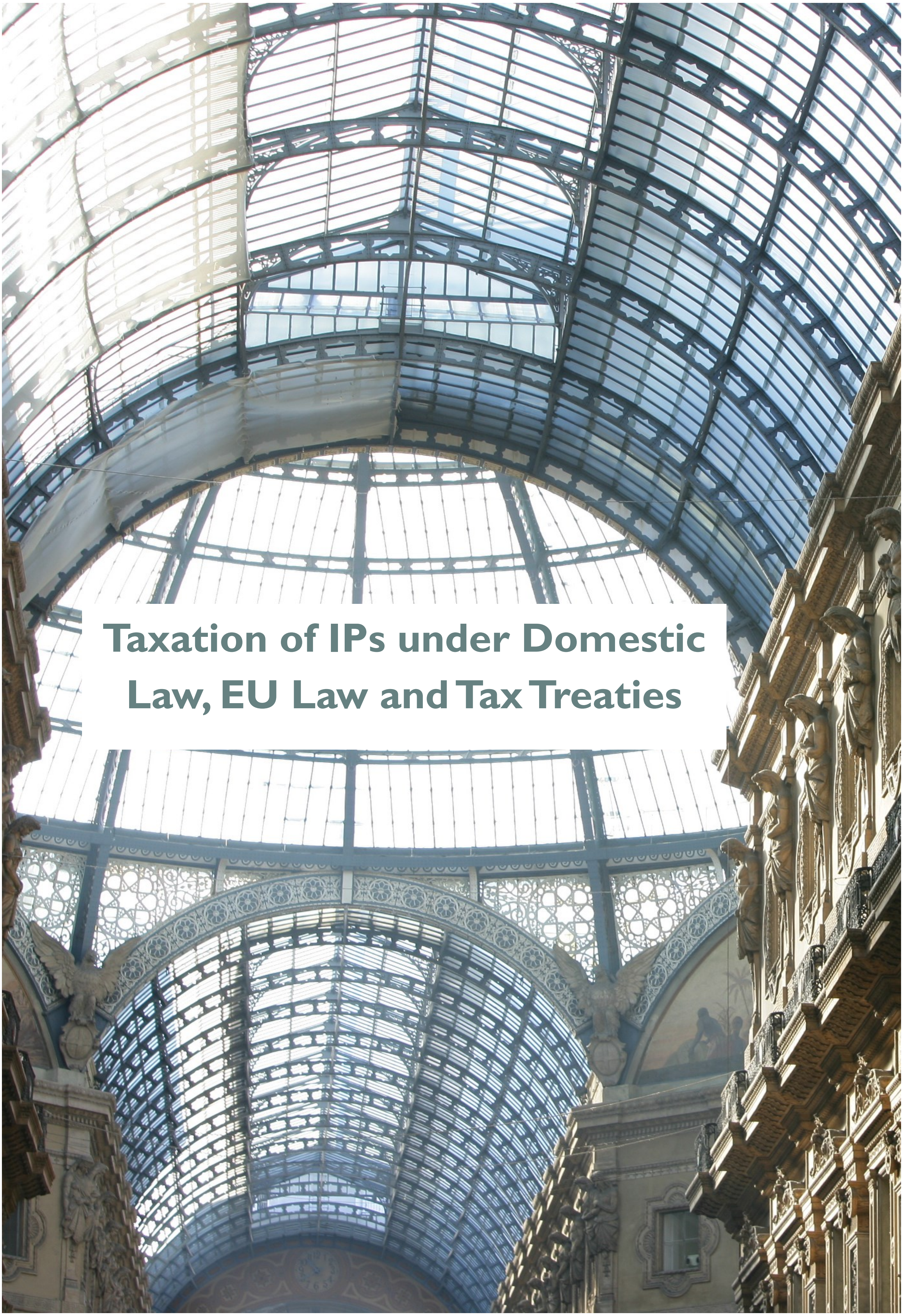
Taxation of IPs under Domestic Law, EU Law and Tax Treaties



On 27 November 2017, a seminar was held in Milan on the topic "Taxation of IPs under Domestic Law, EU Law and Tax Treaties" organised by Prof. Guglielmo Maisto of the Università Cattolica del Sacro Cuore (Piacenza) under the aegis of Italian Council of Ministers and the Organisation for Economic Co-operation and Development (OECD). Prof. Maisto gave the introductory speech, recalling that the event belongs to a series of seminars held annually in Milan since 2004 on topics relevant to tax treaty law, EU tax law or domestic tax law.

