ESTUDIOS

THE IP BOX REGIME

A STUDY FROM AN INTERNATIONAL AND EUROPEAN PERSPECTIVE

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Foreword
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To my sister, Genoveva.

Summary of Contents

List of Abbreviations

AI	Artificial Intelligence
APA	Advance pricing agreement
ATP	Aggressive tax planning
BEPS	Base erosion and profit shifting
CFC	Controlled foreign company
CGI	Code Général des Impôts (France)
CIR 92	Code des Impôts sur les Revenues 1992 (Belgium)
CIRC	Código do Imposto sobre o Rendimiento das Pessoas Colectivas (Portugal)
CIRD	Corporate Intangibles Research and Development
HMRC's	Manual (United Kingdom)
CJEU	Court of Justice of the European Union
CTA	Corporate Tax Act 2010 (United Kingdom)
CTR	Corporate tax rate
DGT	Dirección General de Tributos (Spain)
ECJ	European Court of Justice
ECOFIN	Council of Economic and Finance Ministers of the European Union
EEA	European Economic Area
EPO	European Patent Office
ERA	European Research Area
ETR	Effective tax rate
EU	European Union
GAAR	General anti-avoidance rule
GBER	General Block Exemption Regulation
GDP	Gross Domestic Product
GloBE	Global anti-base erosion
FHTP	Forum on Harmful Tax Practices
KBC	Knowledge-based capital
KDB	Knowledge Development Box (Ireland)

IASP	International Association of Science Parks and Areas of Innovation
ICT	Information and Communications Technology
IMF	International Monetary Fund
IP	Intellectual property
ITA	Income Tax Act 1961 (India)
ITAA	Income Tax Assessment Act 1997 (Australia)
LIS	Ley del Impuesto sobre Sociedades (Spain)
MNA	Modified nexus approach
MNEs	Multinational enterprises
OECD	Organisation for Economic Co-operation and Development
PCM	Madrid Science Park
PE	Permanent establishment
PROs	Public research organisations
R&D&I	Research, development and innovation
SAAR	Specific anti-avoidance rule
SMEs	Small and medium enterprises
S&T	Science and Technology
STA	Scientific and Technological Activities
STET	Scientific and Technological Education and Training
STS	Scientific and Technological Services
TFEU	Treaty on the Functioning of the European Union
TRIPS	Agreement on Trade-Related Aspects of Intellectual Property Rights

Acknowledgements

The first time I heard about IP box regimes was in 2013 when I joined the project “La investigación y la transferencia de conocimiento en el marco del ordenamiento financiero comunitario e internacional” (PROMETEO/2012/073) lead by Prof. Amparo Navarro. Thanks to her ‘*magisterio*’ (as we say in Spanish) I have not only been introduced to the topic of IP taxation, but I have also gotten involved in an enriching university life. I also would like to thank Prof. María Teresa Soler for having contributed to that and for having accepted to write the foreword of this book. My sincere gratitude goes to them and to the other members of the Tax Law department of the University of Alicante.

That year was also when the OECD started its BEPS Action Plan calling such regimes into question. Since then, I have met lecturers, researchers and practictioners from around the world, with whom I have had the chance to discuss and debate on several topics reflected in this book. I am fortunate to be able to call many of them friends. Thanks for your friendship and generosity. I also would like to extend my gratitude to the external reviewers for taking the time to read this contribution and for their valuable comments.

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conversation with him that made this manuscript definitely become a book.

Foreword

IP Boxes also known as Patent Box regimes, are a topic of general interest for all tax jurisdictions, as far as they can be considered a good instrument in order to foster R&D and enhance competitiveness; but also from a negative side, they raise concerns related to harmful tax competition and unfair profit shifting in cross-border situations. If we could identify IP Box regimes with a single idea or word, that would be ‘controversial. In the era of the so-called ‘capitalism of intangibles’, this is due to the underlying goal of attracting high mobile capital, thus increasing the risk of tax competition and creating opportunities for aggressive tax planning strategies, especially in the case of multinational groups.

