1. Introduction

1.1 Who would have thought that there would be competition in the autonomous vehicles space or organs would be printed on a 3D printer?

1.2 The relentless parade of new technologies is unfolding on many fronts. No Ordinary Disruption: The Four Global Forces Breaking All the Trends, a book written by McKinsey directors Richard Dobbs, James Manyika, and Jonathan Woetzel, offers insight into which developments will have the greatest impact on the business world in coming decades. Their “Disruptive Dozen” includes energy storage, autonomous vehicles, advanced robotics and renewable energy. These technologies may have the greatest potential to remake today’s business landscape.

1.3 So what is the starting point of these disruptive technologies? These are results of painstaking efforts of the R&D function.

1.4 In this cutting-edge based global economy, Research and Development (‘R&D’) and innovation are increasingly important components of national economic success, particularly for nations that must compete on factors other than just low factor costs. Research and development is a component of Innovation and is situated at the front end of the Innovation life cycle. Innovation also leads to higher productivity and higher wages, and is a key driver for stronger trade performance. The return on investment on R&D efforts can take a while to materialise and hence Companies tend to focus more on “development” and less on “research” mainly to meet short term operational goals. Given this, the intervention of the Government to stimulate R & D is justified since without such intervention, companies may tend to under invest in R & D compared to the appropriate level of spillovers that R & D may generate for society.

1.5 From an India perspective, a tax policy for innovation indeed goes very well with the current Government emphasis on ‘Make in India’, ‘Startup Action Plan’ and ‘Digital India’.

2. R & D Incentives

Types of Incentives

2.1 Input Incentives

Input Incentives come into play at the beginning of the R & D process when expenses are incurred. These incentives include tax credits, enhanced allowances (super deductions) and accelerated depreciation.

2.2 Output Incentives

Output Incentives, known as Patent Boxes, aim at fostering R & D by providing preferential treatment for income from qualified intangible assets.

2.3 R & D Incentives and Tax Neutrality

In direct taxes, there is a common agreement that taxes should be levied on a uniform basis. The principles of universality and uniformity of taxation require that taxpayers be subject to identical rules and the tax system should not favour (or discriminate against) a particular group of taxpayers. One intuitively perceives that R & D tax incentives, which create a positive distortion in favour of a certain type of activity, do not fulfil the criteria of tax
neutrality. It can be argued that R & D tax incentives breach the principles of equality of treatment and ability to pay by providing a favourable tax treatment to taxpayers performing certain activities than those who do not.

3. **What is a Patent Box Regime**

3.1 Patent Tax concessional regime is primarily a ‘back end’ incentive i.e. they apply after the technology is developed thereby encouraging inventors to maintain their patent in the country where it was developed. In order for domestic businesses to be globally competitive, commercialization of such R&D is essential for economic growth. Hence in those lines, the Patent tax regime has evolved. These tax incentive regimes are often called Patent Box, Innovation Box or License Box regimes.

3.2 **Why is it called a Patent Box?**
The concept was first introduced in 2000 by the Irish and in 2001 by the French Tax Authorities as a reduced rate of tax on revenue from IP licensing or the transfer of qualified IP. It was called Patent Box by the Irish Tax Authorities because there is a box to tick on the tax form. Ireland faced severe criticism in the recent past for its controversial tax mischief legislation viz., Double Irish tax relief and has modified its patent box regime with the new nomenclature ‘Knowledge Development Box’.

3.3 Patent Box Regimes are common in the EU countries and UK also has a Patent Box Regime. It needs a separate mention after Brexit.

3.4 Surprisingly United States, which is at the forefront of technological advancement is yet to introduce a patent box regime. It may be introducing such a regime and could be implemented post the presidential election.

3.5 **Why would a Patent Box Regime be considered a Harmful Tax Practice?**

There were some Patent Box Regimes which were tax driven and wen against the fundamental principle that income should only benefit from an IP regime to the extent the taxpayer itself incurred the expenditure that contributed to the IP. There should be a direct nexus between the income receiving the benefit and the expenditures contributing to the income. It needs to be ensured that taxable profits should not be artificially shifted away from the countries where value is created. Given this concept, the Organisation for Economic Co-operation and Development (‘OECD’) released Action Plan 5 *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance and is discussed below. The discussion is limited to IP Regimes*


4.1 The OECD commenced effort on addressing harmful tax competition in the late 1990s, resulting in a 1998 report, Harmful Tax Competition: An Emerging Global Issue (the 1998 Report). It also created the Forum on Harmful Tax Practices (‘FHTP’) to take this work forward.

