

# Ireland's Knowledge Development Box

## What will it look like?

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Later this month, the Irish Department of Finance will launch a public consultation and invite input on the design of the 'knowledge development box' announced in Budget 2015. We consider recent developments that will affect the design of the 'knowledge development box' and how it might operate.

On 14 October 2014, the Irish Minister for Finance (the "Minister") in his budget statement announced the abolition of the so-called 'double-Irish' structure but also announced the introduction of a knowledge development box ("KDB"). The KDB is expected to be similar to patent and innovation boxes which exist in other European countries. The Minister's intention is that the KDB *"will be best in class and at a low, competitive and sustainable tax rate"*. In his budget statement the Minister acknowledged that the timing and design of the KDB would also depend on the views of the EU and the OECD.

A public consultation on the KDB will be launched later this month with a view to publishing legislation in the next finance bill (likely to be in October 2015). Beyond that, there is little detail on the KDB, how it will operate and when it will be available.

If the KDB had been announced some years ago, draft legislation would have followed quickly as the Minister would have had a relatively free hand in its design within the parameters of domestic policy and EU law. However, recent developments at EU and OECD level (as acknowledged in the Minister's announcement) now limit that freedom.

We outline in this note the landscape within which the KDB must operate and speculate as to what the KDB might ultimately look like. With so many competing influences and restrictions, it is unlikely the design will satisfy all interested parties. Therefore, in advance of designing the KDB, it will be important that the Minister and his advisers are clear on the policy objectives underpinning the KDB, what business activities the KDB is seeking to incentivise and how the KDB will complement Ireland's existing foreign direct investment strategy. In the absence of a clear and targeted strategy there is a risk that the KDB may not have the desired impact in terms of attracting



new investment in intellectual property ("IP") related activities to Ireland.

### What investors will want

Viewed purely from a tax perspective, the preference for most investors would likely be a regime that applies to a broad base of income and which delivers a reasonably low tax rate.

#### Broad base

Under existing Irish law, Irish resident companies that acquire IP are entitled to amortise the cost of the acquired IP (described as "specified intangible assets") for corporation tax purposes. The range of intangibles that qualifies is quite broad and includes patents, trademarks, copyright, secret information and know-how. The "specified intangible assets" definition could provide a good starting point for the purposes of identifying the type of assets that qualify for the KDB.

However, based on recent European and international developments (discussed below) it appears that the range of IP assets in

respect of which the KDB will be available ('qualifying IP') will be limited to patents and assets that are functionally equivalent to patents. In addition, it is likely that the assets that qualify for the KDB will have to be derived from research and development ("R&D") activities undertaken primarily in Ireland. In that respect, the breadth of the KDB regime and the income that qualifies for relief under it may be more closely aligned to Ireland's R&D tax credit regime rather than the broader "specified intangible assets" regime.

We would envisage that the KDB should be available in respect of proceeds from the sale of qualifying IP and infringement income (as is the case under the UK patent box and Dutch innovation box regimes). In addition, and similar to the UK patent box regime, the KDB should also be available in respect of income earned on the licensing of qualifying IP or sale of products incorporating qualifying IP (although not necessarily deriving all of their value from the intangible asset).

### Lower effective rate

Some press reports have indicated that the Minister is considering a 6.25% effective rate for income benefitting from the KDB. This compares favourably against the effective rate available in the UK (10%) but is somewhat higher than the Dutch rate (5%). The Belgian patent box provides a tax deduction equal to 80% of the gross income derived from certain patents (giving an effective rate of 6.8%). If Ireland were to take this approach, an effective rate as low as 2.5% could apply to income benefitting from the KDB.

Under the UK patent box regime the relief is given as a deduction so that the effective tax rate on the qualifying income is 10% (rather than applying a lower rate to qualifying profits). It is understood that this mechanism was adopted for two reasons (i) to make it easier to deal with losses and (ii) to maintain tax rates for treaty purposes. It is also thought that applying a higher headline rate and making the relief available by way of deduction might limit the application of certain controlled foreign corporation rules that apply by reference to rate. Although more cumbersome in its application, this calculation mechanism would be preferable for the KDB.

### What the OECD and the EU will require

#### EU policy

Generally, it seems that the KDB should accord with the broad European strategy to nurture innovation and encourage growth and job creation outlined in “Europe 2020”. Europe 2020 is a policy document that was launched in June 2010 as part of the EU’s response to the global economic crisis. It seeks to coordinate national economic and employment policies. It has set five ‘headline targets’, one of which is to “improve the conditions for innovation, research and development”. Europe 2020 follows on from the Lisbon Strategy, a ten year development plan, launched by the EU in 2000. Nurturing innovation was also one of the key goals of that strategy.

