



**Irish Tax
Institute**

Leaders in Tax

Irish Tax Institute

**Comments on OECD “Agreement on
Modified Nexus Approach for IP
Regimes”**

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About the Irish Tax Institute

The Irish Tax Institute is the leading representative and educational body for Ireland's AITI Chartered Tax Advisers (CTA) and is the only professional body exclusively dedicated to tax. Our members provide tax expertise to thousands of businesses and individuals in Ireland and internationally. In addition many hold senior roles within professional service firms, global companies, Government, Revenue and state bodies.

The Institute is the leading provider of tax qualifications in Ireland, educating the finest minds in tax and business for over thirty years. Our AITI Chartered Tax Adviser (CTA) qualification is the gold standard in tax and the international mark of excellence in tax advice.

A respected body on tax policy and administration, the Institute engages at the most senior levels across Government, business and state organisations. Representing the views and expertise of its members, it plays an important role in the fiscal and tax administrative discussions and decisions in Ireland and in the EU.

Executive Summary

The importance of innovation and support for research and development work has been a central tenet of the OECD's policy agenda for some time. The OECD has played a major role in developing best practices for innovation including the development of the *Frascati* Manual and the launch of the OECD's Innovation Strategy in 2010.

This Innovation Strategy recognises the crucial role of innovation in helping countries grow, following the financial crisis. Commenting on the launch of the Innovation Strategy, Angel Gurría, OECD Secretary-General said:

“Innovation has always been an important driver of growth. However, in recent times, its importance has grown significantly. More than ever, we need to reboot our economies with a more intelligent type of growth, driven by new start-ups, by the most innovative small and medium enterprises and banks, and by our need to develop efficient renewable energies and green technologies for a low-carbon era”.

The September 2014 BEPS report “*Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance*” itself notes:

“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”.

It is therefore vital that the overall innovation policy set by the OECD strikes the right balance between providing whole-hearted encouragement and reward for innovative activities while, at the same time, tackling BEPS concerns. One of the key challenges in striking this balance is to develop principles that can operate effectively across a wide and complex array of innovation methods and global business models, underpinned by diverse intellectual property rights and legal protections.

Our key points on the ‘*Agreement on Modified Nexus Approach for IP Regimes*’ can be summarised as follows:

1. **Overall OECD innovation strategy** - The stated policy objective of the OECD is to encourage innovation, research and development. Tax rules that are introduced to safeguard the integrity of this policy and address BEPS concerns should not result in an actual stifling of the underlying activity or significant increases in the cost of innovation where BEPS concerns do not arise.
2. **Qualifying Assets:** The definition of qualifying assets in the Modified Nexus Approach is far from clear at the moment and the scope of this definition needs very careful consideration. If a narrow definition is taken this will exclude significant amounts of very successful innovation that takes place in industries and businesses where it may not be possible, practical or affordable to seek and defend a patent. We suggest a possible approach to recognising qualifying IP that combines legal recognition, strongly innovative content (based on international standards for innovation and R&D activities) and accounting standard recognition of assets.
3. **Qualifying Expenditure & Outsourcing:** The exclusion of expenditure incurred by related parties will greatly restrict the availability of any relief. MNC's often have a very strong commercial rationale for outsourcing R&D, either to third parties or to specialist centres in different parts of the world within the group. In fact, R&D work on the same technology may

take place over numerous countries in different time zones, to ensure continuity of work around the clock. Excluding work which is paid for and under the direction of a group company in a particular jurisdiction but that is carried on by group companies located in other jurisdictions will impact on the way these MNCs do business and the broader innovation agenda. There may also be EU law concerns if equivalent treatment as qualifying expenditure is not given to R&D expenditure incurred directly by a company in another EU country through a branch or subsidiary where the company exercises the same degree of control and oversight over the activity and related expenditure. The exclusion of related party expenditure will also impact innovative businesses based in smaller economies in a disproportionate way because R&D activities will become centralised in larger markets with more concentrated hubs of expertise and bigger populations for the trial of new products.

