Irish Tax Institute

Leaders in Tax

Knowledge Development Box

IRISH TAX INSTITUTE SUBMISSION

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Introduction

The Irish Tax Institute welcomes the Minister's Public Consultation on the design and implementation of a new Knowledge Development Box (KDB). It is an important element in the Road Map for Ireland's Tax Competitiveness that was published as part of Budget 2015.

This consultation comes at a time when the OECD is considering the introduction of a Modified Nexus Approach for Intellectual Property (IP) regimes, as part of their Base Erosion and Profit Shifting (BEPS) project. The BEPS project is aimed at re-aligning the global profits of multinational companies (MNCs) with their worldwide activities. In response to this OECD work, MNCs are carefully reviewing their worldwide value chains to ensure that they will be BEPS compliant when the full outcome of the BEPS project is known.

Recommendations

Implementation of the Modified Nexus approach

1. **Qualifying Assets**
    - The definition of assets qualifying for the KDB should be drawn as widely as possible to include IP which is legally protected even where it is not capable of being registered. This is vital if the KDB is to be relevant for businesses here with significant investment in unregistered and un-registerable IP assets.

2. **Qualifying Expenditure**
    - The existing R&D tax credit framework should form the general basis for determining KDB qualifying expenditure. However the KDB should allow for reasonable and measurable flexibility for those taxpayers who would be restricted by this approach and require another agreed methodology.
    - Expenditure outsourced to related parties 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.
    - The Modified Nexus approach does not require limits to be placed on 3rd party outsourcing and therefore the KDB should not introduce such limits.

3. **IP Income**
    - A broad definition of IP income should be adopted as provided for in the Modified Nexus approach.
    - A flexible approach to the calculation of overall income should be facilitated. Taxpayers should be able to adopt the most suitable approach and apply this on a consistent basis.

Design of the KDB

The design of the KDB should be governed by the following over-arching principles

4. **Clarity**
    - The rules governing the KDB must be clearly set out in legislation and draft legislation should be made available for consultation prior to enactment.

5. **Minimal compliance costs**
    - A complex regime will lead to high compliance costs for businesses as well as significant tax administration cost for the State. Workable approaches to income and expenditure outlined in this submission, should go some way towards addressing these concerns.

6. **Flexibility**
    - Even within the same sectors, it is clear that businesses differ greatly in their business models, accounting systems, challenges they face and preferences they have for the design and practical implementation of a KDB. It is important to build as much flexibility into the design of the regime as possible, particularly in determining qualifying income and tracking and tracing expenditure.

7. **No restrictions beyond the Modified Nexus approach**
    - The Modified Nexus approach is fundamentally a very restrictive regime, particularly for small open economies, as outlined in our detailed submission to the OECD and which is available at Appendix I. In designing a KDB that conforms with Modified Nexus we must be sure not to deliberately or inadvertently add to these restrictions.

8. **Additional centralised Revenue resources**
    - Promoting innovation is a key Government priority and it is important that adequate resources are provided to Revenue to develop expertise and to administer these innovation tax measures. A Revenue Centre of Excellence which is the contact point for taxpayers in respect of all innovation tax incentives, would be welcome.

Other Design Aspects of the KDB

9. **The benefit of the lower rate should be granted in the form of a tax credit:**
    - Granting the benefit of the KDB in the form of a tax credit rather than requiring the IP activity to be treated as a separate trade would be simpler, easier and less restrictive for taxpayers to apply. This approach is similar to the previous manufacturing relief regime and it would avoid some of the complications affecting the treatment of other reliefs.

10. **The KDB Rate**
    - It is important that the KDB offers a ‘best in class’ competitive rate by international standards.

11. **Maintaining competitiveness**
    - Nine countries currently operate Innovation Boxes of some description and it is likely that all of these boxes will enjoy a period of grand-fathering until June 2021. This is a key strategic factor for Ireland in setting our tax policy. We are facing a period of significant change over the coming months and years and must ensure that our overall approach to the taxation of innovation is sufficiently competitive to maintain and grow our tax base during this time.

A multi-faceted tax policy for innovation

Other aspects of the Innovation offering that are important are:

12. **The R&D tax credit regime:**
    - Businesses need a mechanism to obtain advance assurance on R&D claims to improve the efficiency of Revenue audits and enquiries and prevent uncertainty for taxpayers arising. The regime could also be significantly enhanced by removing or reducing the restrictions on 3rd party outsourcing.

