenses arising from the costs of goods or services sold that contain embedded IP.

2. **Is it possible to avoid the RBR by interposing another party (back-to-back license)?**

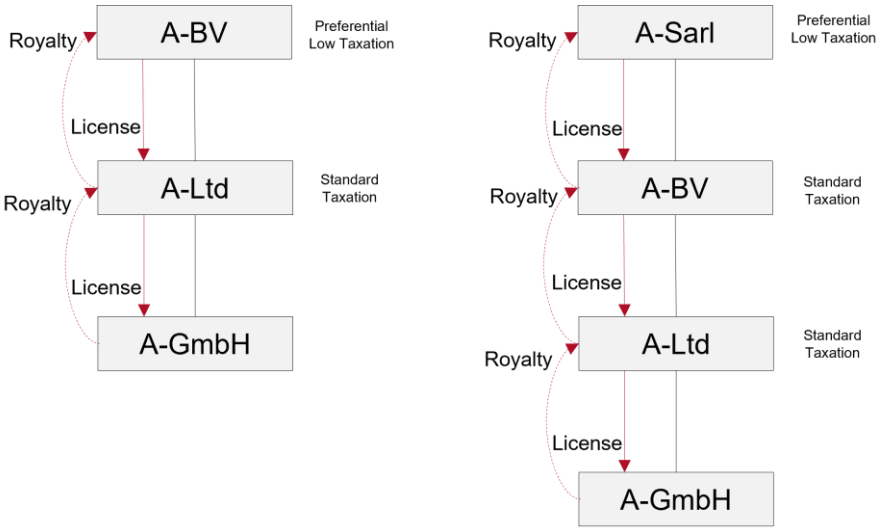
   No, it should not be possible to avoid the RBR by interposing another related party between the German company and the affiliate that enjoys the benefits of a Preferential Regime.

   The RBR restricts the deductibility of royalties paid by a German enterprise not only if the direct licensor is a related party and the income of the direct licensor is subject to a Preferential Regime that is not consistent with the Modified OECD Nexus Approach. Rather, the RBR also applies if the direct licensor in turn licenses the IP from another related party and the income of such "indirect licensor" is subject to a Preferential Regime.

   Therefore, if, for instance, a German enterprise pays royalties to an Irish affiliate that does not benefit from a Preferential Regime, and the Irish affiliate pays royalties to a US affiliate that benefits from a Preferential Regime, the rule will still apply due to the preferential taxation of the US affiliate.

   The application of the RBR in case of back-to-back licensing structures is also not limited in terms of the number of licensing tiers (e.g., if there is a chain of five intercompany licenses, the RBR can be triggered even if only the fifth indirect licensor is a related party which benefits from a Preferential Regime).

Back-to-Back Licensing



3. **What is a Preferential Regime for the purpose of the RBR?**

A Preferential Regime in terms of the RBR can be any tax regime under which the licensor's income is subject to a "deviating low taxation". There are no further restrictive criteria. The criterion of "deviating low taxation", therefore, is the sole criterion in the law.

According to the GTA's circular dated 5 January 2022, in order to determine whether there is "deviating low taxation", the actual taxation of the licensor's income from the licensing of the IP is to be compared with the standard taxation of other income in the same jurisdiction. The circular goes on to state that "standard taxation" as a benchmark is the regular tax rate that would be applied to the income of a legal entity comparable to the licensor without any tax relief (in particular due to the legal form or residence of the creditor or for certain types or sources of income).

The circular also clarifies that the classification of a regime is independent of whether the regime

a. Applies only to royalty income or also to other types of income (e.g., capital gains, dividends).

b. Applies automatically or only subject to an election by the taxpayer.

c. Is “unlocked” by a specific type of income, the taxpayer's legal form or its place of management.

According to the circular, a Preferential Regime need not be based on codified law. So-called tax rulings, i.e., individual agreements between foreign tax authorities and the non-resident recipients of royalties, can also fulfil the conditions of a Preferential Regime within the meaning of the RBR.

However, the circular clarifies that a generally low level of taxation in the licensor's jurisdiction and/or the fact that the licensor's jurisdiction generally does not levy any taxes does not lead to a preferential low tax regime. Therefore, royalty payments into a jurisdiction that does not levy any corporate tax at all should generally not be in the scope of the RBR.