4. **SMEs:** Care must also be taken not to disadvantage SMEs and businesses in certain sectors where innovative work may result in IP other than patents. In many cases, it may not be practical or affordable for an SME to seek to apply for and defend a patent for its innovation.
5. **Tracking and Tracing Qualifying Expenditure:** Very real concerns arise about the feasibility and cost of actually tracking expenditure for every separate IP asset. Work on multiple projects/assets is often closely interconnected (particularly in the technology sector). This type of tracking expenditure to individual assets could also fail to recognise the contribution that projects which are ultimately unsuccessful make to later projects that are successful.

While we welcome the opportunity to provide comments in response to this *'Agreement on Modified Nexus Approach for IP Regimes'*, we must point out that a consultation period of just 2 weeks on such a complex issue will inevitably impact the quality of feedback that can be given.

Ireland recently launched a consultation on introducing an income based IP regime. The government is committed to introducing a regime that is in line with the principles ultimately agreed by the EU and the OECD but it is not possible for Irish stakeholders to consider the critical issues and respond meaningfully to these proposals within such a short period. We believe it is vital that further consultation is held before the rules governing IP focussed tax incentives are finalised.

1. Qualifying Assets

Identifying which assets can qualify for an IP regime under the Modified Nexus Approach is of fundamental importance. The ‘Agreement on Modified Nexus Approach for IP Regimes’ (“the Agreement”) recognises that clarity is needed on this issue. The Agreement states that:

“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 Agreement also states that the Modified Nexus Approach:

“explicitly excludes from receiving benefits, marketing-related IP assets”

In summary, there appear to be three criteria that must be met in order for an asset to qualify under this definition:

- The IP must be a patent or be functionally equivalent to a patent, and
- It must be legally protected and registered (where such processes are relevant), and
- It must not be ‘marketing related’.

These criteria give rise to issues of uncertainty including:

- What does functionally equivalent to a patent mean?
- Can an asset only qualify if it is capable of being registered?

We assume that the criteria outlined cover all types of patents including shorter term Utility Model patents and Supplementary Protection Certificates. We also assume that registered Industrial Designs and Plant Breeders Rights¹ will also fall within this definition. Non-market related Trademarks such as certification marks should also be included.

We consider that the phrase “*where such processes are relevant*” should be interpreted to include IP which is legally protected but which is not capable of being registered (such as copyright in certain jurisdictions).

This definition poses a number of challenges which we outline below:

1.1 The definition appears to be quite narrow

It appears that the definition of what assets can qualify under this definition could be interpreted quite narrowly, although we appreciate that further consideration is being given to this. Some very important categories of IP which are legally recognised in most countries may not qualify. These include:

- Unpatented technology
- Software (protected by copyright whether or not registered)
- Trade secrets
- Know-How
- Clinical Data

¹ Also known as Plant Variety Rights

- Manufacturing Technology

It is important to recognise that any IP tax incentive which is limited solely to patents or other IP rights that are capable of being registered (and are actually registered) will exclude vast amounts of innovative activity which takes place and will not reflect the reality that significant amounts of very successful innovation take place in industries and businesses where it may not be possible, practical or affordable to obtain a patent. Patents are often not available or not appropriate for highly innovative activity for a variety of reasons:

- Innovative processes may not be patentable and legal protection is instead provided through copyright or other forms of protection. For example, much innovative software that reflects the outcome of experimental development activity may not be patentable in many countries. The inclusion of copyright as a qualifying asset would ensure that any IP tax incentive could also support and encourage innovative technology companies.
- For small and medium sized businesses (SMEs), the cost and personnel resources required to file a patent application, and subsequently defend a patent, can make it commercial unfeasible to do so. These businesses often rely on the legal protection available for trade secrets or know-how in many countries to provide protection and avoid the cost of securing and defending a patent.
- Many businesses which create assets that are ‘patentable’ may ultimately not seek to secure a patent for many commercial reasons including the risk of information being exploited by competitors, the length of time it can take for a patent to be granted and the difficulty and cost of securing patents in multiple jurisdictions.
- Know-how developed over time is hugely important for businesses in many sectors and can be a key driver of the businesses success. Tax regimes in many countries recognise this and currently provide tax incentives for the development of know-how. The EU recently published a draft Trade Secrets Directive seeking to harmonise and enhance the legal protections available in this area. Where these are legally protectable, we believe that the benefits of tax measures aimed at encouraging innovations should be available.
- In the pharma sector, approvals to sell drug products for an exclusive period which are granted by regulatory authorities are hugely significant and it can be necessary for significant expenditure to be incurred in obtaining these approvals before innovative products can be sold. On a practical level, these periods of exclusivity provided by regulatory approvals offer similar protection to that provided by a patent and should be included as qualifying assets.

