The Dutch Innovation Box and its recent history

Overview about the history of IP Box (considering the point of view from European Commission and OECD) and the Dutch Innovation Box

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This paper will deal with the Dutch Innovation Box. On the base of the implicit blessing of the European Commission in 2007, the Dutch Innovation Box (and comparable IP regimes in other countries with it) is currently facing possible strong headwinds from the OECD and the same European Commission. This paper will provide for a brief history of IP regimes in a chronological order, presenting some observations about that brief history and, finally, describing the material tax implications of the Dutch Innovation Box.

I. The IP Box regimes: a look through history

A. The European Commission (2006/2008)

The European Commission, through its communication of the 22nd November 2006[1], expressed its approval for the introduction of Intellectual Property (IP)-regimes, aiming to boost Research & Development (R&D) within the European Union (EU). On the same date, the European Commission stated that the Spanish IP-regime, intended to boost R&D, was a generic measure because it was open to anyone and, therefore, could not be included in the forbidden State Aid category[2].

B. The OECD. The Nexus Approach (2015)

The OECD/G20 2015 Final Report on the Base Erosion and Profit Shifting Project (BEPS), Action 5: Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance states[3]: "*[t]he IP regimes listed in Table 6.1 were all considered under the criteria in the 1998 Report as well as the elaborated substantial activity factor. Those regimes are inconsistent, either in whole or in part, with the nexus approach as described in this report*". The IP regimes listed in Table 6.1 are from Belgium, People's Republic of China, Colombia, France, Hungary, Israel, Italy, Luxembourg, The Netherlands, Portugal, Spain, Spain Basque Country, Spain Navarra, Switzerland (Canton of Nidwalden), Turkey and the United Kingdom.

Unfortunately, the Report does not specify nor in which way the IP-regimes reviewed neither in which respect (or in which part(s) of) the Dutch Innovation Box is inconsistent "*in respect of substantial activity*". So much then for the transparency and the substance propagated by the same OECD. Instead, the OECD 2015 Final Report merely provides some generic guidance and states: "*[...] it allows a taxpayer to benefit from an IP-regime only to the extent that the taxpayer itself incurred qualifying research and development (R&D) expenditures that gave rise to the IP income. The nexus approach uses expenditure as a proxy for activity and builds on the principle that, because IP regimes are*

[1] COM(2006) 728 final, 2008/C 10/21, Opinion of the European Economic and Social Committee on the "Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee - Towards a more effective use of tax incentives in favour of R&D".

[2] European Commission, Press release, 13 February 2008, http://europa.eu/rapid/press-release_IP-08-216_en.htm (07.07.2017).

[3] OECD, Countering Harmful Tax Practices More Effectively, Taking into account Transparency and Substance, Action 5 – 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, Paris 2015, http://www.oecd.org/tax/countering-harmful-tax-practices-more-effectively-taking-into-account-transparency-and-substance-action-5-2015-final-report-9789264241190-en.htm (07.07.2017), point 148, page 63.

designed to encourage R&D activities and to foster growth and employment, a substantial activity requirement should ensure that taxpayers benefitting from these regimes did in fact engage in such activities and did incur actual expenditures on such activities"**[4]**.

C. The OECD. The Modified Nexus Approach (February 2015)

The OECD/G20 Report "Base Erosion and Profit Shifting Project", Action 5: Agreement on Modified Nexus Approach for IP-regimes, dated 6 February 2015, states: "*[i]n Brisbane, the G20 leaders endorsed a compromise solution to address this issue, proposed by Germany and the UK. All OECD and G20 countries have now endorsed this compromise solution (see Annex 3) which provides for a required nexus between the location of the activities generating income eligible to the preferential tax treatment and the jurisdiction offering this preferential regime. A grandfathering clause of 5 years has been accepted with no new entries after June 2016*"**[5]**.

Among academic literature, this compromise is known as the so-called "modified nexus approach". This latter was proposed by Germany and the United Kingdom (*pre*-Brexit), after having been informed about the "nexus approach"**[6]**.

D. The European Commission (June 2015)

The European Commission publication, dated 17 June 2015, states: "*[h]ow does the Action Plan relate to the international work against Base Erosion and Profit Shifting? The measures in the Action Plan are very much aligned with the OECD's Base Erosion and Profit Shifting (BEPS) reforms, but are shaped to meet the EU's own particular challenges and needs. The EU strongly supports the BEPS project, which is developing international solutions to profit shifting [...]*"**[7]**.

And also: "*[i]n 2014 the Code of Conduct Group for Business Taxation agreed that, in order to address this problem, preferential regimes, such as patent boxes, should be based on the "modified nexus approach. This means that there must be a direct link between the tax benefits and the underlying research and development activities. The Commission will continue to provide guidance to on how to implement patent box regimes in line with the new approach so as to ensure that they are not harmful, and will carefully monitor its implementation. If within 12 months the Commission finds that member states are not applying this new approach consistently, it will prepare binding legislative measures to ensure its proper implementation*"**[8]**.

