

# The Effect of Anti-Avoidance Provisions Regarding the Promotion of Innovation: Considerations from a Tax Policy Perspective

**This article explores the options used to counter tax avoidance and aggressive tax planning, emphasizing the effect on fiscal measures designed to encourage innovation. Specifically, the author considers the different measures that are intended to ensure a fair balance between the protection of tax bases and the promotion of innovation.**

## 1. Introduction

### 1.1. Research questions posed

The OECD considers research and development, and innovation (R&D (&I)), to be key to productivity and growth.<sup>1</sup> The Europe 2020 strategy also places R&D (&I) at its core with the objective of realizing an overall R&D (&I) spending of 3% of gross domestic product (GDP) in respect of the European Union.<sup>2</sup>

It is generally understood that market incentives alone are insufficient to produce an adequate supply of R&D (&I) and, if there is not an opportunity for profit, R&D (&I) is not undertaken. As a result, state intervention is essential to stimulate private R&D (&I) spending, by way of subsidies, taxes, trade or other policies, and to influence the generation of research and knowledge for sustainable economic growth.<sup>3</sup>

Governments are in charge of defining the tax system, but they can also introduce special measures to encourage entities to undertake particular business activities within

their territories, i.e. extra fiscal objectives. Consequently, taxation can have a regulatory objective by incentivizing certain activities, i.e. tax incentives to foster R&D (&I), such as intellectual property (IP) boxes and penalizing others, i.e. levying a tax on the use of fuel oil to reduce the CO<sub>2</sub> emissions. In this way, governments can influence an individual's behaviour to realize given valuable objectives.<sup>4</sup>

The implementation of tax incentives to encourage R&D (&I) is based on a tax policy decision. In terms of tax competition, countries may introduce special fiscal measures under a defensive or aggressive approach. On the one hand, technology-exporting countries normally implement measures that are intended to retaining intangibles and the related IP rights. As a result, the objective is to counter the location of highly mobile capital in low-tax jurisdictions. On the other hand, technology-importing, or developing, countries adopt an aggressive position with the purpose of attracting intangibles and the related IP rights. In other words, the objective is to encourage companies to undertake certain economic activities within their territories. Consequently, there could be a risk of R&D (&I) delocalization, as a measure would not operate where an asset had been developed or directly exploited.

As is commonly known, intangibles are highly mobile as well as being drivers of value.<sup>5</sup> The nature of such activities makes it very easy to transfer them from one country to another. Globalization and technological innovation have further enhanced that mobility.<sup>6</sup> Consequently, the scope of R&D (&I) may imply a risk of profit shifting. Base erosion and profit shifting, which is primarily undertaken by multinational groups in relation to tax jurisdictions with low or non-taxation, is not only a problem of great global significance that undermines the principle of tax fairness, but also constitutes unfair business competition with other taxpayers that, because of their national dimension, cannot adopt such practices. Indeed, harmful tax practices may result in the transfer of part of the tax burden to less mobile tax bases, i.e. labour, property and consumption, to counter the revenue loss or to improve

\* Doctoral Researcher (FPU14/00028), Tax Law Department, University of Alicante and member of the EURIDTAX Group. The author would like to thank Prof. Amparo Navarro and Prof. María Teresa Soler for their valuable comments and suggestions in the writing of this article. The author can be contacted at [elizabeth@ua.es](mailto:elizabeth@ua.es). This article has been developed as part of the research projects "El Plan de Acción europeo contra la erosión de la base imponible y el traslado de beneficios y su incidencia en el ordenamiento tributario español" (DER2015-64816-P) and "La seguridad jurídica en el ordenamiento tributario español" (DER2015-68072-P), which are financed by the Ministerio de Economía y Competitividad (MINECO).

1. OECD, *Supporting Investment in Knowledge Capital, Growth and Innovation* (OECD 2013).  
 2. *Europe 2020 – A strategy for smart, sustainable and inclusive growth*, COM (2010) 2020 (Mar. 2010).  
 3. In the same vein, according to R.J. Danon, *General Report*, in *Tax Incentives on Research and Development (R&D)*, International Fiscal association (IFA) *Cahiers de Droit Fiscal International* vol. 100a, sec. 1. (Sdu Uitgevers 2015), Online Books IBFD: "[s]tate intervention to stimulate R&D is justified because there is broad agreement that without such intervention undertakings will tend to underinvest in R&D compared to the appropriate level of spillovers that R&D may generate for society". See also Å. Hansson & C. Brokelind, *Tax Incentives, Tax Expenditures Theories in R&D: The Case of Sweden*, 6 *World Tax J.* 2, sec. 3. (2014), Journals IBFD.

4. D. Hancock, *An Introduction to Taxation: Policy and Practice* 2nd edn., p. 7 (Chapman & Hall 1995).  
 5. According to OECD, *Designing Effective Controlled Foreign Company Rules – Action 3: 2015 Final Report* pp. 44-45 (OECD 2015), International Organizations' Documentation IBFD, royalties and IP income, among other categories of income, are likely to be geographically mobile and are, therefore, likely to raise issues regarding base erosion and profit shifting.  
 6. OECD, *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance – Action 5: 2015 Final Report* p. 11 (OECD 2015), International Organizations' Documentation IBFD.

tax collection. In addition, these changes in the structure of taxation could make a tax system less efficient in terms of its effect on growth and employment in the long run.<sup>7</sup>

Since 2013, the OECD has been promoting its Action Plan on Base Erosion and Profit Shifting (BEPS)<sup>8</sup> in an attempt to counter global harmful tax practices that permit multinational groups to undertake aggressive tax planning. The latest Communication of the European Commission of June 2015 also commenced its own initiative to deal with base erosion and profit shifting practices. This EU initiative proposes the relaunch of the common consolidated corporate tax base (CCCTB), which would include specific rules to counter base erosion and profit shifting practices, i.e. preferential regimes rules, limitation on interest deductions, controlled foreign company (CFC) and transfer pricing rules, among others.

There is no doubt of the high economic and technological value of innovative activities. However, at the same time, such activities can result in base erosion and profit shifting. Anti-avoidance provisions may help to counter harmful tax practices, but it is important to emphasize the (negative) effect that anti-abuse provisions can have on encouraging innovation, such as neutralizing their effects. Indeed, even if EU and OECD initiatives cannot be regarded as anti-incentives projects, they have an indirect effect on the design and implementation of R&D (&I) tax measures.

## 1.2. Outline of the article

Bearing in mind what is stated in section 1.1., the objective of this article is to explore the different possibilities that are used to counter tax avoidance and aggressive tax planning, and noting their effect on fiscal measures that are designed to encourage technological innovation. The article is therefore organized into the following sections. Section 2. examines some general features of anti-abuse provisions and introduces section 3., which deals with the compatibility of patent box regimes and CFC rules. Section 4. focuses on R&D (&I) costs in the proposed new CCCTB at an EU level, in particular, considering qualifying R&D (&I) expenses in selected jurisdictions. The article concludes with section 5. and provides answers to the research questions posed in section 1.1.

- .....
7. *A contrario sensu*, the European Commission considers that, given that some categories of taxes are known to be less detrimental to growth than others, i.e. labour taxes, a move towards growth-friendly taxes could generate static and dynamic efficiency gains. Consequently, transferring tax away from labour, especially for the most vulnerable groups, could stimulate the supply of labour by reducing the disincentives to work and could raise the demand for labour by reducing labour costs of entities. On the other hand, transferring taxation from income to consumption reduces the tax burden on savings, as savings are defined as disposable income minus consumption. See European Commission, *Tax Reforms in EU Member States*, Working Paper No. 38 pp. 48-49 (2013), EU Law IBFD.
8. OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD 2013), International Organizations' Documentation IBFD.

