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Global Tax Report: Intellectual Property Tax Planning

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Recent challenges and attention to Intellectual Property (IP) tax planning has prompted governments around the world to consider new tax measures that affect all phases of IP development and business. This often results in IP migrating from one tax jurisdiction to another lower tax jurisdiction. In this issue, we discuss the IP tax regimes of various jurisdictions and related financial consequences that affect investors and taxpayers around the world.

Editor's Note

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US—Benefits of Intangible Property Migrations

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Recent media coverage has highlighted the use of non-US entities by US-based multinational companies to conduct intellectual property operations and to own intangible property related to their businesses. The widespread use of this strategy and the growing significance of intellectual property for business in the 21st century underscore the need for companies that have not yet examined the merits of the strategy to do so. There are several jurisdictions, such as Switzerland, the Netherlands, Luxembourg, Ireland and Singapore, where it has become common for US companies to establish an entity to hold intangible property given the laws of such jurisdictions that are beneficial to the protection and management of intangible property. In addition to the business reasons for consolidating intangible property and operations related to that intangible property in such jurisdictions, establishing an entity to hold intangible property in such a jurisdiction can give rise to significant tax advantages if properly structured.

One benefit to a US company of holding intangible property through a non-US affiliate is the potential to lower the rate of taxation on income earned with respect to such intangible property. For example, royalty payments made by a US company to its non-US affiliate for the use of intangible property held by the non-US affiliate may be subject to a lower rate of tax if the jurisdiction in which the non-US affiliate is organized is a low-tax jurisdiction. The US company, meanwhile, may be able to deduct the royalty expenses required to be paid to the non-US affiliate for the US company's use of the intangible property. This intangible property ownership structure can be particularly advantageous if the non-US affiliate is located in a jurisdiction with which the United States has entered into a tax treaty, thereby reducing or eliminating the US withholding tax that would otherwise be applicable to the royalty payments to the non-US affiliate. In that case, only the non-US jurisdiction's income tax would apply to the royalty payments. The ability to achieve these tax benefits is dependent on the facts specific to the organization and the presence of significant business operations outside the United States.

The manner of transferring intangible property to a non-US affiliate can have a substantial impact on the tax consequences of the transaction. If the intangible property is transferred pursuant to a transaction that is treated as a sale or exchange for US federal income tax purposes, the US company would recognize gain or loss on such transaction. If the US company has sufficient tax attributes (such as losses or credits) to shield any tax arising on the transfer of the intangible property to the non-US affiliate, this type of transaction may be appealing. For some companies, however, it may be possible to structure the transfer of intangible property to a non-US affiliate as a tax-free transaction if the non-US affiliate is treated as a partnership for US federal income tax purposes.

Methods of Transferring Intangible Property to a Non-US Affiliate

The business reasons driving a transfer of intangible property to a non-US affiliate may require that the non-US affiliate be the legal owner of the intangible property, rather than merely the substantive economic owner. Transferring the ownership of intangible property to the non-US affiliate often is also desirable from a US federal income tax perspective in order to receive the tax benefits described above.

In order to achieve an ownership transfer for US federal income tax purposes, all substantial rights with respect to the intangible property must be transferred to the non-US affiliate. One way to achieve such a transfer is an outright assignment of the intangible property rights.

Patents, patent applications and trademarks are types of intangible property that usually can be transferred pursuant to an outright assignment, because they can be specifically identified and typically relate to a specific jurisdiction. Certain other types of "soft" intellectual property, such as know-how, copyrighted material and confidential information are more difficult to divide on a jurisdictional basis. In those cases, it may be appropriate to transfer rights through a perpetual, exclusive, royalty-free license. For US federal income tax purposes, such a license, if properly drafted, is treated as a sale or exchange of the licensed intellectual property.

For intangible assets that have not yet been developed, a US company may wish to enter into a cost-sharing arrangement with its non-US affiliate. Pursuant to the cost-sharing arrangement, the US company and its non-US affiliate would share the costs of developing certain intangible property and would receive certain rights to the benefits arising with respect to any intangible property developed pursuant to the cost-sharing arrangement.

Entering into a cost-sharing arrangement, however, may diminish the potential US federal income tax benefits available to the US company as the US company and its non-US affiliate would be required to share future research and development costs and expenses relating to the intangible property being developed. This can result in the loss of US federal income tax deductions and tax credits previously available as a result of research and development expenses borne by the US company.

The Treasury Regulations relating to cost-sharing arrangements are extremely complicated and require the non-US affiliate to compensate the US company for the platform value of the property contributed by the US company to the cost-sharing arrangement and further require that value be adjusted to the extent future facts show that the US company did not receive sufficient compensation. As a result, tax advantages with respect to intangible property developed pursuant to a cost-sharing arrangement can be limited if substantial development of such intangible property took place in the United States prior to entering into the cost-sharing arrangement.