Moreover, there is an opinion that these regimes, as output tax incentives, can be unfair and discriminatory and when implemented together with input tax incentives, result in a disproportionate protection of R&D. In this respect, compared to input tax incentives which try to foster R&D activity applying tax reductions on the cost side, Patent Boxes apply on the profits arising from IP exploitation, creating a kind of ‘double reward’ effect, and this is precisely the controversial point and what makes these regimes look as the bad boy’ of the story. It seems then when dealing with Patent Boxes, both negative and positive aspects arise at the same time. This impression may be correct, because this is a kind of black and white topic, but this is precisely what makes it attractive and challenging. In

this respect, the main challenge is how to design and implement these regimes in order to get a fair balance between the public interest consisting in the promotion of innovation and the fundamental Tax Law principles at the domestic, supranational (EU) and international level.

On the negative side, it has to be remarked that any tax incentive has a base erosion effect, and R&D tax incentives (both input and output) have this effect in the Corporate Tax revenue. Moreover, R&D tax incentives and especially Patent Boxes, may also have a profit shifting effect, due to the differences in the treatment of income from intangibles in different tax jurisdictions, whether they apply or not these regimes. In this respect, there are some well known examples of tax strategies consisting in the transfer of IP rights to companies located in tax jurisdictions which grant Patent Box regimes.

On the positive side, there are arguments in favour both from an economic and legal perspective. In the first case, even if tax incentives mean less revenue, in the long run the positive spillovers from R&D activities in terms of economic growth and competitiveness in a global market, would also lead to more tax revenue. From a legal perspective, protecting and fostering R&D may be a goal enhanced by specific constitutional grounds, either in itself or related to other public interests (such as protection of environment or health). In this case, this circumstance is what makes R&D tax incentives compatible with the relevant tax principles of ability to pay or equality, provided that other criteria, such as proportionality, will be respected.

In the case of IP Box regimes if, as already mentioned, the main challenge is to find a right balance between

the negative and the positive aspects, that requires: on the economic side, to demonstrate the effective impact of this type of incentives in enhancing and improving R&D activities; on the legal side, to what extent the 'double reward is proportionate. From this perspective, either to maintain or to abolish Patent Boxes may be legitimate tax policy decisions, but if the option is to save these regimes within some constraints aiming to reduce its main disadvantages, then the principle of legal certainty requires consistency in the design and implementation of the 'new' regimes, because the taxpayers undertaking R&D activities, which are generally developed in the medium and long term, need to perform these activities within a clear legal framework, and they have the right to expect a fair play in respect of the tax policy decisions that may affect their activity.

To some extent, we may consider that a kind of 'fair play scenario' was set up as a result of Action 5 of the OECD BEPS Action Plan dedicated to Preferential Tax Regimes. The implementation of this Action was mainly focused on IP Box regimes and the so-called 'Modified Nexus Approach- (MNA) based on a substantial requirement, was the balance or meeting point between keeping fostering R&D and tackling aggressive tax planning.

From the very beginning and in order to preserve the new regimes compliant with the MNA requirement, consistency became a main concern. As far as we consider that compliance a safe harbour, the whole system must be coherent, preventing from the risk of counteracting those regimes by the cross effect of other measures aimed at tackling low taxation, irrespective of intentional or unintentional tax competition; an effect that would jeopardise the benefits of the incentive, thus

creating legal uncertainty. Just to mention two well known examples: the need of consistency between compliant Patent Boxes and CFC rules and the permanent risk of conflict with EU State Aid rules.

