

THE KNOWLEDGE DEVELOPMENT BOX

Public Consultation

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An Roinn Airgeadais
Department of Finance



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Department of Finance

Public Consultation Paper:
The Knowledge Development Box

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Tax Policy Division
Department of Finance
Government Buildings, Upper Merrion Street, Dublin 2
Ireland

E-mail: KDBconsultation@finance.gov.ie

Website: www.finance.gov.ie

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1. Introduction

In the *Road Map for Ireland's Tax Competitiveness*¹ which was published as part of Budget 2015, the Minister for Finance announced the intention to introduce a competitive income-based tax regime for intellectual property, in what will be known as the 'Knowledge Development Box' or KDB.

The *Road Map* was underpinned by extensive research which was undertaken and commissioned by the Department of Finance over the course of 2014. The results of the research were published in a series of seven separate reports on Budget Day, which together comprise an *Economic Impact Analysis of Ireland's Corporation Tax Policy*².

One of the key findings of the research is that the foreign-owned sector is very important for economic growth and employment in Ireland and that Ireland needs a competitive corporate tax offering to attract foreign direct investment ('FDI'). As growth in OECD economies is increasingly driven by investment in intangible assets, putting in place a competitive offering for *knowledge-based* investment which is related to research and development ('R&D') and innovation is considered key for Ireland's continued success in attracting FDI.

Irish Government strategy recognises the importance of ensuring Ireland has a business environment that is regarded as being conducive to innovative firms: see for example *Ireland's Strategy for Growth: Medium-Term Economic Strategy 2014 – 2020*³ and the *Action Plan for Jobs*⁴.

The needs of Ireland's own domestic economy are not the only reasons why the State should prioritise investment in R&D and innovation. International organisations have identified that investment in R&D and innovation is good for growth in the global economy. The OECD *New Sources of Growth: Knowledge-Based Capital* Report from October 2013⁵ highlighted that business investment in what they termed *Knowledge-Based Capital* ('KBC') is increasing and is a significant source of growth. KBC includes a variety of non-physical assets which create future benefits for firms and, while not formally defined, broadly relates to data, software, patents, new organisational processes and firm-specific skills and designs. This report noted that the appropriate tax treatment of KBC can stimulate investment and growth.

¹ http://budget.gov.ie/Budgets/2015/Documents/Competing_Changing_World_Tax_Road_Map_final.pdf

² http://budget.gov.ie/Budgets/2015/Documents/EIA_Summary_Conclusions.pdf

³ <https://www.dfa.ie/media/dfa/alldfawebsitemedia/ourrolesandpolicies/tradeandpromotion/strategy-for-growth-2014-2020.pdf>

⁴ <http://www.djei.ie/enterprise/api.htm>

⁵ <http://www.oecd.org/science/inno/newsourcesofgrowthknowledge-basedcapital.htm>

There are a number of international obligations and key targets that have been agreed and which Ireland is obliged to meet that relate to the field of KBC and innovation including Europe 2020, which was adopted by the European Council in June 2010, under which Ireland has a target of 2.5% of GDP to be invested in R&D⁶.

This broader policy context recognises the competitive international environment in which the Irish economy operates, as countries are increasingly competing for mobile FDI to meet their own inward investment targets.

As the Minister for Finance has repeatedly stated, Ireland will play fair – as we have always done – and play to win. In that regard, in order to enhance further the competitiveness of Ireland’s overall corporate tax regime it will be important to ensure a “best in class offering” in relation to the KDB. It is also necessary that the regime complies with relevant OECD and EU requirements on income-based intellectual property regimes and this will provide certainty to industry about the sustainability of the incentive.

As a small country with a stable annual Budget and Finance Bill process, Ireland has a strong track record for implementing timely tax legislation once international rules have been agreed. This will also be the case for the Knowledge Development Box and, along with the recent enhancements to relief for expenditure on intangible assets, it should give confidence to companies looking to generate their knowledge-based capital in Ireland.

In this context, the Minister for Finance now wishes to consider options for the design and implementation of the Knowledge Development Box. The focus will be on the consultation questions below but respondents are also invited to consider the broader framework for tax expenditures which is contained in the *Department of Finance Guidelines for Tax Expenditure Evaluation*⁷ which was also published on Budget day.