Select Considerations

Transfers of intangible property from US entities to a non-US affiliate are often highly complex transactions from a US federal income tax perspective. Certain of the key US federal income tax considerations in an intangible property migration are discussed below:

a. Section 367(d)

Certain provisions set forth in the Internal Revenue Code of 1986, as amended (the "Code"), limit the ability of a US transferor to receive the tax benefits described above. If, for example, a US entity transfers intellectual property to a non-US corporation pursuant to certain transactions that do not trigger immediate taxation from a US federal income tax perspective, then Section 367(d) of the Code treats the transfer of the intangible property as a sale from the US entity to its non-US affiliate for payments which are contingent upon the productivity, use or disposition of the intangible property. The US entity is treated as receiving payments annually over the useful life of the intangible property (or until the non-US affiliate disposes of the intangible property) and the amount of those payments must be commensurate with the income attributable to the intangible property.

If Section 367(d) of the Code applies to a transaction, the non-US affiliate's upside with respect to the intangible property is limited. With a limited upside in the intangible property, the potential tax benefits to the US company are also limited because higher royalty payments from the US company to the non-US affiliate attributable to the increase in value of the intangible property would be offset by the payments the US company is treated as receiving from the non-US affiliate under Section 367(d) of the Code.

In certain circumstances, the impact of Section 367(d) of the Code on a transfer of intangible property may be avoided by structuring a transaction as a transfer to a non-US affiliate treated as a partnership for US federal income tax purposes, although the benefit of such a transaction depends on a company's factual situation.

b. Section 482

Similar to the rules set forth in Section 367(d) of the Code, Section 482 of the Code sets forth certain requirements on transfers of intangible property between affiliated entities. In general, Section 482 of the Code allows the US Secretary of the Treasury to make adjustments to transactions between certain affiliated entities in order to prevent the evasion of taxes or to clearly reflect the income of the entities.

Section 482 of the Code can have implications in a variety of the aspects of a migration of intangible property to a non-US affiliate. It requires, among other things, that any consideration paid by the non-US affiliate to the US company for the transfer or license of the intangible property be for an arm's-length amount that is commensurate with the income attributable to the intangible property. Section 482 of the Code also would require that any license of the intangible property owned by the non-US affiliate to the US company must be for an arm's-length royalty.

c. Economic Substance

The potential US federal income tax benefits arising from the transfer of intangible property from a US company to a non-US affiliate may invite scrutiny of the transaction by the US Internal Revenue Service (the "IRS"). The economic substance doctrine is one means by which the IRS can attack a transaction. Generally, the economic substance doctrine looks at whether the economic substance of a transaction is different than the form of the transaction.

The common law economic substance doctrine, which was somewhat inconsistently applied, was recently codified in Section 7701(o) of the Code. In codified form, the economic substance doctrine applies an objective test that requires that the relevant transaction change in a meaningful way the taxpayer's economic position, other than with respect to any US federal income tax benefits. This prong of the inquiry can be difficult to satisfy when the potential tax benefits of the transaction are hundreds of millions of dollars and the non-tax business objectives are more difficult to quantify. The codified economic substance doctrine also applies a subjective test which requires that a taxpayer have a "substantial" purpose for the transaction apart from US federal income tax effects.

Provided that substantial business objectives (other than tax benefits) are achieved from the intangible property migration, careful tax planning generally can withstand a challenge on economic substance grounds and can result in significant tax benefits.

In addition to being highly complex transactions from a US federal income tax perspective, such intangible property migrations often involve complicated business, legal, accounting and intellectual property issues, including standing and damage recovery theories in the event of a dispute. Consequently, such transactions usually require significant internal planning and coordinated efforts with advisors. When a company is undertaking a migration of intangible property outside the United States, it is important to seek experienced US federal income tax counsel to ensure that the transaction is undertaken in the appropriate manner.

UK—Innovation: The Name of the Game

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An Overview of the UK's Recent Reform of Intellectual Property Taxation

"[The UK] has a remarkable record of ideas and innovation. We've won more Nobel Prizes than any country of our size. We need to do more to support this ingenuity and ensure this creativity is harnessed in this country. I want to encourage research and development in the pharmaceuticals and biotech industries. So, following consultation with business, I will introduce a 10 percent corporation tax rate on income which stems from patents in the UK."

Alistair Darling, Chancellor of the Exchequer (2009)

It was not uncommon a few years ago for UK multinational companies to house their intellectual property abroad. GlaxoSmithKline, for example, moved a majority of its research activities out of the UK citing unattractive corporate taxation of intellectual property rules. GlaxoSmithKline was not the only company to make that particular complaint or to take that action.

This was no surprise as, at that time, the UK corporate tax system was widely perceived as generally being uncompetitive for corporates and particularly unsympathetic to intellectual property-focussed companies.

The UK corporation tax rate then (and until as recently as six years ago) was 30 percent, there were no specific reliefs available for intellectual property, the Controlled Foreign Company (CFC) regime was extraterritorial in scope and overseas dividends received by UK companies were prima facie subject to tax. In contrast, jurisdictions such as Luxembourg and the Netherlands provided significantly lower corporate tax rates (particularly for holding companies), a wide participation exemption for dividends and gains and a taxpayer-friendly ruling system (not to mention the absence of CFC rules in these jurisdictions).

Since then, a lot has changed in the UK corporation tax landscape.