13. **Capital allowances for intangible assets**
    - While the KDB will be a very important element of Ireland's innovation offering, it is vital that it operates within a framework designed to encourage innovation. An effective capital allowances for the acquisition of intangible assets is another key element of this framework (together with the R&D and personal income tax regimes).

14. **Pooling for foreign tax credits on royalty income**
    - The current absence of pooling for foreign tax credits on royalty income can be a significant cost for business involved in innovation. A review of this policy would be welcome as part of an improved overall innovation package.

15. **A competitive income tax regime**
    - The 52% marginal rate of tax on income is barrier to attracting talented employees who can carry out R&D activity to Ireland. Reducing this marginal rate and reducing the tax cost associated with share based remuneration would be an important step in boosting Ireland's attractiveness as a location to carry out innovative activities.

A KDB for SMEs

While the above recommendations will also be relevant for SMEs, it is particularly important for these smaller businesses that the KDB is designed in a manner which minimises compliance costs, provides certainty as to the level of relief available and applies to as broad a range of IP as possible.

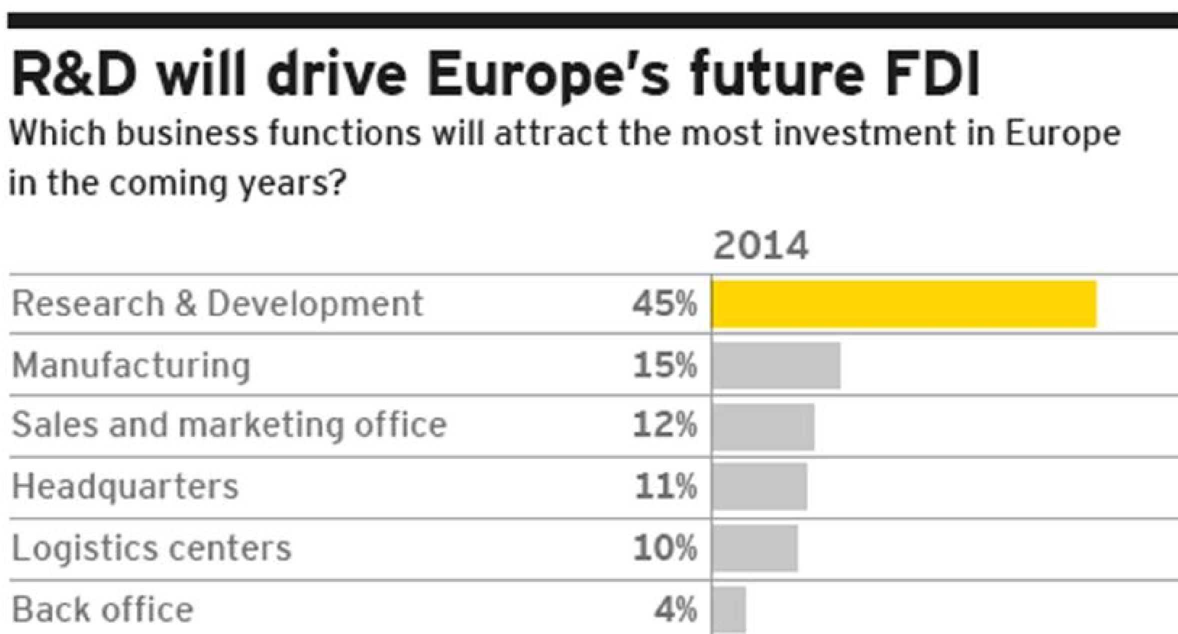
SECTION 1 THE IMPORTANCE OF INNOVATION IN IRELAND

The innovation activity we want to promote in Ireland

R&D and innovation has quite rightly been identified as one of the key pillars of growth by the Government. This is reflected in the Action Plan for Jobs 2015 which outlines the Government's intention to increase the level of innovation performed by enterprise. The Action Plan recognizes that

> *"Innovation support makes a critical contribution to enterprise policy, and to the goal of developing a competitive national economy, through the stimulus given by innovation to high value economic activities and jobs."*

The OECD itself recognises the fundamental importance of R&D as defined in its Frascati programme and the scale of opportunity that investment in innovation can bring is clearly demonstrated in the table below.



One of the key enablers to driving R&D is a well-designed, competitive and sustainable tax policy to support the activity. To achieve such a policy for Ireland (particularly in a BEPS environment), it is important to be clear about the nature of the innovation activities that are actually carried out here both by MNCs and domestic based companies. Not all innovation and R&D work is the same. There will be different functions, assets and risks carried out in Ireland depending on the company's operating model both in Ireland and worldwide and different tax policies will suit different business models. So it is important that they match, insofar as possible.