Prof. Maisto briefly described the structure of the seminar: the topic is selected one year in advance; national reports from a large variety of countries are prepared before the seminar and are published, along with the proceedings of the Seminar, under the series "EC and International Tax Law" published by the International Bureau of Fiscal Documentation (IBFD).

Prof. Maisto then briefly illustrated the 2017 programme before leaving the floor to the first speaker.

Prof. Dr. Matthias Valta – IPs under Domestic Income Tax Law

Prof. Dr. Matthias Valta (Heinrich Heine University of Dusseldorf) started the morning session by discussing the treatment of intellectual properties (IPs) under domestic income tax law in the light of a preliminary analysis of the 13 Country Reports collected. The principal goal of the analysis was to identify the impact of domestic income tax law for the purpose of application of Article 12 of tax treaties patterned along the lines of the OECD Model Convention (OECD Model).

Prof. Valta first discussed the question of the interaction between the definition of royalty under Article 12 (2) of the OECD Model and the renvoi to domestic law under Article 3(2) of the OECD Model. Article 12 refers to different types of IPs, which have to be construed according to the context and domestic tax law. Domestic tax law generally refers (implicitly or explicitly) to domestic IP law, which appears to a wide extent harmonized by the Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPS Agreement). The various IPs covered by Article 12(2) were then analysed.

Prof. Valta then turned to the difference between use and alienation. Article 12 covers the transfer of the "use or right to use" protected IPs and the disclosure of non-protected information (i.e. "know-how"), whereas alienation is covered by Article 13. Time limitation is a typical sign of use, whereas the right to exclusivity within a territory, the transfer of the risk of exhaustion or diminishment in value, as well as lump-sum payments, are typical signs of alienation. He also discussed the difference between the creation of a right for a third party to the use of an IP and the provision of services through the use of an IP.

Some domestic law aspects were then discussed. With regard to the tax treatment of resident persons, it was found that countries generally (i) do not have special income categories for royalty income, (ii) do not allow the capitalization and depreciation of IP expenses, except for cases where the IPs are used in the course of a business, and (iii) grant tax privileges in the form of IP boxes. Few countries limit the deductibility of royalty payments. With regard to the tax treatments of non-resident persons, it was found that many countries have a special category of royalty income for the purpose of applying withholding taxes. With regard to the attribution of IP income under CFC rules, it was found that almost all countries having such rules qualify IP income as "passive income" and attribute it to the resident taxpayer, providing for an exception in cases where the IPs are actively managed by the CFC.

Prof. Dr. Robert Danon – IPs and R&D tax incentives: The policy of coherence, substance and value creation in the post-BEPS world

Prof. Dr. Robert Danon (University of Lausanne/Danon & Salomé) analysed IP and R&D tax incentives in the light of the tax policy principle of substance and value creation that constitutes a pillar of the OECD Base Erosion and Profit Shifting (BEPS) project.

Prof. Danon emphasized that IP and R&D tax incentives aim at fostering investments in R&D activities and may be granted either during the investment phase ("input incentives") and/or upon the emergence of the IP income ("output incentives", e.g. IP boxes). Input incentives are frequently combined with territorial restrictions – requiring the R&D activities to be conducted within the country granting the incentive – by most non-EU Member States and by EU Member States with exclusive reference to third countries. On the other hand, due to EU free movement law constrains, input incentives may not be subject to territorial restrictions within the internal market. While this may lead to double dipping in the case of cross-border R&D outsourcing, many States provide for restrictions aimed at limiting the input incentive in intra-group situations.