Since the late 2000s, the UK has embarked on an ambitious set of corporate taxation reforms to make it an attractive corporate tax jurisdiction. Following implementation of these reforms, the UK corporation tax rate now stands at 23 percent (dropping to 20 percent in 2015)—historically this rate of tax was the domain of countries the UK used to consider (not positively) as "low-tax" jurisdictions, the CFC regime has been significantly recast to be more territorial in scope and application, most overseas dividends received by UK corporates are now tax-exempt in the UK (in the absence of any "tax mischief") and the UK has recently introduced a dedicated regime that applies a reduced rate of UK corporation tax (effectively 10 percent by 2017) to "qualifying" patent income.

It was more than symbolic of the UK's newfound attractiveness as a competitive corporate tax jurisdiction (particularly for patent-rich companies) when on 1 July 2013, GlaxoSmithKline announced that it intends to move 150 overseas research projects back to the UK. This followed another recent announcement by GlaxoSmithKline that it will set up a new factory in the UK (the first in 40 years) which forms a part of GlaxoSmithKline's £500 million investment plans in the UK.

UK Corporation Tax Regime—the Focus on Innovation

The UK has legitimately prided itself on encouraging innovation. In fact, for the size of its population, it has won more Nobel Prizes than any other nation. It is therefore unsurprising that the UK Government has positioned its intellectual property reform (see below) as one of the essential pillars of its new corporate tax policy.

The UK's intellectual property reform focuses (some might say too narrowly) on patents. Commonly referred to as the Patent Box regime (the "**Patent Box**"), the Patent Box allows companies to elect to apply an effective 10 percent rate of UK corporation tax to profits attributable to qualifying patents, whether received as a royalty or embedded in the sales price of products. This, the UK hopes, will encourage UK multinational groups to develop, retain and exploit intellectual property in the UK rather than house it overseas in jurisdictions offering preferential tax treatment to that historically available in the UK.

The Patent Box took effect from 1 April 2013 with the full benefit to be phased in over the next four financial years as follows (with the full reduced rate applying from 1 April 2017):

	Proportion of full benefit available
2013/14	60%
2014/15	70%
2015/16	80%
2016/17	90%
2017/18	100%

Broadly, in order to benefit from the Patent Box, a company must hold "qualifying IP rights" or an exclusive licence in respect of "qualifying IP rights". "Qualifying IP rights" include patents granted by the UK Intellectual Property Office, the European Property Office or under the law of a specified list of countries in the European Economic Area (as well as other rights considered to be similar to patents). In addition, to be considered a "qualifying IP right", the claimant company under the regime or another group company must have undertaken qualifying development for the patent by making a significant contribution to either the creation or development of the patented invention, or a product incorporating the patented invention.

The Patent Box regime contains detailed provisions for calculating the profits of a company attributable to qualifying IP rights (i.e., its "relevant IP profits" to which the reduced 10 percent rate applies). The detail of these provisions is beyond the scope of this article, but, broadly, this involves calculating the "total gross income" of the company's trade and working out the proportion of "relevant IP income" (which includes sales income relating to, licence fees or royalties in respect of, proceeds from the sale of and damages for infringement of a qualifying IP right) to the total gross income of the trade, followed by the deduction of certain items (e.g., capital allowances, personnel costs and other routine expenditures).

It should be noted that the Patent Box is elective and applies only to patents and not generally to other forms of IP (for example, trademarks or copyrights), the income from which will continue to be taxed at the main rate of UK corporation tax (currently 23 percent reducing to 21 percent from 1 April 2014 and further reducing to 20 percent from 1 April 2015).

Limited Application?

One of the key criticisms directed at the Patent Box is that it is limited to a narrow range of intellectual property (patents really) and therefore is likely to primarily benefit a select few patent-heavy industries such as the pharmaceutical and biotechnology industries. In fact, research shows that the distribution of patent holdings in the UK is highly skewed in that the majority of patent applications are filed by a handful of big multinational players (such as GlaxoSmithKline). The Patent Box, critics argue, will be of less assistance to the technology, media and telecommunications sector, which often generates intellectual property (for example, software) that is not patentable.

The second key criticism is that the Patent Box, although announced and marketed as a regime to promote innovation in the UK, (mis)places its emphasis on businesses generating patent income while offering little or no incentive to taxpayers to conduct research and development activities in the UK (although, see further below). This is in contrast to other similar regimes in Europe—the Dutch "innovation box" for example, not only applies to a wider range of intellectual property but also requires research and development to occur in the Netherlands.

The Patent Box does not require the company or group seeking to benefit from the reduced 10 percent rate to have conducted the actual research and/or development in relation to the patented invention or product in the UK (although the Patent Box does require that the company or group must either significantly contribute to the creation of the patented invention in question or, where the patented invention has been "bought into" the company or group, perform a significant amount of development activity in respect of the patented invention or product incorporating the patented invention). This, it could be argued, encourages companies and groups to separate patent income from research and development activities and hold patents on-shore while research and development are outsourced to other jurisdictions with the result that "real" innovation takes place outside the UK and income is then remitted to the UK.