⁶ For further analysis of these and the broader domestic policy framework for R&D, see Chapter 3 of the 2013 Review of Ireland’s R&D Tax Credit (available at <http://budget.gov.ie/Budgets/2014/Documents/Department%20of%20Finance%20Review%20of%20R&D%20Tax%20Credit%202013.pdf>).

⁷ http://budget.gov.ie/Budgets/2015/Documents/Tax_Expenditures_Oct14.pdf

2. The Current International Taxation Position on “Patent Box” Regimes

As already mentioned, knowledge-based capital has become a significant driver of profits in many multinational enterprises (‘MNEs’). As a result, certain countries have introduced regimes commonly known as *Patent Box* regimes which are a form of preferential regime that provides an effective tax rate for intellectual property (‘IP’) income that is below the normal headline rate of corporation tax in the jurisdiction in question.

The OECD’s Base Erosion and Profit Shifting (‘BEPS’) project has brought these income-based IP regimes into focus under Action 5 of the project which addresses harmful tax practices. This work has focused on ensuring that these preferential regimes fulfil the *substantial activity* requirement—thereby preventing their being deemed harmful. The work is building upon previous work carried out by the OECD and essentially involves a detailed elaboration of principles laid out in the 1998 report on harmful tax practices⁸.

The BEPS project may ultimately affect the location in which MNEs opt to develop their IP, as one of the key elements of the project is to align taxing rights more closely with substance. This should result in a greater need for companies to be able to demonstrate real substance in specific jurisdictions in order to be able to qualify for tax benefits. The *substantial activity* requirement in relation to income-based IP regimes is designed to ensure that tax benefits arising under preferential regimes for IP are directly related to real economic activity.

Discussions have been taking place within the context of the OECD BEPS project and the EU Council Code of Conduct on Business Taxation with a view to reaching a consensus on a common approach for assessing IP regimes by reference to economic substance. These discussions are moving towards agreement on a “modified nexus approach” (to implement the *substantial activity* requirement), which links the tax benefits arising under IP regimes to the amount of R&D expenditure that is incurred by companies in developing the IP that will receive such tax benefits. The approach permits countries to provide a preferential rate of corporate tax for IP income so long as there is a direct proportionate nexus between the IP income and the R&D expenditure which generated that income.

While the proposal is still under discussion, it appears likely that a modified nexus approach will be adopted by the OECD and EU and, as such, the design of the KDB will need to be in line with this approach.

⁸ “Harmful Tax Competition – An Emerging Global Issue”, OECD

Attracting investment that generates economic activity with real substance has been a central column of the Irish taxation system for more than 50 years and it is within this context that the introduction of the KDB is being considered.

In that regard, views in respect of all relevant issues are invited. However, it is important that such views should take account of current international developments in relation to income-based IP regimes. To help guide respondents' submissions, an outline summary of the modified nexus approach is provided in Annex I. Respondents should also be mindful that the underlying objective in introducing a Knowledge Development Box is to both retain and attract business with real economic substance in Ireland.

A list of questions is provided in the following section for guidance.

3. The Consultation Questions

In responding to this consultation you are invited to:

- Give your views on the specific questions set out below. You don't have to answer every question – you may choose to answer any or all of the questions.
- Provide details of any approaches or options you feel might be beneficial in dealing with the issues being addressed.
- Provide details of relevant issues not covered in this paper.
- Where appropriate, provide some analysis of the Exchequer cost/yield of your preferred option.
- Comment on the general direction in which you would like to see tax policy in this area develop.

Your views are important as they may help influence the taxation treatment and policy to be applied in the future.

Question 1:

It appears likely that the benefits of income-based IP regimes will be limited to income derived from *“patents and assets that are functionally equivalent to patents”* (see paragraph 8 Annex 1) while marketing intangibles will be excluded. Please provide a description of the assets that you believe to be functionally equivalent to patents and the basis for that belief.

Question 2:

In designing the Knowledge Development Box it is necessary to consider the following items:

- a) The method of calculation of the income qualifying for the preferential rate
- b) The interaction of the regime with current loss relief legislation
- c) The interaction of the regime with double taxation relief

Please comment on the above items and on any other design issues that should also be considered (that are not mentioned in any of the other questions).

