Big read

The changing world of preferential tax regimes

Speed read

Following the OECD's BEPS report on Action 5, countries with preferential tax regimes are adjusting the criteria that need to be met in order for their regimes to meet the so-called modified nexus approach. This article explores those aspects of existing regimes which led the OECD to conclude that the preferential tax regimes of its members amount to harmful tax practices. It also considers which features various countries propose to change to ensure that their preferential tax regimes are acceptable to the OECD.

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In November 2010, the UK government announced its first thoughts regarding a potential patent box regime. Although a little late to the party, the announcement heralded the introduction of a preferential tax regime for certain types of intellectual property (IP). The legislation that put the rules into effect became Part 8A of CTA 2010.

The UK's actions came some time after several other countries had introduced their own types of preferential regimes. France first developed a patent box regime in 1971, and countries such as Belgium, The Netherlands and Luxembourg introduced their preferential tax regimes in 2007 and 2008.

Ironically, not long after the UK introduced its patent box regime, the OECD's base erosion and profit shifting (BEPS) project concluded that preferential tax regimes could often constitute harmful tax practices and made recommendations (in Action 5) to counter the harmful effects of preferential tax regimes. The OECD's discomfort with preferential regimes was not new. Going all the way back to 1998, the OECD had expressed concerns about harmful tax practices linked to geographically mobile activities, such as the provision of intangibles. In addition, the OECD viewed harmful tax practices as including not only preferential tax regimes, but also various types of tax rulings. Although the OECD concluded that preventing harmful tax practices required more than just addressing concerns related to preferential tax regimes, this article focuses only on this aspect of Action 5 of the BEPS project.

The OECD concluded that *all* 16 of its members' preferential tax regimes were inconsistent, either in whole or in part, with what it considered to be an acceptable preferential tax regime. In that context, this article examines the changes countries intend to make in order to comply with the OECD's new standards. It should not be forgotten, of course, that all of the existing regimes have previously been reviewed and approved by the OECD as not constituting harmful tax practices. In the post-BEPS era, however, the requirements for acceptability of preferential tax regimes are clearly greater.

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What is a harmful tax practice?

It is helpful to understand what aspects of preferential tax regimes led the OECD to conclude that these regimes enabled companies to undertake BEPS activities. In its 1998 report, the OECD identified four key and eight other factors that should be used to determine whether a preferential tax regime was *potentially* harmful. Although it is beyond the scope of this article to consider each factor determining whether a preferential tax regime is potentially harmful (as set out on page 20 of the final Action 5 report), one can assume that patent box regimes in general do meet the OECD's definition of potentially harmful tax practices.

In assessing whether a tax regime is *actually* harmful, the OECD notes that a particular regime may not be actually harmful if it does not appear to have created harmful economic effects. The Action 5 report sets out how this is assessed:

- Does the tax regime shift activity from one country to another country that provides the preferential tax regime rather than generate significant new activity?

- Are the presence and level of activities in the host country commensurate with the amount of investment or income?
- Is the preferential regime the primary motivation for the location of an activity?

In addition to the OECD's analysis of what constitutes a harmful tax practice, it is interesting to note the results of a separate study carried out by the EU commission. In its Taxation Papers, *Working Paper N. 57 – 2015*, a working party of the EU Commission sought (amongst other things) to test two arguments, namely:

- to what extent the tax rebate granted by a patent box is effectively promoting what the working party describes as 'local inventorship', which it goes on to note is an 'often advocated justification for granting preferential tax treatment'; and
- the effectiveness and strength of development conditions in ensuring that the link between the tax rebate and the underlying research activities is effectively delivering.

The paper concludes that, overall, the tax advantages linked to patent box regimes tend to *decrease* the likelihood of inventors moving to the country in which the patent box regime exists and actually *deters* local inventions.

Perhaps not surprisingly then, the OECD and this working party of the EU Commission both concluded there ought to be a strong link between the availability of a preferential tax regime and the activity that led to the development of the relevant IP. The OECD refers to this link as the nexus approach and the working party refers to it as a development condition.