The policy trends relating to input incentives inspired the introduction, under BEPS Action 5, of the "modified nexus approach" with reference to output incentives (IP boxes). Indeed, in the pre-BEPS policy the typical policy challenges raised by IP box regimes were the definition of qualifying IP assets and, in a cross-border context, the absence of a sufficient link between the income derived from the IP assets and the actual performance of R&D activities. With the introduction of the modified nexus approach, IP box incentives have to be linked to qualifying R&D expenses. Within the European Union and due to free movement law, the R&D expenses must be incurred by the taxpayer itself (outsourcing in both domestic and cross-border contexts is disallowed, subject to a 30% up-lift), acquisition costs are excluded from the qualifying expenses (the 30% up-lift applies here as well). Third countries, on the other hand, may implement the nexus approach on the basis of a territorial approach. With respect to the definition of qualifying IP assets, the modified nexus approach excludes marketing intangibles. The modified nexus approach consequently implements the policy of substance and value creation of the BEPS project with reference to output incentives. The nexus approach, however, should not be regarded as a best practice for designing efficient R&D tax incentives, but only as a minimum standard in respect to harmful tax practices.

Finally, since under the general policy assessment of the BEPS project the notion of "substance" is not uniform and not always has the same mandatory character, the modified nexus approach could be considered a "super-substance" policy principle that may well interact with other BEPS action items. For example, CFC rules (BEPS Action 3) – replicated by Anti-Tax Avoidance Directive (ATAD) 1 – also address the issue of substance. Conceptually and in relation to third countries, it would have been desirable for the ATAD to provide for an automatic carve-out clause for IP income actually falling within the scope of the modified nexus approach. As for BEPS Action 8, the modified nexus approach is based on principles which are similar, but not completely identical, to those contained in the transfer pricing rules: for example, even if the arm's length principle has been reinforced, it is still possible for a company to outsource some R&D functions and to be regarded as the owner of the IP and entitled to its returns. In these instances, therefore, a portion of IP income may thus not fall within the modified nexus approach and, as a result, be subject to regular corporate income tax. Finally, with reference to treaty abuse (BEPS Action 6), the modified nexus approach could serve as a "safe-harbour" under the principal purpose test (PPT), in order to reduce the uncertainties related to the application of such a rule. That is, where an item of IP income falls within the scope of the modified nexus approach as a result of substantial R&D activities conducted by the taxpayer, respectively within the same state (territorial approach applicable by non-EU States), this may be a strong factual indication that, with respect to this particular item of income, the substance requirement is also met from a PPT perspective.

Prof. Dr. Sjoerd Douma – Taxation of IP: EU free movement provisions and State aid

Prof. Dr. Sjoerd Douma (University of Amsterdam – UVA) illustrated, through the discussion of a case study, the interaction between IP income and the EU fundamental freedom and State aid provisions.

Prof. Douma recalled that the nexus approach provided for in the Final Report on BEPS Action 5 provides that the benefits of IP box regimes shall be granted only to taxpayers incurring R&D expenditures related to the relevant IPs. Such approach seems to allow Member States to take into account R&D expenditures incurred by a foreign PE only if the PE is subject to tax in the Residence State of the company. This provision may encroach with the EU fundamental freedoms, as previous case law of the Court of Justice of the European Union (CJEU) clarified that the promotion of R&D is not grounds of justification that could justify discriminations of foreign exempt PEs. The question remains whether, in the post-BEPS international tax framework, the effective and efficient promotion of R&D may be accepted as grounds for justification.

In addition, if a Member State were to provide benefits in relation to expenses incurred by a foreign PE, based on the case law of the CJEU (e.g. C-368/14 "*Group Steria*"; C-18/11 "*Philips Electronics*" and C-176/15 "*Riskin and Timmermans*"), it could be regarded as infringing the freedom of establishment due to the failure to take into account expenditures incurred by non-resident subsidiaries on an equal basis. This could be the case where the Member State had a consolidation regime allowing to take into consideration expenses incurred by resident subsidiaries, or where under the domestic law of the parent company the profits of foreign subsidiaries and PEs are equally exempted from tax.