Question 3:

What expenditure should be included in the definitions of “qualifying expenditure” (see paragraphs 10 & 11 of Annex I) and “overall expenditure” under the modified nexus approach? Please also provide an explanation of why the expenditure should be included.

Question 4:

How should the Knowledge Development Box interact with current legislation in the area of intellectual property and research and development, including the tax credit for R&D expenditure and capital allowances for intangible assets?

Question 5:

How should IP income be defined – for example, in relation to royalty income embedded in sales of goods and services (see paragraph 17 of Annex 1)?

Question 6:

How should the tracking element of the regime (see paragraphs 22 & 23 of Annex I) operate to ensure that income benefitting from the preferential rate is traceable to the qualifying expenditure but also user-friendly for both companies and Revenue?

Question 7:

Are there any provisions that should be included in the regime to specifically encourage small indigenous enterprises?

4. The Consultation Process

Consultation Period

The consultation period will run from **14th January 2015 to 8th April 2015**, a period of 12 weeks. Any submissions received after this date may not be considered.

How to Respond

The preferred means of response is by email to: KDBconsultation@finance.gov.ie

Alternatively, you may respond by post to:

The Knowledge Development Box – Public Consultation
Tax Policy Division
Department of Finance
Government Buildings
Upper Merrion Street
Dublin 2.

Please include contact details if you are responding by post.

When responding, please indicate whether you are contributing to the consultation process as a professional adviser, representative body, corporate body or member of the public.

Freedom of Information

Responses to this consultation are subject to the provisions of the Freedom of Information Acts. Parties should also note that responses to the consultation may be published on the website of the Department of Finance.

Meetings with key stakeholders

The Department of Finance may also invite key stakeholders to meet with them, including representative bodies, tax professionals and other interested groups or individuals.

Annex I: The Modified Nexus

1. This Annex provides a summary of the modified nexus approach which is currently under consideration within the OECD and EU. A full extract of the section dealing with nexus in the OECD report is provided in Annex II.

2. The objective of the nexus approach is to provide that the benefits of a preferential tax regime are available for the proportion of income that arises from R&D activities of taxpayers receiving the tax benefits. The approach seeks to build on the basic principle underlying R&D tax credits that apply to expenditures incurred in the creation of IP. The nexus approach expands on this and rather than limiting jurisdictions to IP regimes (such as R&D credit regimes) that only provide benefits directly for the expenditures incurred to create the IP, the approach also permits jurisdictions to provide beneficial tax treatment of the income arising out of that IP – so long as there is a direct nexus between the income receiving benefits and the expenditures contributing to that income.

3. Expenditures therefore act as a proxy for substantial activities. It is the proportion of expenditures directly related to development activities that demonstrates real value added by the taxpayer and acts as a proxy for how much substantial activity the taxpayer undertook in a particular jurisdiction. The nexus approach applies a proportionate analysis to income, under which the proportion of income that may benefit from an IP regime is the same proportion as that between qualifying R&D expenditures and overall expenditures in developing the IP asset.

4. The nexus approach determines what income may receive tax benefits by applying the following formula:

$$\frac{\textit{Qualifying expenditures incurred to develop IP asset}}{\textit{Overall expenditures incurred to develop IP asset}} \times \textit{Overall income from IP asset} = \textit{Income receiving tax benefits}$$

5. The nexus approach also allows taxpayers to rely on a ‘rebuttable presumption’. In the absence of other information from a taxpayer, a jurisdiction would determine the income receiving tax benefits based on the calculation above. Taxpayers would, however, have the opportunity to prove that more income should be permitted to benefit from the IP regime if they could show a direct link between that income and qualifying expenditures to develop the IP asset.

Qualifying taxpayers

6. Qualifying taxpayers would include resident companies, domestic permanent establishments of foreign companies, and foreign permanent establishments of resident companies that are subject to tax in the jurisdiction providing benefits.
7. The expenditures incurred by a permanent establishment cannot be used to qualify income earned by the head office as qualifying income if the permanent establishment is not operating at the time that income is earned.

