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R&D tax alert
Belgium

Innovation Income Deduction will replace the PID regime

In order to activate the conclusions from the OECD's BEPS Action 5 report and similar discussions at EU level, Belgium has abolished the patent income deduction (PID) regime from 1 July 2016, subject to a conditional grandfathering rule which allows the old PID regime to be claimed until 30 June 2021 (see previous alert of 12 July 2016).

For several months, the Belgian government has been preparing (pre-draft) legislation with a view to replace the previous PID regime with an "innovation income deduction" (IID) regime that is compliant with the "modified nexus approach" agreed upon within the OECD and EU Code of Conduct group.

Although the pre-draft legislation has not yet been submitted to the Council of Ministers, there generally seems to be consensus on the new regime's headlines. Nevertheless, the below outline is obviously still subject to change upon enhanced insights and further discussions.

General features

The general tenet of the new IID regime remains similar to the previous PID regime, as the IID would also provide a tax-specific deduction on qualifying IP income arising on qualifying IP rights.

However, there are some major expected changes compared to the previous PID regime.

Qualifying IP rights

The intellectual property (IP) rights that qualify for the new IID regime would comprise – similar to the previous PID regime – patents and supplementary protection certificates of which the company is the full owner, co-owner, usufructuary, licensee or exclusive right holder.

However, the list of qualifying IP rights would be expanded to and could reportedly include:

- plant variety rights ("*kwekersrechten / droits d'obtention végétales*") and orphan drug rights ("*weesgeneesmiddelen / médicaments orphelins*") (albeit limited to EU rights) that are requested or acquired from 1 July 2016, of which the company is the full owner, co-owner, usufructuary, licensee or exclusive right holder; and
- copyrighted software (and parts of derivative works or modifications of existing software) generated on 1 July 2016 at the earliest.

Equally new is that the IID regime could likely already apply (on a provisional basis) from the moment a qualifying IP right is requested; as opposed to the PID regime which could only apply from the moment eligible IP rights are granted. In case the IP right would ultimately not be granted, the (provisional) IID benefit would obviously have to be recaptured.

Qualifying IP income

The income streams to which the new IID regime applies would in all likelihood comprise the following income elements, to the extent that these are (1) part of the taxable result of the Belgian or foreign company in Belgium and are (2) at arm's length:

- license fees;
- IP income embedded in the sales price of products/services;
- IP income embedded in the production process; and
- compensation for damages for IP right infringements, awarded on the basis of a judicial decision, amicable settlement or an insurance agreement.

Although this may be more uncertain, it is being considered that capital gains realised upon alienation of qualifying IP rights may, under certain conditions, also benefit from the IID regime going forward.

Quantification and application

The most significant changes compared to the previous PID regime relate to the quantification of the deduction. Under the IID regime, the deduction would – in line with the "modified nexus approach" agreed upon within the OECD and EU – be calculated in three steps:

- Calculation of the net amount of qualifying IP income;
- Application of a "modified nexus" fraction; and
- Multiplication of the result with the IID rate.

The amount of IID would then be deductible from taxable profits. Contrary to the PID regime, any excess IID could be carried forward for use in future tax years.

Net income approach

Unlike the PID regime, which as a general rule applied on a gross basis, the IID regime only applies to the net amount of qualifying IP income that exclusively relates to a qualifying IP right, i.e.:

- the gross qualifying IP income related to the qualifying IP right of the taxable period; less
- the overall expenditure (see below for definition) taken as an expense and borne in the taxable period.

The net income must in principle be determined separately for each qualifying IP right (although this may, subject to some conditions, also be determined on the basis of type or group of products or services).

Although not yet clarified, the IID regime would reportedly also include (1) a "recapture" rule that would (subject to exceptions) require taxpayers to first consume all overall expenditure (allocable to a qualifying IP right) expensed in taxable periods ending after 30 June 2016, before being able to claim the IID on the net income arising thereon, and (2) a "ventilation" rule according to which current-year or carried forward negative net IP income would need to be deducted from (positive) net IP income earned on other qualifying IP rights.

Modified nexus fraction

The amount of net qualifying IP income should subsequently be multiplied with the following "modified nexus fraction", which is also to be determined separately for each qualifying IP right (or type or group of products or services):

$$\frac{\text{Qualifying expenditure (A+B+C)}}{\text{Overall expenditure (A+B+C+D+E-C)}}$$

Qualifying expenditure is, as a general rule, defined as consisting of the following expenses:

- expenses made by the taxpayer (A);
- expenses made by the taxpayer in the context of outsourcing to an unrelated party (B); and
- expenses made by the taxpayer in the context of outsourcing to a related party, insofar as that related person outsources the R&D and invoices, without mark-up, his outsourcing cost to the taxpayer (C).

Qualifying expenditure must directly relate to a qualifying IP right, and does not include e.g. interest payments and costs related to real property.

Overall expenditure, as a rule, comprises the same expenses as qualifying expenditure, with the addition of:

- expenses made by the taxpayer for acquiring the qualifying IP right (D); this expense is therefore not included in item A mentioned above;
- expenses made by the taxpayer in the context of outsourcing to a related party (E), with the exception of expenses listed under item C.

For the purposes of the "modified nexus fraction", qualifying and overall expenditure are calculated on a rolling basis, in particular as cumulative amounts of expenses incurred from the 1st taxable period ending after 30 June 2016. Qualifying expenditure may be uplifted by 30%, but the amount of overall expenditure constitutes the maximum.

In case the "modified nexus fraction" does – as a result of exceptional circumstances – not represent the value added by the taxpayer's own R&D activities to the qualifying IP asset (or the type or group of products or services), taxpayers can reportedly request permission from the Ruling Commission to deviate from that fraction.

IID rate

The amount resulting after calculating net income and applying the "modified nexus fraction" would reportedly be eligible for a 90% deduction (compared to 80% under the old PID regime).

Tracking and tracing

In order to support the IID quantification, taxpayers would have to prepare and retain documentation regarding every IP right (or each type or group of products or services), such as the amount of qualifying IP income, the amounts of qualifying and overall expenditure and the amount of overall expenditure deducted for tax purposes.

A separate form would need to be added to the tax return to support the IID claim.

Entry into force

The new IID regime would apply (retroactively) to tax year 2016 (but only for financial years ending at the earliest on 1 July 2016).

Taxpayers that are eligible to continue applying the PID regime until 30 June 2021, under the grandfathering rule, would need to choose between claiming the PID or IID regime (for the period up to 30 June 2021). In this respect, it is expected that the government will most likely make this choice irrevocable. Hence, taxpayers that have opted to apply the PID regime under the grandfathering rule would not be able to "switch back" to the IID regime, and *vice versa*.

Next steps

The objective is to adopt the new legislation (ultimately) before year-end.

Contacts

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