The statistical analysis carried out by the EU Commission's working party confirmed that the existence of a development condition has a strong effect in reversing the tendency to decrease the likelihood of inventors moving to the country in which the patent box regime exists. The report goes on to state (on page 24):

> 'An interesting development of patent boxes concerns the possibility to impose development conditions for the patent to qualify for the advantageous tax regime. These conditions provide a proxy of the possible effect of conditionality clause [sic] discussed at the EU and OECD, i.e. the so-called nexus approach.'

Clearly, one feature of patent boxes that has led to such regimes being described as a harmful tax practice is the disconnect between where the development of the IP takes place and where the tax advantage is achieved.

The outcome of the BEPS review of harmful tax practices under Action 5 is to recommend that only preferential tax regimes that permit tax advantages to accrue to companies that carry on substantial activity in relation to the relevant IP should be acceptable. After some discussion as to what this would mean in practice, the OECD (off the back of a joint suggestion from Germany and the UK) alighted on the notion of a modified nexus approach. The OECD concluded two things:

- IP regimes should make their benefits conditional on the extent of the R&D activities of taxpayers.
- It was not the amount of expenditure that acts as a direct proxy for the amount of activity but the proportion of expenditure directly related to development activity that demonstrates the real value added by the taxpayer and acts as a proxy for how much substantial activity the taxpayer undertook.

As discussed in more detail below, under the OECD's new definition of an acceptable preferential tax regime, all of the existing preferential tax regimes were, to a greater or lesser extent, inconsistent with what has become known as the modified nexus approach.

In devising the nexus approach, the OECD has sought to restrict patent box relief by reference to related party outsourcing and acquisition costs. The OECD's nexus ratio is expressed as:

$$\frac{a+b}{a+b+c+d}$$

where:

- *a* represents R&D expenditures incurred by the taxpayer itself;
- *b* represents expenditures for unrelated party outsourcing;
- *c* represents acquisition costs; and
- *d* represents expenditures for related party outsourcing.

This means that full relief is available except to the extent to which the taxpayer outsources to third parties or buys in the IP. The OECD report allows its members to elect to uplift *a* and *b* in the numerator by up to 30% to minimise the restrictions on the relief.

Patent box regimes tend to *decrease* the likelihood of inventors moving to the country in which the patent box regime exists

The UK's patent box regime

Certain features of the UK's patent box legislation are worth highlighting, as they help to explain differences between the UK's regime and that of other countries, as well as provide a helpful backdrop to changes that are coming to the UK and also other countries with preferential tax regimes.

The legislation setting out the parameters of the UK's patent box regime are in Part 8A of CTA 2010. For accounting periods commencing after 1 April 2013, income from a range of IP rights can benefit from an effective corporate tax rate that will eventually be 10% (after being phased in). The list of IP rights the income from which can benefit from the patent box regime is set out in CTA 2010 s 357BB. Broadly, the legislation permits income from patents (and similar IP) to benefit from the regime, but notably not income from computer software (i.e. copyright).

Ownership requirements

The IP 'ownership' requirements in relation to the UK's patent box regime (CTA 2010 s 357B) enable a company to benefit from the regime if the company either:

- holds qualifying IP rights or has held an exclusive licence (which is further defined in CTA 2010 s 357BA) in respect of qualifying IP rights; or
- the company has held qualifying IP rights or has an exclusive licence in respect of qualifying IP rights.

Development requirements

Crucially, from a UK perspective, it is important that the company claiming the benefit has been involved in the innovation behind the IP. The UK's patent box regime is not designed to apply where someone else undertook all the development work and the company exploiting the IP

merely enjoys the income from someone else's research and testing. Accordingly, the development condition (set out in CTA 2010 s 357BC) needs to be met. Although the details of the development condition are broken down into four options, the essence of the requirements is that the company seeking to claim the benefit of the patent box needs to have:

1. carried out the qualifying development, i.e. created or significantly contributed to the creation of the invention or performed a significant amount of activity for the purposes of developing the invention or any item or process incorporating the invention (CTA 2010 s 357BD); or
2. been a member of a group in which another company carried out the qualifying development.

The variations on these two themes apply if companies join or leave groups. Essentially, the qualifying development needs to have taken place over a minimum period (12 months) around the time of joining or leaving the group.