The OECD Innovation Strategy notes:

“If policies to promote innovation are to be effective, they need to reflect the ways in which innovation takes place today”.

The OECD has also recognised that innovation is much wider than the traditional idea of R&D which leads to patents:

“There is growing recognition that innovation encompasses a wide range of activities in addition to R&D, such as organisational changes, training, testing, marketing and design.

The latest (third) edition of the Oslo Manual defines innovation as the implementation of a new or significantly improved product (good or service), or process, a new marketing method, or a new organisational method in business practices, workplace organisation or external relations”.

The OECD’s 2013 publication “Supporting Investment in Knowledge Capital, Growth and Innovation” also recognises the need to consider innovation more widely, stating:

“Policy makers should adopt an enlarged concept of innovation, beyond the conventional view in which R&D is pre-eminent. Other forms of knowledge bases capital, such as design, data and organisational capital, should also be policy targets”.

To ensure that IP incentives are able to properly encourage innovative behaviour, they need to encompass the much broader scope of innovation carried out by businesses today. We welcome the specific recognition in the Agreement that further consideration is needed in *“the treatment of copyrighted software or innovations from technically innovative development or technical scientific research that do not benefit from patent protection”*.

We suggest that this broader scope of innovation could be captured in an approach to qualifying IP assets that required that the asset is capable of being separately identified for legal purposes, reflects the output of scientific research or experimental development as recognised under international standards for innovation and also can be recognised as a class of asset that is separable from the goodwill of the business if it was sold by its creator under international accounting standards. By framing the approach to identifying qualifying IP in this manner, this should allow for differences in the form that innovation takes across businesses of different sizes and in different sectors and accommodates the different commercial and legal practices adopted by companies in protecting their most innovative IP.

1.2 The definition may have very different meanings and implications depending on the country concerned

The outlined definition could result in significantly different outcomes across jurisdictions. For example the position on copyright may depend on the jurisdiction concerned. Within the EU, copyright protection cannot be registered but instead is automatically created. However, it seems that in the US, certain copyright protections can be registered. If the policy intention is to include only assets that are capable of (and actually are) publicly registered, then the impact of this may vary from country to country and create an uneven playing field.

There is a need for more detailed guidance on what is functionally equivalent to a patent and careful thought needs to be given to a test which requires registration for an incentive to be available. It is important that the overall tests applying are broad enough to encompass the types of innovation which the OECD supports and encourages and are capable of being applied consistently across countries.

2. Qualifying Expenditure & Outsourcing

The Modified Nexus Approach distinguishes between expenditure which is outsourced to related parties and to unrelated parties.

2.1 Outsourcing to unrelated parties

We welcome the inclusion of expenditure incurred on outsourcing to unrelated parties in the definition of ‘qualifying expenditure’. Outsourcing to third parties is particularly common in certain industries such as pharmaceutical and biotech sectors and can also be important to the SME sector. Outsourcing will often result in quicker and more cost effective completion of innovation projects. For example, the Tufts Center for the Study of Drug Development reports that clinical trials conducted by specialist third party clinical research organisations are completed on average 30% quicker than those conducted in-house. It is important that arbitrary limits are not placed on the level of outsourcing to unrelated parties that can qualify as “qualifying expenditure”.

The Agreement suggests that “*Business realities typically mean that a company will not outsource more than an insubstantial amount of R&D activities to an unrelated party*”. This will not be the case for certain businesses. We would welcome clarification that countries should not place arbitrary limits on the proportion of qualifying expenditure that can be out-sourced, as such limits would adversely discriminate on the sectors and businesses for whom outsourcing is a key part of their innovation process. We would also welcome clarification that countries should not limit the definition of unrelated parties to include only universities, hospitals, R&D centres and non-profit entities for similar reasons.