The progress of each European Member State is monitored under Europe 2020 and each country produces an annual national reform programme which presents the country’s policies to sustain growth and jobs and to reach the Europe 2020 targets. Each of Spain, the Netherlands and the UK mentioned their patent box / innovation box regimes in their national reform programme for 2014 as a tool to stimulate private R&D investment and / or growth. The KDB will similarly be a tool to promote investment in innovation and on that basis seems to accord with established European policy. However, there have been recent developments at OECD and EU level that affect how European countries can promote innovation through preferential tax regimes. These developments will also affect the design of the KDB.

### BEPS Action 5 (Countering harmful tax practices)

The OECD BEPS project, and in particular, Action 5 which in part focuses on preferential intangibles regimes (including patent boxes) is likely to impact on the design of the KDB. In September 2014 a report was issued under Action 5 which recommended that preferential intangibles regimes (such as the proposed KDB) should incorporate a “substantial activity” requirement. The basic premise of the substantial activity requirement is that it should assist in aligning substance with taxable profits.

Three approaches were suggested to introduce a “substantial activity” requirement to preferential intangibles regimes. The first, a value creation approach, was discounted at an early stage leaving (i) a transfer pricing approach and (ii) a nexus approach.



### Transfer pricing approach

Under the transfer pricing approach all income generated by the intangibles may be relieved under the regime if:

- important functions are located in the jurisdiction offering the regime;
- the taxpayer is the owner of the intangibles that the regime applies to and uses those assets; and
- the taxpayer bears the economic risks of the assets to which the regime applies.

The UK was a strong supporter of the transfer pricing approach and has incorporated this methodology into its current patent box. UK taxpayers availing of the patent box must

contribute to the development of the patent or actively manage that process. A UK taxpayer may engage related parties in other jurisdictions to undertake “R&D” activities on its behalf (for an arm’s length fee) and can still claim the full benefit of the regime in relation to the income generated by those R&D activities.

Spain and the Netherlands also supported the transfer pricing approach and under both regimes it is possible for taxpayers claiming the relevant relief to outsource R&D. Under the Dutch regime, at least 50% of R&D activities undertaken to develop non-patent IP must be undertaken in the Netherlands.



### Nexus approach

In contrast, under the nexus approach the benefit permitted by any preferential intangibles regime depends on the extent of the R&D activities carried on by the taxpayer in its own jurisdiction. Effectively, the nexus approach limits the amount of income that may be relieved under a preferential intangibles regime to the proportion of income that is directly attributable to “qualifying expenditure” incurred by that taxpayer in that jurisdiction. The nexus approach also requires that:

- preferential intangibles regimes should only be available in respect of patents and IP that is functionally equivalent to patents;
- the definition of qualifying expenditure should be determined by the relevant jurisdiction but should not include interest payments, building costs or costs incurred acquiring IP;
- the income that may qualify under the regime may include royalties, proceeds from the sale of IP and income from the sale of products directly related to the IP; and
- expenditure on outsourced R&D should only qualify if the activity is undertaken by unrelated parties (regardless of where they are located).

We expect that most taxpayers wishing to avail of the KDB would prefer that if a substantial activity requirement is introduced it would be based on the transfer pricing approach rather than the nexus approach. However, over the past few months it has become apparent that a “modified nexus approach” will form the basis for the OECD’s final recommendations. This OECD approach arises from recent discussions between Germany and the UK.

### UK / Germany joint proposal

Separate to the OECD discussions (but with a view to advancing those negotiations), the UK and Germany have joined forces to consider which approach ought to be adopted. Germany has been a strong proponent of the nexus approach and in the past has challenged the UK's patent box at EU level. The UK, on the other hand, has expressed concerns about the nexus approach and its compatibility with EU law. On 11 November 2014, the UK and Germany made a joint proposal to adopt a modified nexus approach.

