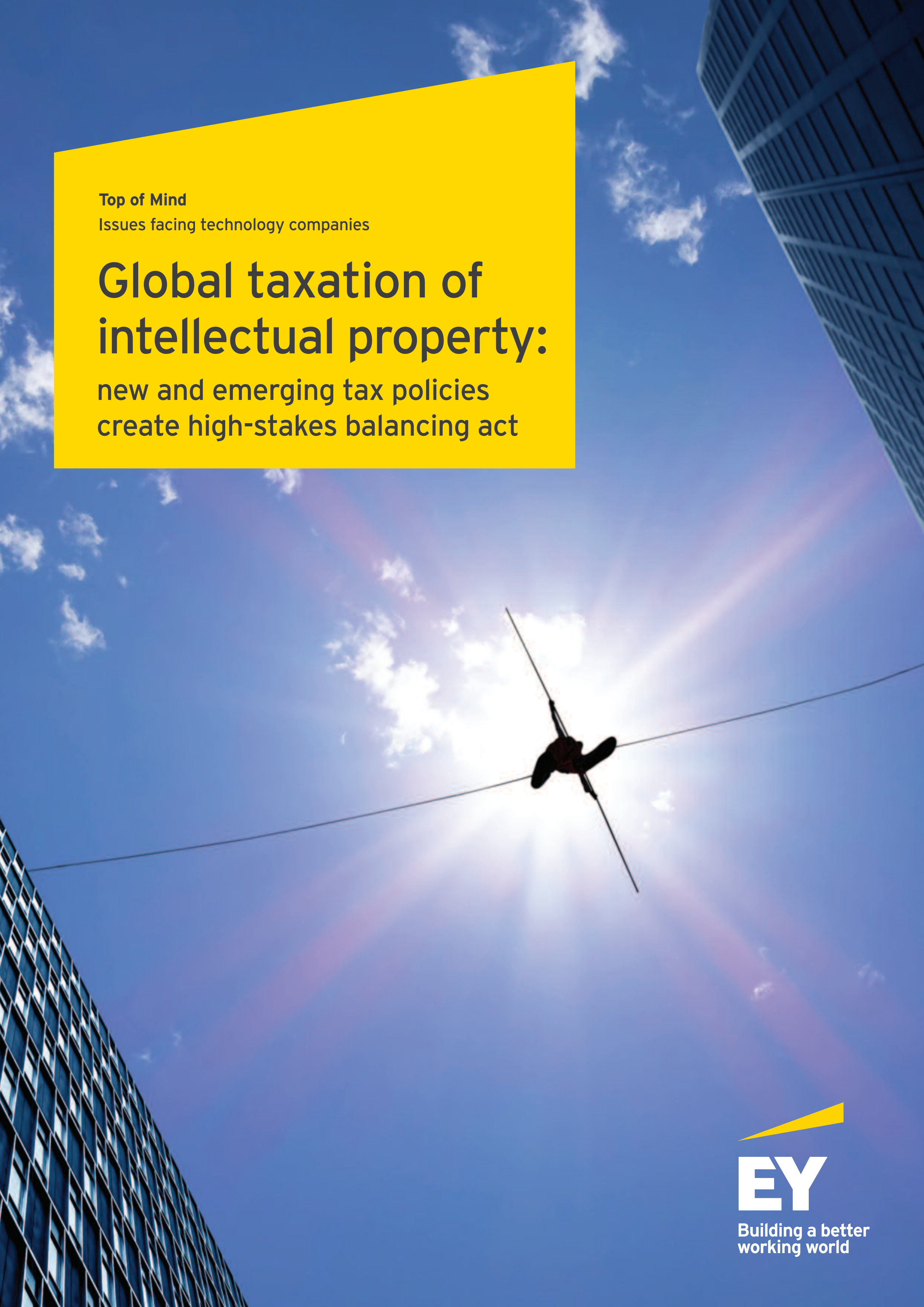
Top of Mind
Issues facing technology companies

Global taxation of intellectual property:

new and emerging tax policies create high-stakes balancing act



Building a better working world

"Companies need certainty about where to locate their core operating assets, including intellectual property and the substantive organizations needed to develop and maintain it. And multinational companies are struggling with the significant inconsistency and competition among nations.

They must constantly balance opportunities for IP tax benefits in Country A with the risk of highly public anti-tax avoidance campaigns in Country B or C. But the global economic reality is that most technology companies — actually, any digitally advanced companies — do not need to replicate a significant supply chain presence in each market they serve; the technology itself enables these companies to serve global markets from a single headquarters location."

