Morgan Lewis

IP Box Tax Regimes

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AGENDA

- IP Box basics
- Tax sticks and carrots
- International landscape—harmful tax practices
- OECD BEPS—2015 action final report topics
- OECD BEPS Action 5
- Examples of different IP Box regime tax rates
- Important aspect of IP box legislation
- U.S. IP Box prospects

What is an IP Box?

An IP Box is a set of tax laws, of a country, designed to incentivize domestic companies (parent companies, or subsidiaries of foreign parent companies) to own, develop, and exploit intellectual property in that country. The incentive comes from a lower tax rate on income from qualifying sales.

Does the U.S. have IP Box legislation?

No.

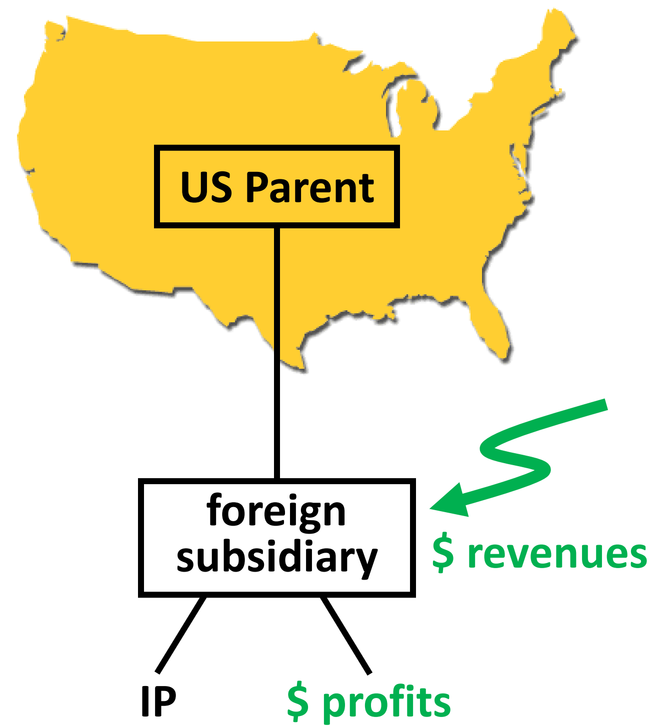
What countries have IP Boxes?

Netherlands, Ireland, UK, China, India, etc.

Will the U.S. adopt IP Box legislation?

Perhaps, but current indications suggest an IP Box won't be part of the initial proposal on corporate tax reform.

U.S. tax base erosion—the perceived problem



Concern has been raised about the ability of subsidiaries of U.S. companies that derive revenues from sales of products and services to earn profits that <u>aren't</u> taxed in the U.S. and subject to only low (or no) tax in the relevant local foreign jurisdiction.

U.S. corporate tax reform will likely try to tackle this problem in one of two ways:

<u>using a stick</u>—e.g., deem the U.S. parent to have earned income (and tax that income) to the extent the foreign subsidiary earns low tax income; or

<u>using a carrot</u>—offer U.S. companies a preferential corporate tax rate on income from IP ← an IP Box is <u>an</u> example of a carrot

Can any country incentivize companies to own their IP locally by offering them a low tax rate on IP-related income?

In theory, yes, countries are generally recognized to have a sovereign right to the sorts of taxes they impose on resident companies.

If there are no "constraints" put on IP-related tax incentives of countries, would that encourage a "race to the bottom" in terms of preferential tax rates?

Yes—so-called "tax havens" have been attracting much more attention in the past few years; they're a cause of "base erosion" (i.e., reducing the tax base of countries into which the companies sell products/services).

If so, what entity would enforce those constraints?

The Organization for Economic Cooperation and Development ("***OECD***"), with the encouragement of the G-20, took a lead role in examining IP Boxes and setting guidelines for "acceptable" incentives, building on its forum on "harmful tax practices" ("***FHTP***").