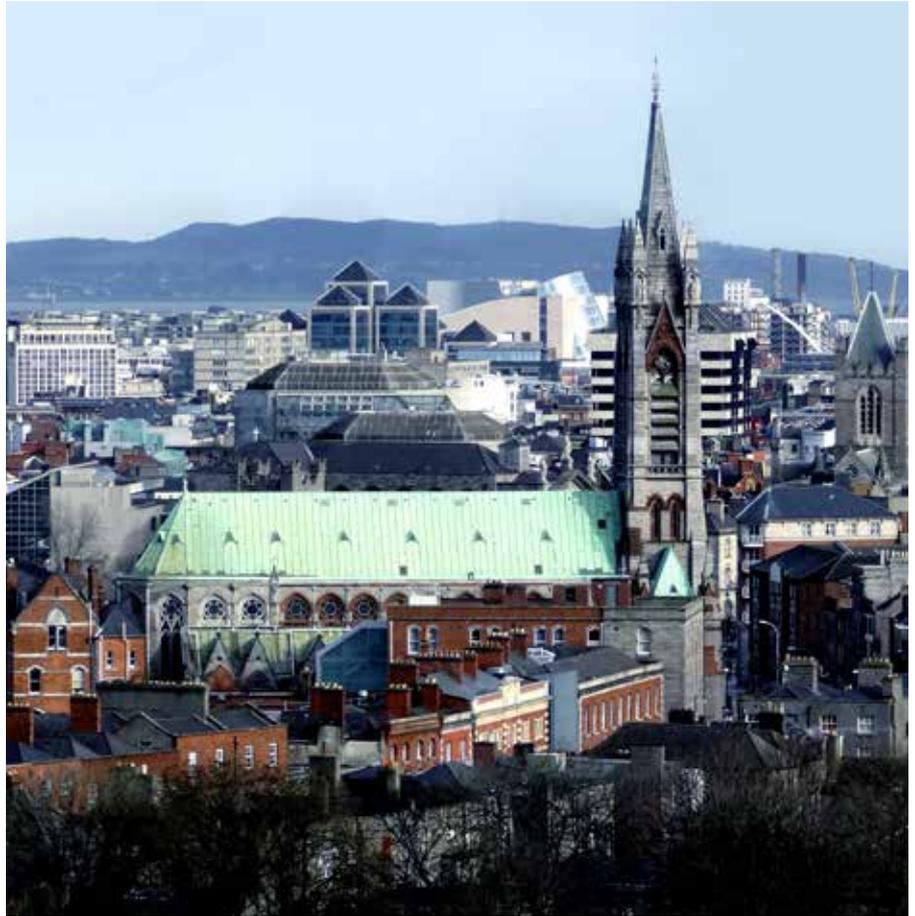
There is very little detail on the modified nexus approach, save for:

- it will require substantial economic activity in the jurisdiction offering the preferential intangibles regime;
- it is based on the nexus approach and will continue to require tax benefits to be directly connected to R&D expenditure; and
- related party outsourcing should be permissible up to defined limits (currently 30% of qualifying expenditure).

The joint proposal was submitted to the OECD Forum on Harmful Tax Practices during its meeting on 17-19 November 2014 and to the EU Code of Conduct Group (the "Code Group") on 20 November 2014. The OECD has confirmed that the proposal will form the basis for finalising the work on Action 5.

The UK must amend its existing patent box to incorporate the modified nexus approach. The UK and Germany have also agreed what they consider to be appropriate grandfathering for preferential IP regimes. All existing regimes will be available to new entrants until 30 June 2016 and to allow time to transition to new regimes based on the modified nexus approach, grandfathering provisions will extend to those taxpayers until 30 June 2021.

From the Irish perspective, the Minister has made some general comments on the potential application of the modified nexus approach to the Irish KDB. He confirmed



that the approach “*accords with Ireland’s overall FDI strategy and corporation tax policy which is focused on attracting investment that is accompanied by real and substantial business activity.*” However, he appears to be somewhat cautious of the modified nexus approach acknowledging “*on the other hand I do have concerns that such an approach, if designed too tightly, could have the potential to limit the scope for use by some smaller countries.*”

The earliest that Ireland’s KDB will be available will likely be the end of 2015. If Ireland adopts the modified nexus approach, in the early years of the KDB it will be difficult for Ireland’s KDB to compete effectively with the current UK patent box.

### EU Code of Conduct

Separate to the OECD's work on harmful tax practices, the EU developed a code of conduct for business taxation in 1997 (the "Code"). The Code is not legally binding but can be politically persuasive. For example Ireland phased out its 10% corporation tax rate when it was identified as a tax measure with harmful features under the Code.

Under the Code, regimes which provide for an effective level of taxation which is significantly lower than the general level of taxation in the country concerned (as would be the case for most preferential intangibles regimes) are regarded as potentially harmful and must then be considered under five other criteria.

