INTANGIBLE MIGRATION AND THE CHALLENGES OF THE PATENT BOX

By Bethany Hagan and Brett Wilkinson

The United States has become increasingly concerned about the issue of intangible migration. Intangible migration occurs when U.S. corporations successfully transfer ownership of their intangibles (assets that are nonphysical in nature) to foreign subsidiaries located in low-tax countries. Intangibles can include goodwill, trademarks, brand recognition, and more. Policy makers have expressed frustration with the way major corporations such as Apple have structured their affairs to shift intangible income to low-tax jurisdictions. Although some commentators and policy makers have celebrated the ingenuity of Apple and others, both the Senate Permanent Subcommittee on Investigations and the Organisation for Economic Co-operation and Development (OECD) have pointed out that such behaviors competitively disadvantage many domestic, smaller, and newly established U.S. businesses because these businesses lack the ability to access the international income-shifting opportunities available to large entities with abundant intangible assets. These businesses stand to gain from efforts to level the tax playing field.

The key driver of intangible migration is the opportunity to access jurisdictions with highly favorable tax rates on income from intangibles. One type of favorable regime is the "patent box" adopted by several European countries, including the United Kingdom. On the surface, these regimes appear to be drivers of innovation and therefore highly desirable to businesses. In reality, they may also create problems for other countries as evidenced by recent concerns expressed by the German government.

Ultimately the U.S. faces two possible options when it comes to confronting such regimes. The first is simply to join those countries with patent boxes by adopting its own such regime. Many commentators who see patent boxes as being business friendly advocate this approach. The second option is to side with Germany in calling out those countries that have adopted patent box regimes for creating an undue bias that undermines the international tax system. The OECD's Action Plan on Base Erosion and Profit Shifting (BEPS) presents an ideal opportunity for the U.S. and other like-minded countries to exert pressure on jurisdictions with patent box regimes.

The Problem of Tax-Motivated Intangible Migration

Before we turn to the difficulties imposed by patent box regimes, it's important to discuss the problem of intangible migration. When an intangible is developed by a U.S. corporation but used by a foreign subsidiary, that foreign subsidiary should pay royalties to the U.S. parent. That's consistent with what would occur between unrelated entities. Intangible migration arises when U.S. corporations successfully transfer ownership of their intangibles to foreign subsidiaries located in low-tax countries. The change in ownership ensures that future income from the intangible is paid to the entity in the low-tax country. This result not only impacts the U.S. revenue stream adversely, but it also places domestic entities at a competitive disadvantage because they aren't able to shield their intangible income from U.S. taxation.

On September 20, 2012, the U.S. Senate Permanent Subcommittee on Investigations held a hearing about offshore profit shifting. In his opening statement, Subcommitee Chairman Senator Carl Levin (D.-Mich.) noted that the vagaries of transfer pricing leave the U.S. revenue stream vulnerable to abuse by multinationals. He noted that the Subcommittee's investigations revealed that between 2009 and 2011, Apple, Google, and Microsoft succeeded in deferring taxes of $35.4 billion, $24.2 billion, and $21 billion, respectively.

In a May 2013 hearing, the same Committee reviewed the tax planning strategies of Apple. In his opening statement, Senator John McCain (R.-Ariz.) expressed concern that most of Apple's profits were shifted abroad despite the fact that around 95% of its research and development (R&D) activity is conducted in the U.S. He pointed out that large corporations such as Apple are able to use legal loopholes, giving them an advantage over smaller domestic corporations. He further noted that when large corporations avoid paying their fair share of tax, the burden is unduly shifted to individual citizens.

Stopping Intangible Migration Using the Tax Law

Technically speaking, there are three different mechanisms in place to prevent intangible migration abuse. First, the Subpart F rules of the U.S. Internal Revenue Code eliminate tax deferral of income earned by foreign subsidiaries on certain types of income. This includes royalty income from related parties received by controlled foreign corporations (CFCs). Second, Internal Revenue Code (IRC) §482 and the associated Treasury Regulations are designed to ensure that a fair transfer price is paid when transactions occur between related parties. Third, IRC §367(d) treats outbound transfers of intangibles as a sale for a stream of annual payments. Although these measures should limit intangible migration, the Subcommittee on Investigations found that there were numerous loopholes that permitted Apple to work around these laws. Such mechanisms included the "check-the-box" rules and "look-through" provisions that enabled royalties paid between related CFCs to escape Subpart F treatment and the use of cost-sharing agreements that enabled the corporation to circumvent transfer pricing rules.

