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Our Ref | Your Ref | 8 April 2015

Dear Sir or Madam

Knowledge Development Box - Public Consultation

Matheson welcomes the opportunity to comment on the proposed knowledge development box ("**KDB**"). We are participating in the related discussions at OECD level on the proposed "modified nexus approach" and understand that the outcomes of those discussions will affect the design of the KDB. As requested in the public consultation paper published by the Department of Finance in January (the "**Public Consultation Paper**"), our comments reflect our understanding that the KDB will be designed within the parameters recommended by the OECD.

Matheson is an Irish law firm and our primary focus is on serving the Irish legal and tax needs of international companies and financial institutions doing business in Ireland. Our clients include over half of the Fortune 100 companies. We also advise seven of the top ten global technology companies and over half of the world's 50 largest banks. We are headquartered in Dublin and also have offices in London, New York and Palo Alto. More than 600 people work across our four offices, including 75 partners and tax principals and over 350 legal and tax professionals.

The Public Consultation Paper requested that respondents address seven questions relating to the design of the KDB. We have included our views on the first six of these in sections one to six below and have set out some more general comments in the final section.

1 Question 1 (Qualifying Assets)

1.1 Incentivising innovation

All intellectual property ("**IP**") that is derived from innovation should be treated as qualifying IP for the purposes of the KDB. Part of the policy underpinning the KDB (as we understand it) is to incentivise innovation in Ireland with a view to stimulating growth and creating jobs. As acknowledged by the Minister for Finance in his budget statement, "*[c]ompanies now invest as much or more in knowledge-based capital as they do in physical capital such as plant and machinery*". If the intention is to incentivise such investment and innovation, the benefit of the KDB should extend to income derived from all such innovation and investment and should not be limited to an arbitrary definition of listed assets.

For the purposes of the KDB, a broad concept of *"innovation"* should be promoted as is currently the case under *Europe 2020* and *Innovation Union*. Under the Innovation Union plan, the European Commission recognised that there is no single definition of innovation but it should be understood to mean *"change that speeds up and improves the way we conceive, develop, produce and access new products, industrial processes and services."* It should be understood as something broader than R&D. Understanding innovation in this way was also advocated by the OECD in their 2013 publication *Supporting Investment in Knowledge Capital Growth and Innovation*.

1.2 **OECD parameters on qualifying assets**

The OECD considers that the benefit of IP regimes should not extend to income derived from marketing intangibles and we expect that the KDB will operate within those parameters. However, we consider that all other IP should be capable of qualifying for the KDB. We suggest that the definition of qualifying IP for the purposes of the KDB should be broadly drawn to include all forms of IP save for marketing intangibles. For this purpose marketing intangibles should be defined strictly and exhaustively.

We note that the OECD is of the view that IP regimes should be available only in respect of patents and IP assets that are "functionally equivalent to patents". However, it remains unclear what the OECD means by the phrase "functionally equivalent to patents". It seems to us that the phrase requires some analysis of the key attributes of patents. In general terms:

- patents are registered rights;
- patents are legally protected;
- the patented invention is derived from innovation; and
- the patented invention is capable of being exploited commercially.

We consider that any other IP assets that similarly are derived from innovation and are capable of being exploited commercially should be considered "functionally equivalent to patents". This should permit income from copyright, trade secrets (such as confidential processes and confidential formulae) and confidential know-how to qualify. All of these forms of IP can be legally protected (as outlined below), however, not all are registerable (although as noted below we do not believe that this should restrict qualification).

1.3 **Forms of legal protection**

The OECD report issued in September 2014 under Action 5 (Countering Harmful Tax Practices) (the "**Action 5 Report**") indicated that in order to qualify for the benefit of an IP regime under the nexus approach, IP assets should be "*both legally protected and subject to similar approval and registration processes, where such processes are relevant*". IP assets are legally protected in different ways. For example, patents are protected under statute. Other IP assets, such as trade secrets and know-how, are not currently protected by statute. Owners of such IP will usually protect it contractually under employment and confidentiality agreements. In addition, the equitable doctrine of confidentiality applies to protect such IP. Although the forms of legal protection are different, the legal remedies available to the IP owner are similar (eg an injunction and /or damages). On that basis, we consider that if the question of whether an IP asset is functionally equivalent to a patent is determined in part by the level of legal protection afforded to the asset, contractual protection and the protection available under the equitable doctrine of confidentiality should be equally recognised on the basis that often the IP owner is afforded equivalent legal rights and remedies.