E. The OECD (October 2015)

Chapter 4 of the OECD 2015 Final Report, dated 5 October 2015, states: "*[q]ualifying taxpayers would include resident companies, domestic permanent establishments (PEs) of foreign companies and foreign PEs of resident companies that are subject to tax in the jurisdiction providing benefits. The expenditures incurred by a PE cannot qualify income earned by the head office as qualifying income if the PE is not operating at the time that income is earned*"**[9]**.

The Report defines patents and patent-like intellectual property assets**[10]**, copyrighted software**[11]** and IP-assets that do not fall into either of the two aforementioned categories, but share familiar features of patents, *i.e.* non-obvious, useful and novel**[12]** and are substantially similar to the before mentioned categories as well as being certified as such in a transparent certification process by a competent government agency that is independent from the tax administration (this category is meant for small companies only) and that determines which IP assets qualify.

The Report furthermore states: "*[...], jurisdictions may permit taxpayers a 30% up-lift to expenditures that are included in qualifying expenditures. [...] Jurisdictions are also permitted to introduce grandfathering rules that will allow all taxpayers benefitting from an existing regime to keep such entitlements until a second specific date ("abolition date"). The period between the two dates should not exceed 5 years (so the latest possible abolition date would be 30 June 2021)*"**[13]**.

Table 6.1 lists the countries that have an IP-regime. These are the countries mentioned in point B of this section. The same inconsistency as mentioned in point B of this section is reprised again without any explanation regarding the respect in which the Dutch Innovation Box would be inconsistent "*in respect of substantial activity*".

F. The European Commission (January 2016)

As part of an Anti-Tax Avoidance Package the European Commission issued the proposal for a Council Directive on 28 January 2016**[14]**.

The proposed Directive does not mention IP-regimes as such. However, it does mention in its Preamble: "*[m]ost Member States, in their capacity as OECD Members, have committed to implement the output of the 15 Action Items Against Base Erosion and Profit Shifting, released to the public on 5 October 2015. It is therefore essential for the good functioning of the internal market that, as a minimum, Member States implement their commitments under BEPS and more broadly, take action to discourage tax avoidance practices and ensure fair and effective taxation in the Union in a sufficiently coherent and coordinated fashion. In a market of highly integrated economies, there is a need for common strategic*

[4] OECD (footnote 3), executive summary, page 9.

[5] OECD, Secretary-General Report to the G20 finance ministers and central bank governors, section A, page 7.

[6] The nexus approach is explained in point B of this section.

[7] European Commission Fact Sheet 17.06.2015, http://europa.eu/rapid/press-release_MEMO-15-5175_it.htm (07.07.2017).

[8] COM(2015) 302 final, Communication from the Commission to the European Parliament and the Council, A Fair and Efficient Corporate Tax System in the European Union: 5 Key Areas for Action, http://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX:52015DC0302 (07.07.2017), chapter 2.3.

[9] OECD (footnote 3), point 33, page 25.

[10] OECD (footnote 3), point 35, page 26.

[11] OECD (footnote 3), point 36, page 26.

[12] OECD (footnote 3), point 37, pages 26-27.

[13] OECD (footnote 3), points 40, 65, pages 27, 35.

[14] COM(2016) 26 final, 2016/0011 (CNS), Proposal for a council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market.

approaches and coordinated action, to improve the functioning of the internal market and maximise the positive effects of the initiative against BEPS. Furthermore, only a common framework could prevent a fragmentation of the market and put an end to currently existing mismatches and market distortions. Finally, national implementing measures which follow a common line across the Union would provide taxpayers with legal certainty in that those measures would be compatible with Union law"[15].

G. The OECD (February 2017)

The OECD has stated that it will conduct Peer Reviews of the Action 5 transparency framework[16]. There will be four separate peer reviews referring to 2017, 2018, 2019 and 2020.

II. Some observations about the recent history of IP-regimes

A. The approval of Dutch Innovation Box

The Introduction of the European Commission Communication, dated 22 November 2006, as mentioned above in Section I, letter A of this contribution, states: "*[i]n the Lisbon strategy Member States committed to make structural reforms to their economies. Within this context, the European Council called for R&D investments to approach 3% of GDP, of which 2% should come from the private sector. [...] Recently, tax incentives have grown to become one of the major instruments used by many Member States [...]. In line with Europe's commitment to become a more attractive place for business R&D the Commission announced, [...], its intention to promote a more consistent and favourable tax environment for R&D, while recognizing Member State competence for national tax policy*"[17].

The Netherlands originally asked for the approval of the European Commission on its IP-Box. The Primarolo group (now: The Code of Conduct Group for Business Taxation), however, in 2007, answered to the Dutch government that there was no reason to submit the Dutch IP-Box to an examination and that it had reached the conclusion that the Dutch incentive was not to be labelled as "harmful"[18]. After that communication, the Dutch government withdrew its request for approval of the European Commission of its IP-Box.

The European Commission publication dated 17 June 2015 states: "*[i]n 2014, the Code of Conduct Group for Business Taxation agreed that, [...], preferential regimes, such as patent boxes should be based on the "modified nexus approach". [...] The Commission will continue to provide guidance to Member States on how to implement patent boxes in line with the new approach so as to secure that they are not harmful, [...]*"[19].