Thirdly, the interaction between the UK CFC rules and the Patent Box is not entirely harmonious—would the UK treat patent box-type regimes outside the UK as being outside the scope of the UK CFC rules? If not, arguably as a quid pro quo, overseas jurisdictions (under their domestic CFC rules) could treat a UK subsidiary of an overseas company that benefits from the Patent Box as though such UK subsidiary were resident in a low-tax jurisdiction and thereby seek to tax profits of the UK subsidiary overseas in their own jurisdictions.

Research and Development Tax Reliefs

As mentioned above, while the Patent Box alone may not incentivise taxpayers to carry out research and development activities in the UK, the UK already has, what it considers, a generous tax relief regime for expenditures incurred on research and development activities and projects that seek to achieve an advance in science or technology.

In the UK, a large trading company (i.e., not an SME—which are entitled to an additional deduction of 125 percent) may claim tax relief in the form of an additional deduction against its taxable profits of 30 percent of its qualifying research and development expenditure (for example, employee costs, software, materials or utilities). This deduction is in addition to the 100 percent deduction available for trade expenses under general UK tax rules (i.e., giving a total deduction of 130 percent for large companies and 225 percent for SMEs).

The UK has gone a step further and introduced an "above the line" tax credit rule recently to encourage research and development in the UK. This rule will enable loss-making large companies to elect to claim a "net of tax" payment of a 10 percent credit in respect of qualifying research and development expenditures incurred on or after 1 April 2013 from HM Revenue & Customs.

Conclusion

While, as the return of GlaxoSmithKline's patents to the UK demonstrates, the UK is expected to become an attractive patent-holding jurisdiction in the short term, it remains to be seen whether this becomes a sustainable model, particularly as more and more European jurisdictions are considering the introduction of similar rules (but which may extend beyond just patents).

However, given the general policy direction of the UK Government in relation to corporate taxation (particularly given the UK Government's stated desire to be the most attractive G-20 corporate tax regime), it is possible that in a few years, the Patent Box will have "evolved" into a full-fledged intellectual property regime—whether or not that becomes a reality, the Patent Box, it must be concluded, establishes a robust framework for preferential tax treatment of intellectual property (albeit limited to patents at present).

Germany—OECD's Action Plan on Base Erosion and Profit Shifting (BEPS) Within the Context of Intellectual Property

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National tax laws and respective governments are faced with huge challenges through globalization and the digital economy. In a borderless world of products and services, the mismatch of domestic tax rules leaves loopholes that allow profits to go untaxed. Multinational enterprises manage to benefit from such tax gaps by allocating profits to specific countries and, therefore, reduce their overall taxes. In the absence of the need to relocate physical assets, transferring intangibles in general and intellectual property (IP) in particular between subsidiaries in different countries is an effective way to exploit such tax gaps by shifting profits cross-border.

While national tax regimes, in general, ensure the match between deductible expenses in the hand of one taxpayer with taxable income of another taxpayer, there is a lack of similar coordination with regard to international transactions. In order to prevent double non-taxation (or at least a reduced taxation under certain conditions) in such cases, the OECD scheduled a plan for "new international standards to ensure the coherence of corporate income taxation at the international level" and published an Action Plan on 19 July 2013 at the G20 leadership meeting.

This article provides a brief summary of the content and the national attempts regarding IP in relation to BEPS.

The OECD Action Plan on BEPS

With a view toward preventing and reducing misuse of international taxation rules, the OECD Action Plan focuses on 15 action points, including—among others—the approach to neutralize the effect of hybrid mismatch arrangements, to strengthen CFC rules and to prevent treaty abuse. In particular, with respect to intangibles, the OECD seeks to limit base erosion via financial payments from the provision of intangibles and intends to assure that transfer pricing outcomes are in line with the value creation.

In this regard certain rules ought to be established to stop BEPS by moving intangibles among group members. Such not-yet-drafted rules shall involve provisions that:

i. Adopt a broad and clearly delineated definition of intangibles

ii. Ensure that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with value creation (and not solely because an entity has contractually assumed risks or has provided capital)

iii. Develop transfer pricing rules or special measures for transfers of hard-to-value intangibles and

iv. Update the guidance on cost-contribution arrangements (also known as cost-sharing agreements or "CSAs")

The expected results include changes to the OECD Transfer Pricing Guidelines and the OECD Model Treaty. According to the plan, the schedule targets a two-year timeline and should be completed in September 2014 and 2015, respectively.

Although the concrete outcome of the above-mentioned action points can hardly be predicted, with respect to the definition of intangibles, the OECD might refer to a definition set forth in its Discussion Draft "Revision of the special considerations for intangibles in Chapter VI of the OECD Transfer Pricing Guidelines

and Related Provisions" dated 6 June 2012. The Discussion Draft defines intangibles as "something which is not a physical asset or a financial asset, and which is capable of being owned or controlled for use in commercial activities". While this specific definition only addresses transfer pricing matters, it is likely that at least a similar broad definition may be adopted for BEPS purposes. However, it is doubtful whether any definition meets the ambitious objective of a clear and broad definition, since the definition provided by the Discussion Draft leaves various questions unanswered and has already been criticized as too vague.