1.4 **IP assets that are capable of registration**

A suggestion has been made in the discussions at OECD level that it may be the case that only registerable IP may be permitted to qualify for IP regimes on the basis that the authenticity and existence of IP can be verified by reference to the relevant register. If IP assets are treated as being outside the regime solely on the basis that they are not subject to an existing approval or registration process, the KDB regime will be very limited in its application and will not achieve the stated aim of encouraging innovation and investment in knowledge-based capital. The concept of knowledge-based capital is widely interpreted by the OECD (in *Supporting Investment in Knowledge Capital Growth and Innovation*) and is understood to encompass *"a wider range of intangible assets, such as data, software, patents, designs, new organisational processes and firm-specific skills."* The OECD publication *Supporting Investment in Knowledge Capital Growth and Innovation* supports government policies to encourage investment in knowledge-based capital and advocates a wide interpretation of that concept.

Restricting the relief only to IP assets that are registerable would result in a proportion of valuable IP assets that are derived from innovation (eg copyrighted software) being excluded from qualification. The technology sector is highly innovative and undertakes a substantial amount of research and development ("**R&D**"). In our view it would be unreasonably restrictive to exclude non-registerable IP (such as copyright) from the range of qualifying IP. We consider that the approach already adopted by the Netherlands could be a reasonable compromise. Non-patented IP (such as know-how) can qualify for the Dutch innovation box if the Dutch Minister for Economic Affairs, Agriculture and Innovation issues an R&D declaration in respect of that IP. If a similar regime were implemented in Ireland, it should result in a much broader range of IP potentially qualifying for the KDB (but only where such IP is officially verified) and accordingly, result in greater investment in innovation.

1.5 **Exclusive licences equivalent to ownership**

Finally, it should be the case that any IP that is licensed to a taxpayer under an exclusive licence should qualify for the KDB if the IP itself would qualify had the taxpayer full ownership of the asset. Some multinational companies have a preference for holding IP in a single entity and licensing it regionally on an exclusive basis. Under the UK patent box, such exclusive licences are treated as akin to beneficial ownership and the licensee is entitled to claim the benefit of the patent box to the extent all other criteria are satisfied. We believe that a similar approach should be taken under the KDB so that multinationals continue to have some flexibility in how they hold their IP.

2 Question 2 (Calculation, loss relief and double tax relief)

2.1 No separate KDB trade

Income qualifying for the KDB should be treated as part of the trading income of the relevant taxpayer and should not be treated as income from a separate trade. Artificially separating the income that is eligible for relief under the KDB from the remainder of the income of the broader trade would add further complexity to a taxpayer's computation (which already will be complicated by incorporating the modified nexus approach). It seems inevitable that tax computations for income qualifying for IP regimes incorporating the modified nexus approach will be complex. We would strongly recommend that no further complexity is added by Ireland's domestic implementation of the modified nexus approach. Treating income relieved under the KDB as income from a separate trade would add an unwarranted element of complexity for Irish taxpayers seeking to avail of the relief.

2.2 Allow KDB relief as a deduction from trading income

We believe that the best approach is to allow the relief available under the KDB regime as a deduction from the taxpayer's trading income. The relief should be treated as equivalent to an expense and should be available before capital allowances and losses carried forward. After deducting the relief, the taxpayer's trading income should be taxed in the usual way at 12.5%. Allowing the benefit in this way should not require changes to the loss relief rules on the basis that income relieved under the KDB regime will simply be treated as part of the taxpayer's trading income. To the extent that the deduction available under the KDB regime results in a trading loss, such a loss should be capable of being utilised in the normal manner under existing loss utilisation rules.

2.3 Opportunity to review double tax relief provisions

Double tax relief on royalties received should also be allowed in the usual way. As a broader comment on the operation of the double tax relief provisions, the implementation of the KDB may provide a good opportunity for Ireland to review the double tax relief provisions that apply to foreign withholding tax on the receipt of royalty income. It is an opportune time to consider introducing a more comprehensive pooling mechanism for foreign tax incurred on royalty income and to simplify the foreign tax credit system generally for royalties, which has become unwieldy and unnecessarily complex in practice.

3 Question 3 (Qualifying expenditure)

3.1 Type of expenditure

The definition of qualifying expenditure should be broadly based and should capture all R&D expenditure incurred by a taxpayer that relates directly or indirectly to an IP asset. For example, expenditure on an R&D project that of itself failed to deliver an IP asset that could be exploited commercially should still be eligible as qualifying expenditure if that project formed the basis for a more successful R&D project that went on to deliver an IP asset that was capable of commercial exploitation. In addition, expenditure on R&D incurred under the terms of a cost sharing agreement should also be eligible for inclusion as qualifying expenditure.