In gathering feedback for this submission, the Irish Tax Institute has met and spoken with a wide range of large and small Irish and multi-national companies and tax professionals advising those companies. We have also met with many key stakeholders involved in developing and promoting innovation and R&D activity in Ireland. We found that in most cases, Irish R&D work is focussed on

process and close to market product innovation and that R&D centres in Ireland may be only one of a number of larger R&D centres in the worldwide group.

While this type of feedback and research provides useful information, it would be much enhanced by the collection of further data and detail on the R&D roles and activity in MNCs. Such data would assist policymakers in ascertaining where, in the international value chains, Irish activities lie and where the functions, assets and risks are located. Fact patterns are important in the overall analysis of the activity in Ireland. It is only when these fact patterns are available that informed decisions can be made about the best tax policies to match these facts.

Activity models post BEPS

Tax policies should encourage the development and expansion of activity that companies want to carry out here both now and into the future. It is important for both foreign and Irish MNCs and for the Government that the outcome of this consultation is a sustainable tax policy for the post BEPS environment. If the feedback from MNCs is that the nature of the activities carried out in Ireland is likely to change fundamentally in the next 5-10 years, then this must also be factored into the design of the innovation strategy.

Driving innovation for SMEs

Designing a strategy that will drive innovation by SMEs as well as MNCs is a complex challenge. While SMEs are unlikely to face the same international fragmentation of R&D that MNCs have to deal with, they have much more limited resources to deal with complex incentives. SMEs need a simple regime that will focus the key employees in the company on driving sales and growing the business to scale.

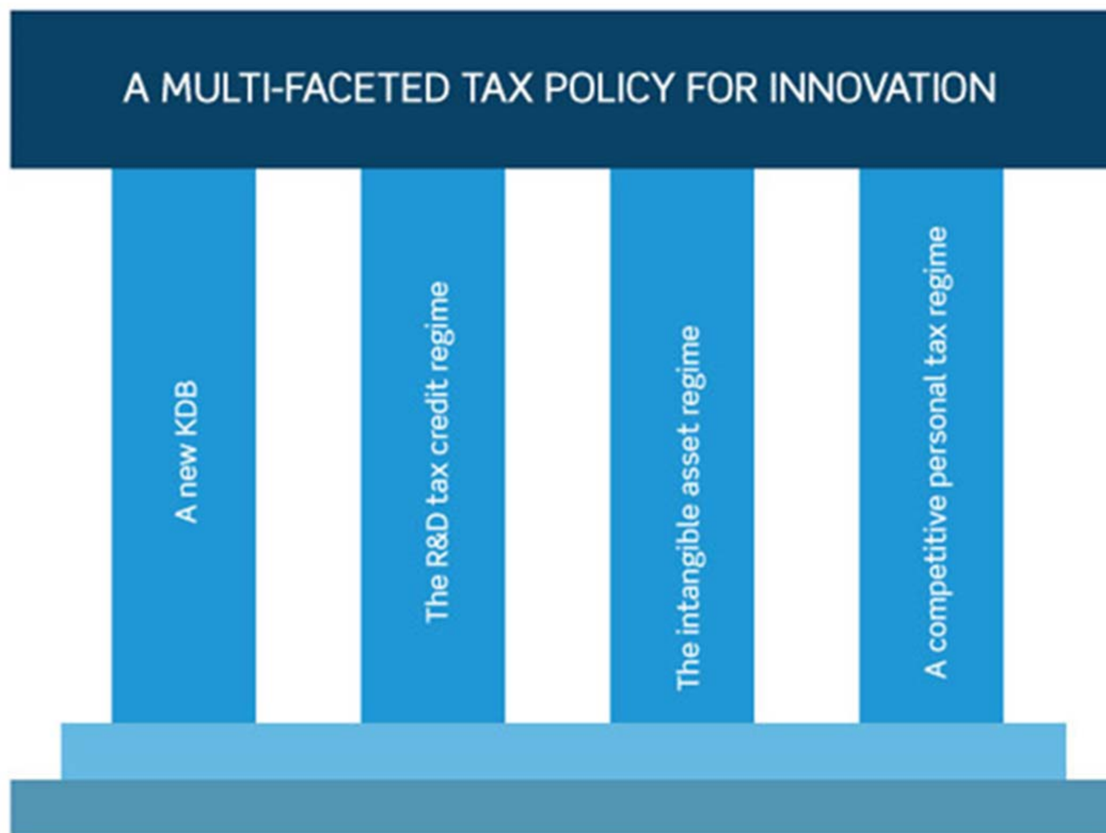
A KDB for them must be simple to understand and implement with low compliance cost – otherwise we could find that SMEs do not participate fully.

