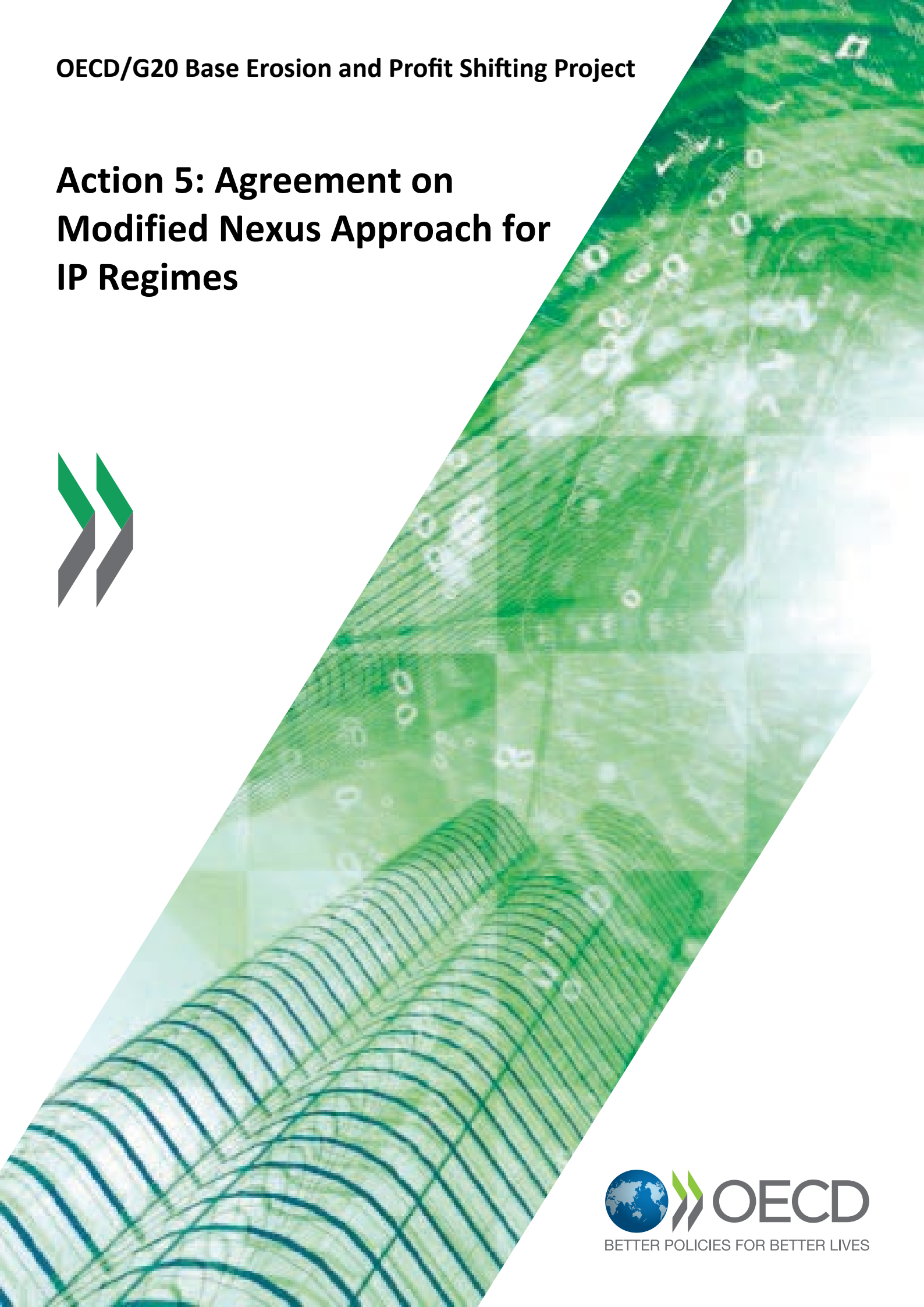
OECD/G20 Base Erosion and Profit Shifting Project

Action 5: Agreement on Modified Nexus Approach for IP Regimes



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BETTER POLICIES FOR BETTER LIVES

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This consensus achieved by the FHTP builds on the joint proposal by Germany and the UK and aims to resolve the concerns countries have expressed about some features of the Modified Nexus Approach and identify what further work is required in order to enable agreement to be reached on this issue during 2015. Concerns have been expressed about how to calculate qualifying R&D expenditure, transitional arrangements between regimes and time allowed for this through grandfathering provisions, and the tracking and tracing methodology for R&D expenditure that will determine whether it qualifies.

The proposal is based on the following elements, which seek to address the concerns that have been raised, whilst reinforcing the nexus approach, providing safeguards against profit shifting, and ensuring that there is equal treatment across all sectors and businesses of different sizes. These also aim to ensure that the approach to implementing new rules is consistent with existing OECD rules on the phasing out of harmful regimes.