With regard to State aid law, Prof. Douma discussed whether IP boxes may constitute State aid under Article 107(1) of the Treaty on the Functioning of the European Union (TFEU). A five-step analysis should be carried out in this respect: (a) establishing whether IP boxes grant an advantage; (b) assessing whether their objective is actually the promotion of R&D (taking into account that only intrinsic objectives are legitimate cause of justification); (c) carrying out a comparability analysis between companies admitted to benefit from the regime that perform R&D activities and those that do not; (d) assessing the potential grounds for compatibility with the internal market and (e) determining if they are proportionate (i.e. suitable and necessary to attain the legitimate objective).

According to Prof. Douma, the test of proportionality is the one that could raise an issue. The question arises whether the OECD nexus approach actually prescribes that expenditures incurred by a foreign exempt PE shall not be taken into account. If the answer is negative and Member States implement the nexus approach in such a way that it does take them into account, then the IP box regime would be non-proportionate, resulting in State aid. The issue is unclear due to the tension between EU fundamental freedoms and State aid provisions. According to Prof. Douma, in the case of conflict between the two, State aid provisions should take precedence.

Prof. Dr. Paolo Arginelli – I&R Directive

Prof. Dr. Paolo Arginelli (Università Cattolica del Sacro Cuore – Piacenza; of Counsel, Maisto e Associati; IBFD) discussed the treatment of IP income under the Interest and Royalty Directive (IRD), Directive 2003/49/EC.

With reference to the definition of royalties included in Article 2(b) of the IRD, three points were addressed. First, whether the interpretation should be given a meaning according to the domestic law of Member States. In this respect, in the absence of an explicit renvoi to domestic law, the interpretation should be given an autonomous EU law meaning. Second, private law instruments on intellectual property law which form part of the *acquis communautaire* should be taken into account. Finally, CJEU case law appears to suggest that, since the definition is patterned after Article 12 of the OECD Model, such Model and its Commentary should be regarded as relevant means of interpretation.

With regard to the subject-to-tax requirement provided for in Article 3(a)(iii) of the IRD, Prof. Arginelli took the view that it should be construed as a "subjective" requirement, as the CJEU did in the *Wereldhave case* (C-448/15) in respect of the Parent-Subsidiary Directive and criticised the view of some scholars and tax administrations interpreting that provision as laying down an objective subject-to-tax requirement. He then discussed the proposals of the European Commission (2003 and 2011) to introduce an objective subject-to-tax requirement as well as the proposal(s) of the Council Presidency to introduce a minimum effective tax requirement.

In relation to potential abuses of the IRD, the application of the beneficial ownership clause was discussed. It was argued that for its interpretation, the latest version of the OECD Commentary should be taken into account. Moreover, it was highlighted that tax authorities may tackle abuses of the IRD under both Article 5(1) and (2) thereof. It was also argued that tax authorities might rely directly on general principle that abuse of EU law is prohibited (which would apply irrespective of any implementation in the domestic law of the Member States).

In respect of formal requirements, most Member States require taxpayers wishing to benefit from the IRD withholding tax exemption to submit a specific attestation before the royalty payment. Prof. Arginelli argued that in the case of late submission of the form, interest as well as penalties should be collected, but no taxes should be recovered. In the case of later assessment based on the alleged abuse of the IRD, it was maintained that recovery should not occur at the level of the payer, but only at the level of the payee, unless it is proven that the payer was not aware of the abuse.

Finally, from a tax policy perspective, Prof. Arginelli expressed concerns about the current system of intra-EU royalty exemption and proposed the introduction of a Directive on the Allocation of Taxing Rights (ATRID) providing for, inter alia, an EU minimum common withholding tax on royalty payments to third countries, which would also trigger the external competence of the EU to conclude tax treaties with such third countries.

Mr. Jacque Sasseville - Article 12 OECD Model: Policy and history

Mr. Jacques Sasseville (United Nations) made an in-depth historical reconstruction of the evolution of Article 12 of the OECD Model, referring in particular to the long debate over source or residence taxation of royalties.