4.2 In Action Plan 5 - Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance (‘BEPS Action 5’), the OECD builds on the conclusions of the 1998 Report. It expands the role of the FHTP, by committing the FHTP to “revamp the work on harmful tax practices.” The FHTP is asked to focus particularly on defining substantial activity as a requirement for any preferential regime; improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes; and evaluating
preferential tax regimes in the BEPS context. The Harmful Tax Practices Report follows a progress report that was released on 16 September 2014 (‘Progress Report’).

4.3 The OECD uses the framework under the 1998 Report for determining whether a regime is a harmful preferential regime and uses 3 stages as follows:

Consideration of whether a regime is within the scope of work of the FHTP and whether it is preferential;

Consideration of the four key factors and eight other factors set out in the 1998 Report to determine whether a preferential regime is potentially harmful;

Consideration of the economic effects of a regime to determine whether a potentially harmful regime is actually harmful.

4.3.1 “Regimes” within the scope of work of FHTP

The FHTP focuses exclusively on regimes applying to income from geographically mobile activities, such as financial and other service activities, including the provision of intangibles. Preferential regimes designed to attract investment in plant, building, and equipment are outside the scope. The focus is primarily on business taxation, including both national and sub-national taxes and consumption taxes are explicitly excluded.

4.3.2 “Preferential” regime

In order for a regime to be considered preferential, it must offer some form of tax preference in comparison with the general tax rules in the relevant country and not with any other country. This would include reduced tax rates as well as reductions in the tax base or preferential terms for the payment or repayment of taxes. Even a small degree of preference is sufficient for the regime to be considered preferential.

4.3.3 What makes a preferential regime “potentially harmful”

Once a regime has been identified as “preferential,” four key factors and eight other factors are used to determine whether the preferential regime is potentially harmful. The four key factors are:

i. The regime imposes no or low effective tax rates on income from geographically mobile financial and other service activities.

ii. The regime is ring-fenced from the domestic economy.

iii. The regime lacks transparency (e.g., the details of the regime or its application are not apparent, or there is inadequate regulatory supervision or financial disclosure).

iv. There is no effective exchange of information with respect to the regime.

The first factor (no or low effective tax) is a gateway criterion: if this criterion is not met, the regime will not be considered harmful. If the criterion is met, the other three key factors and, where relevant, the eight other factors need to be evaluated. It only takes one of the remaining three key factors to be met to have a regime characterized as potentially harmful. The eight other factors generally help to spell out, in more detail, some of the principles and assumptions that should be considered in applying the key factors themselves. They are:

i. Artificial definition of the tax base

ii. Failure to adhere to international transfer pricing principles

iii. Foreign source income exempt from residence country taxation

iv. Negotiable tax rate or tax base

v. Existence of secrecy provisions

vi. Access to a wide network of tax treaties

vii. Promotion of the regime as a tax minimization vehicle
viii. Encouragement of operations or arrangements that are purely tax-driven and involve no substantial activities

4.3.4 What makes a potentially harmful regime “actually harmful”

The final step is to determine whether a “potentially” harmful regime, according to the factors described above, is “actually harmful” by analyzing whether it has harmful economic effects. This analysis considers whether the regime results in a shift of activities from one country to the country providing the regime rather than generating new activities, whether the activities in the host country are commensurate with the amount of investment or income, and whether the preferential regime is the primary motivation for the location of an activity.

4.3.5 Consequences of a regime being found to be harmful

Where a regime is found to be harmful, the relevant country is given the opportunity to abolish the regime or remove the features that create the harmful effect. Other countries may take defensive measures to counter the effects of the harmful regime. Also, under BEPS Action 5, rulings on potentially harmful regimes would have to be spontaneously exchanged with foreign tax authorities. This requirement would apply whether or not the regime is actually harmful.

