THE DUTCH "INNOVATION BOX": A SOUND ALTERNATIVE TO EXISTING IP STRUCTURING, OFFERING AN ETR OF 5% ON R&D ACTIVITIES

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Introduction

Since 1 January 2007, the Netherlands has an important incentive for R&D activities in its corporate income tax act: the Dutch Innovation Box (DIB). Until 2010, the DIB offered a 60% corporate income tax base discount for qualifying profit. However, profit attribution rules were very strict. Today, the DIB offers an 80% corporate income tax base discount for qualifying profit, resulting in an effective tax rate (ETR) on such qualifying profit of only 5%. Also, important hurdles and restrictions have been abolished. In this article, we describe the key features and benefits of the DIB. The DIB could very well serve as an appealing alternative to increasingly scrutinized (offshore) IP structures.

Brief History

Introduced into the Dutch corporate income tax act (DCITA) in 2007, the predecessor of today's DIB was named "patent box", and had a rather limited scope: only income from registered IP (patents) was eligible, and more importantly, the amount of profit to benefit from the patent box was capped at 4 times the development cost of the IP. The patent box resulted in an ETR on qualifying income of 10%.

In 2008, an important improvement was enacted which made not only income from registered IP but also income from qualifying R&D activities eligible for the patent box (hereinafter collectively referred to as "qualifying innovation"). Since then, there are two categories of "entry tickets" to the DIB: registered IP (mostly patents and breeders rights) and "R&D certificates". R&D certificates are issued by an agency of the Dutch Ministry of Economic Affairs, called "Agentschap NL" ("ANL"). ANL assesses whether activities of applicants are sufficiently innovative to be "qualifying innovation" for purposes of DIB, by issuing a patent or R&D-declaration. ANL applies a broad interpretation of innovative activity.

In 2010, the patent box was renamed "innovation box", the effective tax rate was further reduced to 5%, and most importantly, the cap on the amount of profit to benefit from the innovation box was removed.

The Benefits of the DIB

The primary benefit of the DIB lies in an 80% deduction from the net taxable profit from qualifying innovative activities. The remaining profit is taxable at the ordinary corporate income tax rate of 25%, resulting in an ETR over profit from qualifying innovation of only 5%.

The deduction is applied as soon as the (unrecovered part of the) development cost associated with the qualifying innovation (the "threshold amount") has been fully recovered. This means that losses (i.e. accumulated development cost) from qualifying innovation are first recovered at the ordinary rate. Eventually these costs have to be attributed to the DIB income (recapture).

The scope of the DIB is very broad. Not just royalties, but also business profits realized on transactions with both with related parties and third parties may qualify [zin toelichten]. Also profits realized upon the sale of assets (capital gains) resulting from qualifying innovation fall under the scope of the DIB.

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In addition to the significant ETR reduction, a substantial reduction in wage tax liability on wage cost associated with qualifying innovation is also available, reducing the labor costs associated with qualifying innovative activity. The wage tax benefit falls outside the scope of this article.

Which Intangible Assets are Eligible for DIB?

As the DIB only applies to *income derived from assets* developed through qualifying innovation, it is key to determine which assets are eligible for the DIB. However, as the DCITA allows for immediate and full write off of qualifying development cost (since 2007), most enterprises will not report an asset from qualifying innovation in their tax balance sheet. Therefore, for purposes of the DIB, the relevant asset will in fact be a 'virtual' asset. Also, it is not the entry ticket (patent, breeders right, or R&D certificate) itself which is the relevant asset for purposes of the DIB. The relevant asset is the intangible property (IP) directly and/or indirectly resulting from the entry ticket. ("the qualifying IP"). In accordance with internationally recognized rules, technological knowledge or knowhow becomes IP if and as soon as it is marketable.

The DIB applies to "technological" innovation. It does not apply to trade names and logos. However, the definition of the term technological IP in the DCITA is rather broadly. It includes, for example, software development, the development of more efficient corporate processes (such as production processes), and the development of all types of sustainable (resource) technology.

Furthermore, the qualifying IP must be "owned" by the taxpayer. In relation to such qualifying IP, which is difficult to subject to legal ownership, the relevant criterion is exclusive baring of risks associated with the knowledge or knowhow, in combination with exclusive entitlement to the benefits derived from the knowledge or knowhow.