In addition, in focusing on the well-known structures the OECD identified for tax-reduction purposes, it must be expected that those structures might likely be opposed. With regard to IP, the OECD, inter alia, identified licensing agreements between a high-tax jurisdiction and a foreign branch in a low-tax jurisdiction and the interposition of hybrid entities or interposing conduit companies as structures to be avoided. It will be necessary to monitor if and to what extent such structures will no longer be accepted under future OECD standards.

National Reaction on Preventing BEPS

Together with the OECD Action Plan, the German Federal Ministry of Finance published FAQs that explain and provide comments on the OECD approach from a German perspective. While the FAQs generally highlight the OECD approach and Germany fully supports the BEPS Action Plan, the necessity of an agreement on related international taxation principles and a fair tax competition between different countries are highlighted. Further, that the commentary stresses that a "general attack" on multinational entities is not envisaged, because it may affect the attractiveness of Germany as a place for technology and business. Furthermore and in line with the foregoing, substantial changes to the existing OECD standard regarding the allocation of taxable income should be avoided from a German perspective. With respect to IP, such an OECD standard, as a rule, allocates the taxation right to the state of the IP owner's residence without any withholding tax in the state of source. The contrary,(i.e., taxation in the state of source), shall only apply if the beneficial owner of the royalties carries on business in the state of source through a permanent establishment to which the IP is effectively connected. The extent to which the OECD standard qualifies as too much of a change is not clear at the moment, from a German perspective.

Even though Germany has already established several national provisions safeguarding a broad German tax basis (e.g., through CFC rules set forth in the German Foreign Tax Law, various provisions that partially suspend double-tax treaties (treaty override) and sections addressing the phenomena of hybrid entities in some double-tax treaties), the German tax law still leaves room for what the OECD refers to as an "aggressive tax planning technique". Remarkable and in contrast to applicable German tax law, is the OECD approach that may add the principle of "value creation" to the current existing (hypothetical) arm´s-length tests.

Conclusion and Perspective

The political discussion about profit shifting is not a new one; neither on a national nor an international basis. According to the German Federal Ministry of Finance, the mutual understanding and the will of the G20 set forth in the Action Plan on BEPS to find a solution on a common basis, distinguishes the new approach from former approaches, however. If and to what extent this ambition can be achieved, and whether substantial changes in the taxation allocation principles are capable of consensus, remains to be seen. The specific provisions related to implementation of the OECD Action Plan on BEPS are scheduled to be discussed at the G20 meeting in September 2013. In any case, future developments regarding BEPS have to be tracked carefully in order to be able to appropriately adjust any profit-shifting structures, if necessary.

1 Dividends paid to shareholders other than private individuals are free from Hungarian withholding tax.

2 The tax base is the pre-tax accounting profit adjusted for corporate income tax purposes.

3 The scope of qualifying R&D activities is defined in line with the Frascati Manual.

Hungary—Intellectual Property Tax Planning

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Those who have kept an eye out for new opportunities in IP planning know that Hungary was among the very first countries in Europe to make efforts to attract IP-related activity by introducing a special royalty regime along R&D incentives as early as 2005, years before the Netherlands, Luxembourg or Switzerland. It may come as a pleasant surprise that this regime has survived the numerous recent changes in Hungarian tax legislation and stayed more or less the same throughout the past ten years, gradually becoming more and more attractive over time.

Hungary's international tax features provide an ideal environment to optimize the benefits of the royalty regime. Hungary is among the few European countries that do not levy withholding tax on either dividends[1] or royalties paid out to foreign recipients worldwide. Withholding tax-free divided distribution has also stood the test of time, and has become a cardinal feature of Hungary's tax regime. Hungary also has a fairly low corporate income tax rate: The general tax rate is 19 percent, while a reduced rate of 10 percent applies on the first HUF 500 million (€1.7 million) of the tax base[2].

Those investors who are not discouraged by Hungary's tendency to surprise its taxpayers with new industry-specific surtaxes, or frequent changes in its tax legislation, may find the Hungarian IP opportunities very interesting and mostly appealing, indeed.

What Qualifies as Royalty Income?

The Act on Corporate Income Tax defines royalty income very broadly. Royalty income includes any consideration received for the exploitation or sale of the following self-developed or purchased intellectual property: patents, industrial design, other protected intellectual works, know-how exploitation rights, trademarks, trade names, trade secrets and authentic works protected by copyright. This broad scope makes the regime broader than most other European regimes in place today.

The Mechanics of the Royalty Deduction

Hungary provides a deduction for 50 percent of all royalty income when calculating the corporate income tax base. This deductible amount, however, cannot exceed 50 percent of the pre-tax profits. The royalty deduction facilitates a reduced effective corporate income tax rate on the total pre-tax profit of the taxpayer, extending the benefits to non-royalty types of income also. The deduction is especially beneficial to those companies that also receive tax-free dividends and perform substantial R&D.

Before illustrating the mechanics of the royalty deduction, we will introduce another important factor enhancing the benefits of this regime, which is the tax treatment of R&D-related costs.

