BEPS AND BEYOND BEPS:

A BRAVE NEW WORLD IN INTELLECTUAL PROPERTY TAXATION?

Shreyash Shah\(^1\)

In an increasingly interconnected world, national tax laws haven’t always kept pace with global corporations, fluid movement of capital and the rise of the digital economy, leaving gaps and mismatches that can be exploited to generate double non-taxation. This can undermine the fairness and integrity of tax systems. Base Erosion and Profit Shifting (BEPS) is the act of using tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity, resulting in little or no overall corporate tax liability.

Intellectual property ("IP") is highly mobile and can be easily separated from the jurisdiction where it was developed and migrated to low-tax jurisdictions. Over the last few decades, a greater proportion of IP (and the resulting revenue stream) has been moved offshore to minimize tax. In response, some countries have adopted the concept of a "patent box," a tax regime that sharply reduces the rate of corporate tax applied to income resulting from qualifying IP.

*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.

In general, most businesses would prefer general tax relief in the form of an overall corporate tax rate reduction. However, since in some countries incentives can be viewed politically as more feasible than reducing overall corporate tax rates, an alternative tax reform scenario could be the adoption of a patent box regime. Such a regime likely would encourage companies to locate the high-value jobs and activity associated with the development, manufacture, and exploitation of patents in-country.

\(^1\) The author can be reached at shreyash91@gmail.com
What is a patent box?

A patent box regime is simply one where a jurisdiction encourages businesses to invest in, and create, local jobs and activity associated with researching, developing, and creating patents. Preferential tax treatment allows a business to pay a lower rate of corporation tax on profits it can directly attribute to the patent box activities.

However, Action 5 – Countering Harmful Tax Practices More Effectively, contained in the Organisation for Economic Co-operation and Development (OECD)'s report into BEPS suggests patent box regimes are preferential regimes that potentially give an unfair tax advantage over those jurisdictions that have no equivalent.²

The patent box originated in the early 1970s, when the Irish government granted full tax relief for royalties and other income generated from licenses patented in Ireland. Various foreign governments have enacted patent box regimes with the following objectives:

- Retaining income from the creation of intellectual property (IP) within their home countries
- Retaining and attracting engineers and other high-tech talent from around the world

The current conflict

In the past, the OECD reviewed its member countries’ regimes and determined that they met the then existing standards for preferential tax regimes. Many countries have encouraged R&D activity with favourable tax rates between 0% and 15%. With normal rates of corporation tax as high as 45%, this offers an attractive opportunity to reduce group tax, especially given that patent box companies do not typically generate a high level of costs.

There are a number of these regimes in place around the world, many in OECD member countries. Examples include the Netherlands’ application of a reduced rate of five percent to income derived from qualifying IP and Belgium and Luxembourg’s exemption of 80

percent of patent income from corporate tax. The introduction of patent boxes around the world makes holding patents and certain other IP in countries with patent boxes more attractive. As a result, the governments of countries without a patent box regime may want to consider tax policies providing incentives to encourage companies to retain IP in those countries once created.

Patent box regime rates vary as follows: France allows companies paying the French corporate tax rate of 33 percent to pay 15 percent on income from patents and royalties. In the Netherlands, the regime applies a 5 percent rate to patent income, while the U.K. rate is 10 percent, Hungary’s is 8 percent, Belgium’s is 6.3 percent and Luxembourg’s is 5.76 percent.

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.

There is a downside: this system is open to abuse. Companies produce patents in a high-tax jurisdiction, creating tax-deductible expenses. They then shift the profits to a low-tax jurisdiction. This means the country that carries the expenses burden does not benefit from any tax revenue from the profits.

*The LuxLeaks scandals brought to light how multinationals in the EU avoided paying millions of dollars in corporate taxes. A year after, the OECD presented the final package of the international tax reforms discussed previously by the G20 finance ministers. One of its key focuses is the amendment of the IP (intellectual property) regime, such as the patent box regime, so it can create real activity, as opposed to only a way to shift profits for multinationals. The question now is whether the changes will spur growth or not.*
This conflict needs careful handling: how to root out harmful tax avoidance while continuing to encourage innovation. This is what BEPS Action 5 – Countering Harmful Tax Practices More Effectively aims to do.

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 next year, 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.