SECTION 2 A MULTI-FACETED TAX POLICY FOR INNOVATION

The core issue in the Department of Finance consultation paper is the design of a new KDB. However, the consultation paper recognises that other elements of our tax offering for innovation are important to consider.

Presenting a sustainable tax strategy for innovation is a complex matter. The challenges cannot be addressed by the introduction of a Knowledge Development Box alone and we suggest that now is a good time to review the overall model for taxing innovation activity that would operate to support the 12.5% corporation tax rate. This includes:

A. A new KDB;
B. The R&D tax credit regime;
C. The intangible asset capital allowances regime;
D. A competitive personal tax regime.



A. THE NEW KDB

The Consultation Paper makes it clear that the KDB will be a "best in class offering". However it also states that the regime will have to comply with EU and OECD requirements on income based Intellectual Property regimes.

Since the publication of the Government's Consultation Paper on the KDB, the OECD opened a short two week consultation on the "Agreement on the Modified Nexus Approach for IP regimes". The published guidelines include very strict conditionality requirements which we believe could significantly limit the attractiveness of a KDB for most multi-national companies (and indeed for many SMEs).

A full copy of our submission to the OECD on their Modified Nexus Proposals is attached at Appendix 1. We raised a number of difficulties with the published approach:

1. The restrictions included on outsourcing R&D activities to other entities within the group – a common operating model for most MNCs that carry out R&D in multiple jurisdictions for a variety of commercial and geographical reasons;
2. The narrow definition of IP qualifying for the regime which is limited to patents and assets functionally equivalent to patents;
3. The exclusion of acquired IP in the numerator of a very complex formula to calculate the qualifying income. This is of particular concern to countries such as Ireland where one of our key competitive strengths in sectors such as manufacturing lies in business process innovation.
4. The onerous and impractical approach to tracking and tracing suggested by the OECD which involves the tracing of IP assets included in final goods and services sold, right back to the related qualifying and total costs incurred in generating each of those assets.

In particular, the outsourcing restrictions outlined at 1. above, will impact disproportionately on innovative business carried out by MNCs across all industry segments in small economies like Ireland. Global R&D activities are likely to become more centralised in larger markets which offer competitive income based IP regimes but also have the natural advantages of more concentrated hubs of expertise and bigger populations for the trial of new products.

Other important design features of the KDB will be:

1. A broadly defined asset base

It is important for MNCs and Irish businesses that the definition of qualifying IP is as wide as possible. Many businesses are heavily reliant on the know-how and processes they have developed. They will often feel unable to patent this information because it is then in the public domain. The costs of registering and monitoring patent infringements can also be prohibitively high for SMEs.

Furthermore, it is not always possible to patent or otherwise publicly register an IP asset and this is a significant issue for both MNCs and Irish companies. Technology assets such as software are core to the innovation and development work carried out in Ireland but it is not possible to register the copyright in such assets.

The OECD Modified Nexus Approach provides that:

"the only assets that could qualify for tax 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"

It is not possible to approve and register assets such as copyright, non-market related trademarks, know-how and trade secrets, so that approval and registration processes are not relevant for these assets. We would therefore urge that the definition of assets qualifying for the KDB is drawn as widely as possible to include IP which is legally protected even where it is not capable of being registered. This is vital if the KDB is to be relevant for businesses here with significant investment in unregistered and un-registerable IP assets.

2. Key design principles

Below we have provided detailed commentary and technical analysis on a number of key design issues for the KDB which we believe are vital if the regime is to achieve the ambitious target of "Best in class offering". These comments are based on five over-arching principles that should govern its design:

2.1. Clarity – the rules governing the KDB must be clearly set out in legislation so that businesses can understand exactly how the regime operates and subjectivity is kept to a minimum. Revenue Guidance would also be helpful, but the legislation is of paramount importance. Full and open consultation on draft legislation with relevant stakeholders is very important to achieve clarity and prevent unforeseen consequences arising.

2.2. Minimal compliance cost – a complex regime will lead to high compliance costs for businesses as well as significant tax administration cost for the State. On the face of it, he formula proposed by the OECD could place a very heavy burden on business to track and trace expenditure for every separate piece of qualifying IP (as outlined above). Companies generally record their costs by cost centre (e.g. sales and marketing, general administration etc.) rather than by project or asset. Trying to extract all relevant costs from these cost centres to meet the strict tracking requirements of the Modified Nexus Approach is going to be very difficult for all businesses and will add enormously to their compliance costs. Suggestions such as workable definitions of income and expenditure are outlined below which seek to address these concerns.