4. **What is the threshold for low taxation?**

The threshold for low taxation was 25% for royalty expenses incurred until 31 December 2023. As from 1 January 2024, the threshold has been lowered to 15%. When determining whether the royalty income is subject to low taxation, the RBR primarily looks at the individual entity (i.e., the royalty receipts) and there, at the effective tax rate on the gross royalty income. All regulations that affect the taxation of the licensor's income must be taken into account, in particular tax reductions, exemptions, credits or rebates. Special rules apply if the royalty receipts are fully or partly attributed to another party.

Here are some examples from the legislator's explanatory memorandum:

Example 1

The licensor resident in State A generates license income of 100 and has related deductible operating expenses of 20. Due to the preferential tax regime, the lower tax rate in State A, which deviates from the standard taxation rate, is 10%.

Result: The income tax burden within the meaning of Section 4j (2) ITA is 10% and not 8%. The amount of the actual operating expenses incurred has no influence on this due to the revenue-based approach.

Example 2

The licensor resident in State B generates royalty income of 100. The standard tax rate in State B that also applies to the royalty income is 30%, but due to the preferential tax regime, 50% of the royalty income is tax-free.

Result: The income tax burden within the meaning of Section 4j (2) ITA is 15% (i.e., 50% of 30%). The amount of actual operating expenses incurred has no influence here.

Example 3

The licensor resident in State C generates license income of 100. The standard tax rate in State C, which also applies to the license income, is 30%, but State C allows the deduction of notional business expenses amounting to 60% of the license income.

Result: The income tax burden within the meaning of Section 4j (2) ITA is 12 % (i.e., 40 % of 30 %). The amount of the actual operating expenses incurred, which are also deductible in State C, has no influence here either.

Please note that low taxation is also deemed to exist if income taxes of at least 25% (until 31 December 2023) and/or 15% (from 1 January 2024) are legally owed but are not actually levied – either deliberately or due to a legal error.

5. **Can withholding taxes be taken into account when determining whether the royalty income is subject to low taxation?**

In German tax literature, it is commonly believed that withholding taxes on royalty income should be considered when determining whether the royalty income is subject to a "deviating low taxation" in terms of the RBR, though this is not without doubt. The reference point for "deviating low taxation" is the standard taxation of other income in the licensor's jurisdiction. For instance, a Preferential Regime in terms of the RBR exists if royalty income is taxed at 12% and other income at 25%. Because the reference point for the comparison is the taxation of income in the licensor's jurisdiction, the GTA could argue that the classification of a regime as a Preferential Regime should not depend on whether the licensee's jurisdiction imposes a withholding tax. Withholding taxes imposed by the licensee's jurisdiction are not part of the licensor's jurisdiction's taxation. Moreover, if withholding taxes were taken into account, the results could be random, depending, for instance, on whether or not the licensor can claim the benefits of a double tax treaty, also taking into account anti-avoidance legislation in the licensee's jurisdiction.

6. **Given that the threshold for low taxation is 15% as from the start of 2024, will the RBR lose its relevance with the implementation of Pillar 2?**

Yes, the rule may lose some of its relevance with the implementation of Pillar 2. However, unlike Pillar 2, which considers the blended tax rate of all constituent entities within a particular jurisdiction, the RBR primarily focuses primarily on the individual entity. Therefore, even if the blended rate on the net income of all constituent entities within a particular jurisdiction exceeds 15%, the RBR may still apply if the tax rate on the gross royalty income at the level of the particular foreign licensor is less than 15%.

7. **How does the escape for nexus-compliant regimes work?**

The RBR does not apply if the Preferential Regime is consistent with the Modified OECD Nexus Approach as defined in Chapter 4 of the 2015 Final Report on Action Item 5, OECD (2016) "Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance", OECD/G20 Base Erosion and Profit Shifting Project. To determine whether the aforementioned exception applies, it is necessary to analyze whether the Preferential Regime as such is consistent and in line with the Modified OECD Nexus Approach. Therefore, if the Preferential Regime is not consistent and compliant with the Modified OECD Nexus Approach, the GTA are of the opinion that the RBR applies even if the licensor fulfils the criteria for a qualifying R&D activity according to Chapter 4 of the 2015 Final Report on Action Item 5 and thus would in principle be able to meet the requirements of the Modified OECD Nexus Approach.

Example

The licensor is the group's main R&D unit performing substantially all of the group's DEMPE functions. It is engaged in a qualifying R&D activity and researches qualifying IP. The royalty income received by the licensor is subject to a preferential low taxation under a Patent/IP Box regime which does not comply with the Modified OECD Nexus Approach. In this case, according to the view of the German tax authorities, the royalty barrier rule applies. The fact that the licensor performs a qualifying R&D activity and holds substantially all of the group's DEMPE functions does not matter.