## 2. R&D (&I) Tax Schemes and Anti-Avoidance Provisions

### 2.1. In general

Interest in increasing business spending on R&D (&I) is based on its consideration as key factor with regard to productivity and growth<sup>9</sup> as well as the fact that such spending can contribute to social welfare and technological progress.<sup>10</sup> Indeed, technology and innovation are important drivers of economic development, inter alia, resulting in new products and higher income.<sup>11</sup> This may justify a policy of subsidizing scientific and entrepreneurial activities that could result in innovation and, therefore, to the accumulation of valuable intangible assets, such as know-how, patents, trademarks and copyrights.<sup>12</sup>

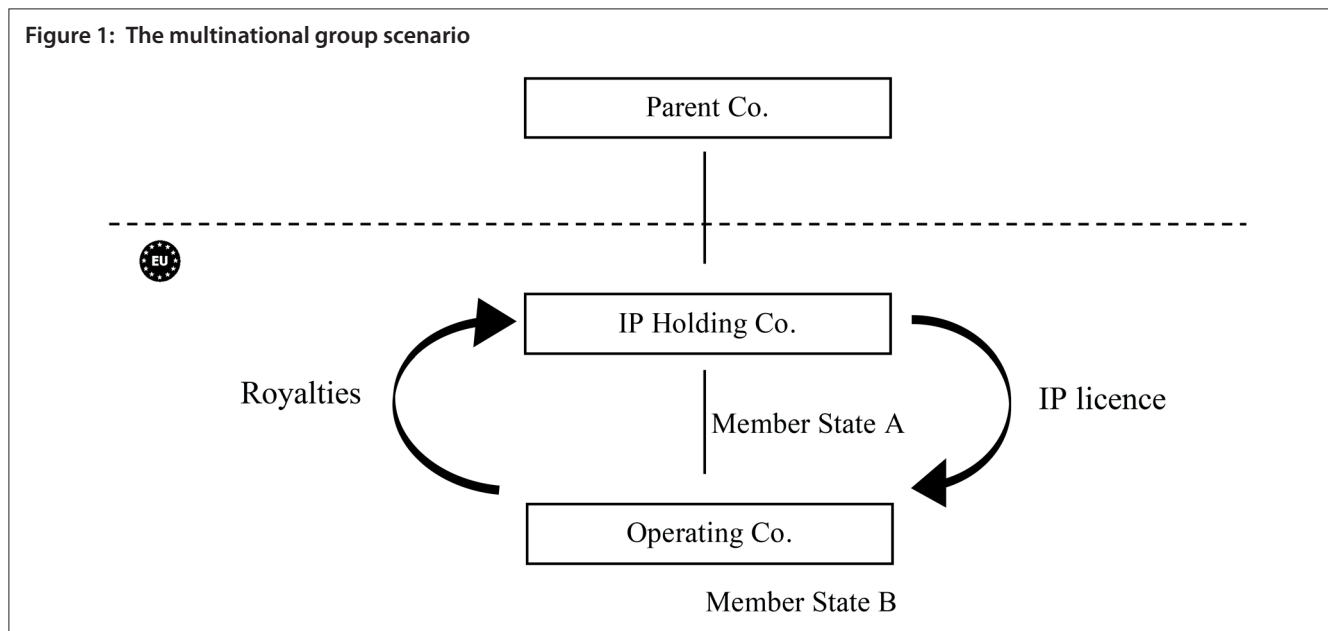
It is widely understood that tax incentives may result in the provision of new goods and services, thereby increasing productivity and higher incomes. As the benefits of R&D (&I) investment is usually greater for the general public than for the investor, enterprises often invest in R&D (&I) to a lesser extent than society would desire. Consequently, tax incentives can make innovation more economically viable.<sup>13</sup> Nevertheless, fiscal incentives can be abused and may be incompatible with EU and international standards. For instance, tax incentives are *prima facie* a selective measure, so they can fall within the scope of State aids in article 107 of the Treaty on the Functioning of the European Union (TFEU).<sup>14</sup>

As noted in section 1.1., R&D (&I) schemes and IP regimes may give rise to a risk of base erosion and profit shifting. Base erosion and profit shifting is mainly undertaken by multinational groups in relation to tax jurisdictions with low or non-taxation. That is, for example, jurisdictions granting special tax regimes, such as the patent box, or jurisdictions with a low level of taxation, i.e. tax havens.

In Figure 1, the IP Holding Co. and the Operating Co. are residents in different Member States and are associated entities within the multinational group directed by the Parent Co., resident in a third state. Consequently, if Member State A has an IP box regime, royalties are taxed at a low rate. As the Interest and Royalties Directive (2003/49)

- .....
9. OECD, *Tax Incentives for Research and Development: Trends and Issues* p. 2 (OECD 2002); OECD, *supra* n. 1, at 17; and European Commission, *A Study on R&D Tax Incentives: Final Report*, Taxation Papers, Working Paper No. 52, p. 38 (2014), EU Law IBFD.
10. M.B. Corchuelo Martínez-Azúa, *Incentivos fiscales a la I+D en la OCDE: estudio comparativo*, Cuadernos Económicos de ICE, Ministerio de Economía y Competitividad 73, p. 197 (2007).
11. A.M. Bal & R.H.M.J. Offermanns, *R&D Tax Incentives in Europe*, 52 Eur. Taxn. 4 (2012), Journals IBFD.
12. P. Arginelli, *Innovation through R&D Tax Incentives: Some Ideas for a Fair and Transparent Tax Policy*, 7 World Tax J. 1 (2015), Journals IBFD.
13. A.M. Bal, *Competition for Research & Development Tax Incentives in the European Union – How an Optimal Research & Development System Should Be Designed*, 66 Bull. Intl. Taxn. 10 (2012), Journals IBFD.
14. Consolidated Versions of the Treaty on European Union and the Treaty on the Functioning of the European Union (TFEU), OJ C115 (2008), EU Law IBFD. For further information on R&D (&I) and State aid, see R.H.C. Luján, *EU Report*, in IFA, *supra* n. 3; A. Nykíal-Mateo, *State Aid Limitations on Fiscal Support to R&D&I*, in *Tax Aspects of Research and Development within the European Union* (W. Nykiel & A. Zalasinski eds., Wolters Kluwer Bus. 2014); and B. Pérez Bernabeu, *R&D&I Tax Incentives in the European Union and State Aid Rules*, 54 Eur. Taxn. 5 (2014), Journals IBFD.

Figure 1: The multinational group scenario



applies, no withholding tax is levied.<sup>15</sup> Finally, if the third state does not have CFC rules, any foreign income cannot be attributed to the shareholders in the parent jurisdiction.

In general, governments have various options with which to counter tax avoidance through the abuse of legal forms. These include general anti-avoidance rules (GAARs), specific anti-avoidance rules (SAARs), and transfer pricing<sup>16</sup> and CFC rules.

## 2.2. GAARs and SAARs to counter the risk of IP profit shifting

### 2.2.1. GAARs

GAARs provide an instrument for the tax administrations to reclassify a given arrangement by interpreting the tax legislation according to its purpose.<sup>17</sup> In Spain, for

example, the Spanish *Ley General Tributaria* (General Tax Law, LGT)<sup>18</sup> contains a number of rules that are intended to counter tax avoidance. These instruments are to be found in article 15, i.e. the “fraus legis” or substance-over-form rule, article 16, i.e. the anti-sham rule, and article 13, i.e. the “taxation of the real transaction” rule, of the LGT.

With regard to R&D (&I), a GAAR may disallow the deductibility of payments, such as royalties, to tax havens under certain conditions. It is, however, difficult to draw the line between wholly artificial structures and genuine activities. As a result, it may be easy for entities to circumvent the application of a GAAR. The effectiveness of GAAR depends greatly on the interpretation adopted by national courts,<sup>19</sup> which results in considerable uncertainty in the application of tax law. Finally, it is important to note that tax planning, even if considered aggressive, is not necessarily illegal.<sup>20</sup>

Action 6 of the OECD/G20 BEPS initiative identifies treaty abuse, in particular, treaty shopping, as one of the most important sources of concerns regarding base erosion and profit shifting.<sup>21</sup> The Report gives most attention to this objective, in proposing a limitation-on-benefits (LOB) clause and a principle purposes test (PPT) rule, but it also recommends the introduction of a GAAR into tax treaties.<sup>22</sup>

15. Council Directive 2003/49/EC of 3 June 2003 on a Common System of Taxation Applicable to Interest and Royalty Payments Made between Associated Companies of Different Member States, OJ L 49 (2007), EU Law IBFD [hereinafter: the Interest and Royalties Directive (2003/49)]. The Interest and Royalties Directive (2003/49) is designed to eliminate withholding tax obstacles in respect of cross-border interest and royalty payments within a group of companies by abolishing withholding taxes on royalty and interest payments arising in a Member State. According to the EU Action Plan, the Interest and Royalties Directive (2003/49) should be amended so that Member States are not required to give beneficial treatment to interest and royalty payments if there is no effective taxation elsewhere in the European Union. (See European Commission, A Fair and Efficient Corporate Tax System in the European Union: 5 Key Areas for Action, COM (2015) 302 final p. 17 (17 June 2015), EU Law IBFD.) As a result, the Working Party on Tax Questions – Direct Taxation of 16 Feb. 2016 considered that the minimum ETR should be 10%. That is, any interest and royalty payment would be exempted from taxes in the Member State where they arise when the ETR resulting from the tax regime applying to those payments in the Member State of the beneficial owner is at least 10%.

16. Briefly, transfer pricing rules are intended to adjust the taxable profits of associated enterprises to eliminate distortions arising whenever the prices or other conditions of transactions between such enterprises differ from what they would have been if the enterprises had been unrelated. The OECD, *supra* n. 8, Actions 8-10 (Aligning Transfer Pricing Outcomes with Value Creation) and Action 13 (Transfer Pricing Documentation and Country-by-Country (CbC) Reporting) address transfer pricing issues.