**Overview of BEPS Action Plan 5 - Harmful Tax Practices**

The initial Action 5 report follows a three-pronged, question-based approach to assess whether a preferential IP (or Patent Box) regime is harmful:

- Is activity shifted from one country to another country due to a preferential tax regime rather than generation of a significant new activity?
- Is the presence and level of activities in the host country commensurate with the amount of investment or income derived in the host country?
- Is the regime’s primary motivation the location of an activity or the location of the income?

In November 2014, the U.K. and German governments proposed changes to the OECD’s Forum on Harmful Tax Practices by adding a “modified nexus approach” requirement to preferential IP regimes under the Action 5 initiative. Under the new “OECD Action 5 Model,” countries with existing IP regimes would have to enter into informal consultation with the OECD to agree on ways to modify their existing regimes. They also would have to close these regimes to new IP by June 30, 2016, and abolish them by June 30, 2021. After they’re abolished, new regimes would be required to conform to the final OECD Action 5 model.
The modified nexus approach would require an IP regime to adopt the following limits:

- The regime is limited only to patents and other similar assets.
- The benefit of the regime is limited to the percentage of actual research and development (R&D) expenses incurred by the entity seeking benefits to worldwide R&D costs. This includes an “uplift” of 30 percent on additional outsourced contract R&D activities, including acquisition costs, and an assessment of the functions, assets and risks of the entity claiming benefits.
- The regime isn’t permitted to engage in related-party outsourcing beyond the 30 percent limit noted above, regardless of whether the R&D activity was performed in the same country where the entity is formed.
- The regime isn’t permitted to classify acquisition costs as a qualified expenditure, except when the cost falls within the 30 percent uplift exception noted above; this eliminates the benefit of a “buy-in” payment.

The modified nexus approach would further require taxpayers to track and trace their expenditures; the country hosting the IP regime would remain responsible for verifying the benefits upon audit. Enforcement of the new rules would rest with the Forum on Harmful Tax Practices, which consists of government representatives from participating countries operating in complete secrecy.

In the Oct. 5 briefing at the OECD in Paris, Mr. Pascal Saint-Amans, director of the OECD’s Center for Tax Policy and Administration, didn't mince words in his presentation on Article 5.

“We don't like patent boxes in terms of tax policy, and they can be extremely harmful if they are given to IP, which isn't developed locally on site,” Mr. Pascal Saint-Amans said.

To rectify this, the OECD’s Article 5 recommendations propose a minimum standards test to allow governments to assess whether there is substantial activity in a preferential regime. This will follow the nexus approach described above.
The article discusses the potential developments that may occur / have occurred in India, Belgium, China, Cyprus, Hungary, Italy, Ireland, Luxembourg, Netherlands, Portugal, Spain, Switzerland, the United Kingdom and the United States. Before we look at the development in IP Regimes in the aforementioned countries, following is a checklist of some possible issues in the design of a patent box regime may include:

- **Qualifying IP**
  - In-country patent
  - Other IP, e.g., copyright, formula, process, design, pattern, knowhow, format?
  - Self-developed, contract, and acquired IP?
  - IP development (R&D) activities required to be performed in-country?

- **IP Income in "Box"**
  - Gross or net IP license income
  - Capital gains?
  - Self developed IP embedded in price of goods or services?
  - Bundled IP licenses

- **Treatment of Income in "Box"**
  - Deduction or partial exclusion?
  - Use of credits against tax on income in box
  - AMT treatment?
  - Cap on tax benefit?

- Elective or Mandatory? If elective, for all IP or per unit of IP?
- Coordination with Existing R&D incentives

### 1. Patent Box – Made in India for Modi's 'Make in India' Project

In order to encourage indigenous research & development activities and to make India a global research & development (R & D) hub, the Government has decided to put in place a concessional taxation regime for income from patents. The Finance Minister in the Budget speech said, “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.”

The aim of the concessional taxation regime is to provide an additional incentive for companies to retain and commercialize 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.

OECD has recommended in BEPS project under Action Plan 5, the nexus approach which prescribes that income arising from exploitation of IP should be attributed and taxed in the jurisdiction where substantial R&D activities are undertaken rather than the jurisdiction of legal ownership only.

The Patent Regime is introduced by insertion of a new Sec. 115BBF in the Income-tax Act, 1961. The new section 115BBF provides that where the total income of the 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 ten per cent.