Entry Tickets to the DIB

The first category of entry tickets to the DIB includes patents and breeders rights (a form of agricultural patents) filed and owned by the taxpayer (hereinafter: "the patent option"). A taxpayer may already be eligible for the DIB if he owns "only" one patent. This may even be an "old patent", i.e. a patent issued to the taxpayer prior to the introduction of the DIB in 2007. Only one patented component of every asset which a taxpayer wishes to bring under the DIB is sufficient. This means that taxpayers who have not patented their products (completely) for reasons of disclosure, can nevertheless fully benefit from the DIB.

The second category of entry tickets to the DIB are the "R&D certificates" (hereinafter: "the R&D option"). R&D certificates are issued by ANL if and when it has determined that the taxpayer's activities are sufficiently innovative. Once ANL has issued the R&D certificates, the taxpayer is entitled to a reduction of wage tax liability relating to the wage costs associated with the qualifying R&D activity, and at the same time the tax payer has its entry ticket to the DIB for the income derived from the qualifying R&D activity. Both the actual R&D activity and the management thereof may qualify. Whereas an invention is patentable only when the invention is "new to the whole world", within the context of R&D-certificates, it is only required that the result from the R&D activity is new to the taxpayer. In addition, the R&D option provides more possibilities to bring software development under the DIB.: Computer software developers in Europe often refrain from patenting, which is why the R&D option is in fact the only entry ticket for European computer software developers to the DIB.

Is Cooperation in Respect of the Qualifying Innovation Allowed?

Whereas some enterprises are capable of carrying out technical innovation on their own, and are able to bear all associated costs, other enterprises may wish, or perhaps even have to, cooperate with other group companies or third parties in order to carry out an R&D project. Does the legal framework of the DIB allow for such cooperation? Suppose a group company would be interested in co-financing an R&D project and would want to share in the proceeds, a so-called Cost Contribution Agreement (CCA). Or suppose a multinational group has the policy of registering all its worldwide patents in the name of a single group company, in view of efficiently protecting its patents from infringements (factoring) [?]. Or suppose a multinational group has the policy of hiring all R&D staff through a single group company, while on-charging the costs to group companies. In this type of situations there is a discordance between the company which is entitled to the developed qualifying IP on the one hand, and the company which has registered the patents or which has received the R&D certificates on the other hand. In a very literal interpretation (maybe to literal) of the relevant provision in the law, this involvement of two different parties may lead to the loss of entitlement to the DIB. This is because the ownership of the entry tickets is not always with the party entitled to the benefits from the qualifying IP. This appears to be contrary to the purpose of the DIB provisions, which is to stimulate R&D activities. The parliamentary history of the

relevant legal provision confirms that participating in a CCA does not necessarily preclude the application of the DIB. This is because in a CCA, parties share the ownership of the IP and therefore in their co-ownership qualify for the DIB.

Outsourcing Qualifying Innovation

How far can a taxpayer, looking to apply for DIB, go in outsourcing R&D activities? As long as the taxpayer meets the "development requirement" (explained below), a taxpayer using patents as an entry ticket can go very far, and a taxpayer using R&D certificates as an entry ticket can go reasonably far. In all cases, the at arm's length principle must be observed. Another precondition is that the entitlement of the taxpayer to the results of the R&D is of such a level that IP has been developed (at least in part) for the account of the taxpayer. After all, absent any (own) IP, there is no entitlement to the DIB.

As mentioned before, the patent option of the DIB has been designed to stimulate investment in innovative technology. Although the DIB requires "own" development of IP (reference is made to part 8 of this article), this requirement appears to be aimed at keeping purchased knowhow out of the DIB, rather than at keeping outsourced R&D out of the DIB. By its nature, the R&D option can only apply if the taxpayer has carried out R&D activities which have resulted in the development of IP.

During the parliamentary proceedings of the DIB, the State Secretary of Finance has introduced guidelines as to which extent activities can be outsourced. According to the State Secretary, a taxpayer is still eligible for the DIB if the taxpayer has carried out more than 50% of the R&D activities itself or has supervised the R&D activities. In the case of supervising activities, it is essential that R&D certificates are obtained (at least in part) for the R&D supervising activities.

