The Changing Landscape for IP Regimes Around the World

Patent Boxes, Innovation Boxes, Intangible Property Boxes, Knowledge Development Boxes (IP Regimes) – countries may use different names, but all of these regimes are designed to allow a preferential rate of tax to be applied to income generated from intangible property (IP).

There are a number of these regimes in place around the world, many in Organisation for Economic Co-operation and Development (OECD) member countries.

In the past, the OECD reviewed its member countries' regimes and determined that they met the then existing standards for preferential tax regimes. In light of the recent OECD Base Erosion and Profit Shifting (BEPS) project, specifically Action 5 which recommends a "modified nexus approach" for IP Regimes, countries may need to assess their current offerings to determine whether their regimes continue to comply with the OECD's recommendations.

In general, the modified nexus approach requires substantial economic activity in the benefiting jurisdiction, and the income benefiting from favorable tax treatment must be proportionate to the research and development (R&D) expenditures incurred by the taxpayer in relation to the IP rights in that benefiting jurisdiction.

Although the OECD cannot force their members to adopt the recommendations in the BEPS action reports, many OECD countries have agreed to comply with the requirements of the modified nexus approach as recommended in Action 5. While the OECD would like IP Regimes to be in compliance by June 30, 2016, they have indicated that countries may enact grandfathering provisions to allow taxpayers to benefit under an existing regime until June 20, 2021.

To date, most countries have yet to announce the details of how they will change their IP regimes to comply with Action 5. The below discusses the potential developments that may occur in China, Ireland, Luxembourg, Netherlands, Spain, Switzerland, the UK, and the US.

China

For several years, China has granted income tax incentives related to qualifying technology income, which includes technology transfers, together with relevant technical consulting, technical services and technical training.

In October, China, which is not an OECD member, announced and clarified that these tax incentives for technology transfers would include a non-exclusive license (with a term of five years or more) so that income tax payable on the license income from qualifying technology would be reduced. This includes tax on patents (inventions, designs and models), computer software copyrights, designs of integrated circuits, new bio-pharmaceutical products and other technology specified by the Ministry of Finance and the State Administration of Taxation. The portion of the annual income from technology transfers up to RMB 5 million will be exempted from income tax; the portion that exceeds RMB 5 million will be subject to income tax at a 50% reduction. Some see this initiative as affirming China's efforts to be known as a location where IP is created, rather than just a location that reproduces existing IP.

Ireland

To date, Ireland has successfully attracted multinational companies looking to structure their IP ownership through the use of amortization and stateless income, rather than formal preferential tax regimes. Ireland's so-called "double Irish structure", where one Irish incorporated company is resident in a tax haven jurisdiction, is a good example of one of the structures that the OECD wanted to address through the BEPS project. Since the double Irish structure may become less viable in the post-BEPS world, it is not surprising that Ireland has announced its intention to establish a preferential tax regime, the Knowledge Development Box (KDB).

The KDB will enable companies to pay tax at 6.25% (i.e., half of the 12.5% corporate tax rate applicable to trading income). The new rate of tax will be available for income arising in accounting periods starting from January 1, 2016. In order to meet the criteria of the modified nexus approach, the income will need to be derived from IP linked to R&D carried out in Ireland or by an offshore branch of the Irish company. Income from computer programs, as well as from qualifying patents, will be able to benefit from the reduced rate.

Although establishing a modified nexus compliant KDB regime is not as beneficial as the creation of stateless income, having a broad KDB regime is the next best alternative for an economy like Ireland. If Ireland could historically attract companies by allowing them to achieve very low effective rates of tax, it now needs to use its well-developed infrastructure to attract companies to actually carry out R&D activities in Ireland. If it is successful in this quest, it is possible the resulting benefits that will flow from a growing R&D capability will be even better for Ireland in the medium to long term than its previous "unofficial" preferential regime.

Luxembourg

Luxembourg is expected to repeal its IP Regime with effect from July 1, 2016, but with grandfathering provisions for those currently benefiting from the regime. While Luxembourg is expected to announce a new regime in the near future, it has yet to announce any details of the possible changes.

It is not surprising that Luxembourg's existing regime is one of those affected by the nexus requirement. With limited reputation as an IP hub and minimal infrastructure, space, and population to support such a hub and enable it to compete as an R&D center, it is perhaps no surprise that the Luxembourg authorities are taking some time to work out the details of their response to Action 5.

Netherlands

At the other end of the spectrum from Luxembourg, the Dutch tax authorities have confirmed their view that their existing IP Regime is largely compliant with the modified nexus approach. The extension of Dutch Innovation Box benefits to IP that is the subject of an R&D deduction will also be retained.

Spain

Spain was one of the first countries to work towards amending its IP Regime to comply with the recommendations of the OECD. Even before the final BEPS reports were released on October 5, the Spanish government had announced in August 2015 their Budget 2016 package, which included amendments to the IP Regime.

Under the existing IP Regime, a partial exemption applies to net earnings derived from the assignment of a right to use qualifying intangible fixed assets. The incentive provided a 60% exemption on such income, so long as the following conditions were met: (i) the assigning party may not reside in a tax haven; (ii) the company's stake in the creation of the asset must be at least 25%; and (iii) earnings obtained upon transfer of the asset between group companies (under conditions) cannot fall under the regime.