17. V. Ruiz Almendral, *Tax Avoidance and the European Court of Justice: What is at Stake for European General Anti-Avoidance Rules?*, 33 Intertax 12, p. 565 (2005).

18. ES: *Ley General Tributaria* (General Tax Law, LGT).

19. In Spain, the limitation of the tax avoidance can be found in several judgements of the *Tribunal Supremo* (Supreme Court, TS), such as in ES: STS 3267/2012, 19 Apr. 2012; ES: STS 1060/2014, 17 Mar. 2014; ES: STS 2540/2014, 19 June 2014; and ES: STS 2796/2015, 18 June 2015, among others.

20. C. Spengel, et al., *Profit Shifting and “Aggressive” Tax Planning by Multinational Firms: Issues and Options for Reform*, Discussion Paper No. 13-044, ZEW, Centre for European Economic Research, 2013, available at <http://ftp.zew.de/pub/zew-docs/dp/dp13044.pdf>.

21. OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances – Action 6: 2015 Final Report* (OECD 2015), International Organizations’ Documentation IBFD.

22. C. Palao Taboada, *OECD Base Erosion and Profit Shifting Action 6: The General Anti-Abuse Rule*, 69 Bull. Intl. Taxn. 10 (2015), Journals IBFD.

Additionally, in defining “special tax regime”, Action 6 proposes new provisions regarding article 11 (Interest), article 12 (Royalties) and article 13 (Other income) of the OECD Model.<sup>23</sup> In accordance with the new provision that has been proposed with regard to article 12 (Royalties) of the OECD Model:

[r]oyalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State may be taxed in the first-mentioned Contracting State in accordance with domestic law if such resident is subject to a special tax regime...<sup>24</sup>

The new provision would permit the taxation in the source state where there is a preferential tax regime in the residence state and this is defined in the relevant tax treaty. Consequently, in Figure 1 (*see* section 2.1.), Member State B, i.e. the source state, could tax the royalties if the IP Holding Co., i.e. the beneficial owner, was subject to a special tax regime as defined in the relevant tax treaty. In this context, it should, however, be noted that, within the EU framework, i.e. the scenario in Figure 1, the Interest and Royalties Directive (2003/49) would apply.

In accordance with this proposal, a “special tax regime” would mean:

any legislation, regulation or administrative practice that provides a preferential effective rate of taxation to such income or profit, including through reductions in the tax rate or the tax base... However, the term shall not include any legislation, regulation or administrative practice [whose application] does not disproportionately benefit interest, royalties or other income, or any combination thereof.<sup>25</sup>

The definition excludes from the term “special tax regime” a provision if the application of such a provision implies a proportional benefit.

This term also excludes any provision “that satisfies a substantial activity requirement”.<sup>26</sup> Such an exception is probably intended to take into account those IP box regimes that, following Action 5 of the OECD/G20 BEPS initiative, have adopted a nexus approach. Similarly, the new US Model (2016) denies reductions to withholding taxes under a tax treaty in respect of deductible related-party payments where the beneficial owner of the payment pays little or no tax on the related income as a result of a “special tax regime”.<sup>27</sup>

Given the “proportional benefit” as an exception, this raises the question how to interpret this expression. If the justification for introducing a special tax regime is the existence of constitutional values or another public interest, i.e. extra fiscal objectives:

tax benefits should be in accordance with the proportionality principle and, in any case, cannot be based on arbitrary decisions.<sup>28</sup>

23. OECD Model Tax Convention on Income and on Capital (26 July 2014), Models IBFD.

24. OECD, *supra* n. 21, at 96-98.

25. *Id.*, at 96-97.

26. *Id.*, at 97.

27. US Model Tax Convention on Income (17 Feb. 2016), Models IBFD.

28. M.A. Gutiérrez Bengoechea, *Algunas notas sobre la extrafiscalidad y su desarrollo en el derecho tributario*, Revista Técnica Tributaria 107, p. 153 (2014).

In this way, the requirements of a valid different tax treatment in comparable situations are (1) an objective and reasonable justification, i.e. constitutional values; (2) the proportionality of the measure; and (3) tax incentives that are checked accordingly, depending on comparability and the type of incentive. With regard to the proportionality requirement, a special provision in respect of R&D (&I) is considered to be proportional only if the same result could not have been arrived at a less distortive measure. In particular, the amount and intensity of the measure must be limited to the minimum needed for such R&D (&I) activities.<sup>29</sup> Consequently, such a special provision would be proportional, and reasonable, if it retained a fair balance between the effectiveness in realizing the objective, i.e. encouraging R&D (&I) activities, and its effect on public resources.

## 2.2.2. SAARs

Countries may also introduce SAARs to counter the risk of profit shifting in relation to certain items. In this respect, there is, in general, an increasing use of SAARs or special measures to address concerns regarding base erosion and profit shifting derived from IP income.<sup>30</sup> For instance, in France, article 11 of the *Loi de Finances pour 2012* (Finance Act for 2012)<sup>31</sup> restricts the conditions for deducting licensing royalties where the licensor and the licensee are related entities. A full deduction for the royalty expense is only allowed if the licensee can demonstrate, and can properly document, that: (1) the use of the licence results in added value for the licensee over the entire licensing period; and (2) the use is real, i.e. does not involve the use of an artificial scheme.<sup>32</sup>

In Austria, for example, from March 2014, royalties paid by an Austrian firm to a foreign recipient are not deductible when the royalties are exempt or subject to an effective tax rate (ETR) of less than 10% in the hands of the recipient.<sup>33</sup> It would appear that the new rules are designed to target patent box regimes.<sup>34</sup> In this regard, the proposal

29. European Commission, Community Framework for State Aid for Research and Development and Innovation (2006/C 323/01) (30 Dec. 2006). In this vein, in Spain, ES: TS, 30 Sept. 1999, Decision No. 718 stated that an excessive tax reduction affects the principle of ability to pay set out in art. 31(1) of the Constitution, in being an unreasonable and inappropriate measure for realizing the purpose of promoting an economic activity, i.e. R&D (&I). According to the TS, such a measure could negatively affect the free movement of people, goods and services.

30. According to J. Freedman, *Defining Taxpayer Responsibility: In Support of a General Anti-Avoidance Principle*, Brit. Tax Rev. 4, p. 352 (2004) the increased use of specific anti-avoidance legislation may give rise to more litigation and greater uncertainty and, therefore, “what we need is not more precise and detailed provisions but a principles or standards approach”.

31. FR: Loi 2011-1977 du 28 décembre 2011 de finances pour 2012 (Law 2011-1977 of 28 December 2011), available at [www.legifrance.gouv.fr/affichTexte.do?cidTexte=JORFTEXT000025044460&categorieLien=id](http://www.legifrance.gouv.fr/affichTexte.do?cidTexte=JORFTEXT000025044460&categorieLien=id) (accessed 28 Feb. 2016).

32. PriceWaterhouseCoopers (PWC), *Worldwide Tax Summaries: Corporate Taxes 2015/16*, p. 675, available at [www.pwc.com/taxsummaries](http://www.pwc.com/taxsummaries) (accessed 28 Feb. 2016).

33. K. Mitterlehner & M. Mitterlehner, *Austria*, in IFA, *supra* n. 3, at sec. 2.4.3. and Y. Schuchter & A. Kras, *Austria – Corporate Taxation* sec. 1., Country Surveys IBFD (accessed 30 June 2015).

34. Danon, *supra* n. 3, at sec. 4.3.4.3. It is important to note that, for the time being, Austria has not implemented a patent box regime, but that indirect effects may arise in its territory from such measures. In this respect, *see* J. Loeprick, *Indirect Access to Intellectual Property Regimes – Effects on Aus-*

to amend the Interest and Royalties Directive to include a minimum effective taxation (MET) clause should be noted. Consequently, any interest and royalty payments would be exempt from tax in the source state when the ETR resulting from the tax regime for such payments in the residence state is at least 10%.<sup>35</sup> The proposed amendment is, in fact, a SAAR, which strengthens the effective taxation of interest and royalty payments in the residence state. The current work on the MET clause takes into consideration the nexus-compliant IP regimes as Member States may retain the possibility to provide entities with effective tax incentives to invest in genuine R&D (&I) in the European Union. As a result, a balance between the promotion of R&D (&I) and a minimum level of effective taxation should be maintained.