But there is even more to be gained from the DIB. Depending of the wording used in the outsourcing arrangement and the actual organization of the R&D project, the sub-contractor for the R&D project may also be eligible for the DIB. Under certain circumstances, the R&D certificates are also available to the sub-contractor. When IP is developed during the R&D process which meets the criteria of the DIB and to which the sub-contractor is entitled, the proceeds earned by the sub-contractor may also benefit from the DIB. In our view, the term "IP", depending on the circumstances, can be interpreted or adjusted in a manner which should also allow R&D sub-contractors to benefit from the DIB. Only in a pure contract-R&D arrangement this might be challenging, because the sub-contractor is often not the (co-)owner of the IP. Where a third party sub-contractor is involved in contract-R&D, often the third party sub-contractor is entitled to market its "own" developed IP, which can often be distinguished from the IP developed by the principal.

Purchase or Contribution of IP

When valuable IP, generating profits, is transferred to a (Dutch) group company, that company may not be eligible for the DIB in relation to that IP because the (Dutch) group company has not developed the IP itself. However, a taxpayer may still qualify for DIB by acquiring (through purchase or contribution) components of IP which is yet to be developed. In the patent option, the DIB appears to only require that it is the taxpayer who has the first use of the qualifying IP. After all, the "development" requirement as meant in the relevant legal provision is a one-off event. By its nature, the R&D option requires own (supervising) activities of the taxpayer in order to obtain the entry ticket. Nevertheless, this does not preclude the purchase of components from being added to the cost of development either, nor does it preclude the entire qualifying IP from being included into the DIB

For completeness sake, we note that acquired IP may also play a role in determining the threshold amount. In the parliamentary proceedings of the (at that time) patent box, it has been clarified that the term "cost of development" of IP, should be interpreted in accordance with the term "acquisition cost and cost of manufacturing" as applicable to (ordinary) assets. For example, when components of (future) IP are acquired from a third party or from a group company, or when existing knowhow is used in the development of new IP, it will have to be determined which costs of acquisition contribute to the threshold amount applicable to the new IP. When components are acquired from group companies, the fair market value of the components at the time of the acquisition will have to be determined and applied (step-up-facility). When own "old" components are used, the historic costs of acquisition or manufacturing will have to be determined and applied.

Profit Attribution

Profit attribution to the qualifying IP

Both for the qualification for the DIB and for the attribution of profits, the Dutch legislator has chosen for a method which is based on transfer pricing.

Therefore, it is important to determine *how much* of the profit can be attributed to the DIB. As a matter of fact, an integrated enterprise generates its profit on the basis of a number of factors. How to determine which part of the total profit is attributable to the DIB? The relevant legal provision merely states that the proceeds must be *derived from* the qualifying IP. The key question is which degree of causal relationship between the IP and the proceeds must be demonstrated and how this should be quantified.

According to the parliamentary proceedings of the DIB, the attribution of proceeds to the DIB should be based as much as possible on transfer pricing attribution methods. Taxpayers are encouraged (but are not obliged) to enter into discussions with the Dutch tax authorities on the matter.

Based on the concept that a taxpayer can have only one applicable 'box', in which all qualifying IP (for which an election for DIB has been made) is included, one collective attribution for all qualifying IP appears appropriate. The wording in the relevant legal provision (proceeds must be *derived from* qualifying IP), appears to require an asset driven profit determination, as well as a residual profit split. Since a purely IP driven approach usually does not lead to an end result, simply because the direct relationship cannot be established, an indirect method may be applied in stead of a purely asset driven direct method (see also below). Please be aware that transfer pricing is 'only' used as an *attribution method*. Therefore, strictly speaking, the obligations and requirements for maintaining transfer pricing documentation as introduced in the DCITA do not apply (i.e. the DIB only requires a light version of transfer pricing application, also referred to as "transfer pricing light"). If however, international transfer pricing issues do exist between the taxpayer and the tax authorities, the DIB attribution should follow the transfer pricing principles and guidelines to the extent reasonably possible.

