CROSS-BORDER TAXATION

OECD and others take aim at base erosion and profit sharing

In order to stimulate innovation, many jurisdictions have implemented some sort of preferential tax regime for income generated by innovative activities. *Friggo Kraaijeveld* explains how innovation box regimes work with regard to cross-border taxation.

Innovation is generally considered to be one of the driving forces behind sustainable economic growth and prosperity. It is also a necessary ingredient for commercial success and the development of emerging economies. In order to create a business climate which promotes innovation, it is necessary to implement policies which subsidize entrepreneurial and scientific activities that strive for innovation, and thus, to the accumulation of (valuable) intangible assets, such as patents, trademarks, know-how and copyrights.

Regarding taxation, there are a few fields of interest in which innovation i.e. the development and creation of intellectual property, play an important role: innovation box regimes, transfer pricing and withholding tax on royalties.

Tax box regime

In order to stimulate innovation, many jurisdictions have implemented some sort of preferential tax regime for income generated by innovative activities. Such preferential tax regimes are often referred to as innovation box regimes.

The OECD and many other jurisdictions have agreed upon a joint action plan to combat base erosion and profit shifting (BEPS), that innovation box regimes must not harm other tax jurisdictions. Innovation box regimes could be harmful if the regime were to encourage artificial shifting of income from one jurisdiction to another jurisdiction by making use of an innovation box regime. The OECD BEPS action plan determines that innovation box regimes may only be applied to benefits from "qualifying intangible assets," where a distinction is made between smaller taxpayers and other (larger) taxpayers. Less stringent requirements apply to smaller taxpayers.

To qualify for usage of an innovation box regime, often various conditions should be met, for example that:

- A research and development certificate/ or other approval by a tax jurisdiction is granted in relation to the development of the intellectual property (in order to be able to track the income from the intellectual property);
- The intellectual property must be self-developed (and not acquired from a related and unrelated party);
- The company must meet certain substance requirements referred to as the "nexus approach" (discussed hereafter); and
- The company must meet certain administrative obligations (in order to be able to track and record the income relating to the innovation or intellectual property);

For those companies that qualify as large companies, additional conditions are often required, which may require that in relation to innovation or intellectual property:
A patent, software tprogram, license to distribute medication or an exclusive license is issued/granted in relation to the intellectual property.

- Countries can decide when a company is considered large. Some jurisdictions consider a company as large if the gross revenues of the company itself exceed a certain threshold and the combined turnover exceeds another threshold.

The OECD BEPS nexus approach aims to avoid income being artificially shifted from one jurisdiction to a company applying the innovation box regime resident in in another jurisdiction. The nexus approach requires that a minimal level of activity (often referred to as "substance") must take place in the jurisdiction of the company applying the innovation box regime. The nexus approach demands that the innovative activities are carried out by the taxable entity itself in its own jurisdiction and effectively restricts the possibility of outsourcing innovative activities to related parties (often) to a maximum percentage of the overall innovative activities.

The outcome of the nexus approach is that only "qualifying intellectual property income" may be eligible to the benefits of the innovation box regime. Qualifying intellectual property is defined as the proportion of income relating to the innovation or intellectual property calculated over the ratio of "qualifying expenditures" compared to overall expenditures for the development of the intellectual property. Qualifying expenditures are in general the overall expenditures incurred for the development of the innovation or intellectual property minus, the expenditures related to research and development outsourced to related parties.

If a ruling is requested and obtained for the application of an innovation box regime, such rulings may be spontaneously, automatically or by request be exchanged with the other jurisdictions involved in the development of the intellectual property. Within the European Union, such exchange of tax rulings is obligatory through a centralised information exchange mechanism.

Transfer pricing

The OECD international arm's-length transfer pricing principle requires that related parties transact with each other against the same prices as unrelated parties would do (referred to as the in the same situation and under the same conditions. If related parties have agreed on prices that are higher or lower than the arm's-length price, the profits of the related parties may be adjusted as if the arm's-length price applied.