The history of Article 12 should be traced back to the work of the League of Nations (LoN). Although there was no reference to income from IPs (patents, copyrights, etc.) therein, the result of the 1923 Four Economists' Report, the 1925 Technical Experts Report and 1927 Draft Convention would have been exclusive taxation of the Residence State. The Committee of Experts that developed the 1928 draft Convention, however, recognized the need to develop a specific rule concerning income derived from IPs in order to prevent double taxation of such income. Based on a country-by-country analysis, in 1930 the Committee reached the conclusion that "income from authors' rights or patents, which is characteristically such and does not fall into the class of industrial or commercial income, should always be taxed by the state in which the intitulee [the person having the right to receive the income] is domiciled". During the same meeting, a sub-committee was appointed in order to draft a Multilateral Convention and the definition of the term "business income" that was included in the Multilateral Convention that was proposed to the Committee in 1933 excluded expressly "rentals and royalties" that were described a way that subsequently evolved into the current definition of royalties in the OECD and UN Model.

The Mexico Model (1943) departed from the approach proposed in the 1930 report and stated that royalties should be taxable only in the State where IP rights were exploited. The London Model (1946), however, adopted the opposite approach, with the exception of royalties paid to associated companies, which could be taxed in the Source State without any rate limitation (this clause could be regarded as the ancestor of the excessive royalty provision included in Article 12(4) of the OECD Model / 12(6) of the UN Model).

In 1957, the OEEC's Fiscal Committee set up Working Party (WP) 8, consisting of representatives from Germany and Luxembourg, to further explore the taxation of royalties. The first two reports of WP 8 proposed that taxing rights on royalties be granted only to the Residence State. After a supplementary report produced in November 1958 that recognized the possibility for a bilateral convention to grant a right to tax royalties at source at a rate of 5%, WP 8 issued its third Report in February 1961 which recommended the exclusive taxation of royalties in the Residence State but also included a general reservation recognizing the right for some States to apply a withholding tax of 5% and a declaration that the other countries "are prepared to allow such States, by bilateral Conventions and subject to reciprocity, a limited right to tax as described above."

That approach was reflected in the 1963 Draft Convention. Article 12 of the Draft Convention granted the exclusive right to tax royalties to the Residence State but the Commentary on the Article included a "special derogation" in favour of certain countries (Greece, Luxembourg, Portugal and Spain), which were free to negotiate and include in their tax treaties a 5% tax at source with a corresponding declaration by the other States that would accept that approach subject to reciprocity. In the 1977 OECD Model, the special derogation was deleted and replaced by reservations by 12 out of the 24 Member States of the OECD (i.e. 50% of the OECD members), which wanted some form of source taxation or royalties.

Mr. Sasseville concluded that, taking into account the long debate that occurred before 1963, one could argue that it was more by accident than by principle that the OECD Model ended up with exclusive residence taxation of royalties.

Prof. Adolfo Martin Jiménez - Article 12 OECD Model: Definition of royalties and overlapping between Articles 7, 12 and 13 OECD Model

Prof. Adolfo Martin Jiménez (University of Cadiz) addressed the potential conflicts of qualification arising from the definition of royalties contained in Article 12 (2) of the OECD Model. Basically these problems arise because the royalty article also applies to business income and, therefore, the interest of both Contracting States (Source / Residence) are not the same where there are withholding taxes in that article. The conflicts between importers and exporters of technology have had an impact in the evolution of Article 12 of the OECD and its Commentary and are at the heart of most of the overlapping (conflicts of classification). Although Residence States (exporters) managed to avoid having a closed definition of royalties in Article 12 of the OECD Model, the evolution of the Commentary left us with a royalty concept that has changed over the years, is not peacefully accepted by all countries and presents contradictions. Two examples illustrate the problems: the relationship of the royalty definition in tax treaties with domestic law and the parts of the Commentary that try to define some of the terms used in the royalty concept.