4.4 Substantial activity

Substantial activity was already considered as one of the “other factors” in the 1998 Report. This factor looks at whether a regime “encourages purely tax-driven operations or arrangements” and states that “many harmful preferential tax regimes are designed in a way that allows taxpayers to derive benefits from the regime while engaging in operations that are purely tax-driven and involve no substantial activities.” This factor will be considered alongside the four key factors when determining whether a regime is potentially harmful. This means that a regime that meets the “no or low effective tax rates” test (key factor 1, which acts as a gateway test) will be considered harmful if there is no substantial activity in the country granting the regime.

Meaning of substantial activity in the context of IP Regimes

There is very limited guidance on what constitutes “substantial activity” which was included in the 1998 Report. The substantial activity requirement applies to all preferential regimes in scope. However, in the first instance the FHTP focused on defining the concept of substantial activity in the context of IP regimes (i.e., regimes providing preferential tax treatment for income arising from qualifying intellectual property).

The FHTP considered the following approaches to defining the substantial activity requirement in relation to IP regimes:

A value creation approach that would require taxpayers to undertake a set number of significant development activities in order to be entitled to an IP regime.

A transfer pricing approach that would require a set level of important functions being assumed in the jurisdiction of the regime by the taxpayer that intends to apply the regime. The taxpayer would have to be the legal owner of the assets giving rise to the tax benefits, use those assets, and bear the economic risks of such assets.

A nexus approach that links the benefits of the regime with the R&D expenses incurred by the taxpayer.
The 2014 Progress Report suggested that the nexus approach was the most appropriate, indicating that the transfer pricing approach was only supported by a few countries and the value creation approach did not have any support over the other two.

4.5 **Nexus Approach**

4.5.1 The OECD BEPS report adopts a “nexus approach” for preferential IP regimes, requiring alignment of the benefits of these regimes with substantive R&D activity. The nexus approach looks at whether an IP regime makes its benefits conditional on the extent of R&D activities of the taxpayers receiving the benefits where the actual R&D activity was undertaken by the taxpayer itself. This requires a direct nexus between the income receiving the benefit and the expenditures contributing to the income. R&D expenditure therefore acts as an indicator of substantial activities. It is not so much the amount of expenditure but the proportion of expenditure directly related to development activities that demonstrate the value added by the taxpayer and acts as a proxy for how much substantial activity the taxpayer undertook. The purpose of the nexus approach is to grant benefits only to income that arises from IP where the actual R&D activity was undertaken by the taxpayer.

4.5.2 According to the OECD, “expenditures act as a proxy for substantial activities.” Mere capital contributions or expenditures for substantial R&D activity by parties other than the taxpayer are not qualifying IP expenditures, except where such activities are undertaken by unrelated parties, irrespective of their residence. Expenditures for activities undertaken by related parties would not count as qualifying expenditures. The rationale behind this approach is that the FHTP considers it unlikely that a company will outsource the fundamental value-creating activities to an unrelated party, regardless of where that unrelated party is located. The Final Report gives countries the option to limit unrelated outsourcing to a certain percentage or proportion.

4.5.3 The proportion of income that may benefit from an IP regime (“the nexus ratio”) is the same proportion as that of qualifying expenditures compared to overall expenditures. This is summarized in the following formula given in the Final Report:

\[
\frac{\text{QE}}{\text{OE}} \times \text{Overall Income from IP Asset} = \text{Income receiving tax benefits}
\]

where: QE means ‘Qualifying Expenditure’
OE means ‘Overall Expenditure’;

4.6 **Qualifying Expenditure**

Qualifying expenditures must have been incurred by a qualifying taxpayer, and they must be directly connected to the IP asset. Qualifying expenditures will be included in the nexus calculation at the time they are incurred, regardless of their treatment for accounting or other tax purposes. In other words, expenditures that are not fully deductible in the year in which they were incurred because they are capitalised will still be included in full in the nexus ratio starting in the year in which they were incurred.