Tax Treatment of R&D Costs

R&D[3] expenditure and amortization realized in the accounts for intellectual property developed as a result of R&D activity are allowed for corporate income tax purposes. In addition, the pre-tax accounting profit of the taxpayer is once more reduced when calculating the taxable base by the direct costs of R&D carried out within the scope of the taxpayer's own activities (additional deduction). Costs of R&D performed directly or indirectly by third parties may only be deductible if the service provider declares that the R&D services have not been purchased from a Hungarian resident taxpayer, a Hungarian branch of a non-resident entity or a Hungarian private entrepreneur. This practically means that a tax deduction for 200 percent of R&D expenditure can be achieved, either in the year in which it has been incurred or, if capitalized, through the years of amortization.

4 Provided that the dividends are not received from a controlled foreign company.

Illustration of the Royalty Incentive

Now, let's see the mechanics of the royalty incentive at an IP company with dividend income and R&D activities. The below examples show how the incentives work in scenarios when the 10 percent corporate income tax rate (Table 1) and a when both the 10 percent and 19 percent corporate income tax rates apply.

I. Taxation of IP company with CIT tax base		
		kHUF
+	Royalty income	600,000
+	Other income	400,000
+	Dividends	200,000
-	R&D deductibles	200,000
Pre-tax profit (PTP)		**1,000,000**
Tax base adjustments:		
-	Royal incentive	300,000
-	Dividends	200,000
-	R&D deductibles	200,000
Tax base:		300,000
Tax (10%)		30,000
Tax/PTP:		**3.00%**

II. Taxation of IP company with 10%-19% CIT tax base		
		kHUF
+	Royalty income	2,000,000
+	Other income	800,000
+	Dividends	400,000
-	R&D deductibles	400,000
Pre-tax profit (PTP)		**2,800,000**
Tax base adjustments:		
-	Royal incentive	1,000,000
-	Dividends	400,000
-	R&D deductibles	400 000
Tax base:		1,000,000
Tax (10%)		145,000
Tax/PTP:		**5.18%**

As shown in the calculations, the licensing company receives royalty income, other income and dividends, and incurs R&D costs. These figures make up its pre-tax accounting profit. To calculate the corporate income tax base, we will deduct 50 percent of the royalty income from the pre-tax accounting profits. Since the deduction in these cases is less than half the pre-tax accounting profit, we may fully utilize the deduction potential. We may also deduct the dividends, as dividends are tax-free income[4] and the R&D costs due to the R&D incentive from the pre-tax accounting profits, and, as a result, we arrive to the corporate income tax base of the company. The first HUF 500 million of the tax base will be subject to 10 percent corporate income tax, while 19 percent corporate income tax will apply above this threshold. The effective corporate tax rates in the above examples, (scaling the tax payable to the pre-tax accounting profits) are 3.00 percent and 5.18 percent. The overall effective tax rate always depends on the ratio of the royalty revenue, the deductible dividends and R&D costs in the given tax year.

The Transfer of Intellectual Property

To make the royalty regime even more attractive, a tax exemption was recently introduced for the transfer of intellectual property assets if the assets were reported to the tax authority within 60 days of their purchase or development. The tax exemption only applies for IP assets owned for at least one year.

This incentive makes the Hungarian regime truly beneficial for non-depreciating assets, or for assets the values of which increase over time. In most other European royalty regimes, reduced rates and benefits do not apply to proceeds of the sale or transfer of the intellectual property itself, which makes the tax-free transfer of Hungarian-held intellectual property unique, and the structure very flexible for future restructuring, if needed.

This short description does introduce all IP-related rules and benefits available in Hungary, but focuses on the main features of a royalty regime which has appealed to many in the past decade. To make it more appealing, the exit from this regime was made tax-free in the recent past, recognizing that flexibility is increasingly becoming one of the most important aspects of international tax planning involving high-value intellectual property.

Poland—Preferential Tax-Deductible Costs for Transfer of Intellectual Property Rights

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Polish tax law contains unique regulations on the determination of tax-deductible costs relating to the transfer of copyrights to works that intellectual property owners ("IP Owners") have already created. IP Owners are defined under Polish intellectual property law as "creators of all forms of intellectual property, with the condition that the result of the creation process must qualify as 'work'," where 'work' is defined as, "each individual creative work, embodied in any form, regardless of its value, designation or medium of expression". IP owners may apply a preferential 50 percent rate of tax-deductible costs to any income gained from such transfers.

There exist the standard tax-deductible costs which may be applied in 2013 to calculate the income of individuals deriving revenues from an employment relationship in a given month amount to PLN 111.25 (standard costs) or PLN 139.06 (increased costs), irrespective of the employee's salary. On the other hand, the rules related to independent contractors generating income from mandate agreements are slightly more beneficial. Their revenues may be diminished by tax-deductible costs calculated as 20 percent of revenues.

From this perspective, the 50 percent rate of tax-deductible costs seems to be a good starting point for IP tax planning, though beginning in 2013, if the 50 percent rate is applied, the total tax-deductible costs incurred in a given tax year in relation to copyrights may not exceed one half of the amount representing the upper limit of the first tax bracket. In 2013, this limit amounts to PLN 42.764.