In an effort to combat intangible migration, the Obama Administration has proposed expanding the Subpart F rules to include excess income from intangibles. According to the March 2014 Treasury Greenbook, "General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals," this provision would apply to excess income from intangibles that are transferred from the U.S. to an affiliate and subject to a foreign effective tax rate of less than 10%. Removing the U.S. tax deferral benefit on intangible income eliminates the key benefit of intangible migration.

The Patent Box Solution

Some countries have pursued patent box regimes as a mechanism for encouraging domestic intangible activity. A patent box regime provides an artificially low tax rate for income from intangibles that are developed and located in that country. This creates an environment that explicitly encourages intangibles to be located onshore. Whether this is a successful strategy is the subject of considerable debate. In their March 2013 *Columbia Law Review* article, "Technological Innovation, International

Competition and the Challenges of International Income Taxation," Michael Graetz and Rachel Doud provide a helpful review of the debate and the evidence regarding the success of R&D tax incentives. They note that current data is too limited to adequately evaluate the merits of the existing patent box regimes, but they do raise valid concerns about the efficacy of this approach. Further, they also point to concerns raised in the research that patent boxes may result primarily in income-shifting activity.

Several European countries, such as Spain, the Netherlands, and the U.K., have adopted patent box regimes. For example, the U.K. patent box regime that's currently being phased in will ultimately provide for a tax on qualifying intangible income of only 10%.

Several proponents of the patent box have recommended that the U.S. adopt such a regime. For example, in their October 2011 article for *The Information Technology and Innovation Foundation*, "Patent Boxes: Innovation in Tax Policy and Tax Policy for Innovation," Robert Atkinson and Scott Andes argue strongly that the U.S. is falling behind in innovation and that the patent box offers an opportunity to reverse this phenomenon. And in their article in the Fall 2013 *Stanford Journal of Law, Business & Finance*, "It Is Time for the United States to Implement a Patent Box Tax Regime to Encourage Domestic Manufacturing," Bernard Knight and Goud Maragani recommend that the U.S. enact a patent box regime designed specifically to boost the domestic manufacturing sector. They envision a regime that requires domestic R&D and production and that benefits small businesses—two features that European regimes lack—and suggest that this would result in increased innovation, a higher number of jobs, and higher-paying jobs in the U.S.

Why Not Adopt a Patent Box in the U.S.?

Given that many European countries have adopted patent box regimes and that the problem of intangible migration exists, why shouldn't the U.S. adopt a patent box regime? Although it appears to be an attractive option, we suggest that there are philosophical reasons why the U.S. should use its influence to encourage the global community to move in a different direction.

The underlying philosophical problems can be seen in the German finance minister's response to the U.K.'s new regime. According to a July 2013 report by *The Guardian*, "Germany Calls on EU to Ban 'Patent Box' Tax Breaks," Germany's Federal Minister of Finance Wolfgang Schäuble has alleged that the patent box regime creates a bias that's inconsistent with core European Union principles. His concern that patent box regimes in European countries place Germany at a competitive disadvantage is well founded. Patent office data discussed by Matthew Gilleard in "Germany Wants European Patent Box Regimes Withdrawn" in the *International Tax Review* reveals that in 2012 the U.K. attracted 27% more German patents to the U.K. than in 2011. Even within Britain there appears to be an awareness of the dangers of a regime deliberately designed to introduce a bias into the international system. In response to the German comments, David Mellor, chief executive of the accounting firm Crowe Clark Whitehill, suggested in "The Patent Box—Successful Investment Initiative or Unfair Advantage?" in the July 2013 *Economia* that the patent box highlights the tension between promoting competitiveness and achieving international consensus. He pointed to the recent OECD call for clarity across jurisdictions and efforts to find consensus on new rules governing the international tax system, which stands in sharp juxtaposition to the U.K.'s patent box approach.

A patent box regime provides an artificially low tax rate for income from intangibles that are developed and located in that country.