The example illustrates that the RBR clearly overshoots its target. The deduction of the royalty expenses by the German business is (partially) disallowed even though the licensor does in principle meet the requirements of the Modified OECD Nexus Approach.

8. **Does the circular of the GTA classify certain tax regimes as Preferential Regimes in terms of the RBR?**

Yes, in order to facilitate the application of the RBR by taxpayers, the GTA has issued a circular containing two lists:

a. The first list contains tax regimes which, based on the conclusions of the OECD's Forum on Harmful Tax Practices, have been classified as Preferential Regimes under the RBR ("**Black-List**", see for more detail under 8. below).

b. The second list contains tax regimes that have not yet been definitively classified and therefore are still under further review and examination ("**Grey List**").

9. **What are the consequences of a tax regime being blacklisted as opposed to being grey-listed by the GTA?**

For blacklisted preferential regimes, the GTA are of the opinion that the RBR applies, provided the income is subject to low taxation. Accordingly, taxpayers should principally not (fully) deduct royalties from the German tax base if the corresponding income of the licensor benefited from such regime (or, if they intend to deduct the royalties, they should fully disclose the fact that the income of the licensor benefitted from a blacklisted preferential regime).

On the other hand, if a regime (such as FDII) is only included in the Grey List, the circular confirms that taxpayers may deduct the royalties from their German tax base. However, the taxpayer's tax office has to issue the assessment notice subject to further review so that the assessment can be amended if it is later determined that the regime in question has to be classified as Preferential Regime under the RBR and therefore has to be included in the Black List.

10. **Which tax regimes are included in the GTA's Black List?**

The Black List contains several former Patent/IP Box regimes (prior to their alignment with the Modified OECD Nexus Approach):

a. **France** - Patent box regime, valid until 31 December 2018

b. **Netherlands** - IP box regime, valid until 30 June 2021

c. **Luxembourg** - IP box regime, valid until 30 June 2021

d. **U.K.** - Patent box regime, valid until 30 June 2021

e. **Belgium** - Patent box regime, valid until 30 June 2021

f. **Malta** – Patent box regime, valid until 30 June 2021

g. **Italy** - IP box regime, valid until 30 June 2021

h. **Switzerland, Canton Nidwalden** – License box, valid until 31 December 2020

i. **Turkey** - Technology Development Zone 2001, valid until 30 June 2021

Although these regimes no longer exist, they remain relevant for the past, i.e., for the period from 1 January 2018 until their respective expiry date, and may therefore become a concern in tax field audits covering these years.

Importantly, the RBR ignores the fact that the OECD's Modified Nexus Approach includes certain grandfathering rules to provide for transitional relief until 30 June 2021 for existing Patent/IP Box regimes that do not comply with the new standards. The RBR applies notwithstanding these grandfathering rules also in the period up to 30 June 2021.

Further examples on the Black List include special tax regimes for economic zones, free zones, development zones, certain business activities or industry sectors and so-called holding company regimes, e.g.,

a. **Switzerland** – special company regimes at cantonal level, valid until 31 December 2019, including auxiliary company regime (a.k.a. domiciliary company regime), holding company regime and mixed company regime

b. **Singapore** - Development and expansion incentive-services, valid until 30 June 2021

c. **Macao** - Macau offshore institution, valid until 31 December 2020

d. **Mauritius** – Global Business License I & II, valid until 30 June 2021

e. **Qatar** - Free zone area Free zone at science & technology park

f. **Aruba**- Exempt Company regime, valid until 30 June 2021

g. **Barbados** - International Business Companies, valid until 30 June 2021

As already mentioned, according to the circular, a Preferential Regime in terms of the RBR does not have to be based on legislation. So-called tax rulings, i.e., individual agreements between foreign tax authorities and non-resident companies, may also fulfil the conditions of a Preferential Regime within the meaning of the RBR. Thus, the RBR may, for instance, also apply when royalties are paid to a non-resident licensor who is exempt from taxation on various types of income, including royalties, under a "tax holiday" ruling.

11. **Is FDII listed as a Preferential Regime on the Black List or the Grey List?**

No, FDII is not listed on the Black List as a Preferential Regime in terms of the RBR. However, FDII is included in the Grey List.