In May 2013, the German Finance Minister questioned the compatibility of the UK patent box with EU rules. The European Commission investigated the claim and considered that the UK patent box did not comply with the Code and was a harmful tax measure. That finding, made in October 2013, was issued only to European finance ministers. It is understood that the regime was in breach of the Code in two ways:

- the link between qualifying patent income and research undertaken in the UK was not strong enough; and
- qualifying income could include income not directly related to the patent.

No amendments were made to the UK patent box following the decision. In December 2013, ECOFIN requested the Code Group to consider all European patent boxes (including those already assessed) against the backdrop of international developments including the BEPS project.

The Code Group produced a report which was considered at the 9 December 2014 meeting of ECOFIN. They confirmed in the report that they have coordinated their work with the OECD and endorsed a version of the modified nexus approach. The Code Group reported that the patent boxes examined are not compatible with the modified nexus approach and should be changed. Member

States will be asked to amend their regimes in 2015 to adopt the modified nexus approach. Similar to the UK / Germany joint proposal, no new entrants should be permitted to avail of existing regimes after 30 June 2016 and any grandfathering provisions should terminate within five years.

The Code Group examined the compatibility of the modified nexus approach with EU law (in particular the freedom of establishment and freedom to provide services). They concluded that the approach of itself was not incompatible with EU law but acknowledged the possibility of national laws incorporating the approach in a way that is incompatible with EU law. Given the coordinated efforts of the EU and the OECD, it seems inevitable that the modified nexus approach will be incorporated into the Irish KDB regime.

### EU State aid rules

When designing the KDB, the potential application of European State aid rules should also be considered. In 1998, in addition to the work undertaken on the Code, the European Commission clarified that State aid rules could apply to beneficial tax regimes introduced by European Member States.

If a tax provision constitutes State aid, it cannot be implemented without prior approval. If a provision that is considered to

amount to State aid has been implemented without prior approval, the Commission can require the Member State to recover the tax forgone. A tax provision may be considered to be State aid if it is selective, ie, if it benefits certain enterprises or industries and is an exception from general tax rules.

In 2007 the Spanish tax authorities notified the Spanish patent box to the European Commission and requested confirmation that the regime did not amount to State aid. The European Commission found that as the relief was available to all corporate taxpayers in Spain, it was not selective and therefore did not constitute State aid. The Commission was of the view that the Spanish patent box did not favour one sector over another or one group of companies over others. They also noted that the fact that some businesses may benefit more from the patent box than others did not necessarily make the measure selective.

The decision should be helpful to the Minister in designing the KDB. It will be important that the Irish KDB provisions are drafted so that all businesses operating in Ireland, domestic and multinationals, regardless of sector, can avail of the relief. It is usually the case that the Minister notifies the European Commission of new tax reliefs to confirm that they do not amount to State aid. We expect that the KDB will be notified in advance of implementation. This is likely to delay implementation of the KDB.



### Our overview

The Minister has not so far outlined what he hopes the KDB will achieve for Ireland or the policy aims he wants the KDB to fulfil. However the timing of the announcement to coincide with the announcement on the so-called 'double-Irish' would suggest its main purpose will be to offer a lower effective rate for onshore exploitation of IP and to attract IP from offshore locations to further support investment by multinationals in Ireland. Based on recent European and OECD developments it seems likely that the KDB will apply to a narrow category of IP, primarily generated by Irish R&D and therefore will form part of the solution for those wishing to bring IP onshore.

Based on the available information the following observations can be made:

- Although the preference is for the KDB to apply to income derived from a broad range of intangibles, BEPS Action 5 may limit that to income from patents and similar rights, which have been accepted by the OECD as appropriate for the relief.
- It seems to be acceptable both to the EU and the OECD that the relief will extend to sales proceeds received on the sale of intangibles (ie, chargeable gains) and awards received on infringement of protected rights.
- It is not yet clear whether the KDB will be permitted to apply to income generated from products simply incorporating the qualifying IP (rather than products deriving their value from the qualifying IP). For the time being, in the design of the KDB, the Minister may wish to adopt a broad approach to qualifying income similar to the UK.
- It seems that the KDB will have to include a substantial activity requirement. At this time it seems likely that a modified nexus approach will be incorporated.

- The qualifying income should be taxed at a low effective tax rate and preferably at a rate not exceeding 5% in order to compete effectively with the Dutch innovation box and to deliver on the Minister's promise of a "best in class" regime. Similar to the UK, the relief should be granted as an enhanced deduction, rather than by applying a lower headline rate.
- The KDB should be available to all Irish corporate taxpayers. It should apply across all sectors and to domestic and international businesses.

Should you wish to discuss any aspect of the KDB, please contact a member of our Tax Team or your usual Matheson contact.

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