To counter any possible incentives for taxpayers to undervalue transfers between related parties, any related party acquisitions of IP will require documentation substantiating the arm’s length price. “Acquisitions” include any transfer of rights whether or not a payment was actually made. A number of the current IP regimes also apply to acquired IP. Under the nexus approach these IP regimes need to be amended to avoid being considered harmful tax regimes, because capital expenditures to acquire IP will be excluded from qualifying expenditures. Only the expenditures incurred for improving the IP asset after it was acquired...
will be treated as qualifying expenditures. Acquisition costs will, however, be included in overall expenditures and will therefore reduce the portion of qualifying expenditures compared to overall expenditures (which in turn will reduce the income that could benefit from an IP regime). As a result, if a taxpayer does not continue to develop acquired IP, there will effectively be no benefit under an OECD-compliant IP regime under this approach.

Where the taxpayer continues to develop the IP, the benefits will likely be reduced under this approach compared to the benefits currently available under a number of IP regimes.

When calculating qualifying expenditures, countries may permit taxpayers to apply a 30% “up-lift.” This up-lift may increase qualifying expenditures but only to the extent that the taxpayer has non-qualifying expenditures. This means that the increased amount of qualifying expenditures cannot exceed the taxpayer’s overall expenditures. Its purpose is to ensure that the nexus approach does not penalize taxpayers excessively for acquiring IP or outsourcing R&D activities to related parties.

4.7 Qualifying Taxpayer

Qualifying taxpayers would include resident companies, domestic permanent establishments (PEs) of foreign companies, and foreign PEs of resident companies that are subject to tax in the jurisdiction providing benefits.

4.8 Qualifying IP

Many of the current IP regimes do not only apply to patents, but also apply to marketing-related IP such as trademarks. Under the nexus approach, the only IP assets that could qualify for tax benefits under an IP regime are patents and other IP assets that are functionally equivalent to patents, if those IP assets are both legally protected and subject to similar approval and registration processes. IP assets that are functionally equivalent to patents are:

- Patents defined broadly (i.e., utility models, IP assets that grant protection to plants and genetic material, orphan drug designations, and extensions of patent protection)
- Copyrighted software
- Other IP assets that are: – Non-obvious, useful and novel – Substantially similar to IP assets in the first two categories – Certified as such in a transparent certification process by a competent government agency that is independent from the tax administration with certain limits

As a result, many current IP regimes will have to be amended in order for them not to be considered as harmful tax regimes.

4.9 Expenditure and income

Taxpayers that want to benefit from an IP regime will have to track expenditures in order to be able to substantiate the nexus between expenditures and income and to provide evidence of this link to tax administrations. In principle, this would be a link between expenditures, IP assets and IP income, and taxpayers would have to track to IP assets. However, where such tracking would be unrealistic and require arbitrary judgments, countries may also allow a product-based approach.

Under this approach qualifying and overall expenditure would not be tracked in relation to specific IP assets but in relation to specific products to which IP assets contribute. This would require taxpayers to include all qualifying expenditure linked to the development of all IP
assets that contributed to the product in “qualifying expenditures” and to include all overall expenditures linked to the development of all IP assets that contributed to the product in “overall expenditures.” However, in certain cases (the Final Report gives the example of medicines that are produced in different colors, dosages or sizes) tracking on an individual product-basis also would not be appropriate. In those cases tracking could be in relation to product families. The Final Report contains a list of mandatory documentation requirements, including, but not limited, to information on how the expenditure was tracked.

4.10 Grandfathering of existing IP regimes

Many existing IP regimes, including all the 16 regimes reviewed by the FHTP do not meet the requirements resulting from the modified nexus approach. The Final Report contains the following guidance on grandfathering. No new entrants should be permitted to any existing IP regime after 30 June 2016. If a new regime consistent with the nexus approach takes effect before 30 June 2016, no new entrants should be permitted after the new regime has taken effect. “New entrants” includes both taxpayers not previously benefiting from the regime and new IP assets owned by taxpayers already benefiting from the regime. Jurisdictions are permitted to allow taxpayers to benefit from the existing regime until a specified abolition date, which may not be later than five years after the date the regime is closed to new entrants, which means that the latest possible date is 30 June 2021. Legislative processes to implement a new IP regime must begin in 2015. The IP regime should not be granted in respect of IP acquired directly or indirectly from related parties after 1 January 2016 (unless such assets already benefitted from an IP regime prior to such transaction). An exception would apply to acquisitions from related parties if this acquisition is part of a domestic or international business restructuring intended to transfer IP assets to regimes that are being modified to comply with the nexus approach.