Channing Flynn
EY Global Technology Industry Leader
Tax Services

IP stakes rise across the world

Intellectual property (IP) is a matter of high stakes, going ever higher. In the US alone, IP-intensive industries represent more than a third of gross domestic product (GDP).[1] And the value of IP continues to grow in the global economy, driven by the network effects of new technologies and digital business models that extend innovation worldwide — seemingly overnight. It's no wonder there is tension in the air.

Multinational companies today can find themselves on a tightrope as they seek to manage their IP cost-effectively in a hypercompetitive global market. And when it comes to the global taxation of income derived from IP, companies are buffeted by tailwinds, crosswinds and headwinds.

Tailwinds. Governments have collectively begun changing the rules of the game, multilaterally declaring an end to what they have deemed harmful, low-tax competition by some countries seeking to attract companies' IP to their shores. Specifically, new tax guidelines, embodied in the Organisation for Economic Co-operation and Development's base erosion and profit shifting report (OECD BEPS Report), more closely align IP taxation with the location of economic activity and value creation. These guidelines are currently being adapted and adopted for the taxation of patented inventions and copyrighted software in countries around the world. All of which is compelling many multinationals to rethink their global IP management and value chains.

Crosswinds. On the one hand, some countries are now looking to lure companies with new (or newly BEPS-compliant) IP tax incentives variously referred to as patent boxes, innovation boxes and knowledge development boxes. These are often combined with research and development (R&D) credits, IP amortization and other benefits. On the other hand, some countries are looking to publicly challenge and fine companies that they deem to be artificially diverting taxable profits from their shores to take advantage of IP tax incentives abroad. Even more paradoxically, some countries are doing both.

Headwinds. Uncertainty is building a strong headwind, as these new tax policies continue to take shape and this next round of tax competition among nations begins to play out. Tax uncertainty hinders business and innovation, as the prospect of variable taxes clouds profitability. A new and unpredictable era of global tax transparency is also ahead, with the rollout of a country-by-country (CbC) information-sharing mechanism among the world's tax authorities — and with spiking media coverage of leaked tax information.

IP tax policy
exerts pressure

So much about IP taxation has changed with the October 2015 publication of the OECD BEPS Report. In the run-up to the report, as governments sought to replenish recession-battered national treasuries, policymakers and the media turned their attention to so-called "stateless income," involving tax havens and tax rulings with low to no tax on IP-intensive businesses.

> "To the Irish Government, encouraging IP business development is not just about creating high-quality jobs, but also the long-term benefits Ireland will reap from having an innovation economy."
>
> **Joe Bollard**
> International Tax Practice Leader
> Ernst & Young Ireland

The BEPS Report (Action 5) called for a "nexus" approach to qualifying for any IP incentives such as patent boxes, which would require a company to locate its R&D and associated jobs in the country offering its preferential tax rate. The report cited 16 countries or provinces whose IP tax regimes did not align with this approach.

In parallel, other OECD provisions redefined taxable presence and transfer pricing of intragroup/intercompany transactions. To ensure compliance, CbC information-sharing mechanisms among the world's tax authorities are being implemented (although not intended for public consumption). Regional bodies such as the European Commission have also weighed in, sometimes seeking even stronger provisions.

Countries push and pull

The concurrent push and pull on multinational companies are evident in the release of various national governments' 2016 budget proposals, among other policy pronouncements and administrative steps. As incentives, a growing number of countries are considering or introducing entirely new patent boxes, while other countries have aligned or are aligning existing patent boxes with the OECD's approach. But taking advantage of such incentives can be a double-edged sword. Many countries – often some of the same as those with patent boxes – have launched anti-tax avoidance strategies, with a particular focus on digitally advanced, IP-intensive companies.

Examples of country approaches include:

- **Australia's** Office of the Chief Economist recently released a report analyzing whether to adopt a patent box,[2] while the country's tax commissioner projected active follow-through on the country's new Multinational Anti-Avoidance Law (MAAL). A subset of tax data for more than 1,800 public, private and foreign enterprises, has also been posted on the Australian Taxation Office's website.
- **India's** finance minister has proposed a 10% patent box regime, as part of his proposed budget for 2016–17, while reiterating his commitment to a General Anti Avoidance Rule scheduled to take effect in April 2017.[3]
- Late last year, **Ireland** unveiled what it says is a BEPS-compliant box that, when combined in a suite of tax incentives including an R&D credit, IP amortization scheme and other benefits, promises a tax rate as low as 6.5% on qualifying IP profits (on patented inventions and copyrighted software).[4]
- The **Luxembourg** Parliament approved legislation in December 2015 amending its IP tax regime to comply with the OECD nexus approach.[5]

