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Intellectual Property Box Regimes

In-Depth Analysis for the TAXE Special Committee

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Intellectual Property Box Regimes

DIRECTORATE GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

Intellectual Property Box Regimes

Tax Planning, Effective Tax Burdens and Tax Policy Options

IN-DEPTH ANALYSIS

Abstract

This paper forms part of a series of analytical pieces on various key tax issues, prepared by Policy Department A at the request of the TAXE Special Committee of the European Parliament. This paper contributes to the current debate on Intellectual Property (IP) Box regimes, IP tax planning and OECD's base erosion and profit shifting (BEPS) project. The aim is three-fold: First, to provide a systematic overview of the 12 IP Box regimes in place in Europe by the end of 2014, and present effective tax rates associated with the IP Box regimes and the use of popular IP tax planning modes; second, to evaluate the IP box regimes on the basis of the EU State Aid rules and the EU Code of Conduct for business taxation; third, to discuss options to reform the taxation of IP income in order to counter profit shifting and tax base erosion.

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This paper is based on the doctoral thesis "Intellectual Property (IP) Box Regimes"[1]. The doctoral thesis was written while working at the Centre for European Economic Research (ZEW) in Mannheim and was defended in the faculty of Business Economics at the University of Mannheim on 25 November 2014. It is made freely available on line at:

http://ub-madoc.bib.uni-mannheim.de/37562/4/Dissertation_Lisa_Evers_IP_Box_Regimes.pdf.

[1] Lisa K. Evers (2014), Intellectual Property (IP) Box Regimes (Tax Planning, Effective Tax Burdens and Tax Policy Options), PhD Thesis, Mannheim University.

1. INTRODUCTION

Intangible assets constitute a major value-driver for multinational companies. The related intellectual property (IP) most notably patents, trademarks and copyrights usually does not have a fixed geographical nexus and can be relocated without significant (non-tax) costs. Multinational companies can use this flexibility to reduce their overall tax burden by allocating valuable IP to group companies resident in low-tax countries. Indeed, recent empirical evidence shows that patent applications are responsive to corporate income tax and that European companies' intangibles are more likely to be held by low-taxed subsidiaries.

Tax planning involving intangible assets has become increasingly popular and recently received widespread attention, as it has been associated with strikingly low effective tax rates on foreign profits of high-tech multinationals such as Google and Apple. This has triggered a debate on profit shifting by multinational companies through relocating valuable intangibles to low-tax countries. As opposed to tax evasion, tax planning is legal and also widely perceived as legitimate because it first and foremost exploits international tax rate differentials and a lack of harmonisation in the field of direct taxes. However, it is not desirable if it results in income not being taxed at all, so called non-taxation, as this creates a competitive disadvantage for companies which may not make use of sophisticate tax planning models, whether due to their size, their geographic focus or their business model. The OECD has acknowledged the issues associated with base erosion and profit shifting (BEPS) and has initiated an action plan to fight back BEPS. This action plan comprises actions which touch upon diverse fields in international taxation and are currently elaborated in detail.

Tax legislators in particular increasingly struggle to tax income from intangible assets in a way that prevents IP income from being shifted abroad. Moreover, policy makers are concerned that research and development (R&D) as well as innovative activities, which are associated with positive spillovers, are relocated to other countries for tax reasons. One policy response to profit shifting and tax base erosion involving intangible assets is to tighten transfer pricing rules and introduce targeted anti-avoidance provisions. For example, in 2008 Germany introduced anti-avoidance rules which govern the transfer of business functions (which may include valuable intangible assets).