On the other hand, the Belgian patent income deduction does not apply to income derived from R&D (&I) that is performed under a development contract or cost-sharing agreement. According to the first paragraph of article 205(3) of the Belgian *Code des impôts sur le revenu 1992/Wet op de inkomstenbelasting 1992* (Income Tax Code 1992, CIR/WIB),<sup>36</sup> income from IP that has been acquired must be reduced by the compensation paid to third parties in obtaining the IP and the amortization applied to the acquisition value of the patents. Consequently, such an anti-abuse provision applies to patents acquired to avoid, first, a double deduction in respect of the costs and, second, a double dip due to the use of successive licences and sub-licences.<sup>37</sup>

This Belgian example leads to the following question: should IP box regimes apply to IP that has been acquired? The broad or narrow scope of the eligible IP rights is based on a tax policy decision. On the one hand, patent boxes can require that any qualifying IP must have been self-developed. As a result, this encourages the creation, exploitation and commercialization of new intangibles. On the other hand, IP box regimes can also permit IP that has been acquired to benefit from the regime. Consequently, income but not the associated genuine activities are encouraged, which brings with it a potential risk of profit shifting. In these last examples, a condition of further development should be required.

This is not possible in countries that do not allow acquired IP to benefit from preferential treatment, i.e. in the Netherlands, Portugal, Spain and the United Kingdom (under certain conditions), among others. On the other hand, other countries have extended the scope of their regimes to include acquired IP assets, i.e. in Cyprus, France, Hungary, Liechtenstein, Luxembourg and Malta, subject to certain restrictions, i.e. in France and Luxembourg.<sup>38</sup>

.....  
*trian and German Affiliates*, WU Intl. Taxn. Research Paper Series No. 13 (2015).

35. See *supra* n. 15.

36. BE: Code des impôts sur le revenu 1992/Wet op de inkomstenbelasting 1992 (Income Tax Code 1992, CIR/WIB).

37. M. de Mil & T. Wallyn, *Belgium*, in IFA, *supra* n. 3, at "Summary and conclusions" and sec. 1.5.7.

38. Danon, *supra* n. 3, at sec. 4.2.2.2.

### 2.3. The "modified nexus approach" as a SAAR

For some years now, income from certain types of R&D (&I) intangibles have been able to benefit from special tax measures that may take the form of tax allowances, exemptions and lower ETRs, among others. The asserted objective pursued by the governments that have introduced IP boxes is to make innovation more attractive and profitable for entities.<sup>39</sup> In this context, it should be noted that patent boxes are officially aimed at encouraging the creation and development of new R&D (&I) intangibles and/or at enhancing the direct use of intangibles in the undertaking of a business, with a view to increase the positive "spillovers" of such creation and exploitation and, therefore, the social welfare. Generally, IP boxes provide an incentive on the basis of reduced tax for economic operators to develop new innovative products and processes or to perform services.<sup>40</sup> The objective of a patent box regime is to provide an additional incentive for companies to retain and commercialize existing patents and to develop new innovative patented products.<sup>41</sup> However, these regimes can also be unfair and discriminatory and can promote tax avoidance. A patent box regime may be considered to be aggressive tax planning, as it may offer a low tax rate on certain IP income and provide an incentive for multinational groups to establish patent-box structures to obtain the tax advantages offered by the regime.<sup>42</sup>

The EU Code of Conduct in business taxation concerns those measures which affect, or may affect, in a significant way the location of business activity within the European Union.<sup>43</sup> According to the Code of Conduct, in assessing if such measures are harmful:

account should be taken of, inter alia:... whether advantages are granted even without any real economic activity and substantial economic presence within the Member State offering such tax advantages, or...

This means that qualifying IP rights should be created, developed and exploited in the territory of the Member State introducing the patent box regime. Due to the globalization and the Single Market, it would appear to be quite complicated that an intangible asset has been created in only one Member State. For instance, in the former (and

.....  
 39. Currently, patent box regimes are basically a European tax incentive. In total, the following 12 Member States have an IP box regime: Belgium, Cyprus, France, Hungary, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Spain and the United Kingdom. Further, in 2011, Liechtenstein and the Swiss canton of Nidwalden introduced patent box regimes. Switzerland is undertaking a tax reform with a strong package of measures to encourage R&D (&I) activities, including an IP box proposal based on the nexus approach. Finally, in Sep. 2015, the United States published a discussion draft with a view to implement a patent box regime.

40. M. Felder, *IP Boxes from a European, Liechtenstein and Swiss Perspective* p. 1 (Schulthess Verlag 2013).

41. Pérez Bernabeu, *supra* n. 14, at sec. 2.

42. European Commission, *Study on Structures of Aggressive Tax Planning and Indicators (Final Report)*, Taxation Papers, Working Paper No. 61 p. 51 (2015).

43. Conclusions of the ECOFIN Council Meeting on 1 December 1997 concerning taxation policy – Resolution of the Council and Representatives of the Governments of the Member States, meeting within the Council of 1 December 1997 on a Code of Conduct for Business Taxation, OJ C 002, 06/01/1998, pp. 0001-0006, available at [http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31998Y0106\(01\):en:HTML](http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31998Y0106(01):en:HTML).

inconsistent) Spanish IP box regime,<sup>44</sup> it was necessary that the transferor had created the assets or IP rights representing at least 25% of its cost.<sup>45</sup> This means that the transferor could have concluded a cost-sharing agreement with other entities located in different Member States to create and develop IP rights. Following the Code of Conduct, a patent box regime that benefits such a situation could fall within the scope of harmful tax competition, as there is no full self-generating R&D (&I) process.

Nevertheless, the aspect noted by the EU Code of Conduct could imply a contradiction with other EU principles. In fact, the limitation of an economic activity to a particular territory could be run counter to the fundamental freedoms of the European Union. This apparent contradiction between the EU principles and the Code of Conduct may make controlling harmful tax practices a difficult task.

Along these lines, the OECD regards preferential tax regimes as a key pressure area. In order for a regime to be considered preferential, the regime must, first, apply to income from geographically mobile activities, i.e. dividends, royalties and IP income. Second, it must offer some form of tax preference, i.e. a tax credit, a tax allowance or a lower tax rate, compared to the general principles of taxation in the relevant Member State, i.e. reflect the principles of ability to pay or equality.<sup>46</sup> The introduction of tax incentives implies to move from the general prohibition in respect of the granting fiscal privileges legitimated by tax justice criteria, mainly, the ability to pay and equality, to the compatibility with the “extra fiscal goals” as legitimated by constitutional values.

The OECD BEPS Action Plan called for proposals to develop solutions to counter harmful tax regimes more effectively, taking into account such factors as transparency and substance in Action 5.<sup>47</sup> Indeed, according to the Deliverable regarding Action 5 of September 2014,<sup>48</sup> this issue was examined and a proposal made for the application of a “nexus approach” that would align R&D (&I) expenditure with the granting of tax benefits. Using such approach as a model, Germany and the United Kingdom issued a joint statement proposing a modified nexus approach (MNA) in November 2014. Under the MNA, which is inspired from existing input incentives and proportionate in nature, the benefits provided by patent boxes are linked to the qualifying R&D (&I) expenditure incurred by the taxpayer itself.<sup>49</sup>

44. ES: Ley 48/2015, de 29 de octubre, de los Presupuestos Generales del Estado para el año 2016 (General State Budget for 2016 (Law 48 of 29 October 2015). Law 48) has amended the patent box regime so that it is in line with the agreements adopted by the European Union and the OECD. Law 48 includes a grandfathering clause. Consequently, the current scheme can be applied up to June 2021.

45. Following the amendment made by Law 48, this requirement disappears.

46. OECD, *Harmful Tax Competition: An Emerging Global Issue* pp. 19-35 (OECD 1998) and OECD, *supra* n. 6, at 19-22.

47. OECD, *supra* n. 13, at pp. 17-18.

48. OECD, *Countering Harmful Tax Practices More Effectively Taking into Account Transparency and Substance – Action 5: 2014 Deliverable* (OECD 2014), International Organizations’ Documentation IBFD.

49. OECD, *supra* n. 6, at 25; Danon, *supra* n. 3, at sec. 4.3.2. and R. Sanz-Gómez, *The OECD’s Nexus Approach to IP Boxes: A European Union Law Perspective*, WU Intl. Taxn. Research Paper Series No. 12 (2015).

According to the Final Report on Action 5 of the OECD/G20 BEPS initiative of October 2015, a consensus has been reached regarding the “nexus approach” as the approach to be adopted in requiring substantial activity for preferential regimes.<sup>50</sup> The eligible income in respect of a tax regime is calculated by applying the following formula:

$$(\text{Qualifying expenditure incurred to develop IP asset} / \text{Overall expenditure incurred to develop IP asset}) \times \text{Overall income from IP asset} = \text{Income qualifying for tax benefits}$$

In this formula, qualifying expenditure is defined as expenditure directly connected to the IP asset, in particular, the R&D (&I) expenditure incurred by the taxpayer and expenditure in respect of unrelated-party outsourcing. In contrast, overall expenditure includes both of these categories, plus acquisition costs and expenditure in respect of related-party outsourcing. As a result, a taxpayer may benefit from an IP regime only to the extent that the taxpayer has incurred qualifying R&D (&I) expenditure in realizing the IP income. However, further aspects on the application of the nexus approach are set out in the Final Report on Action 5 of the OECD/G20 BEPS initiative, i.e. qualifying taxpayers, IP assets, etc. With regard to qualifying expenditure, jurisdictions may permit taxpayers to apply a 30% “up-lift” to expenditure that is included in qualifying expenditure with the purpose of benefiting taxpayers undertaking R&D (&I) activities themselves, but without penalizing taxpayers that acquire IP or outsourcing R&D (&I) activities to related parties. As a result, qualifying expenditure may be increased, provided that qualifying expenditure does not exceed overall expenditure.