2.3. Flexibility – in preparing this submission, the Institute met and spoke with dozens of business owners, tax advisers, legal experts and technical innovation leaders in Irish and multi-national companies as well as in tax practice. Even within the same sectors, it is clear that businesses differ greatly in their business models, accounting systems, challenges they face and preferences they have for the design and practical implementation of a KDB. One size will not fit all and therefore it is important to build as much flexibility into the design of the regime as possible, particularly in determining qualifying income and tracking and tracing expenditure.

2.4. No restrictions beyond the Modified Nexus approach – the Modified Nexus approach is fundamentally a very restrictive regime, as outlined in our detailed submission to the OECD and which is available at Appendix I. In designing a KDB that conforms with Modified Nexus we must ensure that we do not deliberately or inadvertently add to these restrictions. This risk of including additional restrictions is greatest in determining:

- the Irish definition of "qualifying expenditure" (particularly on the issue of outsourcing) and

- the methodology for applying the incentive (e.g. treating the innovation activity as a separate trade)

Such restrictions could add a layer of cost that is not foreseen with the Modified Nexus Approach.

2.5. Additional centralised Revenue resources – promoting innovation is a key Government priority and it is important that adequate resources are provided to Revenue to develop expertise and to administer the key tax innovation supports. The establishment of Revenue Centres of Excellence with a focus on providing detailed information and support could greatly benefit the functioning of these key reliefs. A similar model exists in the UK which could usefully be adapted here. HMRC operate regional R&D Units which provide a range of free support services to business including meeting with taxpayers, facilitating in-house training, attending business exhibitions and speaking at industry events.

3. Detailed design features

The Consultation Document states that:

> *"It is also necessary that the regime complies with relevant OECD and EU requirements on income based intellectual property regimes…"*

In effect, this means that the Modified Nexus formula proposed by the OECD will be applied to the KDB.

Modified Nexus formula

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

We have therefore structured our comments below to reflect the issues arising under the two main elements in the formula:

3.1. The expenditure element - qualifying and overall expenditures incurred to develop IP asset

Within a Modified Nexus approach, there is flexibility for countries to provide their own definition of "qualifying expenditure". However some boundaries seem to apply. The OECD states that qualifying expenditures must be incurred by the taxpayer, must be directly connected to an IP asset and can only include expenditures that are necessary for actual R&D activities.

3.1.1. The existing R&D tax credit framework should form a common starting point for determining KDB qualifying expenditure.

The consensus view from the businesses and advisers we spoke to was that the current R&D tax credit framework would be the most appropriate basis for framing the type of development expenditure that qualifies. This framework applies to all expenses (including overheads) incurred wholly and exclusively in carrying out R&D activity and has been in place for more than 10 years. Broadly speaking it is well understood by the businesses that use it.

This would need to be adjusted to reflect all of the expenditure directly incurred by the taxpayer (some of which may be restricted for R&D tax credit relief purposes) and to take account of expenditure which is eligible for the tax credit regime (such as expenditure on plant and buildings) which is suggested by the OECD should not be included in qualifying expenditure. In tracing historic eligible expenditure, it should not be a requirement that the company has actually claimed R&D tax credit relief – merely that it would be useful to adopt the R&D tax credit relief framework for qualifying activities in framing qualifying expenditure for the KDB.

Additional flexibility should also be provided within the KDB for additional expenditure to qualify where the taxpayer can demonstrate that the expenditure meets the criteria in the Modified Nexus approach as being "necessary for actual R&D activities".

3.1.2. 3rd party outsourcing should not be limited.

The R&D tax credit currently includes limitations on the amount of expenditure that may be outsourced to 3rd parties. Relief is restricted to the greater of:

- €100,000 or
- 15% of all qualifying expenditure.

It is important that no similar restrictions on 3rd party outsourcing are included in the KDB definition of qualifying expenditure, as this would greatly limit the value of the relief.

3.1.3 Simplified formula for SMEs.

If a business does not engage in related party outsourcing and has no acquired IP, the numerator and denominator of the Modified Nexus formula will be the same. Once there is an element of qualifying expenditure incurred, the quantum of expenditure above and below the line should therefore not impact on the level of relief available for the KDB - as the expenditure ratio will always be 1:1. This would significantly simplify the tracking and tracing exercise for businesses with no related party outsourcing and no acquired IP and it is important that this is properly understood by them.