2.2 Outsourcing to related parties

The Agreement clearly states that expenditures on outsourcing to related parties are not included in qualifying expenditures².

We are concerned that this restriction is not reflective of the reality that MNEs currently locate different elements of their innovation functions in different countries for commercial reasons. The OECD’s Agreement recognises the possibility that businesses would have to restructure their IP operations to retain the benefits of existing IP regimes:

“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”.

If some MNEs were to restructure their commercial operations as a result of the Modified Nexus Approach, the likely result is the centralisation of innovation activity in larger countries which have greater capability to host large innovation facilities due to the availability of larger workforces. This would be to the detriment of smaller economies that would not be able to compete with larger economies for large-scale projects. Smaller economies may typically have developed expertise in certain niche areas of larger industries and MNEs have located some research and innovation functions to take advantage of that expertise.

² We note that footnote 8 of the OECDs September 2014 report on Harmful Tax Practices states that jurisdictions that are not member states of the EU could allow local outsourcing to related parties to be included as qualifying expenditures. This would give a competitive advantage to non-EU countries and therefore EU countries should be allowed to include outsourcing to local related parties also.

We fully appreciate the policy that IP incentives should not be designed in a manner that is harmful or that exacerbates BEPS concerns. However, the Modified Nexus Approach as currently designed will have a real impact on smaller economies' ability to compete for innovation projects and result in a shift of activity towards larger economies.

The Agreement suggests that availability of an up-lift of up to 30% would compensate businesses for the inability to include expenditure incurred by related parties (or acquisition costs) as qualifying expenditure. The availability of an up-lift, while welcome, would not adequately compensate small economies for these concerns.

Where an entity in a smaller economy outsources elements of its innovation projects to related parties, the entity will typically operate significant oversight and direction over the project. We suggest that the outsourced expenditure should be included as qualifying expenditure when the entity is involved in the strategic management of the project and bears the real economic risks of the work carried out. This requirement should ensure that there is sufficient nexus between the work carried out and the entity benefiting from the IP incentive.

2.3 Work carried out by overseas branches

Expenditure incurred directly by the entity is considered to be 'qualifying expenditure' in the entity's home country. We understand that this includes expenditure incurred by the company through branches. Restrictions imposed on the eligibility of expenditure as qualifying expenditure may cause concerns from an EU law perspective where they discriminate based on location of the activity. If an EU country provides a tax incentive for activity occurring within its own borders but not for activity which is performed by the same entity in another EU Member State, whether through a branch or subsidiary where the company exercises equivalent control and oversight over the activity, it is potentially in breach of the EU fundamental freedoms.

3 Tracking and tracing of expenditure

The Agreement recognises that an approach to the tracking and tracing of R&D expenditure which is practical for tax authorities and companies needs to be developed in order to implement the Modified Nexus Approach.

The Modified Nexus Approach will require companies to track innovation expenditure on an asset-by-asset basis. We have concerns about the feasibility of businesses actually tracking and allocating expenditure to individual IP assets, as it does not reflect the way many businesses currently carry out innovation. Many businesses carry out interconnected work on multiple projects and IP simultaneously (particularly in the technology sector). The definition of ‘Basic Research’ as per the *Frascati Manual* recognises that research will often be “*experimental or theoretical work undertaken primarily to acquire new knowledge of the underlying phenomena and observable facts without any particular application or use in view*”. Even where such research is ultimately successful, it may prove challenging to link the research work to specific IP assets.

There are also concerns that the approach of linking qualifying expenditure to individual assets will ultimately not reflect the genuine substance and activity carried out on projects which ultimately prove unsuccessful. Given the interrelated nature of many innovation projects, the work carried out on ‘unsuccessful’ projects will often indirectly contribute significantly to projects that ultimately result in the development of successful IP.

A pooling approach to allocation may be more workable in many cases. At a minimum, significant flexibility over the apportionment of expenditure would be needed for businesses. There are well established guidelines for tracking and tracing expenditure in many countries which have R&D tax credit regimes. We welcome the recognition in footnote 3 of the OECD’s September 2014 report on Harmful Tax Practices that countries may modify the nexus approach slightly in this regard and the proposal to develop further guidance. As far as possible, requirements under any new incentive should be consistent with these established guidelines and practices.