Consequently, patent box regimes are now facing a new situation. The initiatives launched by the OECD/G20 in developing BEPS Action 5 and by the European Union in relation to the EU Code of Conduct represent a turning point for the existing regimes. A new deadline is on the horizon and insofar as the countries affected by this process follow the new rules, only those regimes that comply with the new standards will survive in the near future.<sup>51</sup> Some existing regimes have already been amended so as to be in line with the “nexus approach”, i.e. in Spain and the United Kingdom (*see* section 3.3.).

Therefore, the “nexus approach” can be regarded as an anti-avoidance measure. As is commonly held, SAARs usually establish a link between tax avoidance and the lack

50. A total of 43 preferential regimes were reviewed, out of which 16 are IP regimes. With regard to substantial activities, the IP regimes reviewed were all considered to be inconsistent, either in whole or in part, with the nexus approach as described in the OECD, *supra* n. 6.

51. Consequently, new entrants are not allowed to join any existing IP regime that is inconsistent with the “nexus approach” after 30 June 2016. If a new regime that is in line with the “nexus approach” takes full effect before 30 June 2016, new entrants are not allowed to join in the existing IP regime after the compliant IP regime has taken effect. It is considered that amendments to bring a regime into line with the “nexus approach” must have been instituted in 2015. This was the case, for example, in Italy and Spain. Jurisdictions can also introduce grandfathering rules, for example in Spain, that will allow all of the taxpayers benefiting from an existing regime to keep such entitlement until a second specific date, i.e. the “abolition date”. The period between the two dates should not exceed five years, i.e. 30 June 2021 at the latest. After that date, no more benefits stemming from the respective old regimes may be made available to taxpayers. In this context, *see* OECD, *supra* n. 6, at 34-35.

of valid economic reasons.<sup>52</sup> This means that, *a contrario sensu*, the presence of an economically valid justification should avoid the application of the SAAR. With regard to IP box regimes, the fulfilment of the “nexus approach” requirement implies that there is a substantial and genuine economic activity behind the realization of IP income that applies to the preferential tax treatment. As a result, only income that arises from IP where the actual R&D (&I) activities were undertaken by the taxpayer should benefit from an IP box regime, thereby excluding its considerations as a harmful preferential tax regime.

### 3. Anti-Abuse Provisions, CFCs and Patent Boxes

#### 3.1. The framework of CFC rules: Strengthening the design

CFC legislation is intended to counter tax avoidance effected by way of CFCs located in low-tax jurisdictions. As is commonly held, CFCs provide opportunities for profit shifting and the long-term deferral of taxation. There is no doubt that a tax credit in respect of R&D (&I) or a patent box regime implies a tax advantage, in terms that they provide a better tax treatment to a taxpayer undertaking such activities.

The OECD BEPS Action Plan emphasizes the need to address base erosion and profit shifting by the use of CFC rules. In particular, the OECD wishes to see uniform CFC rules to counter BEPS in a more comprehensive manner. The OECD Action Plan on BEPS refers to the “positive ‘spill-over’ effects of CFC rules due to the result that taxpayers would have a much reduced incentive to shift profits into a low tax jurisdiction.”<sup>53</sup>

CFC rules primarily result in the inclusion of income in the residence state of the parent company, but they also have positive “spill-over” effects in source states, as taxpayers have no, or much less of an, incentive to transfer profits to a third low-tax jurisdiction.<sup>54</sup>

Action 3 of the OECD/G20 BEPS initiative recognizes that corporate groups may create low-taxed non-resident affiliates to which they transfer income and that these affiliates may be established in low-tax jurisdictions wholly or partly for tax reasons rather than for non-tax business reasons.<sup>55</sup> CFC rules counter such practices, but some countries do not currently have CFC rules, i.e. *see* Figure 1 in section 2.1., and that others have rules that do not always counter base erosion and profit shifting in a comprehensive manner.<sup>56</sup>

In order to establish whether CFC rules apply, several questions must be considered according to Action 3 of the OECD/G20 BEPS initiative. First, a CFC should be treated as controlled where residents control, at a minimum, more than 50%, either directly or indirectly. Such control could refer to legal control, i.e. the voting rights held in a subsidiary, economic control, i.e. the rights to profits as well as the capital and the assets of a company in certain circumstances, *de facto* control, i.e. who takes the top-level decisions regarding the affairs of the foreign company, or control based on consolidation, i.e. relating to accounting principles. Once a foreign company has been determined to be a CFC, the next question is whether the income earned by the CFC raises concerns regarding base erosion and profit shifting and, therefore, that the relevant income should be attributed to the controlling parties.

#### 3.2. The requirement of substantial economic activity in the context of IP regimes

As a matter of fact, not all CFC income should be attributed under CFC rules. That is, in some cases the establishing of non-resident affiliates can be based on business reasons, i.e. the availability of employees, nature resources, etc. Consequently, income that arises from economic and value-creating activities should be excluded from the scope of CFC rules.

In the same vein, the Court of Justice of the European Union (ECJ), in *Cadbury Schweppes* (Case C-196/04),<sup>57</sup> stated that the use of CFC rules is justified when, in order to counter tax avoidance, they are specifically targeted at wholly artificial arrangements that do not reflect economic reality and whose only purpose would be to obtain a tax advantage. As a result, especially within an EU framework, a substance analysis is required only to subject taxpayers to CFC rules if the CFCs are not involved in genuine economic activities.

As noted in section 1.1., as intangibles are highly mobile, royalties and other IP income can easily be diverted from where the value of the intangible was created or developed. In this context, *see* the situation outlined in Figure 2.

In Figure 2, Country C has a high-technology environment. Accordingly, the Parent Co., located in Country P, which has CFC rules, has established an R&D (&I) Centre there due to the availability of qualified employees, good facilities and resources. It has also established IP Holding Co. given the strong protection of IP rights as well as the preferential tax treatment in Country C. Company B, which is an associated entity resident in Country B, buys the intangibles created by the R&D (&I) Centre and held by IP Holding Co. for its direct use in its industrial process. It also licenses patents to Company A1 and Company A2, which are located in Country A.

Royalties and IP income could be used to transfer purely passive income, i.e. income that does not arise from

52. According to M.T. Soler Roch, *Las normas antiabuso generales y especiales*, VII Jornada Metodológica de Derecho Financiero y Tributario Jaime García Añoveros, Instituto de Estudios Fiscales 12, p. 177 et seq. (2011), in Spain, most SAARs are based on the absence of valid corporate or economic reason other than the tax savings.

53. OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD 2013).

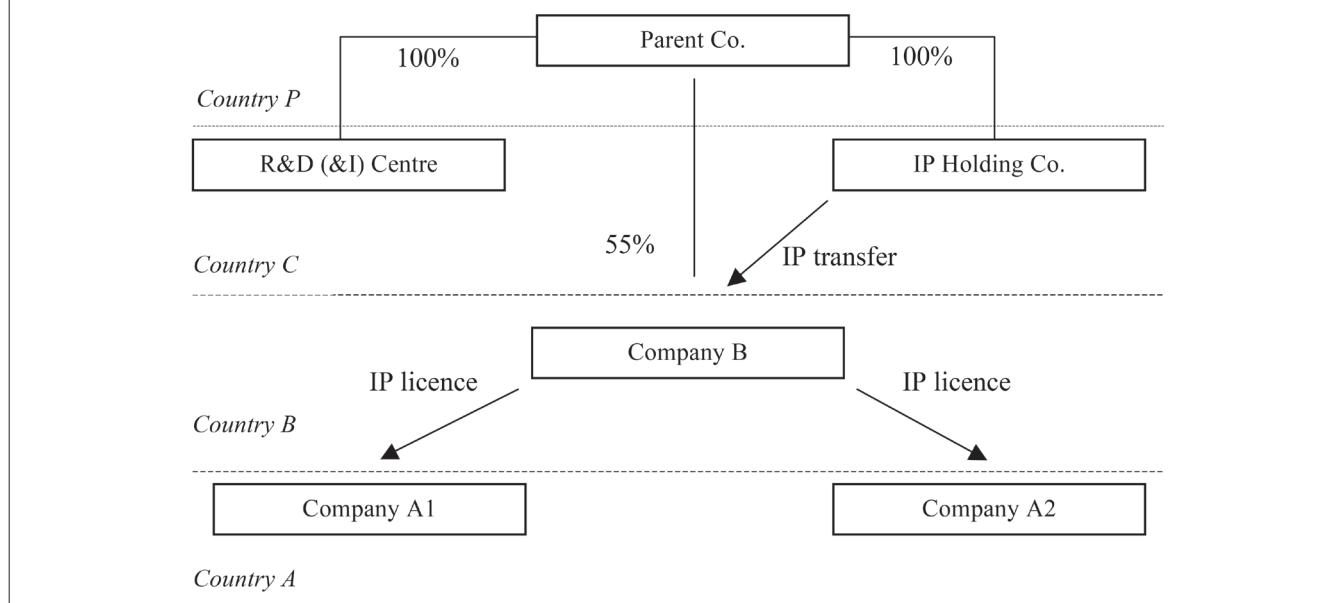
54. OECD, *Public Discussion Draft BEPS Action 3: Strengthening CFC rules* (OECD 2015), International Organizations' Documentation IBFD.