If the company is in a group, the active ownership condition also needs to be met. CTA 2010 s 357BE provides that if the company itself carried out the qualifying development (as in (1) above), it will meet the active ownership condition. Alternatively, the company can perform a significant amount of management activity in relation to the rights in order to meet the active ownership condition. For these purposes, management activity means formulating plans and making decisions in relation to the development or exploitation of the rights (CTA 2010 s 357BE (3)).

Calculation of income

There are two ways to calculate the profit that can be sheltered under the UK's patent box regime.

The default method gives patent box relief by first establishing qualifying patent box trading income as a percentage of total trading income and then this percentage is applied to the profits of the trade. You use the formula:

(RIPI/TI) x 100

(as per CTA 2010 s 357C)

where:

- RIPI is trading income derived from qualifying patents; and
- TI is total gross trading income.

Calculating the relevant IP profits is a several step process (set out in CTA 2010 s 357C et sec.). In essence, the steps are designed to establish the extent of a company's profit arising from IP within the definition set out in CTA 2010 s 357BB (see above). This proportionate method can give rise to interesting outcomes, depending on the relative profit margins of the patent box and the non-patent box income.

The alternative method of calculating the income that can benefit under the UK's patent box regime is the 'streaming' method under CTA 2010 s 357D (1). Streaming can be done voluntarily or it can be mandatory. Calculating the profits that can benefit from the UK's patent box regime where streaming is utilised means that the company must divide its trading income into two streams: one consisting of relevant IP income; and the other consisting of all its other trading income.

Mandatory streaming applies if one of three conditions is met (CTA 2010 s 357DC):

- a 'substantial' (as defined in CTA 2010 s 357 DC(2)) amount has to be brought into account as a credit in calculating the profits of the trade for the accounting period, but which is not fully recognised as revenue for the accounting period;
- the total gross income of the trade for the accounting period includes, broadly speaking, relevant IP income, but also a substantial amount of licence income that is not relevant IP income; or
- the total gross income of the trade for the accounting period includes, broadly speaking, income that is non-relevant IP income and a substantial amount of licence income that is income consisting of any licence fee or royalty that the company receives under an agreement for granting certain types of rights (as set out in CTA 2010 s 357DC(8)).

How does the UK's current patent box regime measure up against the modified nexus approach?

As can be seen from this description of how the UK's current patent box rules operate, the UK already includes a form of development condition. The requirement to continue to be involved in developing the patents goes a long way to achieving the OECD's first recommendation that access to the preferential regime should be conditional upon carrying out R&D activities. In addition, the UK's patent box regime also includes a system for streaming income, either voluntarily or mandatorily.

The UK already includes a form of development condition

One area that needed to be adjusted, however, is the UK's current method for calculating how much of a company's income should be able to benefit from the regime. The modified nexus approach looks at establishing the relevant proportion of expenditure on qualifying IP and applying that proportion to the overall income of the taxpayer.

In response to the OECD's Action 5 report, the UK is in the process of introducing (as part of the Finance Bill 2016) new provisions that will require all profits to be streamed to calculate the relevant IP profit that can benefit from the patent box regime. A new step in the calculation of how much income can be included in the patent box regime multiplies the net income of the qualifying IP (i.e. qualifying IP income less the required deductions for corporation tax deductible expenses, as well as income allocated to a marketing return) by an R&D fraction. The calculation of the R&D fraction is set out in the proposed new CTA 2010 s 357BM – 357BH.

The proposed new CTA 2010 s 357BMA defines the R&D fraction as the lesser of:

- 1; and
- (D + S1) x 1.3 / (D + S1 + S2 + A)

where:

- D is the company's qualifying expenditure on in-house relevant R&D;
- S1 is qualifying expenditure on relevant R&D subcontracted to unconnected persons;
- S2 is qualifying expenditure on relevant R&D subcontracted to connected persons; and
- A is qualifying expenditure on acquiring relevant qualifying IP rights.

The multiplication by 1.3 applies the 30% 'uplift' to the numerator, which is permitted by the OECD rules, increasing the fraction to allow for various circumstances

in which substantive activity by the company would not contribute to an aspect of qualifying expenditure, for example, because of its group structure.

