TAX EXECUTIVES INSTITUTE, INC.

19 February 2015

Forum on Harmful Tax Practices
Centre for Tax Policy and Administration
Organisation for Economic Co-Operation
and Development
Paris, France

Via Email: FHTP@oecd.org

RE: TEI Comments on Modified Nexus Approach for IP Regimes under BEPS Action 5

To Whom it May Concern:

On 19 July 2013, the OECD published an *Action Plan on Base Erosion and Profit Shifting* (hereinafter the Action Plan or the Plan) setting forth 15 actions the OECD will undertake to address a series of issues that contribute to the perception that individual countries' tax bases are being eroded or profits shifted improperly. Pursuant to Action 5 of the Plan, the OECD published a document entitled *Action 5: Agreement on Modified Nexus Approach for IP Regimes* (hereinafter the Agreement), along with a one page "explanatory paper" requesting comments on the Agreement (the Paper). The Agreement and Paper follow on the OECD's release in September 2014 of the BEPS Action 5 deliverable for 2014, entitled *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance*.

The OECD solicited comments from interested parties no later than 20 February 2015. On behalf of Tax Executives Institute, Inc. (TEI), I am pleased to respond to the OECD's request for comments.

TEI Background

TEI was founded in 1944 to serve the needs of business tax professionals. Today, the organisation has 56 chapters in Europe, North and South America, and Asia. As the preeminent association of in-house tax professionals worldwide, TEI has a significant interest in promoting tax policy, as well as the fair and efficient administration of the tax laws, at all levels of government. Our nearly 7,000 individual members represent over 3,000 of the largest companies in the world.[1]

TEI Comments

Timing of stakeholder solicitation and input

TEI appreciates the solicitation from the OECD and the Forum on Harmful Tax Practices (FHTP) of comments and input from stakeholders on the modified nexus approach to intellectual property (IP) regimes as endorsed by all OECD and G20 countries.[2] It is regrettable, however, that the OECD has proceeded on an extremely accelerated timeframe for soliciting stakeholder views on such a contested issue as preferential regimes for IP. With more time to comment, stakeholders would have a much greater ability to consider the issues and submit more helpful and substantive suggestions, especially with respect to the practical issues of tracking and tracing of qualifying expenditures. This would lead to greater support for the final OECD output under BEPS Action 5 generally, and the modified nexus approach specifically, from taxpayers and other stakeholders. Instead, the accelerated process will likely lead to suboptimal results, from substantive, practical, and political perspectives. Nevertheless, TEI would be pleased to engage with the OECD and FHTP on any future proposals to enable taxpayers to track and trace qualifying expenditures on R&D in a manner that is both practical and cost effective for taxpayers, and helpful to tax authorities.

Realignment of commercial operations for tax purposes

The Agreement states that:

> Under the currently proposed Modified Nexus Approach, businesses using already existing Patent Box regimes might see a reduction in income receiving preferential treatment, as R&D expenditure to develop the patent must be undertaken in a more limited number of entities, including the company holding the relevant patent, to qualify. This could impose restructuring costs on groups which have dedicated R&D companies in order for them to retain the relief in future.[3]

TEI appreciates the recognition that many multi-national enterprises (MNEs) have structured their operations in a manner to centralise the ownership of the MNE's IP into a single principal

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[1] TEI is a corporation organised in the United States under the Not-For-Profit Corporation Law of the State of New York. TEI is exempt from U.S. Federal Income Tax under section 501(c)(6) of the U.S. Internal Revenue Code of 1986 (as amended).

[2] *See* Paper.

[3] Agreement, p.3.

company or a few regional entities. There are substantial commercial reasons for structuring an MNE's IP ownership in such a manner, including the ability to easily fund the development of, and license the resulting, IP on a global basis among related and unrelated parties. In contrast, the research and development (R&D) activities themselves are often decentralised because of the difficulty of finding relevant expertise in a single location, even though the R&D activities are generally managed on a global basis. Indeed, in today's polycentric world MNEs are in competition to find the best workforce to conduct R&D activities, and these specialists can be spread across many jurisdictions. Further, any particular technology developed or product sold by an MNE will likely have multiple IP assets embedded within it. These differing IP assets may have been internally developed by the MNE group as a whole, by a single entity within the group, or acquired from an unrelated party, or some combination thereof.

Under the modified nexus approach, however, for the income of an MNE to benefit from a particular jurisdiction's IP regime the same entity that earns the income must also be the one that conducted the activity that led to the development of the IP. Thus, it appears the OECD envisions MNEs conducting the development of IP through a separate entity for each country in which the MNE may perform R&D activities (or perhaps through separate permanent establishments of the same entity). That entity would then be required to directly earn the income from the IP as its owner to benefit from the favourable regime. The entity would thus be a developer, owner, and distributor (via licenses or products) of IP, which is a somewhat anachronistic "silo" approach to business operations for many MNEs today that operate on a global basis through specialised and centralised functions. Such MNEs would need to conduct a potentially wholesale reorganisation of their operations to take advantage of IP regimes that meet the requirements of the Agreement, losing the concomitant business advantages of such an operating structure in the process. Many MNEs will thus be reluctant to engage in such a restructuring and the intended result of such IP regimes – an increase in R&D and the corresponding benefits – may not materialise. In addition, to the extent income from IP assets is earned through the sale of products incorporating the IP, it may be difficult to claim the benefits of such regimes because the IP itself is not licensed. It may also be difficult to allocate the income from the product sales among the several types of IP that may be embedded in the product, only one of which may qualify for the benefits of an IP regime under the modified nexus approach.