- **Switzerland's** recently redrafted national corporate tax reform bill includes mandatory introduction of a BEPS-compliant patent box at the cantonal level, with a maximum cantonal tax deduction of 80% (all in, including any R&D relief and other provisions, compared with the previous 90%).[6]
- The **UK** maintains a stance of being "open for business" but tough on tax avoidance — recently reducing its headline corporate income tax rate and updating its 10% patent box to comply with BEPS, for example, while also legislating "naming and shaming" provisions and strict penalties for offshore tax evasion.[7]
- **US** lawmakers have circulated draft legislation that includes a 10.15% "innovation box" (see page 6).

Details in these and other country-level incentives can vary widely, including grandfathering clauses for existing tax breaks and such provisions as the inclusion of pan-European or outsourced R&D. Balancing and aligning IP taxation amid this global complexity can be eased through advanced pricing agreements (APAs) between taxpayers and tax authorities — even, in some cases, multilateral APAs. But these, too, have been coming under increasing scrutiny in the emerging era of tax transparency. They will clearly be held to the classic arm's-length transfer pricing standard that says any cost to a related party should be handled like a cost to a third party. In addition, at least one country's competitive claim is that its statutory suite of IP incentives and rates compares favorably to any "ruling regime" that relies on APAs.

> "In China, the biggest incentive for foreign multinationals is the huge domestic market, and any company looking to tap the market's potential will just have to figure out how they are going to align their IP."
>
> **Andrew Choy**
> International Tax Services Leader, Greater China
> Ernst & Young (China) Advisory Limited

> "Groups representing the technology industry have suggested several changes to the US innovation box as originally conceived — first and foremost that the proposal be expanded beyond products to include income from services that involve the use of IP."
>
> **Ray Beeman**
> Co-leader, Washington Council Ernst & Young
> Ernst & Young LLP (US)

US begins to think "inside the box"

As discussions continue about how to modernize the American tax code, some influential members of Congress have voiced support for an "innovation box," designed to encourage companies to keep IP, research and associated jobs in the US. Draft legislation has been circulated, but the policy discussions are still at an early stage.

US federal tax incentives related to innovation have remained relatively unchanged since 1981, consisting largely of an R&D tax credit, while many other countries have adjusted their tax policies to attract and keep research and innovation within their borders with mechanisms such as patent boxes. The upshot is that the US ranked 27th out of 36 developed countries in the OECD's 2015 R&D Tax Incentive Indicators.[8]

Should an innovation box proposal move forward in the US, companies will want to provide input on several issues, including:

- The definition of qualifying IP
- The way in which income should be allocated to that IP
- The actual tax rate
- How nexus would be established
- Whether the tax benefit of an innovation box would affect a taxpayer's eligibility for other existing incentives

Many US companies are already paying careful attention and planning ahead, with nearly half of business tax professionals in a recent survey by The Tax Council and Ernst & Young LLP (US) reporting that their organization is modeling the potential effect of an innovation or patent box proposal on their federal tax liability.

For more information, read EY's recent report titled Thinking inside the box: Why it's time to pay attention to innovation/patent box regimes.

The business of IP is ever more complex

For companies, IP is the core of continuous innovation, growth and profitability in the global digital economy. Amid changing tax rules, however, some global IP-intensive companies find themselves at a crossroads regarding how they have structured their supply chains and where they locate the IP they exploit commercially in products and services worldwide.

Much of the mobility of pre-BEPS IP ownership structures is receding. Increasingly, a new nexus test applies, in which qualifying R&D expenditures and acquisition costs must be incurred by the company claiming the tax benefit and not by other subsidiaries in its group. This is the new policy context for patent boxes.

Patent boxes were starting to proliferate as the two-year BEPS process unfolded, joining other already widely used innovation incentives such as R&D tax credits and IP amortization deductions (not to mention competitive top-line corporate income tax rates). Now, all these tax elements are increasingly being packaged and marketed by governments, in addition to such location benefits as a skilled workforce, infrastructure, security and IP protection.

Location, location, taxation

In existing value chains, pre-BEPS patent boxes are in many cases now considered to be "broken boxes" and are being brought into compliance with the new guidelines with modifications to their nexus provisions. From a legal and tax perspective, companies that have held their IP in now-broken boxes have the option of realigning and paying higher taxes where the IP development, enhancement, maintenance, protection and exploitation (DEMPE) actually take place; relocating the people involved in these activities (and particularly their oversight) to the country in which the IP is registered; or redeploying both assets and functions to a third, more tax-efficient location. Grandfathering clauses for these broken boxes may be limited, especially given new OECD transfer pricing rules and other related considerations.