5. India – R & D Function

5.1 Prior to Budget 2016, India did not have an extremely favourable tax regime for R & D. India, despite having a talent pool, still lacks in indigenous research. We have a situation where foreign companies like GE and Shell come and set up R&D centres here and gain competitive advantage globally.

5.2 R & D incentives in India prior to Budget 2016

5.2.1 Indian R & D incentives were limited to input incentives ranging from grants and weighted deduction in respect of R&D expenditure to tax holidays and accelerated depreciation on R&D assets.

5.2.2 Generally, R&D incentives in India are territorial in nature and hence are available to Indian companies or Indian owned companies.

5.2.3 A nodal agency (DSIR) has been established by the Government, under the Ministry of Science and Technology, which formulates and administers various incentive schemes for promoting R&D in India. The tax payer must avail of one of the schemes floated by the DSIR, Government of India, and make an application to the agency, giving necessary information. The DSIR may call the taxpayer for clarifications and after due deliberations, approve the proposal, thus making the taxpayer eligible for R&D incentives.

5.2.4 The schemes are designed by DSIR to encourage R&D by Indian companies. However, certain types of incentives are available to Foreign Companies and PEs of foreign companies as well, e.g. super deduction in respect of contribution made by such PEs to an approved scientific research association or university or college in India.
5.2.5 Though there have been several controversies regarding non-discrimination provisions in relevant treaties concluded by India on which courts have pronounced their judgments, the issue of R&D incentives (relating to non-discrimination provisions) has not specifically come up before the Courts.

5.3 Patent Box Regime introduced in Budget 2016

5.3.1 The Government identified the need for a favourable tax regime for the R & D function and introduced the Patent Box Regime in India in the Budget 2016.

5.3.2 India has been pro-active and the introduction of such a global regime, which seems early, implies that there is a definite focus on innovation and research in the country.

5.3.3 The Finance Minister in his budget speech mentioned that “Research is the driver of innovation and innovation provides a thrust to economic growth. I propose a special patent regime with 10% rate of tax on income from worldwide exploitation of patents developed and registered in India.”

5.3.4 The Memorandum to the Finance Bill, 2016 mentions the reason for introduction of the Patent Box Regime as follows:

“Taxation of Income from 'Patents'

In order to encourage indigenous research & development activities and to make India a global R & D hub, the Government has decided to put in place a concessional taxation regime for income from patents. The aim of the concessional taxation regime is to provide an additional incentive for companies to retain and commercialise existing patents and to develop new innovative patented products. This will encourage companies to locate the high-value jobs associated with the development, manufacture and exploitation of patents in India.

The Organization for Economic Cooperation and Development (OECD) has recommended, in Base Erosion and Profit Shifting (BEPS) project under Action Plan 5, the nexus approach which prescribes that income arising from exploitation of Intellectual property (IP) should be attributed and taxed in the jurisdiction where substantial research & development (R&D) activities are undertaken rather than the jurisdiction of legal ownership only.”

5.3.5 Therefore as part of the measures to promote socio-economic growth, India introduced the Patent Box Regime which provides a special tax regime for incentivizing R & D to spur commercialization of domestic R&D by taxing patent revenues differently from other commercial revenue is a much needed fillip for our country.

5.3.6 From the Budget memorandum, it appears that India had been inspired to bring in such a regime on account of the principles laid down in Action 5 of the OECD BEPS which focuses on countering harmful tax practices.

5.3.7 As mentioned in Paragraph 4 above, the OECD considers that a preferential Intellectual Property regime can potentially constitute a harmful tax practice if it allows taxpayers to derive benefits while engaging in operations that involve limited substantial activities. Therefore, it suggested a modified nexus approach.
5.3.8 What is India’s Patent Box Regime?

(i) Patent Box Regime is an output incentive complimenting the current input incentives already given to the taxpayers.