12. **What is the consequence of FDII being included in the Grey List?**

As mentioned, if a regime is only included in the Grey List, the circular confirms that taxpayers may deduct the royalties from their German tax base. However, the taxpayer's tax office has to issue the assessment notice subject to further review so that the assessment can be amended if it is later determined that the regime in question has to be classified as Preferential Regime under the RBR and therefore has to be included in the Black List. For this reason, even if tax field auditors have not been formally instructed to take up cases of payments by German taxpayers to licensors that can claim the benefits of a tax regime on the Grey List, they may still be inclined to apply the RBR during a tax field audit if only to avoid that such taxpayers are finally assessed before the review process has been completed.

13. **What is the prevailing view in the German tax literature as to whether the FDII qualifies as a Preferential Regime?**

The German tax literature is divided on whether FDII qualifies as a Preferential Regime under the RBR. Some argue that FDII does fit this definition due to leading to "deviating low taxation," which the RBR aims to combat. Others contend that the broad wording of the RBR should be interpreted narrowly, consistent with its original purpose of combating traditional Patent/IP Boxes. Generally, German tax courts tend to apply the law literally, which complicates the debate. However, there are several systematic arguments against the classification of FDII as a Preferential Regime under the RBR, most of which are based on highlighting the different characteristics of FDII and traditional Patent/IP boxes.

14. **Do you expect that FDII will be put on the GTA's Black List?**

It is not anticipated that FDII will be placed on the GTA's Black List. A senior tax official indicated that the GTA is avoiding such a determination for political reasons. However, this stance could change if a case is brought before a German tax court and such tax court independently confirms that FDII is a Preferential Regime under the RBR.

15. **Given that the deduction for FDII income will be reduced from 37.5% to 21.875% in 2026, will the RBR lose its relevance for FDII?**

Yes, the rule is likely to lose most of its relevance for FDII from 2026, as the reduction in the FDII deduction from 37.5% to 21.875% in 2026 will increase the effective tax rate on FDII income from 13.125% to approximately 16.41%. However, there may still be cases where the tax rate on the licensor's gross royalty income still falls short of 15%.

16. **Could the RBR be triggered by a check-the-box election?**

If a German subsidiary of a US parent is treated as a disregarded entity, royalties paid to the US parent are not considered income for US income tax purposes. In contrast, if the German subsidiary is not disregarded or if an unrelated party made the payments, the US parent would be taxed on such income. Although, to our knowledge, German tax literature does not view the US check-the-box regulations as a Preferential Regime under the RBR (and we would strongly advocate against such view for various reasons), this perspective might arise during a tax field audit. Hybrid structures are scrutinized very closely, and the German hybrid mismatch rules may not cover all scenarios a German tax auditor might find worth taxing.

17. **What should taxpayers do if they make royalty payments to licensors benefiting from FDII or other tax regimes on the Grey List?**

In general, although the circular does not explicitly ask taxpayers to declare in their tax returns whether they have deducted from their tax base royalties paid to licensors benefiting from the FDII, the safe approach is to be transparent in the return, given that FDII might be classified as a Preferential Regime and the expenses might ultimately not be fully deductible. If tax returns in which the deduction was claimed have already been filed, it should be analyzed whether the respective Grey List regime in question in fact qualifies as a Preferential Regime in terms of the RBR. German taxpayers who have positive knowledge that one of their tax returns is incorrect are obliged to notify the tax office and correct the tax return.

18. **How is the portion of non-deductible expense determined?**

If the royalty income of the non-resident licensor is subject to a Preferential Regime in terms of the RBR that does not comply with the Modified OECD Nexus Approach, the corresponding royalty expenses incurred by the German business are only partially deductible.

The non-deductible portion shall be determined as follows:

(until 31 December 2023)	(as from 1 January 2024)
(25% ./. effective income tax burden in %)	(15% ./. effective income tax burden in %)
25%	15%

Unlike interest carry-forwards under the German interest barrier rule, the non-deductible royalty portion cannot be carried forward, i.e., the non-deductibility is definitive.

19. **What cases are we currently seeing in ongoing tax field audits?**

Inquiries into the RBR are not limited to specific industries or tax regimes. For example, we have heard of several companies in the pharmaceutical industry that are under a tax audit in Germany and where questions have been raised about the application of FDII rule at the level of the US licensor. We are also aware of German groups that have received such inquiries not only in relation to FDII, but also in relation to former Patent/IP Box regimes, in connection with royalty payments by the German parent company to its subsidiaries abroad. Additionally, several French clients have reported that their German subsidiaries are discussing the application of the RBR with the GTA in relation to the French patent box regime, which did not comply with the Modified OECD Nexus Approach in 2018. These cases are likely to be brought before the German tax courts.