55. OECD, *supra* n. 5, at 11.

56. The first CFC rules were enacted in 1962. Currently, 30 of the countries participating in the OECD/G20 BEPS initiative have CFC rules and many others have expressed interest in implementing such rules. *See* OECD, *supra* n. 5, at 9.

57. UK: ECJ, 12 Sept. 2006, Case C-196/04, *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue*, ECJ Case Law IBFD.

Figure 2: IP structures



any substantial economic activity. However, IP-derived income does not always address base erosion and profit shifting concerns. For instance, in Figure 2, Parent Co. has established non-resident affiliates for business reasons, i.e. the innovation environment. Even if the R&D (&I) Centre, which is located in Country C, has created the IP asset, Parent Co. has been responsible for much of the value creation, as it holds 100% of the shares of the R&D (&I) Centre. Company B also uses, and probably further develops, IP that has been acquired for direct use and exploitation. Consequently, behind the income received from the direct use and exploitation there is an economic activity, i.e. developing new products through the IP that has been acquired. However, Company B licenses the patents that have been acquired from IP Holding Co. to companies located in Country A. In such circumstances, there are no real activities, as Company B is only licensing IP that has been acquired and obtains royalty income for this non-value-creating transaction.

As a result, in a similar way to Action 5 of the OECD/G20 BEPS initiative,<sup>58</sup> a substance analysis considers whether a CFC is engaged in substantial activities in determining what income should be regarded as “CFC income”. Such an analysis can apply as either a threshold test or a proportionate analysis.<sup>59</sup> First, under a threshold, or “all-or-nothing”, test, a set amount of activity, as identified through one or more proxies, would permit all of the income of the CFC to be excluded. A CFC that had not engaged in this amount of activity would have all of its income included in CFC income. Second, under a proportionate analysis, only the amount of income that was proportionate to the amount of activity that the CFC had undertaken would be excluded from CFC income. For instance, if the CFC had undertaken 75% of the activity that would have to be performed to earn the CFC’s income, 25% of its income would be treated as CFC income.

58. OECD, *supra* n. 6, at 24 et seq.  
59. OECD, *supra* n. 5, at 47-49.

With regard to the different ways that a jurisdiction may design a substance analysis, Action 3 of the OECD/G20 BEPS initiative provides a specific option for IP provisions. In this way, the IP income earned by a CFC that satisfied the requirements of the “nexus approach” would not be included in CFC income. In Figure 2, IP Holding Co. is a controlled party, i.e. controlled by 100%, whose income is attributed to Parent Co., as it does not develop any substantial activity. On the other hand, Company B should also be treated as a controlled entity, as Parent Co. has a more than 50% control. Consequently, once the requirements to be a CFC are satisfied, the next step is to decide whether the income earned by the CFC should be attributed to controlling parties.

Consequently, if the taxpayer can demonstrate that income would qualify for benefits under a nexus-compliant IP regime in the CFC jurisdiction, such IP income should not be attributed or subject to the CFC rules. For instance, in Figure 2, the IP income of Co. B is based on the direct use of IP that has been acquired and on the IP licence in respect of IP that has also been acquired. In the latter case, there is no substantial economic activity, i.e. it is “passive income”; therefore, the royalties should not be eligible for a compliant IP regime and should be treated as CFC income. On the other hand, the level of the further development of the IP that has been acquired for the direct use and exploitation must be taken into account, whether or not Company B has itself incurred qualifying expenditure.

To conclude, CFC rules should never apply to patent boxes that are in line with the “nexus approach”. Compliant IP boxes imply that they only grant a special tax treatment to IP income generated by genuine activities. As a result, the risk of profit shifting is removed. On the other hand, it is important to note that the “nexus approach” is compulsory, while Action 3 of the OECD/G20 BEPS initiative regarding CFC rules only contains recommendations for strengthening such mechanisms.



| Table     |                                |                     |       |                   |           |                |
|-----------|--------------------------------|---------------------|-------|-------------------|-----------|----------------|
|           | Qualifying expenditure (x 1.3) | Overall expenditure | Ratio | Tax reduction (%) | IP income | Incentive base |
| Example 1 | 100 (130)                      | 150                 | 0.87  | 52                | 500       | 250            |
| Example 2 | 40 (52)                        | 150                 | 0.35  | 20.8              | 500       | 104            |

### 3.3. Coexistence between the CFC rules and the patent box regime in Spain

In order to be in line with the recommendations of the OECD, the tax reform implemented in Spain in November 2014 amended the CFC regime as governed by article 100 of the *Ley del Impuesto sobre Sociedades* (Corporate Income Tax Law, LIS).<sup>60</sup> In this respect, the Explanatory Memorandum to the LIS expressly states that:

it is necessary that the increase in effective measures in the fight against tax fraud is instituted not only at the domestic level but also within the international framework. In the latter case, the OECD work on BEPS is an essential analysis tool in countering the international tax fraud. Within this scope, the tax reform is a pioneer in introducing measures addressed at such an objective, i.e. the treatment of hybrids and the amendments relating to the CFC legislation. (Author's unofficial translation)

In general, the Spanish CFC regime permits the passive income derived from non-residents entities with direct or indirect holdings in Spain to be incorporated into the tax base of Spanish taxpayers. Following the reform of the LIS at the end of 2014, such attributions of CFC income have increased. As a general rule, a taxpayer should include the total amount of relevant CFC income in the tax base, unless the entity in question has at its disposal the employees and facilities necessary for earning the income. As a result, the CFC regime does not apply when the taxpayer can demonstrate that: (1) the activities and transactions are carried out with the employees and facilities of the non-resident entity; or (2) there is a valid economic reason for the creation of and the business of such an entity. Consequently, in accordance with Action 3 of the OECD/G20 BEPS initiative, not all CFC income should be attributed under CFC rules, i.e. income that arises from economic and value-creating activities should be excluded.

Article 100.16 of the LIS states that the Spanish CFC does not apply if the non-resident entity is established in a Member State of the European Union, provided that the taxpayer can demonstrate there is a valid economic reason for the creation, and the business, of the entity and that there is a real economic activity. In addition, the CFC rules do not apply to "undertakings for the collective investment in transferable securities" (UCITS) that are covered by Directive (2009/65),<sup>61</sup> as amended by Directive (2014/91).<sup>62</sup>

60. ES: Ley del Impuesto sobre Sociedades (Corporate Income Tax Law, LIS).

61. Council Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) Text with EEA relevance, OJ L 302 (2009), EU Law IBFD.

62. Council Directive 2014/91/EU of the European Parliament and of the Council of 23 July 2014 amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as

In such circumstances, substantial or economic requirements are not expressly required.

On the other hand, the General State Budget for 2016 (Law 48 of 29 October 2015) amended the patent box regime to be in line with the various agreements and measures adopted by the European Union and the OECD. In this way, income generated by IP benefits from a reduction, as stated in article 23 of the LIS,<sup>63</sup> in the tax base that is calculated by applying the percentage derived from the following formula:

$$60\% \times \frac{\text{Direct expenses related to IP creation, including the outsourcing expenses of non-related parties (increased by 30\%)}}{\text{Overall expenses related to IP creation, including outsourcing of related parties and acquired IP expenses}}$$

Along the same line as Action 5 of the OECD/G20 BEPS initiative,<sup>64</sup> in calculating qualifying expenditure, taxpayers may apply to a 30% "up-lift" to expenditure that is included in qualifying expenditure (*see* Table).

As a result, the Spanish formula is intended to benefit taxpayers that themselves undertake R&D (&I) activities, i.e. Example 1 in the Table, but does not penalize taxpayers excessively for acquiring IP or outsourcing R&D (&I) activities to related parties. This is probably because such taxpayers may themselves still be responsible for much of the value-creation activity. For instance, in Figure 2 (*see* section 3.2.), Parent Co. has outsourced R&D (&I) activities to the R&D (&I) Centre located in Country C, but Parent Co. holds 100% of the shares, so it may have made a relevant contribution to the creation of the IP asset. Consequently, if Parent Co. were to directly license the IP assets, it would not be penalized. Obviously, the tax benefit would not have been as generous had the company itself undertaken the R&D (&I), i.e. Example 2.