The new rules are proposed to apply to all companies from 1 July 2021, to companies electing to be governed by the new rules from 1 July 2016, and for IP created or acquired after 30 June 2016 (Finance Bill 2016 cl 60, which introduces new Chapters 2A and 2B to CTA 2010). The existing rules run in parallel in the interim.

Other well-known patent box regimes

There are a number of well-known patent box regimes in other jurisdictions that are summarised below.

Belgium

Similar to the UK's regime, Belgium only allows income from qualifying patents to be included in its patent box regime. Belgian companies can then deduct 80% of qualifying gross patent income from their taxable income, the standard rate of corporation tax applying to the remaining 20%. Income that can be deducted includes royalties and licence fees (including 80% of the hypothetical licence fee in cases where patents are used in the manufacture of patented products).

The patent must have been developed (or further improved after having been acquired) by a Belgian company (or a Belgian permanent establishment (PE) of a foreign company) in order to qualify. Whilst the research and development centre must be owned by the Belgian company, it can be located outside of Belgium.

It is expected that Belgium will amend its regime to refine what qualifies for the 80% deduction.

France

In France, qualifying IP income is taxed at a 15% rate of corporation tax (normally it is 33.33%), with IP income being classed as royalty income and capital gains made from the transfer or sale of the IP. The regime applies to patents granted in France and to European patents if the invention would have been registrable in France. Other IP rights are not included. The regime applies to taxable income derived from the licence, sub-licence, sale or transfer of patents, patentable inventions (and improvements made to them) and industrial manufacturing processes that are the continuation of patents.

The IP rights must be owned by the French company. If IP rights have been acquired by the French company, they must be owned for at least two years before the relief can be claimed.

Interestingly, it is not anticipated that the BEPS recommendations will result in significant changes to the existing regime.

Netherlands

On income from IP arising from R&D activity, including global patents, the Netherlands applies a 5% tax rate. The regime applies to all net profits attributable to the qualifying IP, as well as net capital gains. The regime also applies to profits embedded in the sale of goods or services, although more than 30% of the derived income must be attributable to the patent right itself.

Since qualifying IP may originate from R&D undertaken by or for a Dutch taxpayer, it could include trade secrets and other non-patented products. For patents, the activities can be carried out abroad; but IP that has obtained the Dutch government's R&D declaration must be performed in the Netherlands.

On 19 May 2016, the Netherlands government launched a public consultation on the proposed changes to the regime. It is expected that amending legislation will come into force on 1 January 2017. The amendments include the following changes:

- For SMEs, qualifying intangible assets must be self-developed from direct R&D activities; businesses will require 'R&D wage tax certificates' from the Dutch government.
- For other taxpayers, the point immediately above will also apply; but in addition qualifying intangible assets will include patents, software programmes and marketing authorisations for human or veterinary medicines.
- Qualifying income is to be determined according to qualifying intangible asset(s). Limits will be applied to the income if R&D is outsourced to group companies according to qualifying R&D expenses (that is, the total of R&D expenses minus those related to the R&D outsourced to group companies).

Spain

The Spanish government exempts from corporation tax some 60% of net income arising from the licencing or transfer of certain intangible assets. The exemption also extends to capital gains for the transfer of IP assets to unrelated parties. Qualifying IP rights include certain technological IP, patents, secret formulae or processes, designs or models, plans or information concerning industrial, commercial or scientific equipment. Royalties from any other source (such as trademarks or software) are expressly excluded. The exemption applies to gross patent income.

The Spanish regime applies to entities that participate in at least 25% of the cost of creating the IP.

Spain has announced changes to its patent box regime to bring it in line with the 'modified nexus approach', to come into force on 1 July 2016, though a transitional regime will be available.

Under the new rules, the IP income to which the beneficial rate applies will be proportionate to the expenditure linked to generating that income. The 60% exemption will still apply, but there will be a limit to the relief available in cases where the taxpayer was not responsible for developing the intangible asset itself.