The preferential 50 percent rate of tax-deductible costs may be applicable whether the legal relationship under which the IP owner transfers the copyrights is an employment relationship, mandate agreement or other contract. However, to apply the 50 percent rate, the revenue must be gained for the creation and transfer of a copyright to a piece of "work" protected by copyrights, as understood under Polish IP law. Thus, it is essential to properly qualify the individual's activities and the result of such activities.

The determination as to whether or not a given effect of intellectual activities is in fact "work" must be made based on factual analysis, and not only by the decision of the parties to the contract. It is important to note that in order to verify whether a "work" was created, one should analyze the end result of the given intellectual activities, and not the character of the activities as such. Consequently, it is not possible to determine in advance whether concrete works of an employee will be regarded as "works" under Polish IP law. Of course, there are certain groups of products created as a result of intellectual activities that are usually presumed to meet the requirements of the "work" definition (e.g., computer programs) and others which are regarded as not meeting those conditions (e.g., court pleadings), but in practice, the analysis should always be made on a case-by-case basis.

IP tax planning based on the above regulations may require the introduction of a specific type of salary system in relation to a company's employees, under which the chosen employees could obtain their salary as two separate parts. The first part would be the base salary, to which the standard tax-deductible costs would apply. The second part would be the salary from the transfer of IP rights to works created by the employee, to which the more beneficial 50 percent tax-deductible costs could be applied.

Such restructuring of employee salaries may result in significant tax savings because the beneficial effect of using 50 percent tax-deductible costs is reflected in two concurrent areas. First, the final tax base from which tax is calculated is lower as a result of the deduction of a higher amount of costs. Second, note that in Poland, employee income is taxed on a progressive tax scale, with two tax rates: 18 percent and, starting

from the tax base level of ca. PLN 85,000 annually, 32 percent. If the preferential 50 percent tax-deductible costs are deducted, the moment in a tax year from which the 32 percent tax rate is applicable to the employee's income is delayed. Consequently, from the perspective of the whole tax year, the 32 percent tax rate is applied to a lower amount of income, as compared to the situation when preferential costs are not used.

To demonstrate the amount of savings that may be achieved with the application of such IP tax planning, suppose we have two employees whose monthly salary is PLN 12,000 (for the purpose of clarity, we will ignore the social security contributions for this example). The first employee does not enjoy preferential tax-deductible costs and starting from the eigth month of the tax year, pays 32 percent income tax. His annual income tax burden will amount to ca. PLN 33,400. The other employee's salary is also PLN 12,000, but his salary is divided into two equal parts, the first part being a base salary relating to standard activities and the second part relating to the creation of "works" as understood by Polish IP law. Accordingly, the second employee is allowed to benefit from the 50 percent tax-deductible costs in relation to the second part of his salary. Consequently, for the second employee, the application of the 32 percent tax rate to his income is delayed and starts from the tenth month of the tax year. Taking into consideration his whole salary, the final annual income tax burden of the second employee amounts to ca. PLN 28,000. Consequently, the tax saving in such situation in relation to one employee with a monthly salary of ca. PLN 12,000 is ca. PLN 5,000 annually if the discussed scheme is applied. If the tax planning is successfully implemented for a group of employees, the tax savings will be even greater.

In order to increase the degree of safety for both the employee and the employer, the implementation of the discussed structure in a company should focus on the diversification of the employees' intellectual activities and the identification of which of them may be qualified as resulting in an effect that is both creative and individual and would be preserved in some form (e.g., in writing). In light of the already mentioned difficulties arising from the application of the definition of "works" under Polish IP law, when implementing the discussed structure, the major focus should be on the development of detailed company procedures regarding this issue.

In particular, the procedures should introduce comprehensive methods of verification whether in each particular case the result of an employee's intellectual work may in fact be qualified as "work" under IP law, thus qualifying for preferential 50 percent tax-deductible costs. The procedures should ensure that the results of employee activities would be analyzed on a case-by-case basis, not automatically or in advance. For instance, a special permanent committee could be established, which would analyze the intellectual products delivered by employees from the perspective of their qualification as "works", based on the relevant IP law criteria, and which would eliminate the works not demonstrating sufficient creativity or individuality.

It would be unusual for an employee to deliver only works qualifying for the application of 50 percent tax-deductible costs. Consequently, it is important that the internal procedures and employment documentation specify how the salary of the employees qualifying as IP owners of "works" is calculated, and how the parts related to copyrights are distinguished from each other. From a technical point of view, such division into two different types of salaries could be achieved in different ways, e.g., by ongoing (monthly) determination of the value of created works, a flat percentage of the employees' revenues connected with the "works", or salary for the expectation right to acquire copyrights for the works that may be created in a given settlement period.

All the described procedures should serve to protect not only the employees, but also the position of the employer, who acts as a tax remitter with respect to the employees' income and is responsible for the accuracy of the collected and remitted income tax advances.