The amendments introduced by the General State Budget for 2016 are effective as of July 2016. The relevant law also includes a grandfathering clause. Consequently, the existing Spanish regime can be applied up to June 2021.

In addition, the application of the patent box regime depends on the existence of certain conditions set out in article 23 of the LIS. Briefly, these are that: (1) the IP recipient must use the assets or IP rights transferred or licensed for the development of an economic activity; (2)

regards depositary functions, remuneration policies and sanctions, Text with EEA relevance, OJ L257 (2014).

63. The Spanish patent box regime was introduced in 2007, with effect from Jan. 2008). In Sep. 2013, ES: Encourage Entrepreneurs Law 14/2013 amended the design of the regime.

64. OECD, *supra* n. 6, at 24 et seq.

the IP recipient must not be resident in a tax haven; (3) where the licence or assignment contract includes other services, i.e. technical services, it must be to differentiate between these and the primary transmission; and (4) there must be accounting records that allow the differentiation of income and expenses from asset transmissions or the exploitation of the IP rights.

With regard to the interaction between the CFC rules and the patent box regime in Spain,<sup>65</sup> the new CFC regime has been extended to cover the benefits generated by the exploitation of IP.<sup>66</sup> Consequently, IP income generated by a Spanish subsidiary, i.e. the controlled party, located in a low-tax jurisdiction is taxed in Spain. According to this scenario, the IP income generated by a company located in Spain benefits from the patent box regime if it fulfils the requirements set out in article 23 of the LIS, but the IP income generated by a Spanish company under a preferential tax treatment abroad is penalized as it is included in the CFC regime. This is intended to attract R&D (&I) centres to Spain.<sup>67</sup>

However, it should be noted that with regard to these considerations, when CFC income arises from economic and value-creating activities, it should not be attributed under the CFC rules. As Action 3 of the OECD/G20 BEPS initiative states, in respect of IP income, compliance with a nexus-compliant IP regime should be taken into account. As a result, if a Spanish company has a controlled party in a jurisdiction granting a nexus-compliant IP regime, the IP income derived from the CFC should not be attributed under the Spanish CFC regime, unless the income does not qualify for the regime.

#### 4. Tax Treatment of R&D (&I) Costs for the Purpose of the New CCCTB Proposal

Europe's current priorities are to restore growth and promote investment and job creation within a fairer and deeper Single Market. Corporate taxation is an essential element of a fair and efficient tax system, as it represents essential revenue for the Member States and is a relevant factor in influencing company business decisions, for example, as noted in section 3.2. (see Figure 2), with regard to R&D (&I) activities. Many Member States grant tax incentives to encourage spending on R&D (&I).<sup>68</sup> For instance, it is interesting to consider the North West and Scandinavian areas, as the Netherlands and Finland and Sweden are the Member States with the highest number of patents per habitant.<sup>69</sup>

65. The CFC rules can be regarded as a disincentive for the investment or the undertaking of certain projects or activities. See A. Zalasinski, *General Report – Tax Aspects of Research and Development within the European Union*, in Nykiel & Zalasinski eds., *supra* n. 14, at 61.

66. Art. 100.3.d LIS.

67. F. Serrano Antón, *La influencia del Plan de Acción BEPS en la tributación española: impacto en la normativa, incremento de la litigiosidad y el papel de los tribunals*, *Revista de Contabilidad y Tributación* 391, p. 104 (2015).

68. The generosity of R&D (&I) tax incentives is rising, particularly, in the European Union. See Danon, *supra* n. 3, at sec. 1.

69. According to Eurostat 2010, the Netherlands is third behind Finland and Sweden.

On 17 June 2015, the Commission published an Action Plan for a fairer and efficient corporate tax system and proposed five key areas for action.<sup>70</sup> The relaunch of the CCCTB is at the heart of the Action Plan, or the “EURO BEPS Plan”. The new CCCTB proposal is intended to be a mandatory system to better enable it to counter aggressive tax planning. In this vein, the Commission has indicated its intention to consult the public with the purpose of determining possible options for attaining the objectives of the new CCCTB proposal. The consultation seeks to gather views, in particular, on which types of rules would best encourage R&D (&I) activities.

In the currently pending CCCTB project, the Commission has proposed a favourable treatment of R&D (&I) costs by making such costs fully deductible in the tax year in which they are incurred, with the exception of costs relating to immovable property. On the other hand, the Commission notes a more favourable option regarding the promotion of R&D (&I), which would consist of the introduction of more generous provisions for deducting costs, such as super deductions that are currently applied by a number of Member States, for example, the Netherlands.<sup>71</sup>

With regard to the first proposal, i.e. the full deduction of R&D (&I) costs in the tax year that they are incurred, it should be noted that R&D (&I) related expenses can generally be deducted.<sup>72</sup> Consequently, in the author's opinion, this proposal is not groundbreaking, as it is already present in a large number of EU Member States<sup>73</sup> and as it does not confer an additional tax advantage for taxpayers undertaking R&D (&I) activities.<sup>74</sup> Therefore, the intention behind the Commission's proposal is probably harmonization.

The Commission has also proposed the introduction of more favourable tax measures, such as super deductions. Traditionally, tax incentives can be classified into two groups. The first category includes “input incentives”, which are designed to encourage investment in R&D (&I). These incentives are typically referred to as tax credits, enhanced allowances, or super deductions, and accelerated depreciation. On the other hand, there are “output incentives”, which are commonly referred to as IP or patent boxes, which grant tax privileges to income arising from R&D (&I) activities.

70. *Supra* n. 15.

71. European Commission, Public Consultation on the Re-launch of the Common Consolidated Corporate Tax Base (CCCTB), available from 8 Oct. 2015 to 8 Jan. 2016 at [http://ec.europa.eu/taxation\\_customs/common/consultations/tax/relaunch\\_ccctb\\_en.htm](http://ec.europa.eu/taxation_customs/common/consultations/tax/relaunch_ccctb_en.htm).

72. For the deductibility at the Spanish level, see A. Navarro Faure, *Los gastos deducibles derivados de la propiedad intelectual e industrial*, *Crónica Tributaria: Boletín de Actualidad* 6 (2012) and *El régimen jurídico-tributario de la propiedad industrial en España*, *Revista Técnica Tributaria* 58 (2002).

73. See, inter alia, Mitterlehner & Mitterlehner, *supra* n. 33, at sec. 1.3.2.; D. Dalsgaard & N. Winther-Sørensen, *Denmark*, IFA, *supra* n. 3, at sec. 1.3.6.; K. Künnapas, *Estonia*, IFA, *supra* n. 3, at sec. 1.3.6.; and A. Rajamäki, *Finland*, IFA, *supra* n. 3, at sec. 1.1.

74. Generally, expenditure for accounting purposes, i.e. expenditure that is included in the profit and loss account, is normally deducted in the tax year in which it is incurred. Consequently, tax deductibility not only covers R&D (&I) costs, but also other kinds of expenditure incurred by taxpayers in undertaking their businesses, subject to certain conditions depending on each Member State.

With the purpose of making entities more innovative and productive, input incentives may be targeted at different R&D (&I) expenditure subcategories. For instance, in Australia, expenditure on buildings, certain assets and interest cannot be notionally deducted.<sup>75</sup> In this context, the Australian Income Tax Assessment Act (ITAA) (1997) does not grant deductions for R&D (&I) expenditure in relation to expenditure in acquiring technology wholly or partly for the purposes of one or more R&D (&I) activities if an aim of the R&D (&I) activity was, or is, to obtain new knowledge based on that technology or to create new or improved materials, products, devices, processes, techniques or services to be based on that technology.<sup>76</sup>

Such expenditure can relate to R&D (&I) costs in the strict sense, i.e. machinery, equipment or buildings. This is the case in Belgium and Israel. In contrast, Austria and the Netherlands extend the incentive to cover overhead costs. However, Spain, for example, only includes costs on machinery and equipment.<sup>77</sup> Nevertheless, buildings related to R&D (&I) activities could benefit from accelerated depreciation by way of a maximum coefficient of up to 10%.<sup>78</sup> Some countries restrict the qualifying expenditure to R&D (&I) costs that are undertaken domestically.<sup>79</sup> In Australia, from 1 July 2011, the previous R&D (&I) concession was superseded by a new R&D (&I) tax incentive available for eligible R&D (&I) activities that must be undertaken in Australia.<sup>80</sup> Nevertheless, such a condition is often more flexible among Member States. For instance, the Spanish LIS establishes that R&D (&I) activities must be developed in Spain or another Member State of the European Union or the European Economic Area (EEA).<sup>81</sup>