An eligible assessee would mean a person resident in India, who is the true and first inventor of the invention and whose name is entered on the patent register as the patentee in accordance with Patents Act, 1970 and includes every such person, being the true and the first inventor of the invention, where more than one person is registered as patentee under Patents Act, 1970 in respect of that patent.

Illustration

Assessment Year: 2017-18

XYZ Private Limited

<table>
<thead>
<tr>
<th>Particulars</th>
<th>(Amount in INR)</th>
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<tbody>
<tr>
<td>Royalty from patents</td>
<td>100</td>
</tr>
<tr>
<td>Expense incurred on patents</td>
<td>(30)</td>
</tr>
<tr>
<td>Copyright Software Revenue</td>
<td>100</td>
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</tbody>
</table>

http://www.mca.co.in/knowledge-centre/budget-2016-heralds-a-concessional-tax-regime-for-income-from-patents
<table>
<thead>
<tr>
<th>Particulars</th>
<th>Tax Calculation</th>
<th>(Amount in INR)</th>
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<tbody>
<tr>
<td>Royalty</td>
<td>100*10%</td>
<td>10</td>
</tr>
<tr>
<td>Copyright Software Income</td>
<td>(100-50)*30%</td>
<td>15</td>
</tr>
<tr>
<td>Other Business Income</td>
<td>(100-50)*30%</td>
<td>15</td>
</tr>
<tr>
<td><strong>Total tax liability before Surcharge &amp; Cess</strong></td>
<td></td>
<td>40</td>
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As seen in the above illustration, the new beneficial rate of 10% under Sec. 115BBF of the Income-tax Act, 1961 is applied on the gross royalty revenue. The person entitled for this concession will be person resident in India who is the true and first inventor of the invention and whose name is entered in patent registered as the patentee in accordance with Patent Act 1970. Also Intellectual Property income to qualify for such beneficial rate should be from a patent developed and registered in India. Developed in India has been defined to mean the expenditure incurred by the assessee for any invention in respect of which patent is granted under the Patents Act, 1970.


2. **Belgium**

The Belgian government has recently introduced in Parliament a draft bill on urgent tax measures. This draft bill aims to, amongst others, abolish the Belgian patent income deduction regime.

The abolishment of this favourable regime, on the basis of which enterprises were allowed to deduct 80% of the income derived from patents from their taxable basis, is a direct consequence of the OECD recommendations that were made in the framework of Action 5 of the BEPS action plan.\(^4\)

The abolition of the Belgian ‘Patent Box’ regime has effectively entered into force on 1 July 2016, but it will be accompanied by a transitory regime of five years. Under this optional transitory regime, enterprises will have the right to apply, or continue to apply, the 80% patent income deduction until 30 June 2021 with regard to income derived from: (i) patents that have been obtained before 1 July 2016 and for which the “old” patent income deduction has already been applied, (ii) patents that have been applied for before 1 July 2016 but are only effectively obtained after that date, or (iii) patents that have been acquired from another party before 1 July 2016 and of which the patented products and processes have been improved after this date.

Even though no draft bill has yet been introduced in this respect at this time, the Belgian government intends to provide for a new tax incentive for innovation income with retroactive effect as from 1 July 2016. This new regime will coexist with the old patent box regime during the aforementioned five year transitory period. On the basis of the currently available information, the key characteristics of the new regime appear to be as follows:

The new regime will have certain limitations that the old regime did not have income from qualifying IP assets will only be able to benefit from the new tax incentive if the relevant enterprise has incurred qualifying expenses by itself relating to the development of those IP assets. Under this so-called “nexus approach”, enterprises will only be able to

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apply the new favourable tax regime if they have a *sufficient level of substance* in terms of R&D activities conducted with a view to creating qualifying IP rights.

3. **China's R&D Tax Incentives**

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 biopharmaceutical 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 (Chinese Yuan) 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.

4. **Cyprus Patent Box**

**Up to 30th June 2016**, the Cyprus IP tax regime provided for an 80% exemption on the income derived from the exploitation of the IP as well as on any profit relating to the disposal of such IP. Cyprus offers an advantageous regime for businesses investing in IP rights. The IP Box Scheme put in place with effect from 1st January 2012 was a package of incentives and tax exemptions concerning income from intellectual property rights, intended to urge investment in research and development.
The Cyprus corporate income tax rate at 12.5% would normally apply to the 100% of net profits produced. However, following the applicable tax exemptions, only 20% of the profits will be taxed, reaching an effective rate of 2.5% per annum. At 2.5%, this rate is considerably lower than the respective percentage in other countries offering similar ‘IP Box’ schemes, including Luxembourg at 5.7%, the Netherlands at 5% and the United Kingdom’s ‘Patent Box’ regime at 10%.