IP assets

8. The only IP assets that could qualify for tax benefits under an IP regime are patents and other IP assets that are functionally equivalent to patents, i.e. if those IP assets are both legally protected and subject to similar approval and registration processes, where such processes are relevant.
9. Under the nexus approach, marketing-related IP assets such as trademarks cannot qualify for tax benefits under an IP regime.

Qualifying expenditures

10. Jurisdictions will provide their own definitions of qualifying expenditures, and such definitions must ensure that qualifying expenditures only include expenditures that are necessary for actual R&D activities.
11. Qualifying expenditures would include the types of expenditures currently granted R&D credits under the tax laws of jurisdictions which provide such relief. They would not include interest payments, building costs, acquisition costs, or any costs that could not be directly linked to a specific IP asset.

Overall expenditures

12. Overall expenditures would be the sum of all expenditures that would count as qualifying expenditures if they were undertaken by the taxpayer itself.

13. This in turn means that anything that would not be included in qualifying expenditures even if incurred by the taxpayer itself (e.g. interest payments, building costs and other costs that do not represent actual R&D activities) cannot be included in overall expenditures and hence does not affect the amount of income that may benefit from an IP regime— *but see below in relation to acquisition costs.*
14. IP acquisition costs are, exceptionally, included in overall expenditures even though they are not included in qualifying expenditures. IP acquisition costs are a proxy for expenditures on developing the IP concerned that would count as qualifying expenditures if they were undertaken by the taxpayer itself – and are accordingly taken into account in determining the proportionate contribution, involving substantial activity, of the taxpayer to developing the IP.
15. Overall expenditures therefore include all qualifying expenditures, IP acquisition costs, and expenditures for outsourcing that do not count as qualifying expenditures.

Overall income

16. Jurisdictions will define “overall income” consistent with their domestic laws on income definition.
17. Overall income should be limited to IP income. Overall income should only include income that is derived from the IP asset. This may include royalties, capital gains and other income from the sale of an IP asset, and embedded IP income from the sale of products directly related to the IP asset. Overall income should not be defined as gross income from the IP asset but should be adjusted by deducting IP expenditures referable to IP income.

Outsourcing

18. The nexus approach would allow all qualifying expenditures for activities undertaken by unrelated parties – whether or not they were within the jurisdiction – to qualify, while all expenditures for activities undertaken by related parties – again, whether or not they were within the jurisdiction – would not count as qualifying expenditures apart from that which is allowed by the uplift of qualifying expenditure referred to in paragraph 24 below.

19. Jurisdictions could narrow the definition of unrelated parties to include only universities, hospitals, R&D centres and non-profit entities that were unrelated to the qualifying taxpayer. Where a payment is made through a related party to an unrelated party without any margin, the payment will be included in qualifying expenditures.
20. Jurisdictions could also only permit unrelated outsourcing up to a certain percentage or proportion (while still excluding outsourcing to related parties from the definition of qualifying expenditures). Business realities typically mean that a company will not outsource more than an insubstantial amount of R&D activities to an unrelated party, so both a prohibition on outsourcing to any related parties and that same prohibition combined with a cap that prohibits outsourcing to unrelated parties beyond an insubstantial amount should have the equivalent effect of limiting qualifying expenditures to those expenditures incurred to support fundamental R&D activities by the taxpayer.

Treatment of acquired IP

21. The nexus approach excludes IP acquisition costs from the definition of *qualifying expenditures*, apart from that which is allowed by the uplift in qualifying expenditure referred to in paragraph 24, while it allows expenditures incurred on enhancing the IP asset *after* it has been acquired to be treated as qualifying expenditures. The acquisition costs are, however, included in overall expenditures.

Tracking of income and expenditures

22. The nexus approach requires jurisdictions operating an IP regime to require that taxpayers that want to benefit from an IP regime must track expenditures, IP assets, and income to ensure that the income receiving benefits did in fact arise from qualifying expenditure.
23. This means that taxpayers will need to be able to track the link between expenditures and income and provide evidence of this to their tax administrations. Jurisdictions will therefore need to establish a reasonable tracking method based on consistent criteria capable of objective measurement.

