Kluwer International Tax Blog

International Tax Competition and Patent Boxes

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Two years ago, the OECD's BEPS project started with the goal that Multinational Enterprises pay their fair share of taxes. There was some hope that unfair tax competition, especially in the form of US Multinationals not being subject to tax on their foreign income, could be stopped. Realizing, that a change of US tax rules, especially of US CFC rules, would take some time, European countries decided that they had to take action on their own. The reason was that US Multinationals with extremely low tax burden on their income generated in Europe take advantage of European non-harmonized taxes combined with the European basic freedoms. European enterprises cannot compete against these US Multinationals that do not pay taxes on their foreign income at all.

Accordingly, Ireland announced its willingness to change its residency rules, which, in combination with the general Dutch or Luxembourg 0% rate on royalties, form the basis for the advantageous tax structures of Google, Apple, Facebook and others.

However, the apparent success of the EU in combating harmful tax competition did not last long:

Ireland announced introducing an internationally accepted "Knowledge Development Box", by the time its residency tax rules are going to be changed. Ireland plans a tax rate of 6.25% (half the existing corporation tax rate) on royalties.

Whereas US Multinationals do not have to worry about their tax privileges, the race to the bottom of corporate tax rates in Europe is continuing. Ireland will be the first EU Member State introducing a Patent Box based on the internationally agreed standard, the Nexus Approach, developed by the OECD.

Patent Box regimes have got a lot of attention in recent times, especially in the course of the OECD's BEPS project and the equivalent work in the EU's code of conduct group on harmful tax competition. The UK regime took effect in 2013 with a 10% rate on profits from patents. In 2010 the Dutch government improved its regime by lowering the tax rate from 10% to 5%. Other EU countries with similar systems operate in Belgium, Cyprus, Spain, France, Hungary, Luxembourg, Malta, and Portugal.

These regimes that provide for tax preferences on income relating to intangible property were subject to detailed analysis in the OECD and the EU's working groups. The concern of both organizations relate to a lack of substantial activity of the companies being subject to a preferential regime.

The OECD developed an approach (Substantial Nexus) by defining conditions under which Patent box regimes are not considered harmful (see a detailed analysis of Harmful Patent Boxes by Mindy Herzfeld, Tax Notes International, October 2014, 199). It permits jurisdictions to provide benefits to the *income* arising out of IP, as long as there is a direct nexus between the income receiving benefits and the expenditures contributing to that income. The Nexus Approach determines the amount of income that may receive tax benefits by applying a ratio between qualifying expenses and overall expenses to the royalties' income of a company. The Nexus Approach attempts to extend the principle of R&D credits to benefits for royalties' income. This attempt, to tie an income item to an asset generated by a previously incurred expense, is complicated. And, from a practical point of view it seems simply impossible to link e. g. (part of) income from a product which includes several intangibles (various patents, trademarks, know how etc.) to a specific Patent. Reflecting on it, the results show clearly that the Nexus Approach largely fails to recognize the complexities of tracing expenses to income-generating assets. Necessary estimations must be completely arbitrary.

The Nexus Approach differs insofar from the regimes already existing in the EU that provide benefits for R&D *expenditures*. Due to the direct link between expenses and benefits and thus to substantial activity, these regimes are internationally acknowledged and not subject to criticism. In addition the necessary operations to calculate the benefits are easy because they need rules for the granting of a credit to an expense, only.

Considering the complicated Nexus Approach combined with several further exemptions agreed on at the OECD level to reach international consensus, it becomes apparent, that the Nexus Approach cannot ensure substantial activity for any preferential regime. It seems that this is exactly the result that EU Member Countries providing for Patent Boxes wished to achieve: They, and others that follow once the Nexus Approach is formally agreed, will continue competing with low tax rates and doubtful substantial activity for their intangible income.

Other countries, that would lose too much tax income by introducing Patent Box regimes, will not be able to check the application of the Patent Box rules. On the other hand, the country providing for the Patent Box rules does not have any interest in checking the facts that the taxpayers presents. In addition, if foreign tax auditors detected irregularities in the application of a Patent Box rule the resulting tax conflicts will be difficult to solve. At least there should be full transparency for all Patent Box cases.

In summary, it has to be noted that the OECD's Nexus Approach which will be adopted by the EU, too, will not alter the situation of corporate taxation in Europe. Furthermore, the high attention that intangibles as value drivers receive, especially in the OECD's Transfer Pricing work, seems to be completely disregarded when it comes to the respective tax regimes.

It seems that European countries are not ready to stop competing with their corporate tax rates. They wish to attract foreign investment for the price of a small contribution to their taxable income. However, nobody will gain from this competition in the end. In their race to the bottom, EU member countries will drive corporate taxation effectively down to zero. Furthermore, tax structures based on wage taxes and on VAT only, are extremely unfair, since capital income earned by wealthy individuals will not or only be slightly taxed. The difference between "rich" and "poor" will become more and more significant. This development will lead to even more unfair social structures, to a lack of a sound mix of taxes, which is desirable especially in times of crisis. Furthermore, it will weaken the social stability in Europe.

To stop such development, it is time to radically change the European tax system. To secure the future of the European Union's tax income, harmonized direct taxes, a harmonized tax base and minimum tax rates are needed.

Germany has had similar discussions on tax competition between its 16 states already. The Federal Constitutional Court had to decide on the sovereign right of German states to determine their own trade tax rates. The Court argued that this right would lead to destructive tax competition of the states and loss of the trade tax income for Germany as a whole. It would also lead to situations where states would receive income from the fiscal equalization scheme without contributing to it.

This reasoning is more than true for the European Union.

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This entry was posted on Wednesday, March 18th, 2015 at 10:58 am and is filed under BEPS, OECD, Residence
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