OECD BEPS—2015 ACTION FINAL REPORT TOPICS

1	2	3	4	5
address tax challenges of digital economy	neutralise effects of hybrid mismatch arrangements	strengthen CFC rules	limit base erosion via interest deductions & other financial payments	counter HTP more effectively, taking into account transparency & substance
6	**7**	**8**	**9**	**10**
prevent treaty abuse	prevent artificial avoidance of PE status	assure TP outcomes are in line with value creation: intangibles	assure TP outcomes are in line with value creation: risks & capital	assure TP outcomes are in line with value creation: other high-risk transactions
11	**12**	**13**	**14**	**15**
methodologies to collect & analyse BEPS data	require taxpayers to disclose aggressive tax planning arrangements	re-examine transfer pricing documentation	make dispute resolution mechanisms more effective	develop a multilateral instrument

coherence substance transparency

ACTION 5—FHTP BACKGROUND

- 1998 OECD *Harmful Tax Competition—An Emerging Global Issue* → 4 key factors and 8 other factors for identifying tax havens:

Key factors—

I. no or only nominal taxes

II. regime is ring-fenced from domestic economy

III. lack of effective exchange of information

IV. lack of transparency

Other factors—

(i) artificial determination of 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) regime is promoted as a tax minimization vehicle;

(viii) the regime encourages operations or arrangements that are purely tax-driven and <u>involve no substantial activities</u>.

Framework under 1998 OECD *Harmful Tax Competition* Report for determining harmful preferential regimes.

1st—is regime within the scope of the FHTP and preferential?

◊ regime must:

- relate to business taxation of relevant income from geographically mobile activities (e.g., financial & provision of intangibles); and
- be preferential in comparison with general taxation principles.

2nd—is preferential regime potentially harmful?

◊ low or zero effective taxation + one or more of remaining factors $\Rightarrow$ regime is potentially harmful

3rd—is potentially harmful regime actually harmful?

◊ regime must have created “harmful economic effects”

If a preferential regime is actually harmful $\Rightarrow$ other countries may take defensive measures to counter the effects of the harmful regime.

ACTION 5—SUBSTANTIAL ACTIVITY REQUIREMENT

◊ 2013 BEPS Action Plan Action 5 →

Revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on requiring substantial activity for any preferential regime. It will take a holistic approach to evaluate preferential tax regimes in the BEPS context. It will engage with non-OECD members on the basis of the existing framework and consider revisions or additions to the existing framework.

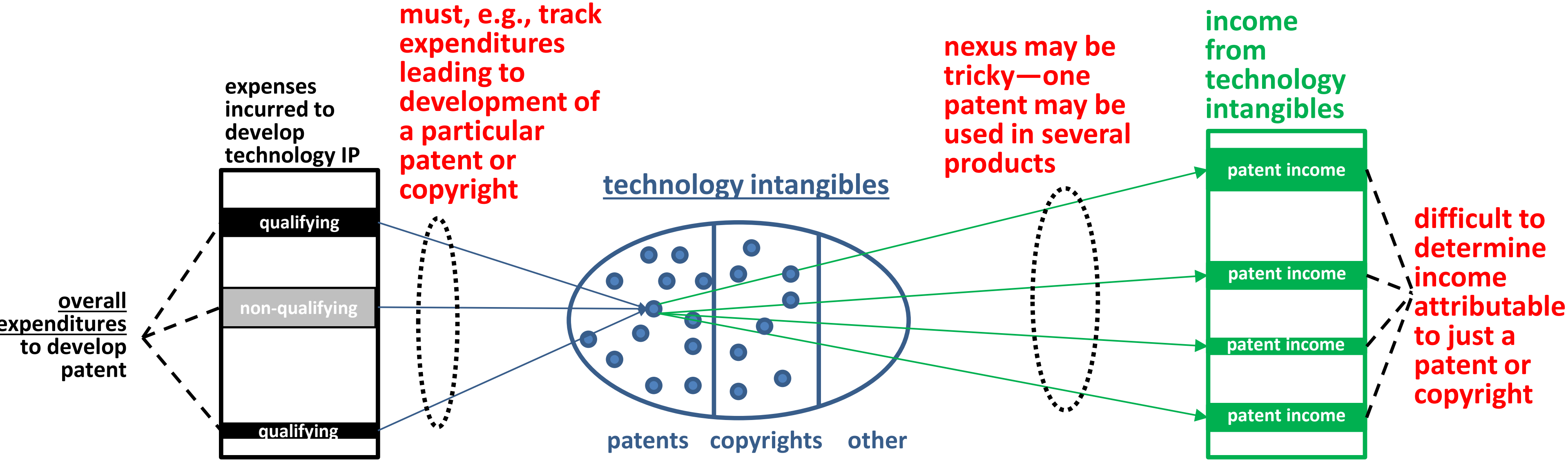
◊ 2014 BEPS Action 5 Report *Countering Harmful Tax Practices More Effectively, Taking Into Account Transparency and Substance* →

- "substantial activity" factor + four key factors will be used to determine whether preferential regime is potentially harmful;
- **substantial activity requirement in context of intangible regimes—**IP-intensive industries are a key driver of growth and employment; countries are free to provide tax incentives for R&D activities provided they're granted according to principles agreed by FHTP.