In relation to intellectual property, the arm's-length principle requires that intercompany prices for the use or acquisition of intellectual property should be done against arm's-length prices and that the profits of the related parties may be adjusted if the prices applied deviate from the arm's-length prices.

In the BEPS project, the OECD has recognised that compared to other assets or services, it is specifically hard to determine the fair market value of intellectual property items. The OECD has therefore agreed that tax authorities may use financial data of later years for determining the arm's-length prices of intellectual property related intercompany transaction in a prior period. These post-transaction financial data may result in arm's-length price adjustments in prior years. This new OECD approach causes great uncertainty for multinational companies, which should be considered when performing intellectual property intercompany transactions. Multinational operations may wish to conclude tax rulings with the

jurisdictions involved at the time of an intellectual property related intercompany transaction, to avoid the uncertainties caused by the new OECD approach.

Within the European Union, such rulings are automatically exchanged through a centralized system. For non–European Union situations, the rulings may also be automatically, spontaneously or by request be exchanged.

In the course of the BEPS project, the OECD agreed that income from intellectual property should be attributed to or split between the jurisdictions where the added value for the business is created. To determine where the added value is created, you must take into account the functions performed, assets used and risks assumed, managed and controlled. As a consequence, no or very limited income can be attributed to companies merely holding the legal title intellectual property but otherwise not performing any significant economic functions (often such empty shell companies are or were located in low tax jurisdictions).

Withholding tax

Many jurisdictions try to protect their tax base by levying withholding taxes on certain payments, including royalty payments for the use of intellectual property. For example, if a company in State A makes a royalty payment of 100 to a company resident in State B, State A may levy a withholding tax at a rate of (for instance) 15%. Consequently, the company resident in State B receives a net amount of 85 instead of 100. Under tax treaties, the royalty withholding tax rates are often reduced, sometimes even to 0%. If the tax treaty states that no royalty withholding tax may be withheld, this would mean in the example above that the company in State B would receive a net amount of 100 instead of 85. In situations where, in the example above, no tax treaty would apply between State A and State B, multinational enterprises can structure their royalty streams through a company resident in a third jurisdiction, State C, where there was a tax treaty with favourable royalty withholding tax rates between State A and State C. In this example,

the company resident in State B would provide a licence to the company in State C and the company in State C would provide a licence to the company in State A, with the aim of reducing the withholding tax rate levied by State A. This structure is often referred to as treaty shopping.

In the OECD BEPS project, it has been agreed that treaty states will in future apply a "principal purpose test" before granting the benefits of tax treaties. The principal purpose test determines that the benefits of a tax treaty will be denied, in case it is reasonable to conclude, with regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of the structure or arrangement (this is called the "subjective test"), unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the relevant tax treaty (this is called the "objective test"). For the example above, State A may deny the benefits of the tax treaty with State C if State A believes that the purpose of having the company in State C is to make use of the benefits of the tax treaty between State A and State C, whereas the company resident in State B does not perform any significant economic functions in relation to the royalty payments received from State A.

Within the European Union, the Interest and Royalty Directive determines that royalty payments between related parties within the European Union should be exempt from royalty withholding tax. However, the principal purpose test also applies to the Interest and Royalty Directive. Care should therefore be taken when structuring royalty payments from the European Union. **AIP**

ABOUT THE AUTHOR

Friggo Kraaijeveld, partner, Kraaijeveld Coppus Legal, Amsterdam. KC Legal is a member of IR Global, the world's largest exclusive network of advisory firms.