3.1.4 R&D that is "unsuccessful".

The adoption of the R&D tax credit relief framework as a common starting point for qualifying expenditure should mean that R&D costs incurred on unsuccessful outcomes on classes of qualifying assets should equally be captured as part of qualifying expenditure for the purposes of the nexus formula.

3.2 Overall income from IP asset.

The Modified Nexus approach requires jurisdictions to define IP income in a manner consistent with their domestic laws on income definition. Overall income should be defined in such a way that the income benefitting from the regime is not disproportionately high given the percentage of qualifying expenditures undertaken by the taxpayer i.e. income should not be defined as gross income from the IP asset. The OECD state that the IP income should be adjusted by subtracting expenditures incurred in the year and which can be allocated to the IP, from gross IP income earned in the year.

It is interesting to note that existing IP boxes in countries such as Belgium, Hungary, and Spain currently adopt a gross income approach.

3.2.1 Broad definition of overall income

The OECD suggests that overall IP income can include royalties, capital gains and other income from the sale of an IP asset as well as embedded IP income from the sale of products directly related to the IP asset.

Current Patent Boxes in place across Europe typically include all of these income and capital flows and it is imperative that the KDB should adopt a similarly broad definition of IP income.

3.2.2 Flexible approach to the calculation of overall income

In some circumstances, IP income will derive directly from the IP asset (e.g. license or royalty income). However, it is much more usual for IP assets to be embedded in products and services and in these situations it can be very difficult to determine the value of the income attributable to the IP asset. This position can be further complicated where multiple and very varied types of IP assets are embedded in a single product.

Given these practical difficulties, it is important that the design of the KDB allows for flexibility of approach in arriving at the calculation of overall income. In many cases the only practical way for a business to attribute profits to IP will be to take an all-inclusive approach and exclude specific items that are clearly not IP creating functions.

One approach would be to adopt the "**residual value"** method of valuation which is widely understood by companies operating within the transfer pricing regime. Using this approach, the business would identify the most relevant identifiable profit centre (e.g. the profit of a particular product line). A routine return on sales and administrative activities is calculated and together with a return on marketing

intangibles, this is deducted from the total identifiable profit to leave the income attributable to the IP asset.

While this approach may be favoured by some larger MNCs and Irish companies, it will not suit everyone and would be particularly challenging for smaller businesses to apply when they are not currently within the transfer pricing regime. The development of a safe-harbour percentage regime could assist these businesses.

Alternatively, some businesses may prefer to use another method of calculation entirely. Provided this is reasonable and is applied consistently year on year, we believe there should be flexibility in the KDB regime to accommodate a wide range of practical situations. There is precedent for such an approach in the calculation of deductible VAT for partially exempt businesses.

4. Separate trade v credit approach

In principle, there appears to be two main approaches to the calculation of the tax benefit.

4.1 A separate trade approach

Notwithstanding that some of the income of a company may be eligible for a tax rate reduction, we do not consider that this merits treating the income eligible for a KDB as income from a separate trade for Irish tax purposes. A separate trade approach gives rise to difficulties where losses arise. Loss may arise in either the KDB or the rest of the business' trade. If there is any ring-fencing of losses this would reduce the attractiveness of the KDB. At a minimum it is important that losses could be offset on a value basis (similar to the current model for 12 ½% and 25% activities).

There are differing approaches to loss relief in different countries. For example, some ring-fencing applies to losses in the current French IP Box. While the UK loss relief rules are complicated, they do provide significant flexibility to groups to offset non-IP related losses against IP income, and also to offset IP losses against non-IP related income, while still maintaining the integrity of the box approach. Liechtenstein, Luxembourg, the Netherlands, and the Swiss Canton of Nidwalden, allow for losses to be offset against other income but require a recapture adjustment to be made.

Again it is interesting to note that the issue of losses does not arise in existing boxes (Belgium, Hungary, and Spain) which apply a gross income approach rather than a net income approach because no expenditure is attributed to the IP activity.

4.2 KDB tax benefit applied as a tax credit

Rather than treating the preferential IP income as income arising from a separate trade, an equivalent value benefit could be provided by way of a credit from tax payable to give the same overall tax benefit. This is similar to the approach that was taken in granting the benefit of manufacturing relief and avoids the potential loss restrictions that arise when a separate trade exists. A worked example is included at Appendix II.