The efficient IP tax regime of Cyprus in conjunction with the protection offered by EU and all major IP treaties and protocols in which Cyprus is signatory is what makes Cyprus highly attractive for the acquisition or development IP assets.

In an effort to respond to the critics of the international competition in nexus-free patent boxes, the OECD published a detailed report, the Action 5 of the BEPS Action Plan. Based on this detailed report, on 30 December 2015 the Cyprus Ministry of Finance announced an amendment to the current IP tax regime to be in line with OECD’s recommendations contained in BEPS Action Plan 5.

Under this consensus the Cyprus IP Box Regime accepted ‘new entrants’ until the 30th of June 2016. As the new regime will phase out gradually, Cyprus will be allowed to introduce grandfathering rules and will protect in this way the taxpayers who benefit from the current regime. Under these rules companies entering the Cyprus Regime until 30th of June 2016 can benefit of its provisions until 30th of June 2021. For the purposes of the above provisions, ‘new entrants’ can be both taxpayers who were not benefiting from the existing regime before and new IP assets held by taxpayers already benefiting from the existing regime.

**Tax Incentives offered under the Old Cyprus Patent Box**

i. 80% of any income generated from IP owned by Cypriot resident companies (net of any direct expenses) is exempt from income tax.

ii. 80% of profit generated from the disposal of IP by Cypriot resident companies (net of any direct expenses) is exempt from income tax.
iii. Any expenditure of a capital nature for the acquisition and/or development of IP can be claimed as a deduction in the tax year in which it is incurred and the immediate four following years on a straight-line basis.

For an IP to secure the above benefits the taxpayer should be the owner of the IP, officially registered either in Cyprus or abroad, and the IP should be used in the production of income. Further, Cyprus’ wide network of double tax treaties will be considerably reduced foreign withholding taxes on royalty income.

**The new IP Box Regime**, defines what constitutes qualifying intangible assets, qualifying profits/income, overall income and qualifying expenditure, as well as guidelines for maintaining accounting records.

The most significant change which will have an impact on many existing IP structures is that rights used for the purposes of marketing products and services such as business names, brands, trademarks, image rights etc. will no longer be considered as qualifying intangible assets.

Additionally, qualifying expenditure will only include the total research and development costs incurred in any tax year wholly and exclusively for the development, improvement or creation of qualifying intangible assets and where costs are directly related to the qualifying intangible assets. An uplift expenditure will be added to this.

The calculation of taxable income will remain consistent with the previous IP Box Regime, and continue to allow for an 80% of the qualifying income to be treated as a deductible expense for tax purposes. In the case of losses only 20% of the loss can be carried forward or be surrendered for the purpose of group loss relief.

Proper books of account and records of income and expenses must be kept for each intangible asset by any person who wishes to claim the above described benefit.

**The revised IP Box Regime is applicable from 1 July 2016 onwards.**
5. Hungary

In order to comply with the requirements set out in BEPS Action Plan 5, Hungary has revamped its preferential tax regime related to income derived from IP, making the regime much more stringent. *The new BEPS compliant regime will apply to IP acquired after 30 June 2016.*

*Under the current regime,* royalties from IP benefit from 50% lower taxation than the already low general corporate income tax rate applicable in Hungary, resulting in effective tax rates of between 5 to 9.5% depending on the level of profitability. In cases of significant expenditure associated with IP income, even lower effective tax rates can be achieved due to deductions from the general tax base calculated on gross income from IP, rather than on profits associated with IP. Additionally, the sale of IP currently benefits from a full tax exemption provided that a one year holding period was maintained or that the proceeds are utilised for further IP purchases.

*Under the new regime,* the definition of royalty will be limited to payments made with respect to industry related protected IP and will no longer include payments made with respect to trademarks, know-how or other marketing related IP nor will it cover IP protected by copyright laws other than copyrighted software.