Ultimately, if other countries can't be dissuaded from pursuing patent box regimes, it may become necessary for countries like the U.S. and Germany to join them. But there's considerable risk in deciding to move in that direction. On May 19, 1998, the OECD sounded the alarm with a report titled "Harmful Tax Competition: An Emerging Global Issue." And the OECD recently noted that the same "race to the bottom" concerns remain today. In its report on harmful tax competition, the OECD described the classic prisoner's dilemma scenario in which each country is compelled to offer incentives to compete, but collectively their actions render them all worse off. Consistent with this, in February 2013 the Institute for Fiscal Studies (IFS) noted in "The IFS Green Budget" that the patent box regimes in other European countries exerted pressure on the U.K. to adopt similar policies but warned that if other countries ultimately follow suit, all countries would lose. Given the dangers of each country attempting to bias the international tax system to its advantage, it seems that the U.S. would be better advised to seek the repeal of international patent box regimes rather than to join the race. One avenue for addressing the problem is through the recently announced OECD plan for addressing international income shifting.

The OECD Action Plan

In July 2013, the OECD released its Action Plan on Base Erosion and Profit Shifting (BEPS). The plan notes that although tax policy is the right of sovereign nations, frictions arise when domestic systems intersect. In recognition of this, the plan provides for 15 actions to be delivered over a two-year period. These actions include addressing treaty problems (such as the appropriate definition of "permanent establishment" in the modern economy), transfer pricing issues, and the development of a multilateral instrument to amend existing bilateral treaties.

One item, Action Article 5, is directed at countering harmful tax practices. The OECD notes that it will renew its focus on harmful tax practices and will evaluate regimes offering preferential tax treatment.

In response to Action 5, the OECD has very recently released its first deliverable, "Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance." The report emphasizes the need "to align taxation with substance by ensuring that taxable profits can no longer be artificially shifted away from the countries where value is created." The report also identifies several different approaches to defining what constitutes "substantial activity" and notes that once an approach is determined, progress can be made on evaluating intellectual property regimes. This presents an opportunity for countries such as the U.S. and Germany to aggressively make the case against patent box regimes.

Are Patent Box Regimes Harmful?

According to OECD's "Harmful Tax Competition: An Emerging Global Issue," there are several factors that are helpful in evaluating a regime. Regimes that foster harmful tax competition tend to promote the shifting of activity rather than the creation of new activity. They tend to have income generation and investment levels that are inconsistent with the level of activity in the country. And they draw activity to a host country primarily because of the preferential tax regime rather than because of other inherent benefits of being located in that country.

The patent box regimes show some of these characteristics. As Graetz and Doud noted in their 2013 *Columbia Law Review* article, "The variety of public policies that have emerged from contests among nations to capture…benefits for [their] citizens and residents sometimes have beggar-thy-neighbor aspects." Although it's too early to draw definitive conclusions about the U.K. patent box, there's already evidence that it exhibits some of these characteristics. For example, it has been widely reported that the U.K.'s patent box regime motivated pharmaceutical company GlaxoSmithKline (GSK) to bring back patents to the U.K. that previously had been held abroad. The reports also note that GSK is building new manufacturing facilities in the U.K. It remains unclear whether the type of activity the patent box generates is truly new activity or is simply activity that would have occurred elsewhere but is being shifted to the U.K.

Regimes that foster harmful tax competition tend to promote the shifting of activity rather than the creation of new activity.

Further evidence that the patent box is inducing shifts in activity can be seen in comments from leading accounting authorities. For instance, KPMG's "Taxing Corporations in a Global Economy Is a New Approach Needed?" states that there's evidence that companies that had migrated out of the U.K. are now *returning*. In the same report, the Institute of Chartered Accountants of Scotland (ICAS) noted, "Anecdotal evidence is that a sizeable number of international businesses are considering locating, or returning, to the U.K. because of this increased attractiveness of U.K. corporate tax regime." Of course, these comments reflect not only the patent box but the broader tax reforms made in the U.K. corporate tax law.

The long-term effects of the patent box remain to be seen, but initial observations raise concerns about its role in promoting harmful tax competition. To the extent that the patent box is shifting activity rather than spawning new activity and to the extent that activity is moving solely for tax reasons, other OECD countries may have a legitimate case against it.