5. The KDB Rate

It is important that the KDB offers a 'best in class' competitive rate by international standards. Other countries with existing patent boxes have adopted different approaches to setting the rate that applies to qualifying income.

The current Patent Boxes in operation in the UK and Italy both offer rates on qualifying income of approximately **half** of the headline rate of corporation tax in those countries i.e. 10% and 15.7% respectively.

The Netherlands, Belgium and Luxembourg offer rates under their current Patent Boxes at circa **one-fifth** of the headline rates of corporation tax (5%, 6.8% and 5.84% respectively).

The KDB rate will be particularly important in light of the fact that grandfathering will be available for existing Patent Boxes in a number of key competitor countries.

6. A KDB for SMEs

SMEs will generally carry out the majority of their R&D activities in Ireland. They are less likely to fragment their R&D operations to other locations until they expand significantly into overseas markets. However, while this issue of related party outsourcing may not arise, SMEs often have to carry out a level of unrelated outsourcing work to universities and other 3rd party specialists. It is important that this commercial reality is accommodated within any KDB model.

The KDB priorities that SMEs have raised with us are:

1. Simplicity and certainty of treatment (they have limited resources to deal with a complex regime); and
2. A broader definition of IP that will encompass as much as possible within the definition of "functionally equivalent" to patents.

Many SME's incur very significant R&D costs in their early years such that they are in an overall loss making position. We know from the experience which led to the R&D tax credit regime being amended to accommodate refundable credits, that this is a significant number of businesses. It is important to be aware that such companies will not be in a position to avail of an income based KDB. It is also important that restrictions on the use of losses are not a feature of the KDB design, as this could significantly limit its benefits for SMEs.

B. THE R&D TAX CREDIT REGIME

The R&D tax credit regime is a very important and valuable relief for businesses carrying out R&D in Ireland. The positive contribution made by the credit has been confirmed by research carried out by the Department of Finance in 2013.

Improvements such as the removal of the base year restriction ensure that Ireland's tax credit regime is well regarded internationally and competitive with offerings elsewhere. However, one important area of concern that has been raised by the Institute on many occasions has come to the fore again in the current discussion on a new KDB. Small domestic businesses across the board find it very difficult to gain certainty on the R&D tax credit they are entitled to claim and tell us consistently that the compliance costs are a major deterrent to making claims. In fact one business we spoke to told us that the cost of putting together an R&D claim exceeds the cost of their annual statutory audit.

In a survey carried out by the Institute in early April 2015, 88% of members responded that it is critical or very important that the R&D tax credit regime works well in ensuring that the forthcoming KDB will be successful.

When we sought feedback from the companies we met, and concerns were raised about the extent to which current types of expenditure are excluded from R&D claims at present and difficulties currently being experienced with the administration and implementation of the R&D regime. There is broad consensus that businesses need a mechanism to obtain advance assurance on R&D claims to prevent protracted Revenue audits and enquiries and high levels of uncertainty.

This issue is not unique to Ireland. The UK carried out a consultation in January 2015 and the Chancellor made the following announcement in the recent Budget

> *"Following a consultation on improving access to R&D tax credits for smaller companies, the government will introduce voluntary advanced assurances lasting 3 years for smaller businesses making a first claim from autumn 2015 and reduce the time taken to process a claim from 2016. The government will produce new standalone guidance aimed specifically at smaller companies, backed by a 2-year publicity strategy to raise awareness of R&D tax credits. HMRC will publish a document in the summer setting out a roadmap for further improvements to the scheme over the next 2 years."*

Similar steps to provide an R&D assurance mechanism for businesses operating in Ireland would improve the operation of the credit, reduce the uncertainty and compliance cost and provide a more stable basis for linking the KDB with the R&D regime.

In addition to this provision of assurance on the R&D tax credit, the regime could also be significantly enhanced by removing or reducing the restriction on 3rd party outsourcing. R&D is a risky and expensive investment for businesses and 3rd party outsourcing has become normal business practice in many sectors. The restrictions included in the current regime cause difficulty for many companies and the overall knowledge based incentive offerings would be much enhanced if they could be reviewed.

C. THE INTANGIBLE ASSET REGIME – CAPITAL ALLOWANCES

Given the amount of business process innovation work that is carried out in Ireland, it is not surprising that MNCs operating here commonly incur significant expenditure on intangible assets for use in that R&D activity. The Modified Nexus approach does not recognise this acquisition expenditure and the uplift capped at 30% to compensate for outsourcing and acquired IP is inadequate.