In the case of Tax Treaties, the risk of low taxation comes from the Treaty provision itself, especially in those bilateral Conventions which follow the allocation rule for intangibles set up in article 12 of the OECD MC. The combined effect of this rule with a Patent Box regime applied in the residence State (the only one allowed to tax the IP income), will result in effective low taxation. At the Treaty level, this could be solved by a subject to tax clause, but even in this case the scope of the clause could be limited and the safe harbour still preserved, if the low taxation is due to a preferential tax regime that meets an economic substance requirement; this has been the solution adopted by the US MC (2016) in the case of royalties. A similar concern is reflected in the current discussion about the carve-outs related to the proposals included in Pillar Two of the OECD Work Plan. It seems that the risk of inconsistency will continue to be a never-ending story when dealing with the new IP Box regimes.

In any case, and whatever may be the approach to the Patent Box dilemma, a comprehensive and solid study of IP Box regimes is required. This is the outcome of this monography where the author, Dr. Elizabeth Gil, Tax Professor in the Universidad de Alicante, deals with the core topic as well as with related and relevant issues such as the concept of research, development and innovation. The author fixes the dogmatic root of these regimes in the theory of tax incentives, and includes the analysis of tax policy designs, legal constraints and potential conflicts, with special attention to the EU Law

perspective. The result is a new and excellent contribution to her main field of research.

The dilemma will continue, but in these difficult times the wind may blow in favour of fostering research, and now not only for economic growth and competitiveness in the long run, but for more urgent reasons related to salvation and recovery.

María Teresa Soler Roch

February 2021

Introduction

It is commonly held that research, development and innovation (R&D&I) may play an important role in economic development. Even the socioeconomic and political dimension, the academia contributions to that issue have not been generally made from a juridical, but economic, perspective.

It is generally understood that market incentives alone are not enough to produce an adequate supply of R&D&I and if there is not an opportunity for profit, R&D&I will not be undertaken by firms. As a result, it is essential state intervention in order to stimulate private R&D&I spending –through subsidies, taxes, trade or other policies– and influence the generation of research and knowledge for a sustainable economic growth. Precisely this serves also as a justification because “there is a broad agreement that without such intervention undertakings will tend to underinvest” in R&D&I.[1]

The Organization for Economic Co-operation and Development (OECD) considers R&D&I key to productivity and growth perfromance,[2] and the Europe 2020 strategy puts R&D&I at its heart with the objective of achieving an overall R&D&I spending of 3% of the Gross Domestic Product (GDP).[3]

Intellectual Property (IP) box regimes were introduced with the purpose to foster innovation by granting a tax benefit to those that assign certain intangibles for their exploitation and further development. Indeed, when

talking about R&D&I, two phases or moments can be distinguished. On the one hand, the R&D&I as an activity (input) and, on the other hand, the R&D&I as a result (output). Precisely, it is the second stage, i.e. when the R&D&I process has ended and a result might be generated, that the IP box regime as the *prima facie* example of output incentives applies. Hence, input incentives support the creation of R&D&I intangibles, while output incentives encourage the further development and exploitation of IP assets.

Therefore, the IP box regime may be regarded as a tool to promote the transfer of knowledge from the tax system. The fact that companies receive a tax benefit if they transfer intangibles (either through alienation or through a licence contract), it will have an incentive effect to do so.

Beyond the innovative effect pursued by the introduction of IP box regimes, this output incentive has been debatable since the very beginning for being a source of tax avoidance and tax planning. In fact, the European Commission sees the IP box regime as an indicator of aggressive tax planning (ATP). Moreover, the OECD has identified it as a 'hot issue' in the frame of its Action Plan on Base Erosion and Profit Shifting (BEPS), being BEPS Action 5 a turning point for such regimes.

As a result of the Final Report of BEPS Action 5, an agreement on the implementation of the (modified) nexus approach has arisen for the survival of the so-called 'patent box regime'. Accordingly, the risk of the BEPS effects is dissipated in the case of an IP box based on the nexus approach. The author's hypothesis is that the nexus approach acts as a special anti-avoidance rule. Thus, even if the nexus approach ensures that the

tax benefit is granted to intangibles arising from genuine R&D&I activities, this does not mean that IP box regimes are a good tax practice nor a tax planning source.