(ii) India’s patent tax regime allows a concessional tax rate on revenue derived from patents. A new section 115BBF of the Income-tax Act, 1961 (‘Act’) has been introduced as follows:

a. where the total income of an **eligible assessee** includes any income by way of **royalty** in respect of a **patent developed and registered in India**, then **such royalty shall be taxable at the rate of 10 %** (plus applicable surcharge and cess) on the **gross amount of royalty**.

b. No expenditure or allowance in respect of such royalty income shall be allowed under the Act.

(iii) Definitions in the order in which the words are used in the Section are as follows:

(a) ‘**eligible assessee**’ means a person resident in India and who is a patentee;

(b) ‘**patentee**’ means the person, being the true and first inventor of the invention, whose name is entered on the patent register as the patentee, in accordance with the Patents Act, and includes every such person, being the true and first inventor of the invention, where more than one person is registered as patentee under that Act in respect of that patent

(c) ‘**true and first inventor**’ does not include either the first importer of an invention into India, or a person to whom an invention is first communicated from outside India (as per Section 2(y) of the Patents Act, 1970

(d) ‘**royalty**’ in respect of a patent, means consideration (including any lump sum consideration but excluding any consideration which would be the income of the recipient chargeable under the head “Capital gains” or consideration for sale of product manufactured with the use of patented process or the patented article for commercial use) for the—

(i) transfer of all or any rights (including the granting of a licence) in respect of a patent; or

(ii) imparting of any information concerning the working of, or the use of, a patent; or

(iii) use of any patent; or

(iv) rendering of any services in connection with the activities referred to in sub-clauses (i) to (iii)

(e) ‘**patent**’ means a patent for any invention granted under the Patent Act (Section 2(1)(m) of the Patent Act)

(f) ‘**invention**’ means a new product or process involving an inventive step and capable of industrial application (Section 2(1)(i) of the Patent Act)

(g) ‘**inventive step**’ means a feature of an invention that involves technical advance as compared to the existing knowledge or having economic significance or both and that makes the invention not obvious to a person skilled in the art (Section 2(1)(ja) of the Patent Act)

(h) ‘**developed**’ means at least seventy-five per cent of the expenditure incurred in India by the eligible assessee for any invention in respect of which patent is granted under the Patents Act, 1970
(iv) From the above, it can be construed that the Patent tax regime in India is primarily a financial incentive provided by the Government to commercialize Indian patents and thereby enabling India’s economic growth.

(v) Qualifying IP assets

The Section applies only to income from patents registered under the Patents Act, 1970 and does not extend the benefits to other IP assets that are functionally equivalent to patents — such as formulas, processes, designs, patterns, know-how and inventions — even though they may not be eligible for or may not have sought patent protection.

A lot of innovation in India is taking place in the computation software and digital economy and it is unclear whether Patent Box tax regime would be available in respect of such innovation. In case of computer related inventions, Section 3 of the Patents Act, 1970 provides that a computer program per se is not patentable. The Indian Patent Office in February 2016 issued guidelines for the examination of Computer-Related Innovations patent applications which clarify that a number of CRIs such as computer programs per se, algorithms and mathematical models may not be eligible for patent protection and hence may make a number of technology-driven companies ineligible for the regime.

Therefore, unless a computer program is eligible for patent registration, it would not be entitled to the tax exemption.

Obtaining a patent registration may be a time-consuming process, while commercial exploitation of the IP may commence pending registration. An IP-intensive business may have a bundle of IPs that are exploited on an aggregate basis, while only some of the IPs may be patented. In such situations, breaking the aggregate income from IP exploitation and allocating it to patented IP may be a challenge.

Considering these situations, the scope of qualifying IP assets may need to expand beyond registered patents. Specifically, the issue should not be whether or not an IP is patented (or even patentable), but rather whether the IP is linked to qualifying R&D substantial activity and corresponding expenditure in the relevant jurisdiction.

(vi) Qualifying IP income

IP income that qualifies for the preferential tax treatment under the Section royalty earned from exploitation of a patent. Income from sales of goods manufactured is not a qualifying income. It may be noted that IP income may also be embedded in the sale of products and benefits may need to be granted to such an income as well. A consistent and coherent method may be needed for separating income unrelated to IP (e.g., marketing and manufacturing returns) from income arising from IP.