In terms of the items of expenditure that should be included as qualifying expenditure, we would suggest at a minimum, that expenditure that currently qualifies for the R&D tax credit would (with some modifications for example for building costs) provide a good starting point for identifying qualifying expenditure for the purposes of the KDB.

3.2 **R&D outsourced to related companies**

We note that the Action 5 Report suggested that expenditure on R&D that is outsourced to related companies should generally not be considered qualifying expenditure save for the proposed 30% uplift. This policy will be more likely to negatively affect taxpayers seeking to avail of IP regimes in smaller countries where taxpayers will more likely have to outsource at least part of the R&D to personnel in other jurisdictions. At the very least, the maximum permitted uplift in qualifying expenditures should be available to taxpayers under the KDB regime.

3.3 **R&D outsourced to third parties**

On the other hand, the OECD will not seek to restrict expenditure on R&D outsourced to third parties from being included as qualifying expenditure, although, they noted that countries could restrict such expenditure if they wished. From an Irish perspective we believe that it is important to include expenditure on R&D outsourced to third parties as qualifying expenditure. R&D is frequently outsourced to third parties with particular expertise. For example, in the pharmaceutical industry clinical trials are frequently outsourced to unrelated third parties. Under the Irish KDB all expenditure on outsourced R&D should be treated as qualifying expenditure. In addition, where R&D is outsourced to third parties through an related company (which may or may not earn a margin), the price paid to the third party for undertaking the R&D should also qualify.

3.4 **Acquired IP**

The OECD has also indicated that in circumstances where a taxpayer acquires IP, the cost of the acquired IP should not be included as qualifying expenditure, whereas, it should be included in overall expenditure. We consider that this is unreasonably harsh on taxpayers who acquire IP from third parties and we have already raised this in our submission to the OECD on the modified nexus approach. A reasonable compromise might be to permit taxpayers who acquire IP from third parties to include in qualifying expenditure the portion of the cost of the IP that represents the amount of expenditure incurred by the seller in the development of the IP. The full cost of the IP could continue to be included as part of the overall expenditure as is currently envisaged.

4 Question 4 (Interaction with existing regimes)

4.1 **Three separate regimes**

The KDB regime should be in addition to and should not limit or be limited by the tax credit regime for R&D expenditure or the capital allowances regime for intangible assets. Each of the three regimes seeks to incentivise different behaviour. The capital allowances regime for intangible assets incentivises acquisition and utilisation of IP in Ireland whereas the tax credit regime for R&D expenditure incentivises investment in R&D. The KDB regime should reward taxpayers for commercially exploiting IP assets produced through that R&D and should encourage taxpayers to retain IP assets in Ireland. The combination of all three regimes in a post-BEPS environment could potentially lead to Ireland being regarded as an attractive location for undertaking R&D and holding and exploiting IP.

4.2 Interaction with R&D tax credit regime

If a taxpayer claimed R&D tax credits in the development of an IP asset, that taxpayer should not be precluded from claiming relief under the KDB regime. Nor should R&D tax credits claimed by a taxpayer be clawed back if a taxpayer claims the benefit of the KDB regime. As noted above, both regimes are seeking to incentivise different behaviour and taxpayers should be entitled to claim the benefit of both regimes.

4.3 Interaction with capital allowances regime for intangible assets

Equally, it appears to us that capital allowances for intangible assets should continue to be available to a taxpayer in parallel with relief under the KDB. If acquired IP is further developed by an Irish taxpayer, income derived from that development should qualify for the KDB. In those circumstances, relief under the KDB regime should be available in priority to capital allowances deductible under section 291A of the Taxes Consolidation Act 1997 ("**TCA**") and any related interest incurred.

Under section 291A TCA taxpayers are permitted to offset capital allowances on intangible assets only against the profits of a separate IP trade. This requirement often makes the regime cumbersome for taxpayers to apply. The requirement to recognise income from the IP trade separately for the purposes of section 291A TCA will further complicate the application of the KDB regime. In our view, the better approach would be to remove the separate IP trade requirement from section 291A TCA entirely. This would enhance the attractiveness of that regime and help in minimising the complexity of the KDB regime.

5 Question 5 (IP income)

5.1 Broad definition of IP income

Similar to the UK patent box regime, for the purposes of the KDB regime IP income should be broadly defined. It should include royalties, income from the sale of products incorporating the IP, infringement payments and proceeds earned on sale of an IP asset.

5.2 Direct link between income and qualifying expenditures

We expect that the formula proposed by the OECD under the modified nexus approach will be incorporated into Irish law for the purposes of calculating qualifying income. However, as suggested in the Action 5 Report taxpayers should have an option to prove, in certain circumstances, that more income should be permitted to benefit from the IP regime if they can show a direct link between that income and qualifying expenditures. This option should be incorporated into the Irish legislation.