Once the Final Report of BEPS Action 5 was published in October 2015, jurisdictions started to implement the nexus approach to ensure the survival of their IP box regimes. However, a grandfathering clause was granted until the 30 June 2021 to those undertakings benefiting from pre-existing IP regimes. Consequently, an 'expiry date' has been established for the pre-BEPS regimes. After 30 June 2021, no more benefits stemming from the respective old regimes may be made available to taxpayers.

It seems the survival of IP box regimes is assured provided that they are based on the nexus approach, however other anti-BEPS measures such as the recommendations related to CFC rules included in the BEPS Action 3 or the proposal to introduce a subject-to-tax clause in tax treaties (BEPS Action 6) turns its future more unclear. Moreover, in recent times, the OECD work on Pillar Two calls the continued existence of IP box regimes into question. Now, that the final countdown for non-complaint IP regimes is closer and only IP-nexus approach regimes can survive, nothing seems sure for IP box regimes. Is this a never-ending story?

The work is organised in six chapters. The first chapter delimits the concept of R&D and innovation, by studying the definitions included in the OECD Manuals and by a reference to the tax legislation of different jurisdictions. Chapter 2 focuses on R&D&I as a result and, in particular, to the knowledge transfer, by providing with a concept and with a mention to different forms of

collaboration. This chapter ends with the introduction of the topic of IP box regimes. Chapter 3 analyses the different options for publicly funding R&D&I, i.e. direct subsidies and tax incentives. The author then focuses on tax incentives and explores the classification of R&D&I tax incentives and the limits for its introduction. As mentioned, IP box regimes may create BEPS effects, so Chapter 4 focuses on the introduction of anti-BEPS measures to counreact such effects and how IP box regimes interact with them. Chapter 5 analyses the compatibility of IP box regimes with EU Law. Indeed, Member States are not fully free in the implementation of tax incentives as the prohibition of State aids applies and fundamental freedoms need to be respected. This chapter ends with a reference to the EU strategy on harmful tax practices. With the aim to determine how IP box regimes can be a good tax practice, Chapter 6 provides with an overall overview of the relevant elements in the design of IP box regimes. For such purpose, the author has explored IP regimes among the European Union countries.

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1. R.J. Danon, "Tax Incentives on Research and Development (R&D). General Report", *Cahiers de Droit Fiscal International*, Vol. 100a, Sdu Uitgevers, The Hague, The Netherlands, 2015, p. 19. Also in C. Brokelind AND Å. Hansson, "*Tax* Incentives*, Tax Expenditures Theories in R&D: The Case of Sweden"*, *World Tax Journal*, Vol. 6, No. 2, 2014, p. 175.

2. OECD (2013), *Supporting Investment in Knowledge Capital, Growth and Innovation*, OECD Publishing, Paris.

3. COM (2010) 2020, *Europe 2020 – A strategy for smart, sustainable and inclusive growth*, Brussels, March 2010. In the framework of the Barcelona European Council (2002), it was already decided that investments in R&D should increase from 1,9% till 3% of EU GDP for 2010 and two-thirds of the total should be funded by the private sector [COM (2002) 499 final, *More research for Europe. Towards 3% of GDP.* Brussels, 11 September 2002].

Chapter 1

R&D&I as an activity based on Science and Technology

. INTRODUCTION

R&D&I is regarded as an economic activity due to the fact that its realisation will produce goods and services. This may imply not only an advantage for the producer, but also a benefit for the society as a whole, e.g., a scientific improvement. R&D&I is indeed based on science and technology (S&T). It could be affirmed that science comprises the knowledge obtained through observation and experiment, which allows the formulation of general principles related to the nature or the society. On the other side, technology would be a set of theories and techniques related to the design, production, processes, products and the organisation. Thus, knowledge is behind science (knowledge-driven) and technology is addressed to satisfy social and economic needs (need-driven).

