OECD explains agreed approach on intangible property regimes under BEPS Action 5

Executive summary

On 6 February 2015, the Organisation for Economic Co-operation and Development (OECD) released a trio of papers that address three of the focus areas in its Action Plan on Base Erosion and Profit Shifting (BEPS). The OECD will present these developments during the G20 Finance Ministers’ meeting on 9-10 February 2015.

One of the documents, titled Action 5: Agreement on Modified Nexus Approach for IP Regimes (the Action 5 Paper), describes the consensus on the approach for a substantial activity requirement for intangible property (IP) regimes such as patent boxes in connection with BEPS Action 5 (harmful tax practices). The agreed approach builds on the “modified nexus approach” developed jointly by the German and UK governments.1 The Action 5 Paper describes conceptual issues with respect to the modified nexus approach and additional work that will be done in order to allow agreement on the detailed rules to be reached in 2015.

Detailed discussion

Background

The interim report on Action 5 of the BEPS Project, “Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance,” released on 16 September 2014 (the Report), reflected consensus on the importance of having appropriate substantial activity requirements with respect to preferential tax regimes in connection with the determination whether such regimes are to be considered harmful tax practices.2 However, full consensus had not been reached yet on defining substantial activity. For IP regimes, one of the proposed approaches was the “nexus approach,” which would allow benefits granted with respect to IP income in line with the expenditures linked to generating such income.

The German and UK Governments jointly proposed a modified nexus approach in November 2014, which has now been endorsed by all OECD and G20 countries.
Conceptual issues
The Action 5 Paper notes the general acceptance of the nexus approach, subject to modifications relating to the level of qualifying expenditure, grandfathering provisions, and the tracking and tracing of expenditure.

The Action 5 Paper states that under the agreement, to compensate for the fact that related-party outsourcing and acquisition costs will not constitute qualifying expenditure, countries may allow for an “up-lift” of qualifying expenditure by the amount of actual expenditures on outsourcing and acquisition costs but not to exceed 30% of the amount of qualifying expenditure of the company. The Paper provides an example of how the up-lift would be computed.

Further work to be done
The Action 5 Paper states that an approach to the tracking and tracing of research and development expenditure that is practical for tax authorities and companies to implement needs to be developed in order to implement the modified nexus approach. Agreement will also be needed on transitional provisions to enable companies to transfer IP from existing regimes into new regimes. The OECD will work to agree on practical methods that should be used for identifying qualifying expenditure, taking into account the particular issues associated with expenses incurred prior to introduction of the modified nexus approach.

The Action 5 Paper also indicates that countries are allowed to introduce grandfathering rules, with final abolition required to be no more than five years after the date the regime is closed to new entrants, which would be no later than 30 June 2021.

Timing, grandfathering and reporting issues
The Action 5 Paper states that under the agreement there can be no new entrants to any existing regime after the date that a new regime consistent with the modified nexus approach takes effect and, in any event, no later than 30 June 2016. Further, any legislative process necessary to make this change must commence in 2015. For this purpose, “new entrants” include both taxpayers not previously benefiting from the regime and new IP assets owned by taxpayers already benefiting from the regime.

The Action 5 Paper further indicates that the OECD will produce further guidance on the definition of qualifying IP assets, addressing in particular the exact scope of IP assets including, for example, the treatment of copyrighted software or innovations from technically innovative development or technical scientific research that do not benefit from patent protection.

This work on implementation will be concluded by 30 June 2015, and the agreed approach and additional guidance will be included in the 2015 progress report on Action 5.

The OECD invites comments on any of these implementation issues to be sent by 20 February 2015. The OECD may hold a consultation on any issues raised in early March 2015.

Implications
Companies that are benefiting from IP regimes should continue to monitor OECD developments with respect to Action 5 and, more specifically, the discussion surrounding a substantial activity requirement and the agreed approach with respect to IP regimes. They also should monitor related developments in the countries where they operate or invest.
Endnotes


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EYG No. CMS191

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