First, although the concept of royalties in Article 12 of the OECD Model is a closed definition, the meaning of the terms it uses depends on domestic law. But there are very relevant differences in how terms like know-how, copyrights or related rights, software etc. are protected in the domestic laws of different countries. Para. 18 of the Commentary to Article 12 of the OECD Model recognized that domestic law and contracts are relevant to define the terms in the royalty definition. But which law? Is it that of the Residence State, that of the Source State, other laws (e.g. the law of the contract)? Most interpreters resort to the law of the Source State, but para. 18 Commentary only mentions "the relevant law" and the history of the royalty definition shows that OECD States did not want to apply the law of the source State. Therefore, conflicts of classification can be frequent.

Second, to avoid those problems, the Commentar, in some aspects, have evolved towards a contextual definition of the terms used in Article 12.2 of the OECD Model. The move has always reduced the scope of the royalty concept, which has not been easily accepted by source countries, has favored tax planners and has led to conflicts of classification too. This is the case, for instance, in respect of the term "use", where gradually the Commentary have tried to resort to a definition of "use" (included in Article 12) or "sale" (excluded from Article 12) based on the essence of the transaction, regardless the domestic law of the Source State. Another example is the distinction between know-how and technical assistance. While it is clear, in the Commentary on Article 12 of the OECD Model (1977), the intention to remove from the definition of royalties any payment for the supply of information that is not know-how in a strict sense (e.g. technical assistance), some (developing) countries still interpret the royalty definition as including technical assistance or khow-how, more in line with the original royalty definition in the OECD context. The Commentary on mixed transactions reinforced that move of excluding technical assistance from the royalty definition.

Moreover, the 2017 changes to the UN Model add a new context to that confusing landscape since they depart on very relevant aspects from the OECD Model and may also cause other problems of classification (the new technical services article, the definition of "use" with regard to use of equipment, and the proposed Commentary on software in Article 12).

Prof. Martín Jiménez then discussed the fact that, while in the 2017 OECD transfer pricing Guidelines (OECD TP Guidelines), as revised in the light of BEPS Actions 8-10, the OECD has taken an economically oriented approach for the purpose of establishing the entitlement of IP returns, Article 12 of the OECD Model still relies on the legal qualification of the relevant transactions. The coexistence of these two different approaches in the OECD materials may cause uncertainties and lead to conflicts of qualifications as well.

After having highlighted the contradictions of the OECD Commentary and the progressive departure of the UN Model from the OECD Model, Prof. Martín Jiménez concluded by mentioning that before thinking of new revolutionary approaches in the context of Action 1 BEPS (digital economy), an effort should be made to sort out the mess connected with the international definition of royalties since, in the end, Article 12 and 12 A of the UN Model offer an alternative for taxing at source business profits that is not limited by the PE threshold.

Prof. Alexander Rust – Technical service fees in the new UN Model and royalties in Article 12 UN Model

Prof. Alexander Rust (WU Vienna) examined the recently proposed Article 12A of the UN Model, which deals with fees for technical services. These fees are defined very broadly and, subject to certain specific exceptions (e.g. teachers) include consideration for any service of a managerial, technical or consultancy nature. Mere routine services, however, should fall outside the scope of the definition.

Prof. Rust analysed the main traits of the new provision and also carefully drew the lines that should be followed when determining if Article 12A, rather than Article 12 (Royalties) or Articles 7 (Business profits) or 14 (Independent personal services), applies. The distinction between Article 12 and 12A becomes important only if the relevant tax treaty applies different source tax rates; such distinction is based on the person who applies the knowledge: (i) if the knowledge is used by the service provider in order to provide the relevant service, Article 12A governs; (ii) if the knowledge is transferred by the provider to the client, who will then use it, Article 12 applies.

Article 12A allows for greater source taxing rights as it allows the Contracting State where the payor is resident to levy tax on a gross basis on technical services fees, regardless of whether the services are actually performed in such State.

This provision, which clearly deviates from the OECD Model, is also meant to (i) further the "matching principle" (a deduction for the payor should be matched by taxation on the payee), (ii) put domestic and foreign service providers on a level playing field and (iii) stymie base erosion. In this respect, Article 12A of the UN Model takes over from one of BEPS Action 1's proposals, i.e. the levy of withholding tax at source as a curb to base erosion.