Additionally, benefits will be calculated from IP related profits rather than from gross income. Further, following the “nexus approach” imposed by Action 5 of BEPS, benefits will be limited to the proportion of the taxpayer’s own R&D expenditure as opposed to acquisition costs paid for already developed IP or R&D costs incurred by other group companies.

Existing IP schemes will be able to benefit from grandfathering rules that last until 30 June 2021.
6. Italy

In 2015, Italy introduced its first Patent Box regime, a special tax benefit allowing reduced taxation for income derived from the direct use or licence of IP assets by companies and commercial entities which perform R&D activities. The programme is new to Italy but follows the recent European trend to assess appealing tax measures in order to attract foreign investments and relocate IP assets. Differing from most of the existing IP regimes in other countries, the Italian Patent Box has wider and peculiar advantages targeted specifically to the Italian market.5

**Measure of the tax incentive**

The tax relief consists of an exclusion from the taxable base – for both corporation tax (with an ordinary rate of 25.7%) and regional tax (with an ordinary rate of 3.9%) purposes – of a percentage of the income sourced from the usage of intellectual property. The percentage of income excluded is set at 30% in 2015, increasing to 40% in 2016 and 50% from 2017 onwards. The regime is optional, lasts irrevocably for five years and can be renewed.

**What types of R&D expenses are included in the Italian Patent Box?**

The regime covers traditional R&D activities such as fundamental and applied researches, but is also extended to a large number of investments which includes, for instance: studies and actions on brand development and design of products, processes and services; activities carried out in order to realize software protected by copyright; preventive research, test, market survey and other studies (counterfeiting measures included); and finally, communication and promotion activities, able to increase the distinctive features and the prestige of a brand.

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How do companies calculate Patent Box profits?

In practice, the tax relief consists of an exclusion from the eligible income of a percentage - 30% in 2015, 40% in 2016 and 50% from 2017 onwards - of the income sourced from the usage or licence of intellectual property.

The income eligible for the exemption is determined by multiplying the relevant IP income for the so called 'nexus ratio'. The relevant IP income is differently calculated in relation to its sources (eg capital gains, direct inward use or licence). The nexus ratio is the product of the division between qualifying R&D expenses and overall R&D expenses. Qualifying expenses are the sum of all the direct and indirect R&D costs borne by the company in order to maintain, develop or enhance the relevant IP asset. Overall expenses includes the sum of qualifying expenses plus the cost of production or acquisition of the relevant IP asset.

7. 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.

The assets qualifying for the regime include patented inventions, copyrighted software and other specified forms of IP, including patents pending. However, the regime does not extend to marketing intangibles such as trademarks, brands and image rights.

8. Luxembourg - Abolition of Existing IP Regime

On 14 October 2015, the Luxembourg Minister of Finance presented a bill to Parliament on the state budget for 2016. This bill contains several proposals affecting corporate taxpayers. One of the main proposals is the abolition of the intellectual property regime.

Similar tax relief systems, known as "IP box" or "Patent box", were set up by around 10 EU Member States which, being more and more competitive to attract companies to their territory, have alerted the OECD. The abolishment of the Luxembourg IP box regime is thus a logical continuation of the OECD’s actions aimed at preventing harmful tax practices, materialized in the Base Erosion and Profit Shifting (BEPS) action plan.

Further to the discussions at the international level, it was agreed that IP regimes must comply with the new modified nexus approach. This approach means there must be a direct nexus between the income receiving benefits and the activity contributing to that income.

As the current Luxembourg IP box regime is not in line with such an approach, Luxembourg Minister of Finance proposed to abolish it as of 1 July 2016 for corporate
income tax and municipal business tax purposes (and 1 January 2017 for net wealth tax purposes). The abolishment of the Luxembourg IP box regime will however be progressive, i.e., the existing regime will be maintained until 30 June 2021.

In practical terms this means that taxpayers currently benefiting from the IP regime may continue to do so until 30 June 2021, but special rules exist for new entrants. They may be admitted to the Luxembourg IP box regime up to 1 July 2016, and benefit from such regime until 30 June 2021, provided that the qualifying IP rights were:

- created or acquired from unrelated parties or improvements were made to such rights before 1 July 2016;
- acquired directly or indirectly from a related entity before 31 December 2015;
- acquired directly or indirectly from a related entity after 31 December 2015 but before 1 July 2016 and such IP rights were eligible at the time of their acquisition for the Luxembourg IP box regime or a foreign IP regime corresponding to the Luxembourg one.