Our capital allowances regime provides a measure of relief for acquisition expenditure and plays a very important role in the overall suite of knowledge based incentives available. However it is a capital allowances based regime and that fundamentally limits the benefit it can provide up to the period when the allowances end.

Nonetheless, in the absence of recognition for acquired IP in the Modified Nexus approach that is finally agreed, it is important to ensure that the design of our capital allowances regime for acquired IP meets is competitive and meets the needs of companies engaged in innovation.

D. A COMPETITIVE INCOME TAX REGIME

Ireland has the 9th highest marginal income tax rate of the 34 OECD countries and the highest tax rates apply here at much lower income levels than in most other OECD countries. This high income tax burden affects both domestic and FDI businesses. As the government has recognised in its recent Statement of Priorities 2014-2016, our overall objective must be to lower this high marginal rate in order to maintain our competitiveness.

A key element of any innovation tax strategy is attracting the key employees and executives who will establish and drive the R&D function. This will be even more critical in light of the Modified Nexus Approach and overall BEPS projects emphasis on substance supporting the incidence of tax. The location of an innovation project can hinge on the availability key highly skilled employees. Our high personal tax rates are proving to be a significant obstacle to attracting these key skilled employees to Ireland. While welcome measures were taken in last year's Budget to reduce the income tax burden for middle income earners, the marginal rate of 52% remains. Reducing this marginal rate would be an important step in boosting Ireland's attractiveness as a location to carry out innovative activities. It would have significant benefits for all businesses in better enabling them to attract, reward, and incentivise key employees.

Additionally, while we welcomed the changes to the SARP regime made in Finance Act 2014, the regime should be kept under review to ensure it is sufficient to enable businesses to attract key employees to located in Ireland.

For some businesses, the ability to offer share based remuneration is another important factor in attracting talented employees to Ireland. For innovative start-ups it can be difficult to attract experienced employees from established businesses and often will need to offer share based remuneration to attract these key employees. The tax treatment of share based remuneration should be reviewed with a view to introducing a more favourable regime which would be an important part of the framework for encouraging innovation in Ireland.

CONCLUSION

The design of the new KDB needs to be broad enough in scope to cover the main types of innovation activity actually carried out in Ireland and creating jobs here. This includes activities such as business process innovation, product development, infrastructure engineering etc all of which contribute to the innovation taking place and which generate substance and intangible value for companies here.

Discussions on the Modified Nexus approach are still on-going at the OECD and Ireland is participating in those discussions. There are serious difficulties with the approach as regards outsourcing restrictions, definitions and practical issues on implementation. Our discussions with innovation businesses in Ireland indicate that these difficulties present real barriers to potentially availing of a KDB here compared with larger countries.

Pending final agreement on Modified Nexus there are other related aspects of our innovation offering that could usefully be reviewed in advance of Budget 2016, including the operation of the R&D tax credit, the capital allowances regime for intangible assets and our high marginal income tax rates. These changes, together with a KDB offering a competitive rate by international standards, will help to keep Ireland "best in class" for attracting critical R&D business and ensure that we are well placed to avail of investment opportunities in a post BEPS environment.

The Best in Class design of a KDB is a critical tax policy development for 2015 and the Institute would strongly urge that detailed draft legislation is published for stakeholders to review well before the publication of the Finance Bill. The Consultation Paper published in January was an important first step in the consultation process, but should not be the last.

Appendix I

Institute submission to OECD on the Modified Nexus approach

Irish Tax Institute

Comments on OECD "Agreement on Modified Nexus Approach for IP Regimes"

February 2015

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:

> "e*xplicitly 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 Rights[1] 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

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[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 expenditures[2].

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.

Appendix II

Example – Separate trade vs credit approach

Assumptions

- Company A has a total taxable profit of €2,000,000
- Of this profit, €1,000,000 is identified as qualifying for the KDB
- KDB rate of 5% (i.e. 40% of headline 12.5% rate)
- Tax if no KDB relief = €2,000,000 x 12.5% = €250,000

Calculation if treated as a separate trade:

- Non-IP profit taxed at 12.5% = €1,000,000 x 12.5% = €125,000
- Qualifying profit taxed at Box rate = €1,000,000 x 5% = €50,000
- Total tax payable = €125,000 + €50,000 = €175,000

Calculation if relief granted by way of a credit (similar to manufacturing relief)

- The credit is calculated as:
  - Qualifying Income x (100% minus the KDB rate as a % of CT rate) x CT rate
- Credit = €1,000,000 x 60% x 12.5% = €75,000
- Total tax payable = €250,000 - €75,000 = €175,000