Expanding the coverage of qualifying IP income to IP income embedded in the sale of manufactured products would also support the Government’s “make in India” and would also be compliant with Action 5.

(vii) Optional

To avail the benefits of the lower rate of taxation mentioned in the scheme is at the option of the assesse. The Taxpayer should be mindful that even if in 1 out of 5 years gross basis tax is not paid, the Taxpayer would not be able to claim benefit of the lower tax rates for 5 years.

(viii) No deduction of expenses
It has been mentioned that if royalty from patents is taxed at the rate of 10%, the assessee would not be allowed deduction of expenses.

*Depreciation*
In the initial years, till depreciation is high, one may consider not taking the benefits under the lower rates of the patent box regime since the cost of depreciation would be high and may even result in a tax loss in the initial years.

Let us take an example of a patent developed and registered in India at a value of Rs. 5 crores and royalty income @ 5% which is Rs. 10 crores.

In initial years, the depreciation on patent of Rs. 5 crores @ 25% would be Rs. 1.25 crores. Tax on gross basis on Income of Rs. 10 crores @ 10% would be Rs. 1 crore. If tax is paid under the normal provisions after considering deduction of expenses, there would be loss of Rs. 25 lakhs.

*Other expenses*
The current section does not provide the nature of expenses which would not be allowed as a deduction. However, as per general understanding, any expenses incurred for earning the royalty income would not be allowed as a deduction.

Given the above, it would be best to check the tax payable under both the scenarios before a decision is taken to avail the benefits of the lower rate of taxation under the patent box regime. This should also be read with sub-paragraph (vii) above on the scheme being optional for the Taxpayer.

(ix) Developed
In the Finance Bill 2016, the definition of ‘developed’ was ‘means the expenditure incurred by the assessee for any invention in respect of which patent is granted under the Patents Act, 1970’.

The Section as introduced in the Act has amended this definition as follows: ‘developed’ means **at least seventy-five per cent of the expenditure incurred in India by the eligible assessee** for any invention in respect of which patent is granted under the Patents Act, 1970.

Under the Section which has been introduced some leeway has been given and the Taxpayer can incur up to 25% of the expenditure for the patent outside India. In that sense, it is not territorial. This may have been considering that the Taxpayer may have to incur expenditure outside India. However, it does not mention whether the payment can be made to a related party and whether arms’ length principles would be applicable to such expenditure.

5.4 Indian Patent Box Regime vis-à-vis Action 5’s nexus approach

5.4.1 The following chart outlines the comparison:

<table>
<thead>
<tr>
<th>Feature</th>
<th>Action 5</th>
<th>Indian Patent Box Regime</th>
</tr>
</thead>
<tbody>
<tr>
<td>Objective</td>
<td>Benefits are conditional on R &amp; D activities of the Taxpayer</td>
<td>No specific link with the expenditure</td>
</tr>
<tr>
<td>Qualifying Taxpayers</td>
<td>Resident Companies, domestic Permanent Establishments of Foreign Companies and Foreign PE’s of Resident Companies</td>
<td>Qualifying taxpayer is a person resident in India. An Indian PE of a foreign enterprise will therefore be not covered.</td>
</tr>
</tbody>
</table>
which are subject to tax in the jurisdiction providing benefits

| Formula for calculation of deduction | Proportion of income that benefits from the incentive is the same proportion that qualifying expenditures bear to the overall expenditure. The nexus ratio applied to the ‘Overall income from IP asset’ is: Qualifying Expenditures incurred to develop IP asset Overall expenditures incurred to develop IP asset The expenditure on acquired IP and related party outsourcing would not be included in the Qualifying Expenditure (i.e. in the numerator) but will be included in the Overall expenditure thereby reducing the ratio to be applied for claiming the tax relief. Regimes may also provide for a 30% up-lift on qualifying expenditures subject to overall limits, to cater to taxpayers that acquire IP or outsource activities. | Beneficial rate of 10% applicable on the income by way of royalty in respect of the patent developed and registered in India. No deduction of expenditure in relation to the income is allowed to the taxpayer |

| Qualifying IP assets | Patents and other IP assets that are functionally equivalent to patents if they are both legally protected and subject to similar approval and registration processes. Broadly include Patents, copyrighted software, other IP assets that are non-obvious, useful and novel (Refer Paragraphs 34-38 of the Final Report) | Qualifying IP Assets are only Patents registered under the Indian Patents Act, 1970. The Taxpayer should incur at least seventy-five per cent of the expenditure in India for the patent to qualify the patent for the beneficial rate of tax |

| Overall Income | Overall income should be obtained by subtracting IP expenditures allocable to the income and incurred in the | Gross royalty income and other income including capital gains, embedded income are not included |
year from gross IP income earned in the year. Such income may include royalties, capital gains, income from sale of IP assets, embedded income from sale of products/processes directly related to the IP asset.

