BDO

APRIL 2015
www.bdo.com

AN ALERT FROM THE BDO INTERNATIONAL TAX PRACTICE

# BDO KNOWS:
# INTERNATIONAL TAXATION

## SUBJECT

## BEPS ACTION ITEM 5 – MODIFIED NEXUS APPROACH FOR PREFERENTIAL INTELLECTUAL PROPERTY REGIMES

## AFFECTING

Multinational companies that own intellectual property ("IP") and are utilizing a preferential IP regime.

## BACKGROUND

Many countries have introduced favorable tax regimes for income that is derived from ownership of intellectual property. These regimes are more commonly referred to as "preferential IP regimes" or "patent box regimes." The preferential IP regimes were enacted with the aim of attracting foreign investment, specifically in the technology sector, into the respective countries. While the definition of IP differs for each jurisdiction, it generally includes patents, designs, copyrights, models, and similar related products. Some countries also allow trade names, trademarks, and other marketing-related IP assets to be included in the definition of IP.

Currently, most countries do not require that work related to the IP be carried out within the country or by the legal entity that owns the IP in order for a company to avail itself of the benefits. In other words, the tax benefit is available as long as the IP is owned by a company that is a resident of that country even if no expenditure related to that IP has been incurred directly by that legal entity or within the jurisdiction. For example, under the United Kingdom patent box regime effective April 2013, any profits derived from a product that is protected by a patent are taxed at a preferential rate of 10% as opposed to the corporate tax rate of 21%, regardless of whether the expenses related to the product have been incurred in the United Kingdom or by the same legal entity.

The Organization for Economic Cooperation and Development ("OECD") Forum on Harmful Tax Practices ("FHTP") realizes that many companies are artificially shifting profits to these jurisdictions in order to take advantage of the preferential IP tax regimes similar to that of the United Kingdom. The FHTP has, therefore, laid out a proposal that limits the preferential treatment unless there is some nexus, in the form of activities performed or expenditure incurred on research within the tax jurisdiction, which ties the legal ownership of the IP to the income that is derived from it.


## CONTACT:

**ROBERT PEDERSEN**
International Tax Practice Leader
(212) 885-8398 / rpedersen@bdo.com

**BOB BROWN**
Partner
(412) 281-6018 / rmbrown@bdo.com

**HOLLY CARMICHAEL**
Partner
(408) 352-1985 / hcarmichael@bdo.com

**FABRIZIA HADLOW**
Senior Manager
(312) 239-9224 / fhadlow@bdo.com

**SCOTT HENDON**
Partner
(214) 665-0750 / shendon@bdo.com

**JERRY SEADE**
Principal
(713) 986-3108 / jseade@bdo.com

**CHIP MORGAN**
Senior Managing Director
(310) 557-7517 / cmorgan@bdo.com

**WILLIAM F. ROTH III**
Partner
(616) 776-3761 / wfroth@bdo.com

**BRAD RODE**
Partner
(312) 233-1869 / brode@bdo.com

**MONIKA LOVING**
Partner
(404) 979-7188/ mloving@bdo.com

## DETAILS

Action 5 of the Base Erosion and Profit Shifting ("BEPS") Action Plan is focused on countering "harmful tax practices more effectively, taking into account transparency and substance." It specifically requires substantial activity within a country for availability of any preferential regime, thus ensuring that the taxable profits are not artificially shifted away from the country or countries where the value is created. In line with this objective, the FHTP has proposed that the regimes that are determined to be harmful should be modified to adopt a nexus approach for taxing IP income and any new preferential regimes that are introduced in the future should similarly follow the principles outlined by the FHTP ("Modified Nexus Approach").

This Modified Nexus Approach requires that there should be nexus between the income receiving the benefits and the expenses contributing to that income. Under this approach, the countries should allow only that part of IP income to qualify for the preferential rates that is connected with the research and development ("R&D") expenditure incurred to generate this income. More importantly, the FHTP proposed that the qualifying expenditure should be incurred directly by the legal entity claiming the preferential treatment. Outsourcing of R&D activity to a subsidiary company should generally not be allowed and such outsourced expenditure should not qualify as being incurred by the same legal entity and within that country. This focus on expenditures aligns with the underlying purpose of preferential IP regimes by ensuring that the regimes that are intended to encourage R&D activity only provide benefits to taxpayers that in fact engaged in such activity.

Moreover, the Action 5 Deliverable released under the 2014 BEPS Package also states that it is the proportion of total expenditures directly related to R&D activities, rather than the amount of the expenditures, that demonstrates real value added by the taxpayer. According to the FHTP, it is this proportionate expenditure that should be taken into account under the nexus approach. Therefore, only the proportion of income that is the same as the proportion of qualifying expenditures to the overall expenditures should qualify for preferential IP treatment.

Furthermore, while countries can formulate their own definitions of "qualifying expenditure," "overall expenditure," and "qualifying assets," the definitions should follow the principles laid down under the Modified Nexus Approach.

The Modified Nexus Approach would, therefore, severely restrict the amount of income that is currently being taxed under the existing preferential IP regimes. The FHTP recognizes that, in order to continue to take advantage of the beneficial tax treatment, businesses would incur significant restructuring expenses to migrate the R&D activity to such tax-friendly jurisdictions. While discussions are in progress to develop the transitional and grandfathering rules for such situations, the new IP regimes and the taxpayers that will be receiving these benefits for the first time would be required to meet the framework laid down by the Modified Nexus Approach.

## HOW BDO CAN HELP OUR CLIENTS

Taxpayers that are currently receiving beneficial treatment under preferential IP regimes should analyze their current corporate and operational structures to determine whether the income related to their IP would continue to qualify for lower tax rates under these new rules. Contractual arrangements with related and unrelated parties may also need to be analyzed to determine whether and how the Modified Nexus Approach will affect their tax positions. While it will take time for legislation to be formulated under BEPS, the Modified Nexus Approach or a similar concept is likely to be implemented. Therefore, any IP-related tax planning that is undertaken by the taxpayers going forward should take this approach into consideration.

BDO's international tax practice has the knowledge and expertise to assist in reviewing your structure, to model various options and outline their potential impact on your organization, and to provide planning solutions to optimize their effect on your company's income tax expense.

The Tax Practice at BDO is among the largest tax advisory practices in the United States. With 58 offices and more than 400 independent alliance firm locations in the United States, BDO has the bench strength and coverage to serve you.

BDO is the brand name for BDO USA, LLP, a U.S. professional services firm providing assurance, tax, financial advisory and consulting services to a wide range of publicly traded and privately held companies. For more than 100 years, BDO has provided quality service through the active involvement of experienced and committed professionals. The firm serves clients through 58 offices and over 400 independent alliance firm locations nationwide. As an independent Member Firm of BDO International Limited, BDO serves multinational clients through a global network of 1,328 offices in 152 countries.

BDO USA, LLP, a Delaware limited liability partnership, is the U.S. member of BDO International Limited, a UK company limited by guarantee, and forms part of the international BDO network of independent member firms. BDO is the brand name for the BDO network and for each of the BDO Member Firms. For more information, please visit www.bdo.com.

*Material discussed in this tax alert is meant to provide general information and should not be acted on without professional advice tailored to your firm's individual needs.*

© 2015 BDO USA, LLP. All rights reserved. www.bdo.com