The focus of this work is on a contrary approach which involves offering an attractive tax environment to retain or even attract IP income. In this regard, the most significant policy development in recent years has been the increasing popularity of Intellectual Property Box regimes. They offer a substantially reduced corporate income tax rate for income derived from patents and often other kinds of intangible assets. France (in 2000) and Hungary (in 2003) were the first countries to adopt such policies. However, IP Boxes only received widespread attention when they were introduced by the Netherlands and Luxembourg in 2007. At the beginning of 2015, 11 member states of the European Union (EU) as well as Liechtenstein and the Swiss Canton of Nidwalden operated an IP Box regime. Tax rates for eligible income vary between 0% (Malta) and 15% (France). The specific design of the regimes, most notably the scope of eligible types of IP and IP income and the treatment of expenses (i.e. the IP Box tax base) differs significantly across countries side.

It is interesting to note that many of the IP Box regimes in place in Europe have explicitly been introduced as innovation policies aimed at making the country a more attractive location for R&D activities which eventually give rise to intangible assets. This is also the tax policy aim pursued by 'traditional' R&D tax incentives such as R&D tax credits which

are now in place in many developed countries, including 10 of the 13 European countries currently operating IP Box regimes. These policies target the cost-side of R&D investment, as they are linked to the amount of R&D expenditures, whereas IP Box regimes target the income-side.

The aim of this work is to contribute to the current discussion on how to tax IP income. In doing so, it focuses on IP Box regimes and on the implications of IP tax planning. The contribution to the literature on the taxation of IP income is three-fold:

First, to provide a systematic overview of all IP Box regimes which are in place in Europe by the end of 2014. In this regard, several important elements of the regimes in addition to the statutory IP Box tax rate are considered. In particular, the scope of eligible IP, the scope of eligible IP income, the treatment of acquired IP and the determination of the IP Box tax base which involves the treatment of expenses relating to IP income.

Second, to analyse IP Box regimes and popular IP tax planning models drawing on effective tax rates. For this purpose, IP Box regimes and cross-border IP tax planning models are incorporated into forward-looking measures of the cost of capital and the effective average tax rate, building on the methodology put forward by Devereux and Griffith but with a focus on investments in self-developed intangible assets. Effective tax rates go beyond the statutory tax rate by incorporating additional aspects of a tax system, inter alia the tax treatment of R&D expenses.

Effective tax rates serve as an analytical tool for exploring the potential effects of taxes on investment decisions. In this regard, effective tax rates may on the one hand reveal tax-induced distortions of investment decisions. On the other hand, they indicate incentive effects of tax provisions such as IP Box regimes and R&D tax incentives. Hence, by incorporating IP Box regimes and IP tax planning models into measures of effective tax rates, the analytical tools available for analysing the potential effects of taxes are extended on investment decisions, such as where to create and exploit intangible assets. Disregarding tax planning opportunities when determining effective rates may overstate the effective tax burden multinational companies face. In addition to this, a comparison of the effective tax burden of profitable investment projects allows for assessing the attractiveness of IP Box countries in terms of a location for investments in intangibles as well as in terms of a location for the exploitation of such assets. Finally, the effective tax rates presented in the thesis may serve as tax variables for empirically investigating the incentive effects of taxes on investment decisions.

Third, to contribute to the current tax policy debate on how to tax income from intangible assets, by critically discussing the IP Box regimes in place in Europe in light of their underlying tax policy goals as well as in view of the initiatives to counteract harmful tax competition and the European State aid rules. In addition, possible reform options which aim at limiting the leeway for base erosion and profit shifting involving intangible assets are discussed. In doing so, differentiation is made between the perspectives of the R&D country where IP is created, the source country where it is exploited and the residence country of the ultimate parent of a group of companies. Additionally, the implications of the base erosion and profit shifting (BEPS) project of the Organisation for Economic Co-operation and Development (OECD) are addressed and a brief summary of the implications of the proposal for a Common Consolidated Corporate Tax Base (CCCTB) in the EU for IP tax planning is provided.

2. MAIN FINDINGS

1. Tax legislators increasingly struggle to tax income from intangible assets in a way that prevents intellectual property (IP) income from being shifted abroad. In this regard, the most significant policy development in recent years has been the introduction of Intellectual Property Box regimes which have become increasingly popular among the EU member states. They offer a substantially reduced corporate income tax rate for income derived from selected kinds of intangible assets.