<table>
<thead>
<tr>
<th>Qualifying Expenditures</th>
<th>Directly related to the IP Asset</th>
<th>No specific mention for qualifying expenditure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expenditure on Outsourced R &amp; D Activities</td>
<td>Expenditures incurred by related parties (through outsourcing) would not be included in qualifying expenditures. Unrelated outsourcing may however be permitted up to certain levels.</td>
<td>No specific conditions provided for outsourcing. The benefits are available to the patent holder, even though some of the activities would have been outsourced.</td>
</tr>
</tbody>
</table>

5.4.2 The ‘Nexus’ in the Indian Patent Box regime

In the Indian patent box regime, there is no express condition on the income deriving the tax benefits and the quantum of R&D expenditure incurred.

The following definitions under Section 115BBF would be relevant in implanting the ‘nexus’ approach within the Indian regime:

- “developed” means at least seventy-five per cent of the expenditure incurred in India by the eligible assessee for any invention in respect of which patent is granted under the Patents Act, 1970
- “patentee” means the person, being the true and first inventor of the invention, whose name is entered on the patent register as the patentee, in accordance with the Patents Act, and includes every such person, being the true and first inventor of the invention, where more than one person is registered as patentee under that Act in respect of that patent;

These conditions indicate a nexus with R&D activities being carried in India, other than the leeway of 25% as discussed above. However, the specific limitations as prescribed under BEPS report for acquired IP and for related party outsourcing are not included in the Indian tax law.

5.4.3 Indian Patents Act

The process of registering a patent in India is not an easy and is time consuming – could take between 4-8 years. As per statistics available, the number of applications filed for patents in India has reduced.

The main condition for claiming the benefit of the lower tax rate mentioned in the patent box regime is that the patent must be developed (with a leeway of 25%) and registered in India. Even though the registration takes 4-8 years, but patent is effective retrospectively, the tax benefit would only be available prospectively.
There is no specific restriction under Patents Act for outsourcing of research & development activity, whether to a third party or to a related entity. However, outsourcing of R&D outside India, may be subject to the definition of ‘developed’ under Section 115BBF of the Act.

6. Way Forward

6.1 The introduction of the Patent Box Regime under the Indian Tax Law is a welcome move and is in conjunction with the ‘Make in India’, ‘Start up India’, ‘Digital India’ initiatives of the Government of India. With a strong technology- and knowledge-driven economy, India may be in a sweet spot to attract investors in such a regime. Given the competition with more favourable patent box regimes in other countries, especially in the EU, the Government could consider further improving the regime as follows:

6.1.1 Extending the benefit to other IP assets which are functionally similar to patents - This will make a wider range of innovative and knowledge-based enterprises eligible to claim the benefits and Action 5 does not seek to limit the qualifying IP assets to only patents

6.1.2 Extending the benefit to Income from IP income embedded in the sale of manufactured products – This would also support the Government’s “make in India” and would also be compliant with Action 5

6.1.3 Certain exemptions / deductions could be given considering that patents are granted retrospectively to cover the period of 4-8 years taken to register the patent

6.1.4 Reduction in the time required to register a patent

6.2 The BEPS Report lists down 16 country’s regimes on tax-incentives for IP that are inconsistent (partly or fully) with the nexus approach. These countries include UK, Netherlands, China, Belgium, France, Italy, Luxembourg, Spain. The BEPS Report also states that “Countries with such regimes will now proceed with a review of possible amendments of the relevant features of their regimes”. In light of this, we may have to make amendments to the reconsiders the Indian Patent Box regime to meet the BEPS tests.