Czech Republic—Intellectual Property Tax Planning Incentives

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Introduction

Unlike Ireland, Switzerland, Belgium, Luxembourg, Malta, the Netherlands and many other countries, the Czech Republic does not offer any special intellectual property (IP) tax regimes, but does offer a number of incentives with respect to aspects of IP research, development and investment.

Income from IP is taxable at the general corporate income tax rate of 19 percent. IP assets are generally depreciated for tax purposes on a monthly basis (18 to 72 months depending on the type of IP or over the period over which the taxpayer has a right to use; generally 32 months for software and results of R&D activities). IP assets that are being created for reasons other than trade or repetitive provision to third parties (e.g., software developed for internal purposes) is not activated and depreciated for tax purposes but is expensed, as expenses are accrued in accounting under GAAP.

The Czech Republic provides taxpayers with relatively generous research and development (R&D) incentives, general investment incentives, free services provided by CzechInvest (The Czech Investment and Business Development Agency) and, in some cases, no exit taxation on transfer of IP out of the Czech jurisdiction. These incentives, combined with lower labor costs of good qualified workers compared with other EU countries, offer beneficial business opportunities for investors in the Czech Republic in the area of IP.

Research and Development

R&D expenses are generally tax-deductible. Besides that, taxpayers performing R&D projects may be eligible for an additional 100 percent deduction of such expenses under certain circumstances.

R&D projects are defined by the Czech Income Tax Act as written projects drafted prior to the start of works on the project describing the activities, estimated costs and further details about the R&D project. Expenses eligible for an additional 100 percent deduction typically include labor or material costs. The additional deduction cannot be claimed in relation to royalty payments, services and intangible results of R&D acquired from other parties (with the exception of certification costs), or expenses covered by a subsidy from public resources, for example.

Unused R&D deductions can be carried forward for three tax periods immediately following the tax period in which the entitlement to a deduction arose.

R&D incentives should be enhanced as of 2014 under the proposed amendment to the Czech Income Tax Act, which is expected to be passed by the parliament later this year. For instance, it should be possible to claim 110 percent of costs in respect of qualifying R&D activities exceeding the costs in the previous tax period (as an incentive to increase R&D expenses) and certain services provided by certain third parties should also qualify for the additional deduction (most notably services provided by universities).

Besides the R&D tax incentives, corporate income tax relief for a period of ten years (tax holiday) can be claimed with respect to large-scale investments, in technological and strategic services centers (subject to conditions), among others. The conditions include, inter alia, the minimum amount of the investment, maximum amount of public subsidies or the fulfillment of EU public support rules.

Zero-Exit Taxation

Capital gains on alienation of IP would generally be combined with other income and expenses and taxable at a 19 percent corporate income tax rate. There is no exit taxation in the Czech Republic, which offers relatively straightforward tax planning opportunities for transfer of IP to more favorable tax jurisdictions once it is developed. In some cases, IP may be transferred out of the Czech Republic without hidden reserves being taxed at the 19 percent corporate income tax or any other form of exit tax.

For instance, there are no controlled foreign company (CFC) rules in the Czech Republic, and foreign subsidiaries of Czech companies achieving passive income (e.g., from holding IP) benefit from the same tax rules as subsidiaries achieving active income. Contributing IP held by a Czech company into a foreign (EU) subsidiary with a beneficial IP tax regime may serve as an example of a transaction that would result in the transfer of IP out of the Czech Republic that should not, in principle, trigger any taxes in the Czech Republic.

A cross-border merger with a company from another EU jurisdiction (being the successor company of the Czech one) may serve as another example of a transaction resulting in transfer of IP into a jurisdiction with more attractive IP taxation. Income from such IP should be taxable in the jurisdiction of the successor company as of the day of deletion of the Czech company from the Czech Commercial Register unless a permanent establishment to which the IP can be allocated survives in the Czech Republic.

A cross-border merger may even result in an increase of the IP value for tax purposes in the receiving jurisdiction, so further transfers may lead to lower capital gain taxation (a so-called tax step-up). This would be available, e.g., in cases where the successor company is a German, Luxembourg or Dutch tax resident (in general, the tax step-up would not work the other way around, if the Czech company acted as the successor).

Tax planning using zero-exit taxation may easily attract the attention of the tax authorities. For instance, OECD Transfer Pricing Guidelines are applied in the Czech Republic and should be obeyed carefully. It is also worth mentioning in this respect that the Czech tax law contains general anti-abuse rules (GAAR) and also the general law principle of law circumvention prohibition and substance over form are well-established in the Czech jurisdiction. Both the Supreme Administrative Court and the Constitutional Court are relatively consistent in enforcing these rules. Business (non-tax) reasons must be in place to justify the substance of every transaction, including tax-neutral cross-border mergers, otherwise the transaction can be reclassified by the tax authorities (e.g., as taxable alienation of IP) and taxed accordingly.

Conclusion

In summary, the Czech Republic may not provide for a special IP tax regime, but its R&D tax regime and investment incentives, relatively low corporate income tax rate (19 percent) and favorable labor market conditions may make it an attractive jurisdiction for investors intending to develop IP and is worth considering for IP tax planning in this particular stage of the IP business.

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