Uplift for acquisition costs and outsourcing expenses

24. Countries may allow for an up-lift of qualifying expenditure in relation to acquisition costs and outsourcing expenses within the modified nexus approach. However, two conditions must apply to this uplift:

- (i) The uplift may only be granted to the extent that the acquisition costs and outsourcing costs have actually been incurred; and
- (ii) The uplift is limited to 30% of the qualifying expenditures incurred by the company. The 30% limit relates to the overall amount of both outsourcing and acquisition costs.

Example 1:

A company incurred qualifying expenditure of €100 and costs for acquisition of IP assets of €10. It outsourced its R&D to a subsidiary which incurred R&D costs of €40.

Maximum up-lift amount = €100 x 30 % = €30

Overall qualifying expenses including a limited percentage of outsourcing and acquisition costs = €130

Example 2:

A company incurred qualifying expenditure of €100 and costs for acquisition of IP assets of €5. It outsourced its R&D to a subsidiary which incurred R&D costs of €20.

Maximum up-lift amount = €100 x 30 % = €30

Overall qualifying expenses including a limited percentage of outsourcing and acquisition costs = €125

Annex II: Extract in relation to the nexus approach from the OECD Report on BEPS Action 5: Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance

Revamp of the work on harmful tax practices

To counter harmful regimes more effectively, Action Item 5 of the BEPS Action Plan (OECD, 2013a) requires the FHTP to revamp the work on harmful tax practices, with a priority and renewed focus on requiring substantial activity for any preferential regime and on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes. This excerpt relates only to the substantial activity requirement.

Substantial activity requirement

Introduction

Action Item 5 specifically requires substantial activity for any preferential regime. Seen in the wider context of the work on BEPS, this requirement contributes to the second pillar of the Base Erosion and Profit Shifting (BEPS) project, which is to align taxation with substance by ensuring that taxable profits can no longer be artificially shifted away from the countries where value is created. The framework set out in the 1998 Report (OECD, 1998) already contains a substantial activity requirement. This requirement is grounded in particular in the twelfth factor (i.e. the eighth other factor) set out in the 1998 Report. This factor looks at whether a regime “encourages purely tax-driven operations or arrangements” and states that “many harmful preferential tax regimes are designed in a way that allows taxpayers to derive benefits from the regime while engaging in operations that are purely tax-driven and involve no substantial activities”. The 1998 Report contains limited guidance on how to apply this factor.

The substantial activity factor has been elevated in importance under Action Item 5, which mandates that this factor be elaborated in the context of BEPS. This factor will then be considered along with the four key factors when determining whether a preferential regime within the scope of the FHTP’s work is potentially harmful. The FHTP is therefore considering various approaches to applying the “substantial activity” factor for the purposes of its work. The FHTP’s work on substantial activity has focused in the first instance on what this would require in the context of regimes which provide a preferential tax treatment for certain income arising from qualifying Intellectual Property (“intangible regimes” or “IP regimes”). There is a clear link between this work and statements in the BEPS Action Plan that current concerns in the area of harmful tax practices may be less about traditional ring-fencing and instead relate to corporate tax rate reductions on particular types of income, such as income from the provision of intangibles¹. All intangible regimes in member countries are being

reviewed at the same time as part of the current review and none of these regimes had been reviewed as part of the earlier work. The elaborated substantial activity requirement can therefore be applied without needing to re-assess intangible regimes previously reviewed. Under Action Item 5, the substantial activity requirement applies to all preferential regimes within scope, including preferential regimes other than IP regimes, and the FHTP will also consider this aspect.

Substantial activity requirement in the context of intangible regimes

Regimes that provide for a tax preference on income relating to intangible property raise the base-eroding concerns that are the focus of the FHTP's work. At the same time, it is recognised that IP-intensive industries are a key driver of growth and employment and that countries are free to provide tax incentives for Research and Development (R&D) activities, provided that they are granted according to the principles agreed by the FHTP.