Many multinationals conduct the bulk of IP development in their headquarters territory, which is not necessarily the most competitive tax environment. The question becomes where they commercially want to undertake R&D, taking into account all relevant business and location considerations, and whether they want to migrate R&D activities into hubs or outsource to good companies for localization or other specific submarket considerations.

Whether for companies rethinking, building or expanding value chains, IP taxation may not top the list of criteria for where to locate substantial operations. But it can become a critical competitive differentiator as the choice narrows to the top three candidates for locating the company's next US$5 billion research facility, to give an example.

And ultimately, the question may not come down to a single national choice. For many companies with decentralized business models and global R&D, there will be multiple choices and evaluations, with taxation as only one of those choices. And the patent box itself would not be the sole IP tax determinant, either, but part of a total calculation of IP and corporate tax benefits.

> "Planning around IP used to be very flexible but now planning has to be very closely linked to business realities and value creation."
>
> **Jim Hunter**
> EY Asia-Pacific Tax Leader
> Ernst & Young Tax Services Limited

Key IP
considerations and actions

"Intellectual property is now the most valuable asset class on the planet" — so begins analysis published this year by World Intellectual Property Organization. And in yet another indication of the mounting stakes surrounding IP, the analysis goes on to say that intangibles including IP make up 80% of company value today (where 80% of company value in the 1980s was tangible).[9]

Key takeaways
Companies must find the right balance on the tightrope between tax opportunity and risk as IP stakes go ever higher and policy winds continue to swirl. Tax executives and their C-level peers need to consider action along the following lines:

- Closely monitor the global, interacting and kaleidoscopically changing landscapes of technology and taxation for both opportunities and risks.
- Make sure that the tax function is fully aware of what is going on inside the company, as well, and that tax executives are included from the start in any discussion regarding business change.
- Employ a much more active engagement strategy with tax administrators, for appropriate tax outcomes, and with tax policymakers, for rational rules and regulations.

Ask yourself
- Are you making sure that your company's profits and profit-making activity align? This is particularly important for reflecting on where key IP value-driving activities are performed.
- Do you conduct risk and opportunity assessments including possible value chain scenarios and strategies? These should be done periodically as well as episodically amid ongoing and sudden changes in the tax environment.
- Are you maintaining adequate documentation and analysis? This is your first line of defense as a new era of tax transparency begins.
- Have you assessed your ability to readily respond to changing IP rules and the increased likelihood of associated challenges? This is a key consideration regarding both government and media inquiries.
- Are you joining with other like-minded companies to educate policymakers and influence policy? Understanding global digital business models is fundamental to sound decision-making.

"As companies consider new jurisdictions for IP ownership, understanding the availability and application of IP incentive regimes will be a critical part of good business planning."

Stephen Bates
International Tax Services
Ernst & Young LLP (US)

> "Now the burden is on companies to understand what incentives are available, how tax regimes are changing and how sustainable they might be — that's all increased dramatically."

Ian Beer
International Tax Services
Ernst & Young LLP (UK)

Conclusion

Even the most experienced tax directors may not be fully aware of emerging IP tax risks and opportunities — whether due to national policy changes or even to new business developments inside their own companies. But now more than ever, the tax aspects of any decision on how to commercialize IP globally must be considered in full, and early in the business strategy process.

Consider this scenario: R&D accidentally creates a permanent establishment in a country, which in turn results in noncompliance with tax filings that then leads to disputes, penalties and interest while driving reputational risk. Or this scenario: an opportunity is missed, whether it is a tax aspect of operational model efficiency or something as simple as not claiming an appropriate R&D incentive.

The global scenarios are myriad, and the need for aligning business and tax strategy cannot be overstated amid today's fast-paced changes in digital technology and taxation.

> "This competition among nations will not settle out any time soon — and the paradox is the way in which it manifests itself. Yes, there are legitimate opportunities for IP tax reductions and exemptions, but we are also seeing aggressive cross-border challenges of companies that try to enjoy these benefits."
>
> **Channing Flynn**
> EY Global Technology Industry Leader
> Tax Services

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Find out more

Global taxation of intellectual property: new and emerging tax policies create high-stakes balancing act is part of EY's ongoing analysis of digital economy taxation. For more information, or to discuss how IP taxation might affect your own organization, contact Channing Flynn, at **+1 408 947 5435** or **channing.flynn@ey.com**, or any of the contacts below.

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