2. A survey of all 12 European IP Box regimes implanted in Europe by the end of the year 2014 reveals that the regimes differ considerably in terms of the IP Box tax rate, the scope of eligible types of IP and IP income, the treatment of acquired IP and the calculation of the IP Box tax base. Malta, Cyprus and Liechtenstein offer the lowest statutory IP Box tax rates (0%, 2.5% and 2.5%). In turn, France has the highest tax rate (15% plus surcharges. The widest scope of eligible types of IP can be found in the Swiss Canton of Nidwalden, Cyprus, Hungary, Liechtenstein and Luxembourg. In addition to patents, the regimes in place in these countries apply to designs, models, trademarks, copyrights (including software) and certain other types of intangibles. In terms of the types of eligible income, most regimes are limited to royalties from licensing-out IP and capital gains from the disposal of IP. Income from internal use additionally benefits from the IP Box regimes in Belgium, the Netherlands and the United Kingdom. The vast majority of IP Box countries apply the IP Box tax rate to IP profits, thereby requiring that current IP expenses (e.g. IP management expenses or financing costs) be allocated to IP income. The treatment of historical R&D expenses which have been deducted in the past before the IP Box regime was opted for differs from this in most countries. 7 out of 12 IP Box countries do not stipulate the recapture of such expenses. This implies that the original deduction of such expenses at the regular tax rate is not offset. Finally, the vast majority of regimes are available for acquired IP, without requiring that such IP be further developed by the taxpayer. Belgium, the Netherlands and Portugal are an exception to this.

3. Based on these characteristics, IP Box regimes can broadly be divided into two groups. One group of regimes (including Belgium, the Netherlands and the United Kingdom) is more targeted at incentivising R&D investment and innovation. Most notably, they focus on patents and other trade intangibles, but exclude marketing intangibles, and are available for income from internal use. The Belgian and Dutch regimes furthermore do not apply to acquired IP which is not further developed by the taxpayer. The UK regime is available for acquired IP but operates a comparably strict development and active ownership conditions. The design of the second group of regimes (including Cyprus, France, Hungary, Malta and the Swiss Canton of Nidwalden) is more suitable to attract mobile IP income, in particular by allowing acquired IP to benefit from the IP Box treatment and by not applying the regime to income from internal use.

4. Due to primary European law requirements, countries are not free to restrict the IP Box benefit to IP which has been created domestically in order to incentivise domestic R&D activity. Nevertheless, there is still some leeway to amend the regimes' design in order to strengthen the link between the IP Box benefit and real activity. In this respect, it seems sensible to exclude acquired IP and IP which was created before the implementation of the IP Box from the regimes' scope. In addition, countries should consider extending the scope of eligible IP income to income from internal use, as incorporating intangibles in the production of goods or

the rendering of services is generally associated with real activity in the IP Box countries and may give rise to positive spillovers arising from knowledge gains.

5. IP Box regimes are associated with large reductions in the effective average tax burden of investments in self-developed intangible assets. This effect stems not only from the low IP Box tax rates but from the treatment of R&D expenses. Regimes that do not require the recapture of historical R&D expenses which have been deducted before the application of the IP Box regime (and thereby at the higher regular tax rate) are particularly generous. Depending on the profitability of the investment project, these IP Box regimes may even be associated with negative effective average tax rates.

6. A comparison of the effects of IP Box regimes to those of traditional R&D tax incentives, such as R&D tax credits, shows that the IP Boxes generally reduce the effective average tax burden to a larger extent. In most IP Box countries, companies may, at the same time, benefit from both types of incentives and thereby further reduce the effective tax burden of investment projects.