In response to the initial reports published by the OECD on Action 5 in September 2014 and February 2015, the Spanish government approved the following changes to the regime:

- The requirement that the company's stake in the creation of the asset must be at least 25% was abolished
- The fixed 60% exemption will be replaced by the following formula:
  - Calculate ratio
    - Numerator – total direct expenses incurred for the creation of the intangible asset (including expenses paid to third-party subcontractors) × 130%
    - Denominator – all direct expenses incurred for the creation of the IP (including expenses paid to third-party subcontractors)
  - Multiply ratio
    - By 60% to determine the exemption percentage to be applied to the taxpayer's IP income

The formula implies that the current 60% exemption will remain applicable for companies that have created the IP, but will be proportionally reduced for companies that have not created the IP. Similar to the UK, Spain has not extended the scope of its IP Regime to include computer software.

The 2016 Budget package was passed on October 30, 2015, with an effective date of July 2016 for the IP Regime amendments.

Switzerland

Similar to Ireland, Switzerland was quick to announce that it would establish an IP Regime. As it has been possible historically to obtain very competitive rates of tax in Switzerland, it also needs to make itself an attractive location for IP rich companies or risk losing existing companies, as well as future investments. The proposal (which is to be introduced at the cantonal level) will enable tax rates as low as 8.5%. The new provisions are being introduced in conjunction with enhanced tax deductions for R&D expenditures (again at the cantonal level). Switzerland seems to be more focused on attracting R&D that leads to the development of patents, as computer software does not look like it is going to be included in the Swiss IP Regime. Switzerland has been and looks like it will continue to be a jurisdiction of greater attraction to companies with patentable technology, such as pharmaceutical companies, rather than seeing itself as a technology hub like Ireland.

The speed at which Switzerland has announced its proposals to introduce a BEPS compliant IP Regime (to replace its historic system of agreeing low tax rates on a taxpayer by taxpayer basis) is a good indication of how important a competitive tax system is to the country.

UK

The UK's existing IP Regime is close to being an acceptable model for IP Regimes under the OECD's modified nexus approach. Indeed, as one of the two countries to take the lead in developing and advocating for the modified nexus approach, one would expect the UK to adjust its current approach less than most.

On December 9, 2015, the UK announced that it intends to include changes to its IP Regime in the proposed 2016 Finance Bill. The changes would be effective from July 1, 2016 and include grandfathering provisions. The UK had previously confirmed its commitment to having an IP Regime that complies with the modified nexus approach. Interestingly, the UK has not taken this opportunity to extend the scope of its IP Regime to include computer software. Presumably, the UK sees itself more similar to Switzerland (in relation to the kind of R&D for which it is best suited) than Ireland.

One of the main changes the UK proposed is to withdraw the proportional split method of calculating profit for the IP Regime. Proportional split is a method of calculating the income to which the IP Regime can apply by reference to IP profit as a proportion of total profit. As readers may be aware, the modified nexus approach focuses on calculating the appropriate amount of profit that can benefit from the IP Regime by reference to qualifying expenditures as a proportion of total expenditures.

The UK's proposal requires companies to allocate separate qualifying income and deductions to "sub-streams" corresponding to the different IP assets (or products, or product families) and to then calculate a profit for each sub-stream. For purposes of calculating the nexus fraction (which is the proportion of the profit from the IP which may be included in the IP Regime), companies would then take into account only development activity undertaken by the company itself for each asset (or products, or product families). The resulting profit would be eligible for taxation at the reduced corporate tax rate of 10%. There is a view that, following the introduction in 2012 of the UK's current IP Regime, there were good examples of companies deciding to carry out some of their R&D activities in the UK because of the ability to take advantage of the IP Regime (for example, the news reports of GlaxoSmithKline's decision to locate a £200m R&D facility in the UK). If this is correct, it is not surprising that the UK has acted quickly to propose revisions to its existing IP Regime.

US

In the US, an IP Regime proposal was introduced with fairly liberal definitions of intangible property and qualifying income such that many feel the regime may not be compliant with the modified nexus approach if enacted as proposed. While the discussion in the US has emphasized the need for the IP Regime to be broad enough that many taxpayers can benefit from it, there is acknowledgement that the US will be under significant pressure to comply with the OECD's recommendations. Most agree, however, that it will be important for the US to enact some form of IP Regime in order to remain competitive with the growing number of countries that already have IP Regimes in place.

First Among Equals

The swift response from several OECD countries to harmonize their preferential IP tax regimes with the modified nexus approach almost certainly reflects the importance to certain countries of the competitiveness of their tax regimes. If IP Regimes need to look more similar to each other going forward, the race to become first among equals will be won by the combination of a preferential tax regime and all the other aspects that go into making an attractive jurisdiction for inward investment, not least good infrastructure, a suitably educated and accessible workforce, a reliable political and legal environment and, of course, a broadly competitive tax system that goes beyond just a preferential IP tax regime. We expect OECD member countries with existing IP Regimes to adapt them to meet the modified nexus requirements. It will also be interesting to see what else OECD member countries adapt to maintain their attractiveness for inward investments in a world of apparently ever more level playing fields.

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21631/12/15