

Tax News Bulletin

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Impact of BEPS Action 5 on Dutch innovation box

In its effort to counter harmful tax practices, in 2013 the OECD introduced the Action Plan on Base Erosion and Profit Shifting (BEPS). The Action Plan is scheduled to be completed by September 2015. The objective of the OECD is that the plan be implemented by member states in the next few years by introducing or tightening (anti abuse) legislation and by revising tax treaties. In July 2014 the OECD published its Action 5 2014 deliverable. A new concept introduced in Action 5 is the so called modified nexus approach (“MNA”). The MNA has the potential to significantly impact IP tax regimes, including the Dutch “innovation box”.

What does the MNA entail?

Action 5 is titled: “countering harmful tax practices more effectively, taking into account transparency and substance”. One of the Action 5 deliverables is the agreement on a “modified nexus approach” (“MNA”) for IP regimes. The general idea behind this agreement is that preferential tax regimes such as IP regimes can become (part of) harmful tax practices when the taxation of profit is not in line with the substantial activities. Therefore, a substantial activity requirement is introduced. If the substantial activity requirement can not be met, the IP regime becomes unavailable. The MNA links substantial activity to R&D expenses. In other words, substantial activity is deemed to take place there where the expenses are incurred. Without going into detail, the following MNA formula is likely to become the new standard shortly (perhaps as soon as 2016) for OECD/G20/EU member states which have IP tax regimes, or which plan to introduce one.

The formula determines and limits the taxable profit which allocable to the favorable IP tax regime, as follows:

$$QE / OE \times OII = TBI$$

Where:

QE = Qualifying Expenses

OE = Overall Expenses

OII = Overall IP Income

TBI = Tax Benefit Income

According to the Action 5 report, the objective of the MNA to limit the allocation to qualifying income if R&D activities and/or expenses are outsourced to a group company. In that case, the outsourced expenses are not included in the QE. As a result the qualifying income will be reduced accordingly.

Example:

R&D expenses in Dutch innovation box qualifying company	100	
R&D expenses in German (contract R&D) group company		100
Total R&D Income		400

The allocation according to the MNA-formula will be as follows

$$QE (100) / OE (200) \times OII (400) = TBI (200)$$

Therefore, in this example the Dutch company is allowed to allocate a limited amount of 200, instead of 400, to the innovation box regime.

When adding the German-UK approach to the MNA (see below), there would be an additional allocation of 30% ("Uplift"), as a result of which the qualifying income will be 260 instead of 200, and the adjustment will be 140 instead of 200.

After publishing the Action 5 deliverable, the MNA approach was adopted by Germany and the UK in their bilateral agreement on the UK patent box regime. The German – UK bilateral agreement includes an allocation uplift of 30%, a grandfathering period until 2021 for existing patent box systems which are not in line with the MNA, and closing old regimes to new entrants by 30 June 2016. The European Union Code of Conduct Group adopted this "adjusted" MNA at their meeting of 5 December 2014. Finally the OECD and the G20 adopted this adjusted MNA in their Action 5 agreement on MNA, published February 2015.

Other MNA issues

In its Action 5 report, the OECD also requires that the qualifying IP for IP tax regimes must be linked with 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.

This means that taxpayers should provide the tax authorities with a certain third party statement (a patent or other certificate) enabling the tax authority granting the tax regime, to verify whether there really is a qualifying IP.

Does this mean that, under the MNA, the Dutch “WBSO certificate” still qualifies as an entry ticket to the innovation box? The WBSO certificate might still qualify, however additional safeguards may have to be built in.

Innovation box to be modified?

It is clear that if the MNA as described above will be introduced across the board and the Netherlands adopts it, the current Dutch innovation box regime would have to be amended as currently Dutch taxpayers are not obliged to make the adjustment pursuant to the above-mentioned formula.

It is currently not expected that the WBSO certificate will be waived as an entry ticket, as it seems to be in line with the nexus condition. This was also stated by the Dutch State Secretary of Finance in his letter to the Code of Conduct Group (Ecofin) of 9 December 2014.

Our comments

From the above summary it becomes clear that the OECD BEPS Group continues to introduce measures to prevent member states from continuing or introducing harmful tax regimes.

However, it appears that the MNA-formula is not in accordance with the at arm’s length principle. The fact that outsourced expenses do not qualify as IP regime qualifying expenses does not take into account the weighing and value of the functions performed in the several group companies. If the key R&D performing entity indeed performs all key R&D functions and the outsourced activities performing entity only performs routine functions, the outsourced expenses should - in line with the functional analysis based on the at arm’s length principle – also qualify as qualifying expenses.