20. **Are there already any pending court cases?**

We have received unconfirmed rumors of two pending cases. One of these cases is said to be pending before the tax court of Hesse but we have no information which foreign tax regime is at question in this case. The other case is said to be pending before a tax court in North Rhine-Westphalia. We have been told that the second case concerns a Swiss licensor. However, it is not known whether the Swiss licensor benefitted from a Patent/IP Box regime, a special company regime or from a Swiss tax holiday ruling.

21. **Will it be possible to draw conclusions from these court rulings for other regimes (e.g., FDII)?**

Yes. During the proceedings, the respective local tax court will need to decide whether to refer the case to the German Constitutional Court or to the European Court of Justice (ECJ). A referral to the German Constitutional Court may be considered if the court is convinced that the RBR is unconstitutional. Conversely, a referral to the ECJ may be considered if the court concludes that the RBR infringes upon one of the European fundamental freedoms. Should the court choose not to refer the case to either the Constitutional Court or the ECJ, it will have to interpret the provision itself. In the case concerning the Swiss licensor, the scope of application of the RBR could become highly contentious if the Swiss licensor benefitted from the regime for Swiss special companies or from a tax ruling. The court would then have to decide whether the scope of application of the RBR should extend to other tax regimes beyond the traditional Patent/IP Box regime also to other tax regimes or whether it should refuse to apply the RBR to such other tax regimes in line with the original intent and purpose of the provision. The outcome of the Swiss case could therefore also be of interest for the FDII cases, as FDII is not a traditional Patent/IP Box regime, either.

22. **What can taxpayers do in preparation of a tax audit?**

If a tax field audit for 2018 and/or subsequent years has not yet been initiated, taxpayers should check in advance of the commencement of such tax audit whether they paid royalties to a related party abroad and whether such royalties were subject to special tax treatment in the other jurisdiction so that the RBR may apply. If the royalty income was subject to special tax treatment in the other jurisdiction, they should check whether the foreign tax regime is on the GTA's Black List or the GTA's Grey List. If the regime is included in either list, taxpayers should seek professional advice to confirm the recommended course of action in their particular case.

23. **What should taxpayers do if a tax audit has already been initiated?**

If a tax audit has already been initiated and the tax field auditor has raised the question of whether the RBR applies to certain royalty expenses, the chances of success of a negotiated solution in the tax field audit will depend on whether the regime is on the Black List, the Grey List or on no list. If the regime is on the GTA's Black List, the tax field auditor will in principle be bound by the GTA's circular and the scope for negotiation with the taxpayer will be quite limited. If, however, the tax regime is

on the Grey List or is not listed at all, the taxpayer should try to convince the tax auditor that the RBR should not apply as part of an overall compromise with the tax auditor.

24. **What should taxpayers do if they received amended tax assessment notices after a tax audit?**

Taxpayers who receive amended tax assessments following a tax audit and who disagree with the application of the RBR to their circumstances may lodge an appeal within one month of receiving the assessments. However, lodging an appeal does not suspend the taxpayer's obligation to pay the assessed tax. To avoid payment of the tax, taxpayers may also consider applying for a suspension of the payment obligation. It is important to note that if the taxpayer is granted a suspension of the payment obligation and eventually loses the case, interest at a rate of 6% per annum will be charged on the outstanding tax from the date the suspension of payment is granted. Conversely, if the taxpayer pays the tax and later wins the case, the interest rate applied on the tax refund would be around 1.8% per annum (which rate may be amended form time to time) starting at the time the tax was paid. During the appeal's process, both the taxpayer and the tax office can present their arguments and explore the possibility of a compromise. However, changing the tax office's legal stance may be difficult, especially if the tax regime in question is on the administration's Black List and therefore non-negotiable because of the circular. In such instances, it might be advisable to bypass the administrative appeal procedure and, with the tax office's agreement, take the case directly to the local tax court by way of a so-called "leapfrog" action.