OECD adopts modified IP-based nexus approach—

$$\text{income receiving tax benefits} = \frac{\textit{qualifying expenditures}\ \text{incurred to develop IP asset}}{\textit{overall expenditures}\ \text{incurred to develop IP asset}} \times \text{overall income from IP asset}$$

pictorially—

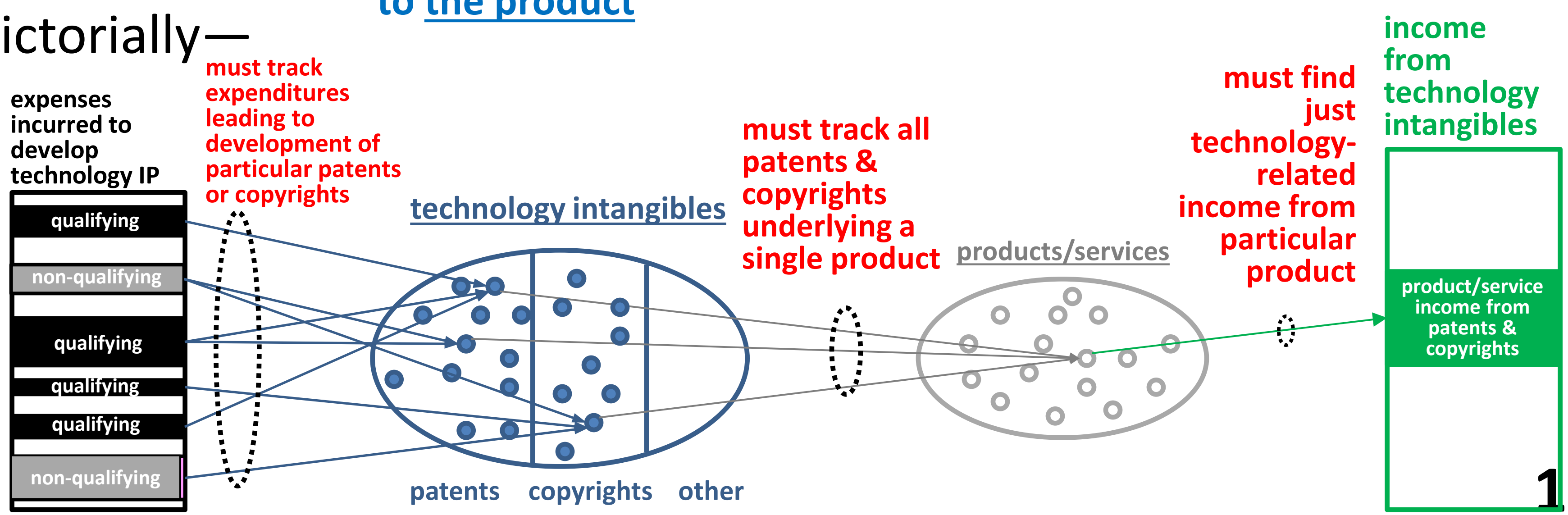


Action 5—Substantial Activity Requirement [cont'd]

IP-based nexus approach requires tracking IP expenditures, IP assets, & IP income—where such tracking would be unrealistic and require arbitrary judgments, jurisdictions may also choose to allow application of product-based nexus approach so that the nexus can be between expenditures, products (or product families) arising from IP assets, and income:

$$\text{income receiving tax benefits} = \frac{\textit{qualifying expenditures}\text{ incurred to develop }\underline{\text{all IP assets}}\text{ contributing to }\underline{\text{the product}}}{\textit{overall expenditures}\text{ incurred to develop }\underline{\text{all IP assets}}\text{ contributing to }\underline{\text{the product}}} \times \text{overall income from }\underline{\text{the product}}\text{ directly linked to all underlying IP assets}$$

pictorially—



ACTION 5—SUBSTANTIAL ACTIVITY REQUIREMENT [CONT'D]