Profit attribution - continuation of development of IP (phasing in)

How should already existing IP be accounted for? In many enterprises, profit contributing IP already exists before applying for DIB. That IP often still contributes to post DIB profits. It will not be easy to determine a detailed asset driven profit split for existing IP. It is therefore more feasible to apply a functional split, in which the profit contribution of the "old" IP, taking into account the actual technological development of the new replacing products, is considered to decrease gradually (often referred to as "phasing in").

In cases where the old IP is absorbed entirely by new qualifying IP and therefore ceases to generate income as an independent IP, in our view no tax liability over the fair market value of the existing IP should arise upon the moment at which the existing IP is absorbed by the new qualifying IP, for lack of a realization event. Upon determining the threshold amount (the cost of acquisition or development) of the new qualifying IP, there is no basis for taking into account a higher amount than the historical costs of acquisition or manufacturing as a contribution to the threshold amount.

Profit attribution - methods

Below, we will summarize the appropriate methods for attributing profit to the DIB.

1) The direct method

The direct method is appropriate when the taxpayer only markets the IP through licensing and the receipt of royalties, and in the case of breeder's rights.

For example, the cost plus method (CPM) could be applied when the R&D activities are not a key entrepreneurial function of the taxpayer.

2) The indirect residual profit method (RPM)

Many enterprises will in practice apply for the RPM. RPM appears to be most appropriate method for enterprises where R&D is a key entrepreneurial function.

In general terms, the steps to be performed are as follows:

a) Carry out an analysis of the company's supply chain.
b) Distinguish between routine functions and entrepreneurial functions.
c) Determine a remuneration for each of the routine functions, based on the outcome of a and b. If e.g. manufacturing is a routine function, the remuneration can be determined by a CPM.
d) Determine a remuneration, based on the results of a, b and c for each of the entrepreneurial functions. This is a percentage of that residual profit.
e) Split the EBIT of each taxable year in accordance with c and d
f) Where necessary, apply an adjustment factor for the phase-in discount. Finally, the 80% deduction from the taxable base can be applied to the outcome of f, after the threshold amount has been taken into account. The increasing percentage of the phasing in should be in tune with the expected rate at which old IP will be replaced by new IP.

The DIB and Economic Substance

In accordance with common international understanding and standards of transparency, transfer pricing and exchange of information, the Dutch authorities focus on economic substance requirements. It is the communis opinio that a Dutch subsidiary or permanent establishment of a foreign enterprise can neither be considered to bear risks, nor can it be allowed to handle and carry out transactions in relation to R&D activities, without being in control of the R&D activities[2]. Therefore, the Dutch tax authorities will require a certain level of substance from foreign companies performing R&D activities and looking to apply for the DIB.

How to apply for the DIB

There are several ways to apply for DIB in practice. According to the DIB provisions, taxpayers are to check-the-box in the applicable corporate income tax return. Therefore, the DIB is an optional regime, applicable only upon election by the taxpayer. .

In practice most multinational taxpayers apply for certainty in advance with the local tax inspector (ruling). The Dutch tax authorities are well known for their ruling practice, and therefore multinational taxpayers may expect to find a rather enthusiastic yet realistic approach from the Dutch tax authorities if they apply for the DIB. The Dutch tax authorities have installed a group of specialized DIB-inspectors, who monitor and process all DIB ruling requests.

Conclusion

The DIB offers taxpayers an ETR of only 5% for profit from qualifying R&D activities, a step-up-facility for the tax basis in acquired (purchased or contributed) IP, and a substantial reduction in wage tax liability associated with the qualifying R&D activities. As such, the DIB offers a very feasible alternative to existing IP-structuring. Especially since the early day hurdles and restrictions of the DIB's predecessor have been abolished, and the scope of eligible R&D activities has been extended significantly. And last but not least, the DIB allows for outsourcing of R&D activities to a reasonable extent.

It is key that the qualifying IP comes with relevant economic substance in the Netherlands Economic substance is becoming increasingly important in a globalizing environment (reference is made to the OECD documents on transparency and exchange of information).

[2] Please refer to Chapter D.1.2.2 of the OECD Transfer Pricing Guidelines.

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For further information regarding the Dutch Innovation Box, or for any other R&D related questions, please contact one of our Tax Advisors

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