Overall, TEI appreciates the need to align IP regimes with "substance" so that there is not a race to the bottom among countries that ultimately does not result in the other economic and development benefits tax jurisdictions seek when implementing such regimes. However, it should be recognised that the necessary restructuring by MNEs to take advantage of the regimes under the modified nexus approach will be significant and costly, if it occurs at all, and that the application of the modified nexus approach presents practical difficulties beyond the tracking and tracing issues identified in the Agreement and Paper. In particular, the alignment of returns given tax favoured status with the entity that developed the IP, rather than with the entity that owns the IP, would be a deviation from the arm's length principal should such an approach be applied to determine the return to the IP rather than just whether the return is entitled to tax favoured status.

Thus, TEI submits that the modified nexus approach may have potentially unintended negative consequences for taxpayers. In particular, in TEI's view jurisdictions may be tempted to deny (or reduce) deductions for royalties paid to a related IP owner in circumstances where the owner did not itself develop the IP. While it would be inappropriate for tax administrators to point to the OECD's recommendations under BEPS Action 5 as authority for making what would in reality be a transfer pricing adjustment (instead of, *e.g.*, the recommendations under BEPS Action 8-10), the Agreement nevertheless might be read to indicate that only in such cases does an IP owner have the necessary "substance" to be entitled to the income, and thus the payor to the deduction. TEI therefore recommends that the OECD explicitly state that the guidance under BEPS Action 5 applies only for the purpose of determining whether a jurisdiction's IP regime is appropriate and the extent to which taxpayers can benefit from the tax incentives. The OECD should also state that the BEPS Action 5 guidance does not apply for the purpose of determining whether taxpayer's are entitled to royalty and other expense deductions in the payor jurisdiction or entitled to recharge R&D costs among the members of an MNE group that benefit.

Other IP regimes and activity other than R&D

From the brief discussion in the Agreement and Paper, it appears that the only activity worthy of a preferential regime or ruling from a jurisdiction is R&D and that the only preferential IP regimes that exist focus on patents. We understand, however, that the OECD and the FHTP may issue other documents and recommendations covering additional activities and regimes. TEI encourages the OECD to expand the discussion of IP regimes and activities in future public fora. TEI also recommends that the OECD and FHTP provide ample time for stakeholders to review and comment upon any proposals included in such documentation.

Definition of IP assets

The Agreement states that under the modified nexus approach "the only IP assets that could qualify for benefits under an IP regime are patents and functionally equivalent IP assets that are legally protected and subject to approval and registration processes . . . ."[4] Moreover, the approach "explicitly excludes from receiving benefits marketing-related IP assets such as trademarks."[5] Recognising that limiting IP regimes to patents as the only "qualifying IP asset"

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4 *Id*. at p.5.

5 *Id*.

is too narrow an approach, the Agreement goes on to state that the "FHTP will therefore produce further guidance . . . addressing the exact scope of IP assets, for example, the treatment of copyrighted software or innovations from technically innovative development or technical scientific research that does not benefit from patent protection . . . ."[6] TEI agrees that limiting the availability of IP regimes among OECD and G20 countries to patents alone would be myopic, especially considering the role software plays in today's economy, and the wide ranging definition of intangibles under Chapter VI of the OECD Transfer Pricing Guidelines. TEI recommends that the FHTP construe definition of an IP asset broadly for purposes of qualifying IP regimes so that the economic and development benefits targeted by such regimes are not too narrowly or inappropriately channeled into a single type of intellectual property, potentially distorting such benefits.

Tracing/Tracking and grandfathering

With respect to the reporting requirements under the modified nexus approach, particularly the tracking and tracing of R&D expenditures, the Agreement rightly notes that it will be difficult for taxpayers to provide detailed documentation about qualifying expenditures for past years if taxpayers are not currently tracking such expenditures. For this reason, it is alarming that the OECD and G20 countries have seemingly agreed to abolish the current preferential IP regimes no later than 30 June 2021, which would end all current tax benefits taxpayers enjoy under such regimes. This would include taxpayers who will be grandfathered into such benefits under the 30 June 2016 closing date for any new entrants into the old regimes. For example, a patent obtained in June 2015 and qualified for an IP regime before 30 June 2016 will only receive the benefits of the regime for a short period of the patent's life (less than a third in the case of a 20 year life), even though the budgeting and funding decisions underlying the R&D required to develop the patent may have been made assuming the benefits of the IP regime would be available for the life of the patent. For this and other reasons, TEI recommends that taxpayers continue to receive the benefits of the old regimes based on the expiration date of the underlying legal protection for the IP asset at issue (at least for patents), rather than ending all benefits as of 30 June 2021 regardless of the underlying asset.

As noted above, TEI would be pleased to engage with the OECD and FHTP regarding future proposals that would enable taxpayers to track and trace qualifying expenditures for R&D to help ensure that the proposals are both practical and cost effective for taxpayers, and helpful to tax authorities. Absent a specific proposal in the Agreement and given the very short time period in which to respond to the OECD's request for input, TEI is regrettably unable to provide specific recommendations on tracking and tracing in this letter.

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[6] *Id*.

Conclusion

TEI appreciates the opportunity to comment on the Agreement and Paper regarding a modified nexus approach to IP regimes under BEPS Action 5 on harmful tax practices. These comments were prepared under the aegis of TEI's European Direct Tax Committee, whose Chair is Nick Hasenoehrl. If you have any questions about the submission, please contact Mr. Hasenoehrl at +41 786 88 3772, nickhasen@sbcglobal.net, or Benjamin R. Shreck of TEI's legal staff, at +1 202 638 5601, bshreck@tei.org.

Sincerely yours,
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