- **IP assets**—patents and other IP assets functionally equivalent to patents, including copyrighted software
- **nexus ratio**—intended to be cumulative with time
- **nexus ratio**—could be treated as rebuttable presumption
- **qualifying expenditures**—incurred by qualifying taxpayer, directly connected to IP asset, <u>including</u> unrelated-party outsourcing but <u>excluding</u> acquisition costs
  - blue-sky R&D costs not included in qualifying expenditures of a specific IP asset "to which they have a direct link" could be spread pro rata across IP assets or products; and
  - jurisdictions may permit a 30% "uplift" to extent taxpayer has nonqualifying expenditures.
- **overall expenditures**—qualifying expenditures + acquisition costs + related party outsourcing
- **overall income**—only includes income derived from IP asset
  - services income likely included
  - must carve out income unrelated to IP assets (e.g., marketing and manufacturing returns)—e.g., using transfer pricing principles

EXAMPLES OF DIFFERENT IP BOX REGIME TAX RATES

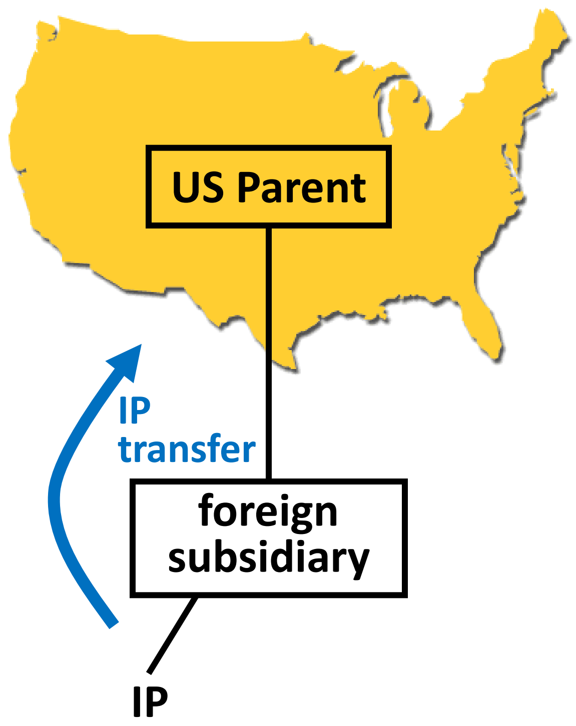
country	Patent / Innovation Box rate	statutory corporate rate
Belgium	6.8%	33.99%
China	15%	25%
France	15.5–17.1%	33.33%
Hungary	5–9.5%	9%
India	10%	30%
Ireland	6.25%	12.5%
Israel	9–16%	24%
Italy	21.98% phasing down to 15.7%	24%
Korea	5–11% (sale), 7.5–16.5% (royalty)	22%
Liechtenstein	2.5%	12.5%
Luxembourg	5.76%	27.08%
Malta	0–6.25%	35%
Netherlands	5%	25%
Portugal	11.5%	21%
Spain	11.5%	25%
Switzerland	12–15.6%	24.41%
Turkey	10%	20%
UK	phasing down to 10%	19%

IMPORTANT ASPECT OF IP BOX LEGISLATION

For U.S. companies to take advantage of an IP Box regime, they have to be able move their IP held by offshore companies back to the U.S. in a non-punitive way.

Current U.S. tax laws would trigger tax on most transfers of property from a foreign subsidiary to its parent (e.g., a distribution).

As part of implementing any IP Box legislation, U.S. tax laws would have to be changed to allow tax-free transfers of foreign-held IP rights.



US IP Box Prospects

- ◊ IP Box legislation would be one piece of corporate tax reform, which is one piece of overall tax reform (along with individual and pass-thru tax reform).
- ◊ U.S. federal government "Big 6" expected to issue a high-level tax reform document in the next month or two. Corporate tax reform topics may include—
  - corporate tax rate in low-to-mid 20% range;
  - move to some form of "territorial" tax system—i.e., low-to-no tax imposed on dividends from foreign subsidiaries;
  - deemed two-tier low-tax repatriation of existing earnings held by foreign subs.
- ◊ unclear which (other) base erosion "sticks" or "carrots" will be included.
- ◊ U.S. multinational corporations deciding whether or not to bring IP (rights) back to the U.S. will have to consider overall worldwide tax position, <u>including</u> tax initiatives of foreign countries.

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Rod Donnelly focuses his practice on the tax aspects of complex international corporate transactions. Representing large multinational corporations, his experience includes transfer pricing, especially with an intangible property component, at both the planning and controversy stages. Rod's experience also includes Subpart F and foreign tax credits, as well as tax-related aspects of manufacturing supply chain and R&D, at both the planning and controversy levels.

THANK YOU