7. By means of IP tax planning, multinational companies may make use of a beneficial research infrastructure and generous R&D tax incentives in one country and at the same time benefit from low tax rates on income from exploiting IP in another country (e.g. due to an IP Box regime). Popular IP tax planning models are the disposal of IP to subsidiaries resident in low-tax countries, intra-group licensing and intra-group contract R&D arrangements. The underlying reasoning is to shift profits from exploiting IP to a low-tax country and thereby to reduce the overall tax burden of the multinational, without having to shift the R&D activity as well. Countries in which IP is created usually limit the leeway for such kind of profit shifting through transfer pricing rules.

8. An amended version of the Devereux & Griffith model to incorporate these IP tax planning models shows that tax planning does not achieve its profit shifting objective if the transfer prices reflect the true value of IP. Hence, the disposal of IP to a lower-taxed subsidiary only achieves its tax planning objective of reducing the effective tax burden of a multinational group if the multinational is able to understate the value of the asset when it is transferred. By contrast, the disposal of IP triggering an exit tax on the full earnings value of the IP increases the group's effective tax burden. This implies that if the country in which the IP is created succeeds in levying an exit tax on the full earnings value of the IP upon its disposal, multinational groups of companies do not face an incentive to relocate IP to subsidiaries resident in low-tax countries. However, in theory and in practice, identifying the 'true value' of IP is a difficult if not impossible task.

9. Similarly, licensing-out IP by the parent to a low-taxed subsidiary does not result in a lower effective average tax burden of the group if the full return from exploiting the asset in the hands of the subsidiary is siphoned off to the licensor (the parent company) through a royalty payment. Licensing-out IP to low-taxed affiliate only results in a reduction of the group's effective tax burden if the royalty payment corresponds to only a fraction of the return from exploiting the asset.

10. By contrast, contract R&D arrangements which are set up in such a way that the low-taxed subsidiary commissions the parent company to carry out R&D on its behalf may generally achieve a reduction of the group's effective average tax burden, provided that the contractor is reimbursed on a cost-plus basis. According to transfer pricing rules, this requires that the principal bears the risks and the

costs of the creation of the intangible and direct and supervise the R&D activity. However, if the contractor is reimbursed based on the profit-split method, the picture is fundamentally different and largely corresponds to the case of the disposal of the asset or the licensing arrangement. This indicates that applying the profit-split method for determining contract R&D fees significantly reduces the leeway for profit shifting by means of intra-group contract R&D arrangements. These findings are of importance given a possible move towards the profit split method in certain countries or even under the OECD transfer pricing rules for intangible assets which are currently under revision.

11. The introduction of an IP Box in Cyprus (2012) and the United Kingdom (2013) stirred up a discussion about whether IP Boxes constitute harmful tax measures or violate the EU State aid rules. In the past, the Spanish IP Box, which applied to a wide set of IP, was not classified as State aid by the EU Commission. However, one might come to a different conclusion with regard to the regimes which are only available for patents and similar IP. Nevertheless, the regimes seem difficult to challenge through the State aid rules as they are not explicitly selective by favouring certain undertakings based on objective factors such as region, sector, size or legal form.

12. In contrast to this, it becomes increasingly clear that the Code of Conduct for Business Taxation will have a considerable impact on the IP Box regimes. At the end of 2014, the EU member states endorsed the 'modified nexus approach' which specifies the substantial activity criterion of the Code of Conduct with respect to IP Box regimes. In a second step, the Code of Conduct group concluded that all IP Boxes violate the nexus approach and need to be changed along its lines. This first and foremost involves that the amount of eligible income has to be limited to the share which relates to in-house R&D activity and R&D outsourced to third parties, whereas IP income which relates to intra-group contract R&D and acquired IP needs to be excluded for the most part. The nexus approach further limits the scope of eligible IP to patents and comparable intangibles and stipulates that the IP Box benefit should be applied to net, instead of gross, income. The implementation of the nexus approach will therefore likely result in a considerable standardisation of the IP Box regimes in the EU member states. Member states are required to amend their regimes accordingly by the end of June 2021. The implications of these developments might even extend beyond the EU as Switzerland has expressed its intention to design the proposed cantonal IP Box regime in accordance with the nexus approach.