Prof. Rust raised some concerns on the sensibility of the UN approach. First, prevention of base erosion does not seem to establish a sufficient nexus with the source country. Second, Article 12A treats goods and services in a different way. It is not clear why base erosion through the provision of services should be treated differently from base erosion through the sale of goods.

Ms. Sophie Chatel – Royalties in the context of the Multilateral Instrument, the PPT and the LOB provisions

Ms. Sophie Chatel (Head of the Tax Treaty Unit – OECD) analysed the impact that the new provisions of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) may have on cross-border royalty payments. Ms. Chatel focused in particular on the MLI rules aimed at preventing the granting of treaty benefits in inappropriate situations, i.e. the revised preamble of tax treaties, the PPT and the Simplified LOB.

Ms. Chatel illustrated the potential implications of these anti-abuse rules by discussing an example based on the facts of the Canadian case *Velcro* in the context of the implementation of the new standards on treaty abuse. *Velcro* involved royalty payments by a Canadian company to a Dutch company, which was bound to upstream 90% of the income to its Dutch Antilles parent. The taxpayer succeeded in persuading the Canadian court that the Dutch company was the beneficial owner of the royalties and that, as a consequence, it was entitled to the Canada-Netherlands Tax Treaty. In Ms. Chatel's view, the outcome would have been different if the Canadian court could have relied on a PPT clause drafted as the one included in the MLI, which may apply either alone or as backstop to the Simplified LOB in cases where the income recipient passes the Simplified LOB test (e.g. by relying on the equivalent beneficiaries test).

Finally, Ms. Chatel addressed the case where a jurisdiction is picked for locating an IP not because of a more favourable treaty with the source country of the royalty, but rather because of a special tax regime (e.g. IP box regimes) available in that jurisdiction. According to Ms. Chatel, these situations do not always fit squarely in the anti-treaty shopping rules, as routing the royalty flows through the IP company jurisdiction does not achieve a better withholding tax rate in the source state, but triggers a better rate of taxation in the IP company jurisdiction. Ms. Chatel noted that these arrangements are dealt with expressly by the 2016 US Model, which denies treaty benefits on US-sourced royalties if the beneficial owner is enjoying a special tax regime in the other Contracting State.

Prof. Patricia Brown – Cross-border transfer of IPs and tax treaties

Prof. Patricia Brown (University of Miami) analysed certain issues related to the transfer of intangibles under tax treaties.

Starting from the analysis of Article 13 of the OECD Model – which does not include a specific provision dealing with gains from the sale of IPs and thus attributes the exclusive taxing rights to the Residence State of the alienator – she observed that since its first drafting in 1976, Article 12 of the US Model included certain contingent gains in the definition of "royalties" (i.e. "gains derived from the alienation of any such right or property which are contingent on the productivity, use, or disposition thereof"). While this language was intended to attract in the United States the taxation rights on those contingent gains, it was dropped from the 2016 US Model since it was realized that with respect to those kinds of transactions, the United States are generally the Residence State of the alienator of the IPs and not the Source State (or the State of the purchaser).

With regard to the transfers of intangibles between related parties – e.g. from the parent company which has developed the IPs to its subsidiary – Prof. Brown highlighted the main transfer pricing issues related to such transactions, which are frequently associated with the absence of comparable transactions and with the difficulty to accurately estimate the anticipated benefits that will derive from transferred IPs, taking into account only the information available at the time of the transaction. She considered the growing role of the functional analysis prescribed by the OECD TP Guidelines, and in particular of the DEMPE rule (under which a particular relevance should be attributed to the functions of development, enhancement, maintenance, protection and exploitation of the IPs), as an instrument to tackle abusive transfers of intangible assets to "empty boxes" located in countries with preferential tax regimes. She further referred to several examples of transactions where valuable intangibles may be transferred with no tax actually levied (e.g. transfers of employment contracts/image rights to offshore entities).

As a final remark, based on the current policy of taxing indirect sales of real estate properties and considering the increasing value embedded in companies owning intangible assets, Prof. Brown provocatively suggested the possibility to tax the gains arising from the sale of IP holding companies as proxies for the gains arising from the transfer of intangible assets.