The FHTP considered three different approaches to requiring substantial activities in an IP regime. Discussions about the specific approach to choose are ongoing with much progress having been made already. The continuing discussions are focused on reaching consensus on an approach to requiring substantial activities as soon as possible. The first approach was a value creation approach that required taxpayers to undertake a set number of significant development activities. This approach did not have any support over the other two. The second approach was a transfer pricing approach that would allow a regime to provide benefits to all the income generated by the IP if the taxpayer had located a set level of important functions in the jurisdiction providing the regime, if the taxpayer is the legal owner of the assets giving rise to the tax benefits and uses the assets giving rise to the tax benefits, and if the taxpayer bears the economic risks of the assets giving rise to the tax benefits. A few countries supported the transfer pricing approach, suggesting that it was consistent with international tax principles, and they expressed concerns with the nexus approach, including questions about its compatibility with European Union law etc. Many countries raised a number of concerns with the transfer pricing approach, which is why the work of the FHTP did not focus further on this approach. The third approach was the nexus approach.

This approach looks to whether an IP regime makes its benefits conditional on the extent of R&D activities of taxpayers receiving benefits. The approach seeks to build on the basic principle underlying R&D credits and similar "front-end" tax regimes that apply to expenditures incurred in the creation of IP. Under these front-end regimes, the expenditures and benefits are directly linked because the expenditures are used to calculate the tax benefit. The nexus approach extends this principle to apply to "back-end" tax regimes that apply to the income earned after the creation and exploitation of the

IP. Thus, rather than limiting jurisdictions to IP regimes that only provide benefits directly to the expenditures incurred to create the IP, the nexus approach also permits jurisdictions to provide benefits to the income arising out of that IP – so long as there is a direct nexus between the income receiving benefits and the expenditures contributing to that income. This focus on expenditures aligns with the underlying purpose of IP regimes by ensuring that the regimes that are intended to encourage R&D activity only provide benefits to taxpayers that in fact engage in such activity.

Expenditures therefore act as a proxy for substantial activities. It is not the *amount* of expenditures that acts as a direct proxy for the amount of activities. It is instead the *proportion* of expenditures directly related to development activities that demonstrates real value added by the taxpayer and acts as a proxy for how much substantial activity the taxpayer undertook. The nexus approach applies a proportionate analysis to income, under which the proportion of income that may benefit from an IP regime is the same proportion as that between qualifying expenditures and overall expenditures. In other words, the nexus approach allows a regime to provide for a preferential rate on IP-related income to the extent it was generated by qualifying expenditures. The purpose of the nexus approach is to grant benefits only to income that arises from IP where the actual R&D activity was undertaken by the taxpayer itself. This goal is achieved by defining “qualifying expenditures” in such a way that they effectively prevent mere capital contribution or expenditures for substantial R&D activity by parties other than the taxpayer from qualifying the subsequent income for benefits under an IP regime. If a company only had one IP asset and had itself incurred all of the expenditures to develop that asset, the nexus approach would simply allow all of the income from that IP asset to qualify for benefits. Once a company’s business model becomes more complicated, however, the nexus approach also by necessity becomes more complicated, because the approach must determine a nexus between multiple strands of income and expenditure, only some of which may be qualifying expenditures. In order to address this complexity, the nexus approach apportions income according to a ratio of expenditures. The nexus approach determines what income may receive tax benefits by applying the following calculation:

$$\frac{\textit{Qualifying expenditures incurred to develop IP asset}}{\textit{Overall expenditures incurred to develop IP asset}} \times \textit{Overall income from IP asset} = \textit{Income receiving tax benefits}$$

Jurisdictions could treat this calculation as a rebuttable presumption. In the absence of other information from a taxpayer, a jurisdiction would determine the income receiving tax benefits based on the calculation above. Taxpayers would, however, have the ability to prove, in certain circumstances to be defined in further guidance being developed by the FHTP, that more income should be permitted to benefit from the IP regime if they could show a direct link between that income and qualifying expenditures to develop the IP asset. This version of the nexus approach may require greater record-keeping on the part of taxpayers, and jurisdictions may need to establish notification and monitoring procedures. Difficulties may arise around how to establish the direct linkage between expenditures and income, but it could ensure that taxpayers that engaged in greater value creating activity than is reflected in the calculation above would be permitted to have more income benefit from the IP regime. Jurisdictions that did decide to adopt this version would still use the calculation above to establish the presumed amount of income that could qualify for tax benefits.