25. **What are the taxpayers' chances of success before the German tax courts?**

The chances of success for taxpayers challenging the RBR before the German tax courts appear to be fairly promising. The RBR has been criticized for being overly broad and potentially disproportionate, which raises concerns about its constitutionality. Such overreach may violate the constitutional rights protected by the German constitution, such as the constitutional right of equal treatment and the ability-to-pay principle enshrined therein. Furthermore, in cases involving transactions between Germany and other European Union member states, there is a significant likelihood that the RBR could be found to infringe upon European fundamental freedoms, such as the freedom of establishment and the freedom of services. These arguments strengthen the taxpayer’s position in court. Additionally, with growing scrutiny and ongoing legal debates, it is expected that court decisions addressing these issues will emerge in the near future, providing further clarity and potentially supporting taxpayer claims. Thus, the legal landscape appears favorable for taxpayers disputing the application of the RBR.

Annex: Section 4j ITA – Expenses for the provision of rights

1. [1]Notwithstanding an existing double taxation convention, expenses for the provision of the use of rights or the right to use rights, in particular of copyrights and intellectual property rights, industrial, technical, scientific and similar experience, knowledge or skills, for example plans, samples and processes, are deductible only in accordance with paragraph 3, if the licensor's receipts are subject to a low taxation pursuant to paragraph 2 that deviates from regular taxation (**Preferential Regime**) and the licensor is a related party to the licensee pursuant to section 1 (2) of the German Foreign Taxation Act (*Außensteuergesetz*). [2]If the licensor pursuant to sentence 1 or another party related to the licensee pursuant to sentence 1 within the meaning of section 1 (2) German Foreign Taxation Act has in turn expenses for such rights from which the rights pursuant to sentence 1 are indirectly or directly derived, any expenses pursuant to sentence 1, notwithstanding an existing double taxation convention, are also deductible only in accordance with paragraph 3 if the further receipts of the further licensor are subject to a low taxation pursuant to paragraph 2 that deviates from regular taxation and the further licensor is a related party to the licensor pursuant to sentence 1 within the meaning of section 1 (2) German Foreign Taxation Act; this shall not apply if the deductibility of the expenses at the level of the licensor or the other party related to the licensee is already limited under this provision. [3]Permanent establishments which are treated for income tax purposes as licensees/beneficial owners or licensors of the right to use rights also qualify as licensees and licensors, respectively. [4]Sentences 1 and 2 shall not apply to the extent that the low taxation results from the fact that the licensor's or the further licensor's receipts are subject to a preferential tax regime that is in line with the Nexus approach as set forth in Chapter 4 of the 2015 Final Report on Action Item 5, OECD (2016) "Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance", OECD/G20 project "Base Erosion and Profit Shifting". [6]Sentences 1 and 2 shall not apply to the extent that, on the basis of the receipts resulting from the expenses, an adjustment amount within the meaning of section 10 (1) sentence 1 German Foreign Taxation Act must be applied.

2.[2] [1]A low taxation within the meaning of paragraph 1 exists if the taxation of the licensor's or further licensor's receipts, which deviates from the regular taxation, results in a tax burden of less than 25 percent (until 31 December 2023) / 15 percent (as from 1 January 2024); the lowest burden shall be decisive in the case of several licensors. [2]In determining whether a low taxation exists, all provisions affecting the taxation of the receipts from the provision of the use of rights or the right to use rights have to be considered, in particular tax reductions, exemptions, credits or reliefs. [3]If the receipts from the provision of the use or the right to use rights is fully or partly attributed to another party, or if, for other reasons, a party other than the licensor or the further licensor is taxed fully or partly, the sum of the tax burden shall be taken into account. [4]Section 8 (3) sentence 2 and 3 German Foreign Taxation Act shall apply accordingly.

3.[3] [1]Expenses referred to in paragraph 1 shall be deductible only in part in cases of low taxation pursuant to paragraph 2. [2]The non-deductible part shall be determined as follows

(until 31 December 2023)	(as from 1 January 2024)
(25% ./. direct tax burden in %)	(15% ./. direct tax burden in %)
25%	15%

[1] Available from OECD Publishing, Paris, https://doi.org/10.1787/9789264241190-en.

[2] Section 4 j(2) sentence 4 ITA amended by law of 27 June 2021 (BGBl. I p. 2035); sentence 1 amended by law of 21 December 2023 (BGBl. 2023 I No. 397); for application see section 52 para. 8c sentence 2 ITA.

[3] Section 4j(3) sentence 2 ITA revised by law of 21 December 2023 (BGBl. 2023 I No. 397); for application, see section 52(8c) sentence 2 ITA.