The identification of R&D&I definitions for tax purposes is not an easy task due to the existence of several definitions based on different instruments. Moreover, it is quite frequent that those ‘names’ are followed by diverse ‘last names’ depending on which instrument is based. In this vein, the research could be basic or applied; the development usually will be experimental and the innovation probably will be technological.[4]

The lack of clarity may appear to constitute a serious obstacle to make firms invest in R&D&I. If there is no certainty that, for example, a specific project will be eligible under a specific tax scheme, companies will not probably undertake that project. Indeed, clarity, consistency and predictability are essential to assist companies in making R&D&I investment decisions partly on the basis of tax incentives.[5] In other words, the incentive effect pursued by a specific measure will not take place if there is not certainty in the application of such measure.

In the early 1960s, the OECD held a meeting with national experts in R&D surveys. The result of such assembly was the so-called Frascati Manual.[6] The Frascati Manual was originally written for collecting and issuing national data on R&D. However, over the years, it has become the standard for R&D surveys and data. In regard of innovation, the first edition of the so-called Oslo Manual was published in 1992.[7] The Oslo Manual is the foremost international source of guidelines for the collection and use of data on innovation activities in industry.

Therefore, Frascati and Oslo Manuals provide internationally accepted definitions on R&D&I that are often followed by countries granting tax incentives. Notwithstanding this, the possibility of a broader benchmark will be explored in section 4.

Accordingly, two categories of activities based on S&T may be distinguished: (i) scientific and technological activities such as R&D, education or technical services; and, (ii) the so-called process of scientific and technological innovation. Hence, a relevant issue would be the difference between R&D&I and other scientific

and technological activities, especially in borderline cases, e.g., industrial activities such as prototypes and pilot plants, among others.

. R&D AS A SCIENTIFIC AND TECHNOLOGICAL ACTIVITY

Scientific and technological activities (STA) are systematic activities associated with the generation, advancement, dissemination and application of knowledge in all fields of S&T.[8] These activities refer to R&D, education and training (STET) or scientific and technological services (STS).[9]

According to Frascati Manual, R&D

> "comprise creative and systematic work undertaken in order to increase the stock of knowledge –including knowledge of humankind, culture and society– and to devise new applications of available knowledge".[10]

This definition requires that five criteria are met. That is to say, the activity should be: (i) aimed at new findings; (ii) based on original, not obvious, concepts and hypotheses (creative); (iii) planned and budgeted (systematic); (iv) uncertain about the final outcome; and, (v) lead to results that could be possibly reproduced (or transferred).[11] Precisely, these are the core criteria for the identification of R&D activities and projects.

The term R&D includes three activities:

(i) basic (or fundamental) research, defined as experimental or theoretical work undertaken primarily to acquire new knowledge of the underlying foundations of phenomena and observable facts, without any particular application or use in view;

(ii) applied research, defined as original investigation undertaken in order to acquire new knowledge, but it is directed primarily towards a specific practical aim or objective;

(iii) experimental development, explained as systematic work, drawing on knowledge gained from research and practical experience and producing additional knowledge, which is addressed to the production of new products or processes, or to the improvement of existing products or processes.[12]

While the Frascati Manual encompasses R&D in all field of sciences, R&D in social sciences and humanities is excluded in a number of jurisdictions (e.g., Australia, China or United States) for tax relief purposes according to the OECD report prepared in 2018.[13]

In addition, the Frascati Manual deals with other STA that even if they are similar to R&D, they are not regarded as R&D. The presence or absence of the above-mentioned criteria will distinguish R&D from non-R&D activities. For instance, design activities are quite related to R&D activities as they normally take part of a research project (or of an innovation process). However, the novel and uncertain criteria are not frequently met in design activities. Something similar occurs with software development. There is no doubt that the information and communications technology (ICT) sector is present in innovation processes and quite often software development allows the performance of R&D. Notwithstanding this, software development as R&D should be aimed to “the systematic resolution of a scientific and/or technological uncertainty”, e.g., the development of new operating systems or languages.[14]