Some schemes also consider R&D (&I) wages to be eligible costs, including, for example, payroll withholding taxes. For instance, in Belgium, there is an 80% exemption in respect of professional withholding taxes on wages paid to specific personnel with a PhD or a master's degree in the scientific or engineering domain employed in an R&D (&I) programme, i.e. the *exonération du précompte professionnel*.<sup>82</sup> In the Netherlands, a 35% wage tax reduction is granted to employers in respect of salaries paid to

employees undertaking certain R&D (&I) activities that must be systematically organized in the country.<sup>83</sup>

In addition, input incentives can be related to IP expenditure, such as the costs and expenses incurred in acquiring patents, investments in intangible assets or the purchase of new technologies. This is the case in Cyprus, where IP costs, as well as IP income, are covered by R&D (&I) incentives. In the Czech Republic, the scope of such expenditure is broader, as the R&D (&I) tax incentives are aimed at both R&D (&I) costs and IP expenditure.<sup>84</sup>

Finally, R&D (&I) cost can be divided into other less frequently used subcategories, such as R&D (&I) services, consumables and outsourced services.<sup>85</sup> In the United Kingdom, the incentive base relates to all these categories as well as R&D (&I) costs, i.e. machinery, equipment and buildings, and R&D (&I) wages.<sup>86</sup> Consequently, the staffing costs of directors or employees directly and actively engaged in relevant R&D (&I) can be qualifying expenditure for the R&D (&I) tax relief.<sup>87</sup> Expenditure on workers, e.g. consultants and agency workers, who are provided to the company by a staff provider may also qualify for the R&D (&I) tax relief, as it is the staff provider who contracts the individual whose services the staff provider then supplies, but not through another person.<sup>88</sup>

In the United Kingdom, the following areas may also qualify for relief: (1) consumable or transformable materials used directly in undertaking R&D (&I);<sup>89</sup> (2) the cost of relevant payments to the subjects, i.e. volunteers, in respect of clinical trials; (3) utilities such as power, water and fuel used directly in undertaking R&D (&I), but not, for example, telecommunications costs and data costs; and (4) computer software used directly in R&D (&I).

75. The superseded AU: Income Tax Assessment Act (ITAA) (1936) sec. 73B(1), Div. 3, Pt. III, Vol. 1 defined R&D (&I) expenditure as "expenditure incurred by the company during the year of income, being: (a) contracted expenditure of the company; (b) salary expenditure of the company, being expenditure incurred on or after 1 July 1985; or, (c) other expenditure incurred on or after 1 July 1985 directly in respect of research and development activities carried on by or on behalf of the company on or after 1 July 1985 ...".

76. AU: Income Tax Assessment Act (ITAA) (1997), secs. 355-225, Subdiv. 355-B, Div. 355, Pts. 3-45, Ch. 3, Vol. 7.

77. European Commission, *supra* n. 9, at 57, "Table 5.3 – Detailed incentive base across countries".

78. Art. 11.2.c LIS.

79. European Commission, *supra* n. 9, at 55.

80. Div. 355 ITAA (1997). See also T. Toryanik, *Australia – Corporate Taxation* sec. 1., Country Analyses IBFD (accessed 18 Aug. 2015).

81. Arts. 35.1.b and 35.2.b LIS.

82. Ernst & Young, *Worldwide R&D incentives reference guide 2014-2015* p. 25 (Mar. 2014), available at [www.ey.com/Publication/vwLUAssets/EY-worldwide-randd-incentives-reference-guide/\\$FILE/EY-worldwide-randd-incentives-reference-guide.pdf](http://www.ey.com/Publication/vwLUAssets/EY-worldwide-randd-incentives-reference-guide/$FILE/EY-worldwide-randd-incentives-reference-guide.pdf).

83. M. Schellekens, *Netherlands – Corporate Taxation* sec. 1., Country Surveys IBFD (accessed 20 Aug. 2014).

84. European Commission, *supra* n. 9, at 56, "Table 5.2 – Incentive bases used across countries".

85. In the United Kingdom, costs incurred in connection with subcontracted R&D (&I) activities are qualifying expenditure, although there are different rules for small and medium-sized entities (SMEs) and large companies. Under the SME scheme, 65% of the spending on certain R&D (&I) activities carried out for the company by a subcontractor may be reclaimed, but, if the subcontractor and the company are connected, or have jointly elected for connected parties treatment, special rules apply. Under the large company scheme, it is only possible to claim expenditure on activities that are undertaken directly on behalf of such a company by certain specific kinds of subcontractors (UK: Corporation Tax Act (CTA) (2009), secs. 1078, and 1133-1136).

86. European Commission, *supra* n. 9, at 57, "Table 5.3 – Detailed incentive base across countries".

87. Secs. 1123 and 1124 CTA (2009).

88. *Id.*, at secs. 1127-1132.

89. *Id.*, at secs. 1125 and 1126, which reads: "Revenue expenditure incurred on consumable items employed directly in R&D on or after 1 April 2004 ... The term 'consumable items' covers consumable or transformable items. This includes water, fuel and power of any kind. Software is not within consumable items as it is not consumed or transformed". A good example of consumable item would be a laboratory chemical used in the R&D (&I) process, which is consumed in the R&D (&I) process or converted into unusable products. Another example could be electronic components that are integrated into a larger assembly in such a way that they are effectively transformed into part of a larger prototype and are no longer available for use for other purposes. (See Her Majesty's Revenue & Customs (HMRC) Corporate Intangibles Research and Development Manual (CIRD) 82400.)

## 5. Conclusions

There is no doubt as to the very significant economic and scientific value of R&D (&I) activities. Such activities are drivers for productivity, competitiveness and job creation. The encouragement of these activities can also contribute in the creation of a “knowledge culture” in society. According to Action 5 of the OECD/G20 BEPS initiative, IP-intensive industries are a key driver of growth and employment.<sup>90</sup> Consequently, countries are free to provide tax incentives for R&D (&I) activities with the purpose of enhancing high-level technologies, innovative processes and the number of patents.<sup>91</sup> As is commonly held, countries strongly encouraging scientific research and technological innovation were better suited to deal with the effects of the economic crisis and unemployment issues. There is also no doubt that R&D (&I) activities may give rise to abuse, market distortions and profit shifting due to their very mobile nature.

As noted in section 2.2.2., new provisions have been implemented to target base erosion and profit shifting concerns arising from patent box regimes, for example, the non-deduction on royalties as introduced by Austria in 2014. As the European Commission states, unilateral action by Member States would not adequately tackle the problem of aggressive tax planning and would create other problems, i.e. uncoordinated measures against profit shifting can do more harm than good.<sup>92</sup> Therefore, even if such measures may be effective in countering IP profit shifting, SAARs and other specific provisions may result in more litigation and greater uncertainty, in particular when taken unilaterally. As a result, “a principles or standards approach” is required.<sup>93</sup> In this vein, the substance requirement may act as a standard in realigning the taxation of profits with the substantial activities that

generate them. And indeed, “reinforcing substance requirements in the existing international standards” is one of the three key pillars of the OECD BEPS Action Plan.

In the context of IP regimes, the substantial activity requirement is based on the nexus approach. Consequently, IP income eligible for a nexus-compliant IP regime can fully benefit from the incentive. This implies the non-consideration of abusive behaviour and the existence of valid economic reasons with regard to the transaction undertaken. On the other hand, CFC rules should never apply to IP income that arises from the CFC, but qualifies for a compliant patent box regime in the CFC jurisdiction.

It should also be noted that the Final Report on Action 3 of the OECD/G20 BEPS initiative contains recommendations, and not minimum standards, that are designed:

to ensure that jurisdictions that choose to implement them will have rules that effectively prevent taxpayers from shifting income into foreign subsidiaries.<sup>94</sup>

This purpose is realized in respect of R&D (&I) and IP schemes where there are real and value-creating activities with regard to any income earned.

The proposals regarding Action 6 of the OECD/G20 BEPS initiative affect tax treaties. IP income should therefore be subject to tax in the source state if the residence state has a patent box regime that meets the requirements set out in the relevant tax treaty.

In conclusion, a tax measure is proportional when it maintains a fair balance between its effectiveness in encouraging R&D (&I) activities and IP structures, on the one hand, and the effect on tax revenue, i.e. in protecting tax bases and avoiding profit shifting, on the other.

90. OECD, *supra* n. 6, at 24.

91. In reality, the OECD (*supra* n. 6) does not make recommendations on the introduction of IP regimes and jurisdictions remain free to decide whether to implement such regimes. Rather, the OECD (*supra* n. 6, at 24) describes the outer limits of an IP regime that grants benefits in respect of R&D (&I) activities, but does not have harmful effects on other countries.

92. COM (2016)23/2: Communication from the Commission to the European Parliament and the Council: Anti-Tax Avoidance Package: Next Steps towards delivering effective taxation and greater tax transparency in the EU, p. 3.

93. Freedman, *supra* n. 30, at 352.

94. OECD, *supra* n. 5, at 11.