Cyprus

Cypriot companies are entitled to an 80% relief for income generated from IP or the disposal of IP for income tax purposes. The regime applies to a wide range of intangible assets, including copyrights, patented inventions and trademarks. The IP must be used in the production of income. Relief is offered for any income generated from IP or the disposal of IP (net of direct expenses). The IP must be owned by a Cypriot resident company, although the IP can be officially registered either in Cyprus or abroad.

There is no requirement that the IP be self-developed by the company.

Last December, Cyprus announced that it would adapt its regime in line with the 'modified nexus approach'. Among the anticipated changes are: the reduction in qualifying IP assets (including the complete removal of trademarks); R&D expenditures will in future need to be 'tracked and traced'; and, in cases of IP asset acquisition,

the regime will only apply to expenditure made on improving the IP asset.

Luxembourg

In Luxembourg, there is an 80% exemption from net income derived from qualifying IP, which results in an effective tax rate of 5.7%. The definition of IP covered is broad, including patents, trademarks, designs, domain names and software copyright. The regime includes royalties and licence fees. If patents have been developed by the company and are used internally, a notional royalty can also be included (as if the company had licensed the right to use the patent to a third party).

Net capital gains are also included in the regime.

The economic owner of the IP rights has to be a Luxembourg company, which can develop or acquire the rights (but does not in fact have to improve them) and must have exclusive exploitation rights in the country for which protection is granted.

In October 2015, a bill was presented to the Luxembourg Parliament to abolish the existing regime because it was not in line with the 'modified nexus approach'. It is likely that Luxembourg will introduce a new regime, but no details have been provided as yet. Taxpayers already benefiting from the existing regime can continue to do so.

Have any countries taken the opportunity to introduce new regimes?

Italy

Italy introduced an exemption from both corporate income tax and local tax on income derived from qualifying intangible assets. For 2015 and 2016, the exemption is 30% and 40% of the relevant income, after which it rises to 50%. Italy also has an exemption on the capital gains on an IP transfer, although 90% of the amount paid has to be reinvested into other IP.

The qualifying intangible assets can include patents, certain brands 'functionally similar to patents', and a wide range of industrial, scientific and commercial formulae and processes, such as trade secrets and designs.

Qualifying income, which includes exploitation of copyrights, is calculated by multiplying the overall income derived from the IP asset by the ratio of 'qualifying R&D expenditures' over the 'total expenditures incurred to develop IP'. Eligible R&D activities include basic research, applied research, design, creation of software, IP registration costs and promotional activities. The R&D activities must be carried out directly by the taxpayer (in Italy) or through agreements with universities of other research entities.

Together with Italian companies, foreign companies with a permanent establishment in Italy can take advantage of this relatively new regime, as long as they are resident in a country with a double taxation treaty with Italy.

Ireland

In Ireland, a tax rate of 6.25% will apply to profits derived from qualifying IP for Irish companies and from qualifying R&D activity that leads to the creation of qualifying assets for Irish-resident companies. The new regime covers patented or similarly protected inventions and, possibly, copyrighted software. The taxpayer must have incurred the R&D expenditure and this expenditure is subject to the same technical qualification criteria as would be the case for R&D tax credit claims under the existing R&D tax credit legislation.

What challenges lie ahead?

The above review of established or recently introduced IP regimes in several different countries illustrates how quickly the situation is changing and the conflicting pressures on national governments to address public concerns about harmful tax practices and the desire to create a competitive tax regime. We can expect to see other countries follow suit, seeking to balance as best as possible the advantages of a preferential tax regime with the enhanced requirements of the modified nexus approach.

The changes that have been made to date by individual countries are instructive.

> A due diligence exercise may or may not reveal whether the target's records enable the buyer to identify IP assets

Much has been written about the challenges of these newly redesigned IP regimes. For example, tracking R&D expenditures over long periods of time in order to enable the relevant R&D fraction to be calculated can be difficult for many companies. These types of challenges can become compounded in the event of an M&A transaction. For example, a due diligence exercise may or may not reveal whether the target's records enable the buyer to identify IP assets in the old as well as the new regimes. In addition, it may be more difficult to track expenditures on old assets, as the grandfathering provisions come to an end in 2021. These and other issues will need to be assessed as companies determine how beneficial a particular IP regime will be to them. ■

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