Where the amount of income receiving benefits under an IP regime does not exceed the amount determined by the nexus approach, the regime has met the substantial activities requirement. The remainder of this section provides further guidance on the application of the nexus approach and the above calculation.

A. *Qualifying taxpayers*

Qualifying taxpayers would include resident companies, domestic Permanent Establishments (PE) of foreign companies, and foreign PEs of resident companies that are subject to tax in the jurisdiction providing benefits. The expenditures incurred by a PE cannot qualify income earned by the head office as qualifying income if the PE is not operating at the time that income is earned².

B. *IP assets*

Under the nexus approach as contemplated, the only IP assets that could qualify for tax benefits under an IP regime are patents and other IP assets that are functionally equivalent to patents if those IP assets are both legally protected and subject to similar approval and registration processes, where such processes are relevant. The nexus approach focuses on establishing a nexus between expenditures, these IP assets, and income³. Under the nexus approach, marketing-related IP assets such as trademarks cannot qualify for tax benefits under an IP regime.

C. *Qualifying expenditures*

Qualifying expenditures must have been incurred by a qualifying taxpayer, and they must be directly connected to the IP asset. Jurisdictions will provide their own definitions of qualifying expenditures,

and such definitions must ensure that qualifying expenditures only include expenditures that are necessary for actual R&D activities. They would include the types of expenditures currently granted R&D credits under the tax laws of multiple jurisdictions⁴. They would not include interest payments, building costs, acquisition costs, or any costs that could not be directly linked to a specific IP asset⁵.

D. Overall expenditures

Overall expenditures should be defined in such a way that, if the qualifying taxpayer incurred all relevant expenditures itself, the ratio would allow 100% of the income from the IP asset to benefit from the preferential regime. This means that overall expenditures must be the sum of all expenditures that would count as qualifying expenditures if they were undertaken by the taxpayer itself. This in turn means that anything that would not be included in qualifying expenditures even if incurred by the taxpayer itself (e.g., interest payments, building costs, acquisition costs, and other costs that do not represent actual R&D activities) cannot be included in overall expenditures and hence does not affect the amount of income that may benefit from an IP regime. IP acquisition costs are an exception, since they are included in overall expenditures and not in qualifying expenditures. Their exclusion is consistent with the principle of what is included in overall expenditures, however, because they are a proxy for expenditures incurred by a non-qualifying taxpayer. Overall expenditures therefore include all qualifying expenditures, acquisition costs, and expenditures for outsourcing that do not count as qualifying expenditures.

Often, overall expenditures will be incurred prior to the production of income that could qualify for benefits under the IP regime. The nexus approach is an additive approach, and the calculation requires both that “qualifying expenditures” include all qualifying expenditures incurred by the taxpayer over the life of the IP asset and that “overall expenditures” include all overall expenditures incurred over the life of the IP asset. These numbers will therefore increase every time a taxpayer incurs an expenditure that would qualify for either category. The proportion of the cumulative numbers will then determine the percentage to be applied to overall income earned each year.

E. Overall income

Jurisdictions will define “overall income” consistent with their domestic laws on income definition. The definition that they choose should comply with the following principles:

Overall income should be limited to IP income: Overall income should only include income that is derived from the IP asset. This may include royalties, capital gains and other income from the sale of an IP asset, and embedded IP income from the sale of products directly related to the IP asset.

Income benefiting from the regime should be proportionate: Overall income should be defined in such a way that the income that benefits from the regime is not disproportionately high given the percentage of qualifying expenditures undertaken by qualifying taxpayers. This means that overall income should not be defined as the gross income from the IP asset, since such a definition could allow 100% of the net income of qualifying taxpayers to benefit even when those taxpayers had not incurred 100% of qualifying expenditures. Overall income should instead be adjusted by subtracting IP expenditures allocable to IP income and incurred in the year from gross IP income earned in the year⁶.

F. Outsourcing⁷

The nexus approach is intended to ensure that, in order for a significant proportion of IP income to qualify for benefits, a significant proportion of the actual R&D activities must have been undertaken by the qualifying taxpayer itself. The nexus approach would allow all qualifying expenditures for activities undertaken by unrelated parties – whether or not they were within the jurisdiction – to qualify, while all expenditures for activities undertaken by related parties – again, whether or not they were within the jurisdiction – would not count as qualifying expenditures⁸.