5.3 Treatment of routine return and marketing return

Also following the approach adopted in the UK, it seems reasonable that the taxpayer would be required to remove part of the routine return and marketing assets return from IP income in calculating the qualifying income for the purposes of KDB relief. The routine return and marketing assets return could be calculated under a formula or on a just and reasonable basis where the taxpayer believes that is more appropriate.

6 Question 6 (Tracking and tracing)

One of the most unappealing aspects of the modified nexus approach is the suggestion that taxpayers claiming relief under IP regimes will be required to engage in the administratively burdensome task of tracking qualifying expenditure and attributing that expense to IP income. As you will be aware, this is not an exercise taxpayers typically undertake and it will require investment by taxpayers wishing to avail of IP regimes.

6.1 Difficulties inherent in tracking and tracing

So far the OECD has suggested that tracking and tracing could be undertaken on an IP asset by IP asset basis or on a product by product basis. The difficulties inherent in both approaches have been raised by taxpayers. For example, requiring tracking and tracing by reference to either IP assets or products will easily be complicated in circumstances where one IP asset is incorporated into a number of products and when a product incorporates a number of IP assets (as is likely to be the case). It may be more practicable (if permitted within the confines of the modified nexus approach) to require taxpayers to track and trace expenditures across business units or product or service families.

6.2 Allow flexibility for the taxpayer

We expect that different tracking and tracing mechanisms will be workable for different taxpayers depending on their industry, range of IP, product and service offering and operating models. Accordingly, in order for the KDB regime to be workable for as many taxpayers as possible, we would suggest permitting taxpayers to implement a tracking and tracing method that is appropriate and reasonable in their circumstances. Designing a flexible regime will be key to encouraging as broad a range of taxpayers as possible to avail of the relief and invest in innovation. We therefore consider that it will be important to permit taxpayers to identify for themselves the most suitable method of tracking and tracing which they should continue to apply consistently. In our view, this is a better approach than seeking to design a "one size fits all" method for tracking and tracing.

7 Other Comments

We welcome the Minister for Finance's intention that Ireland's KDB will be a "*best in class*" regime within the parameters of what is agreed at OECD and EU level. In this respect, we believe the following points are important:

- Incorporation of the modified nexus approach to IP regimes will significantly increase the complexity in claiming relief under those regimes. There is merit in **designing a regime that is relatively less complex** (within the permitted parameters) than others that are available. A more straightforward regime of itself should appeal to taxpayers. The legislation should be accompanied by clear and comprehensive guidance notes for taxpayers, including computational examples of how the relief is anticipated to operate.

- Jurisdictions with **existing patent box regimes**, such as the UK and Luxembourg, will continue to operate their current regimes, which are not compliant with the modified nexus approach, until 2021. Ireland will be disadvantaged during that six year period. While we understand that it may be difficult to introduce an interim KDB regime which at least matches the competing patent box regimes for that period, some additional consideration should be given on how the gap can be bridged for that six year period.

- The KDB regime should allow **flexibility to taxpayers** where possible (within the permitted parameters) so that the regime is workable for as many taxpayers as possible. This is particularly true of the tracking and tracing requirement.

- The **effective tax rate** available in respect of qualifying IP income under the regime should not be higher than that available in competitor jurisdictions. We would suggest, given incorporating the modified nexus approach means that the application of the relief is likely to be much narrower than that originally envisaged when announced, that the effective tax rate should not exceed 2.5%.

- The Department of Finance or the Revenue Commissioners may wish to consider designing a **pre-approval process** for the KDB regime so that taxpayers have certainty in its application. This would be helpful to taxpayers and may encourage a higher rate of uptake.

- Following implementation of the regime, the Department of Finance and / or the Revenue Commissioners should **monitor taxpayer uptake of the regime** and should continue to review the design and uptake of IP regimes in other jurisdictions with a view to making improvements to the Irish regime where required.

- In designing the KDB regime, the Department of Finance will be cognisant of the on-going work of the OECD on the base erosion and profit shifting ("**BEPS**") project. The work under many of the BEPS actions is targeted at aggressive tax planning and likely will limit the ability of taxpayers to avail of the benefits under preferential regimes. With that in mind, the design of the KDB regime should not be overly-restrictive as taxpayers seeking to rely on the regime will likely also be required to satisfy other post-BEPS provisions.

Thank you for the opportunity to comment on the design of the KDB. Should you wish to discuss any of the comments made in this submission, please do not hesitate to contact us.

Yours faithfully

Sent by email, bears no signature

MATHESON