In its drive toward transparency, Luxembourg should also adopt an additional measure concerning the IP regime. It was proposed in the draft law to introduce an automatic exchange of information on the identity of the taxpayers benefiting from the IP regime on rights created or acquired after 6 February 2015. Such exchange should be possible under the existing domestic legislation or provisions of a relevant tax treaty.

As the original announcement from the Luxembourg government was to modify the present regime, there will be an introduction of a new BEPS compliant regime.6

9. Netherlands

On 19 May, the Dutch Ministry of Finance issued for public consultation on the internet a draft bill for the revision of the Dutch innovation box regime. The main purpose of the draft bill is to bring the Dutch innovation box regime in line with the final report on

action 5 of the OECD base erosion profit shifting (BEPS) project. If the draft bill is adopted in its current form, some profits will no longer be eligible for the Netherlands’ lower innovation box tax rate, and some intangibles will no longer qualify for the regime.7

New innovation box proposal - All intangible assets developed after 30 June would be governed by the new regime with respect to financial years beginning on or after 1 January 2017. A grandfathering rule is proposed, providing that qualifying intangible assets created before 30 June continue to benefit from the current regime until 1 July 2021. Further, patented intangible assets or breeder’s rights developed by the taxpayer before 1 January 2017 will be considered as qualifying intangibles under the new regime, even if the proposed additional requirement under ii below is not satisfied. These will continue to qualify for the innovation box without a time limitation.

10. Portugal

The Portuguese Government has amended the tax rules applicable to corporate income deriving from patents and other industrial property rights. The new law – Decree Law 47/2016, of 22 August – is expected to meet the requirements agreed upon in the EU and OECD for combating “erosion of the tax base and the transfer of profits”.

The new law establishes a transitional regime applicable to patents and companies already benefiting from the old incentive regime, which is repealed from 1 July 2016, safeguarding the application of the same until 30 June 2021.

All patents filed by June 30 will be eligible for the regime under the existing rules whereby companies can enjoy reduced taxation of income deriving from patent transfer or licensing contracts. We note that the existing rules as well the new law apply only to “patents” (utility models are not mentioned although foreseen in the Portuguese IP law) or “industrial designs or models” (currently named designs or models).

All patents filed after June 30 will be subject to the new rules.

7 http://mnetax.com/netherlands-innovation-box-tax-regime15357-15357
11. 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.

**12. 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.
13. United Kingdom

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.

14. United States

Since the July release of a discussion draft of the Innovation Promotion Act of 2015 (IPA), 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. However, 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.

The proposal would tax certain income derived from IP at an effective tax rate of 10.15%. While the income that is attributed to IP under the proposal would be very broad, the amount of income that actually would be eligible for the reduced tax rate is reduced significantly by a factor that compares research costs incurred in the US to overall costs incurred worldwide (excluding costs of goods sold, interest and taxes). In addition, the proposal would not apply to income derived from the provision of services that involve the use of IP, nor would the proposal apply to LLCs, partnerships or other pass-through entities. A separate part of the proposal would reduce the US tax barriers for companies that on-shore their IP into the US.

CONCLUSION - WHERE THINGS ARE HEADED

The swift response from several OECD and non-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.
Hardly surprising, therefore, that there is now a stampede to introduce such tax breaks, each one tailored slightly differently.

Current providers already include Belgium, Cyprus, France, Hungary, Ireland, Luxembourg, Malta, Netherlands, Spain and of course the UK. Italy is introducing one (which will especially benefit sectors such as luxury goods and fashion), as well as Switzerland (presumably aimed at watches and cuckoo clocks). There is now also active discussion in the United States about joining the bandwagon. The United States just signaled its willingness to enter a race with the European Union for attracting technology investment — a race that will surely end with multinational enterprises walking away with the top prize. As EU jurisdictions fall over each other to adopt patent box regimes and the OECD seems ready to endorse a modified nexus approach for testing the validity of these regimes, the U.S. Senate Finance Committee’s international tax reform working group has recommended the enactment of its own preferential structure for taxing intellectual property income.

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. It is expected that countries with existing IP Regimes to adapt them to meet the modified nexus requirements. It will also be interesting to see what else the countries adapt to maintain their attractiveness for inward investments in a world of apparently ever more level playing fields.