13. Countries face several tax policy options to counteract profit shifting through IP tax planning. From the perspective of the source countries, the most commonly discussed proposals are withholding taxes on royalties and royalty deduction limitations. In turn, from the perspective of R&D countries (the countries in which IP is created), these are the application of retroactive price adjustment clauses in case of the intra-group disposal of IP and the application of the profit split method when determining contract R&D fees. Finally, the residence countries of the ultimate parent of a multinational group of companies might limit the incentive for profit shifting through controlled foreign company rules. However, all of these reform measures raise economic, legal and practical concerns. Most notably, they may be associated with double taxation if implemented on a unilateral basis. This in particular holds true if the countries involved all take measures but do not coordinate them. As a consequence, although the aim might be the elimination of non-taxation, double or even multiple taxation, might be the result. Therefore, a coordinated approach is required.

14. The current BEPS (base erosion and profit shifting) initiative of the OECD stirred up hope for a coordinated move to tackle tax base erosion and profit shifting. Several of the actions proposed by the OECD also address the issues raised by IP Box regimes and IP tax planning models. Most notably, the BEPS action plan involves revamping the OECD's work on harmful tax practices (action no. 5) and developing transfer pricing and profit allocation rules to prevent base erosion and profit shifting involving intangible assets (action no. 8). The deliverables for action no. 5 involve the application of the (modified) nexus approach when assessing whether IP Box regimes constitute harmful tax practices. Hence, the conclusions drawn for the Code of Conduct regarding the implications of the modified nexus approach for the IP Box regimes also apply here. Member states of the OECD required amending their regimes to align them with the modified nexus approach by the end of June 2021. As output for action no. 8, the OECD published a revised draft of chapter six on the transfer pricing rules for intangible assets. It remains to be seen how the revised guidelines for transactions involving intangibles will affect IP tax planning.

15. Selective and isolated changes to the current international tax system might not be sufficient. The fact that corporate taxes are not internationally harmonised constitutes one of the main reasons for intra-group profit resulting in tax base erosion. Hence, in order to address the root cause of profit shifting and tax base erosion, it might be necessary to fundamentally harmonise corporate taxation. In this regard, the concept for a Common Consolidated Corporate Tax Base (CCCTB) put forward by the EU Commission currently constitutes the most prominent reform proposal. At least within the EU, the CCCTB would eliminate the issue of profit shifting by means of IP tax planning. Instead companies would face incentives to shift labour and tangible assets, two of the three factors which form part of the formula applied to allocate a group's profits to its affiliates under the CCCTB (sales being the third). For this reason, some scholars propose to completely rely on the location of consumption for allocating profits and to replace the traditional corporate income tax involving separate accounting by a destination-based cash flow tax. Both a CCCTB and a destination-based cash flow tax raise numerous technical issues. They should therefore be further developed and considered as medium- to long-term reform options.

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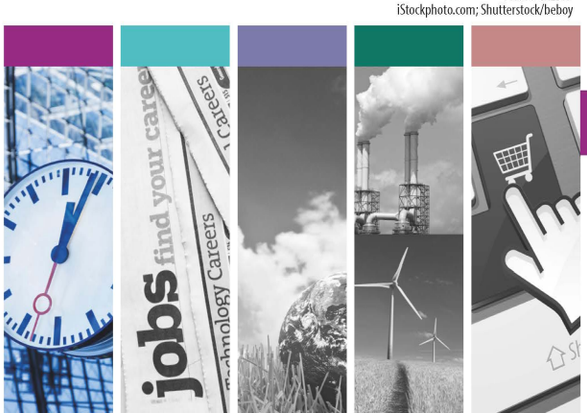

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