ASEAN

Patentability of Computer Related or Implemented Inventions (CRIs or CIIs) in Singapore, Indonesia, Thailand, Vietnam, Philippines and India

Patent legislation and practice in the patentability assessment of computer related or implemented inventions differ from country to country. "Computer Related Inventions" (CRIs) or "Computer Implemented Inventions" (CIIs) has been given an explicit definition in some countries such as in the Philippines and India. These countries both define CRIs or CIIs as those inventions involving computers, computer networks, or other programmable apparatus, in which one or more features are realized by means of a computer program. On the other hand, in countries such as Singapore, Indonesia, Thailand, and Vietnam, no definition is provided.

This article aims to demonstrate patentability assessment of CRIs or CIIs, based on each of the abovementioned country's current governing rules and regulations for patents, and guidelines for patent examination (where available)

Singapore

Singapore's patent legislations do not expressly discuss CRIs or CIIs. However, the Intellectual Property Office of Singapore's (IPOS) Examination Guidelines for Patent Applications of May 2016 sets out general principles on assessing patentability of these type of inventions.

In Section 8.6, *"considering the actual contribution of claims directed to computer-implemented inventions (CIIs), Examiners should determine the extent to which the computer (or other technical features) contributes to the invention defined in the claims"*. Accordingly, *"it must be established that said computer (or other technical*

features) defined in the claims, is integral to the invention such that the actual contribution constitutes said computer (or technical features)."

In Section 8.7, example of claims related to a **"computer-implemented"** business method would be deemed an invention *"if the various technical features … interact with the steps of the business method (i) to a material extent; and (ii) in such a manner as to address a specific problem."* A sample of a claim having a "material extent" is given wherein the claim recites *"known hardware components for implementing a business method … but if the overall combination of the hardware provides, for example, a more secure environment for performing transactions, then the hardware would be regarded to interact with the business method to a material extent to address a specific problem,"* and the actual contribution of such claim which may be considered as an invention is *"the use of that combination of hardware for the business method"*.

On the other hand, if the technical features in the claim are recited *"such that they are no more than the workings of a standard operating system … such an interaction would not be considered to be a material extent and it is apparent that no specific problem is solved"*, the actual contribution thereof may be considered as the *"business method"*, and the claimed subject matter would not be deemed as an *"invention"* by merely including the term *"computer-implemented"* or synonymous generic term.

Indonesia

Similarly in Indonesia, CRIs or CIIs has not been given definite context. Nevertheless, Indonesia's present patent law, the Law of the Republic of Indonesia No. 13 of July 28, 2016, on Patents (2016), explicitly excludes [in Chapter II Article 4d] *"rules and methods that only contain computer programs."* This is further elaborated by the law as a computer program without any character, technical

effects, and solution to problems.

Also, the law illustrates pointers of which invention may be considered patentable in this area of technology. According to the law, if the computer program has characters (or instructions) that provide technical effect and function so as to produce a solution to a problem (whether tangible or intangible), such may be patentable.

An example would be an algorithm, which is defined as *"an effective method expressed as a finite sequence of instructions that have been defined to compute a function."* Given an initial state and initial input (possibly empty), these instructions gives a computation that when executed, processed through a sequence of defined limited condition(s), creates an "output" and stop at the end of the condition(s). Change of condition therein should not be deterministic, an example of which is a randomization algorithm using a random input. Another example that can be granted a patent is encrypting information by encoding or decoding such that the information cannot be deciphered by a third party.

Thailand and Vietnam

Similarly, a definition of CRIs or CIIs has not been established in Thailand and Vietnam. The governing laws in both Thailand and Vietnam, namely, Patent Act B.E. 2522 (1979) as amended by Patent Act (No. 2) B.E. 2535 (1992) and Patent Act (No. 3) B.E. 2542 (1999) [Section 9] in Thailand, and the Law on Intellectual Property [Article 59] in Vietnam, exclude *computer programs per se* from being protected. Hence, in Thailand, for example, a process claim containing a step realized by means of a computer program along with other important steps realized by other technical means may be deemed patentable.

Philippines

In the Philippines, the Republic Act 8293 (IP Code) [Section 22.1 to 22.2] and the Revised Implementing