A) The Modified Nexus Approach – conceptual issues

1. Nexus Approach: General acceptance of the Modified Nexus Approach as presented in the OECD Report on Action 5, but requiring further modifications relating to the level of qualifying expenditure, grandfathering provisions and the tracking and tracing of expenditure:

2. Up-lift: Under the currently proposed Modified Nexus Approach, businesses using already existing Patent Box regimes might see a reduction in income receiving preferential treatment, as R&D expenditure to develop the patent must be undertaken in a more limited number of entities, including the company holding the relevant patent, to qualify. This could impose restructuring costs on groups which have dedicated R&D companies in order for them to retain the relief in future. Furthermore, to disregard any IP acquisition costs at all might have an impact on commercial decisions. To reflect these concerns raised by businesses, countries may allow for an up-lift of qualifying expenditure within the Modified Nexus Approach. However, one needs to take into account that the very conceptual basis of the Modified 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. Accordingly, such up-lift needs to be restricted. It may only be granted to the extent that expenditure in the context of outsourcing and acquisitions has actually taken place, and it is in any case limited to a certain percentage of the qualifying expenses of the respective company: **30%**. This percentage-based limitation relates to the overall amount of both outsourcing and acquisition costs. For the avoidance of doubt, acquisition costs and expenditures for outsourcing to related parties are not included in qualifying expenditures, but are taken into account in determining the limitation described in the preceding sentence[1].

[1] This does not change the effect of note 8 on page 51 of the 2014 Deliverable on Countering Harmful Tax Practices More Effectively (OECD, 2014).

Example (1):

Parent company incurred qualified expenses of 100,
parent company incurred costs for **acquisition of IP** assets of 10,
subsidiary company incurred R&D expenses 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):

Parent company incurred qualified expenses of 100,
parent company incurred costs for **acquisition of IP** assets of 5,
subsidiary company incurred R&D expenses of 20.

- Maximum up-lift amount = 100 x 30 % = 30
- Overall qualifying expenses including a limited percentage of outsourcing and acquisition costs = 125

B) Timing, grandfathering and reporting issues

1. Close old regime to new entrants: Countries choosing to have IP regimes will need to bring the applicable rules in line with the Modified Nexus Approach. That means that 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 no later than 30 June 2016. The FHTP further agrees that any legislative process necessary to make this change must commence in 2015. This transition period for the closure of existing regimes to new entrants recognises that countries will need time for any legislative process.

   "New entrants" include both new taxpayers not previously benefiting from the regime and new IP assets owned by taxpayers already benefiting from the regime. Further, it is understood that new entrants are only those that fully meet all substantive requirements of the regime and have been officially approved by the tax administration, if required. New entrants therefore do not include taxpayers that have only applied for the regime.

2. Final abolition of old regime: In order to give protection for taxpayers benefiting from existing regimes, countries are allowed to introduce grandfathering rules. Under such rules, all taxpayers benefiting from an existing regime may keep such entitlement until a second specific date ("abolition date"). The period between the two dates should not exceed 5 years (so the abolition date would be **30 June 2021**). After that date, no more benefits stemming from the respective old regimes may be given to taxpayers.

3. Further work to be concluded by June 2015:

- Reporting requirements under Modified Nexus Approach: An approach to the tracking and tracing of R&D 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 FHTP acknowledges that it might be difficult for companies to provide detailed information about qualifying expenditure for past years under the Modified Nexus Approach if – until the time at which new rules are introduced – there is no requirement for them to track such expenditure. The FHTP will agree practical methodologies for identifying qualifying expenditure that companies and tax authorities should use recognising the particular issues regarding qualifying expenditure with respect to expenses incurred prior to the introduction of the Modified Nexus Approach. Failure to do so will mean that no tax benefit may be granted to those companies under the Modified Nexus Approach. Special rules will be developed for this time period to ease the tracking and tracing of such expenditure.

- Additional safeguards: The FHTP will continue to discuss measures to mitigate the risks that new entrants seek to avail themselves of existing regimes with a view to benefiting from grandfathering. Examples could include enhanced transparency (e.g. requiring spontaneous exchange of information on taxpayers benefiting from a grandfathered regime regardless of whether a ruling is provided), monitoring of new entrants, and possible restrictions, so as to mitigate the risk of new entrants availing themselves of existing regimes with a view to benefiting from grandfathering.

- Guidance on the definition of qualifying IP assets: Under the Modified Nexus Approach the only IP assets that could qualify for benefits under an IP regime are patents and functionally equivalent IP assets that are legally protected and subject to approval and registration processes, where such processes are relevant. The Modified Nexus Approach explicitly excludes from receiving benefits marketing-related IP assets such as trademarks. The FHTP recognises the need for clarity on the definition of qualifying IP assets. The FHTP will therefore produce further guidance on this definition, addressing in particular the exact scope of IP assets, for example, the treatment of copyrighted software or innovations from technically innovative development or technical scientific research that do not benefit from patent protection, always provided of course that such assets have been developed with sufficient nexus.