As a matter of business practice, unlimited outsourcing to unrelated parties should not provide many opportunities for taxpayers to receive benefits without themselves engaging in substantial activities because, while a company may outsource the full spectrum of R&D activities to a related party, the same is typically not true of an unrelated party. Since the vast majority of the value of an IP asset rests in both the R&D undertaken to create it and the information necessary to undertake such R&D, it is unlikely that a company will outsource the fundamental value-creating activities to an unrelated party, regardless of where that unrelated party is located⁹. Allowing only expenditures incurred by unrelated parties to be treated as qualifying expenditures thus achieves the goal of the nexus approach to only grant tax benefits to income arising from the substantive R&D activities in which the taxpayer itself engaged that contributed to the income. Jurisdictions could narrow the definition of unrelated parties to include only universities, hospitals, R&D centres and non-profit entities that were unrelated to the qualifying taxpayer. Where a payment is made through a related party to an unrelated party without any margin, the payment will be included in qualifying expenditures.

Jurisdictions could also only permit unrelated outsourcing up to a certain percentage or proportion (while still excluding outsourcing to related parties from the definition of qualifying expenditures). As explained above, business realities typically mean that a company will not outsource more than an insubstantial amount of R&D activities to an unrelated party, so both a prohibition on outsourcing to any related parties and that same prohibition combined with a cap that prohibits outsourcing to

unrelated parties beyond an insubstantial amount should have the equivalent effect of limiting qualifying expenditures to those expenditures incurred to support fundamental R&D activities by the taxpayer.

G. *Treatment of acquired IP*

The basic principle underlying the treatment of acquired IP by the nexus approach is that only the expenditures incurred for improving the IP asset after it was acquired should be treated as qualifying expenditures. In order to achieve this, the nexus approach would exclude acquisition costs from the definition of qualifying expenditures, as mentioned above, and only allow expenditures incurred after acquisition to be treated as qualifying expenditures. Acquisition costs would, however, be included in overall expenditures. Acquisition costs (or, in the case of licensing, royalties or license fees) are a proxy for overall expenditures incurred prior to acquisition. Therefore, no expenditures incurred by any party prior to acquisition will be included in either qualifying expenditures or overall expenditures.

H. *Tracking of income and expenditures*

Since the nexus approach depends on there being a nexus between expenditures and income, it requires jurisdictions wishing to introduce an IP regime to mandate that taxpayers that want to benefit from an IP regime must track expenditures, IP assets, and income to ensure that the income receiving benefits did in fact arise from the expenditures that qualified for those benefits. If a taxpayer has only one IP asset that it has fully self-developed and that provides all of its income, this tracking should be fairly simple, since all qualifying expenditures incurred by that company will determine the benefits to be granted to all the IP income earned by that company. Once a company has more than one IP asset or engages in any degree of outsourcing or acquisition, however, tracking becomes essential. Tracking must also ensure that taxpayers have not manipulated the amount of overall expenditures to inflate the amount of income that may benefit from the regime.

This means that taxpayers will need to be able to track the link between expenditures and income and provide evidence of this to their tax administrations. Jurisdictions will therefore need to establish a reasonable tracking method based on consistent criteria capable of objective measurement. This could take the form of, for example, research codes identifying the purpose of individual research expenditures or descriptions of research expenditures. Not engaging in such tracking will not prevent taxpayers from earning IP income in a jurisdiction, but it will prevent them from benefiting from a preferential IP regime.

The main complexity associated with tracking arises from the fact that a preferential rate is applied to certain IP income, which is a function of the regime rather than the nexus approach, and existing IP regimes suggest that taxpayers are willing to comply with certain often complex requirements when an optional tax benefit is made conditional on such requirements. Because the nexus approach will standardise the requirements of IP regimes across jurisdictions, it may in the long term reduce the overall complexity that taxpayers that are benefiting from multiple IP regimes currently face. Financial accounting often already requires tracking of IP income and expenditures on a project-by-project basis. It is recognised that the existing systems may not fully support the requirements of the nexus approach and that it may take time to set up systems that do support these requirements. The FHTP recognises that discussions with business would be necessary.