Even more concerning is the possibility that patent boxes simply encourage artificial income shifting. Graetz and Doud note that although many countries appear to be aiming at increasing domestic R&D, others appear to be simply trying to capture some tax revenue using income shifting. They suggest that "given the mobility of IP income, one cannot help but conclude that firms are more likely to shift income eligible for patent box treatment to low-tax jurisdictions than to increase local R&D in response to patent box breaks."

The Role of the EU in Achieving a Solution

For the most part, the patent box has been a European phenomenon. According to Kevin A. Bell in the April 2012 *Tax Management Transfer Pricing Report*, "Johnson & Johnson Tax Counsel Sees Winners In Belgian, Netherlands Patent Box Regimes," European countries that currently operate patent box regimes include Belgium, France, Hungary, Luxembourg, the Netherlands, Switzerland, Spain, and the U.K.

It's clear that the EU has a vested interest in encouraging innovation. Its Lisbon Strategy was designed to promote EU competitiveness and advance a "knowledge society," although its goals largely been unattained (for more, see Ricardo Rodriguez, John Warmerdam, and Claude Emmanuel Triomphe, "The Lisbon Strategy 2000-2010: An Analysis and Evaluation of the Methods Used and Results Achieved," *Directorate General for Internal Policies*, July 2010). In fact, it appears that the patent box regimes in Europe are some of the only tangible signs of the strategy's success.

Although the patent box seemingly embodies the spirit of the "knowledge society" that European leaders envisioned, concerns about harmful tax competition are growing. The German finance minister's public call for the EU to revisit the patent box is a public manifestation of the concerns that economists and tax experts have discussed quietly. This call was amplified with a European Commission report issued in October 2013 titled "EC Says U.K. Patent Box Regime Violates EU Code of Conduct." It concluded that the U.K. Patent Box Regime violates two of the five criteria for evaluating special tax regimes of the EU Code of Conduct. The potentially violated criteria are that "tax advantages are granted even absent any real economic activity and substantial economic presence" and that "the basis of profit determination for companies in a multinational group departs from internationally accepted rules, particularly those that OECD approves." No final decision on the violation was reached at the December 2013 meeting of the EU Council of Economic and Finance Ministers. The Code of Conduct Group has been charged with analyzing the U.K. and all other patent box regimes, and the group's conclusions are pending.

In his September 1, 2013, article in the *International Tax Review*, "Germany Wants European Patent Box Regimes Withdrawn," Matthew Gilleard quotes the director of the Directorate-General for Taxation and Customs Union of the European Commission as also raising concerns about the U.K. patent box regime and noting that running a low-tax regime to entice certain business is inconsistent with the Code of Conduct. Others question the likelihood that the EU will force the U.K. to abandon its regime. For example, Gilleard cites a PricewaterhouseCoopers (PwC) tax partner as suggesting it's unlikely that the regime will end. In sum, Federal Minister of Finance Schäuble's claims that the patent box isn't aligned with the EU's rules to avoid discriminatory tax and that it's inconsistent with the "European spirit" are attracting further review. As innovators scramble to avail themselves of the U.K.'s new tax haven status, other countries are left wondering whether the patent box solution has in fact become Europe's patent box problem.

The Future

Ultimately, the issue of intangible migration presents a major concern that the U.S. must address. As noted by the OECD and the Subcommittee on Investigations, when some multinational corporations have access to tax avoidance techniques that aren't available to others, this puts other businesses at a disadvantage, undermines the integrity of the tax system, and burdens individual taxpayers unduly. The existence of patent box regimes in several European countries increases the returns to intangible migration and creates an inappropriate bias in international taxation. **SF**

Bethany Hagan is a graduate student in the Master of Taxation program at Baylor University. She is an active member of Beta Alpha Psi and tutors undergraduate accounting students. She has accepted a position with Ernst & Young, where she will work after graduation. You can reach Bethany at Bethany_Hagan@baylor.edu.

Brett Wilkinson, Ph.D., is the Chapman Chair and head of the Department of Accounting at Kansas State University. He also is a member of IMA's Dallas Fort Worth Area Chapter. You can reach him at bwilkinson@ksu.edu.