Without any doubt, in this statement the European Commission (and the Code of Conduct Group for Business Taxation) is referring to page 62 of the OECD 2015 Final Report, which stated: "*[i]n respect of substantial activity the IP-regimes reviewed were all considered under the criteria in the 1998 Report as well as the elaborated substantial activity factor. Those regimes are inconsistent, either in whole or in part with the nexus approach as described in this report*"[20] and labelled all EU Member State IP-regimes, which were mentioned in this report, as harmful.

As the IP-regime of The Netherlands was specifically mentioned in the OECD 2015 Final Report, in referring to this Report, the Commission (and the Code of Conduct Group for Business Taxation) has consequentially labelled the IP-regime of the Netherlands wholly or partly harmful.

The point is how is it possible that the same institution declared, in 2007, the legitimacy of the Dutch IP-regime and, in 2015, the same Dutch IP-regime was classified as harmful?

B. Observations about the "harmfulness" notion

In 2007, the Primarolo Group used the phrase "not harmful" as a shorthand to state that the Dutch IP-Box was "not incompatible" with EU Law (and perhaps that the Dutch IP-Box was helpful in supporting the Lisbon strategy as well). Philosophically speaking, the criteria "not harmful" and "harmful" lack any objective meaning if they are not used on the base of some stable notion. For "stable notion" I mean "an objectively determined or determinable notion". In other words, "not harmful" as used by the Primarolo Group derives its objective meaning from its reference to EU Law.

The OECD uses the word "harmful" in a different way. In order to demonstrate what I mean a somewhat longer quotation of Chapter 1, Sections 2 and 3 of the OECD Final Report of 5 October 2015 – mentioned in Section I, Point E of this contribution and hereinafter referred to as the October Report – is necessary. The October Report states: "*[t]he goal of the OECD's work in the area of harmful tax practices is to secure the integrity of tax systems by addressing the issues raised by regimes that apply to mobile activities and that unfairly erode the tax bases of other countries, potentially distorting the location of capital and services. Such practices can also cause undesired shifts of parts of the tax burden to less mobile tax bases, such as labour, property and consumption and increase administrative costs and compliance burdens on tax authorities and taxpayers. The work on harmful tax practices is not intended to promote the harmonisation of income taxes or tax structures generally within or outside the OECD, nor is it about dictating to any country what should be the appropriate level of tax rates. Rather, the work is about reducing the distortionary influence of taxation on the location of mobile financial and service activities, thereby encouraging an environment in which free and fair tax competition can take place. This is essential in moving towards a 'level playing field' and a continued expansion of global economic growth. Countries have long recognized that a 'race to the bottom' would ultimately drive applicable tax rates on certain sources of income to*

[15] COM(2015) 302 final (footnote 8), chapter 2.

[16] OECD, Peer review of the Action 5 transparency framework, Paris, 1st February 2017, http://www.oecd.org/tax/beps/beps-action-5-peer-review-and-monitoring.htm (07.07.2017).

[17] COM(2006) 728 final, http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:52006DC0728 (07.07.2017), Introduction.

[18] Letter of the Dutch Staatssecretaris van Financiën (Member of the Dutch Government responsible for tax matters) to the Dutch Parliament (Second Chamber), dated 1st October 2007.

[19] COM(2015) 302 final (footnote 8), chapter 2.3.

[20] OECD (footnote 3), point 148, page 63.

zero for all countries, whether or not this is a tax policy a country wishes to pursue, and combating harmful practices is an interest common to OECD-countries and non-OECD countries alike. By agreeing on a set of common criteria and promoting a co-operative framework, the work not only supports the effective fiscal sovereignty of countries over the design of their own tax systems, it also enhances the ability of countries to react against the harmful tax practices of others"**[21]**.

The October Report finds its core within the principle of "the integrity of tax systems", as it states that it is the self-imposed goal of the (work of the) OECD "*in the area of harmful tax practices*" to secure "*the integrity of tax systems*". What "*the integrity of tax systems*" exactly entails is unfortunately not explained to the reader of the Report. The reason why this explanation is missing is that the phrase "*integrity of tax systems*" lacks of, in my opinion, any kind of objective meaning. Any attempt for defining it, could be arbitrary because it is not a stable notion nor it can be referred to any other stable notion. In other words, declaring the goal "*to secure the integrity of tax systems*" is a seemingly sympathetic, but meaningless statement.

The line *"addressing the issues raised by regimes that apply to mobile activities and unfairly erode the tax bases of other countries, potentially distorting the location of capital and serviced*" is presented by the Report as the way in which "*the integrity of tax systems*" is (to be) "*secured*". This line works within a framework of subjective notions. What is deemed to be "unfair" is in the eye of the beholder. One vividly remembers that the OECD Members Germany, France and Italy classified the Irish corporate tax rate of 12.5% as "unfair" and tried to force the Republic of Ireland to abandon this rate when the latter was in financial trouble. The Republic of Ireland was of the opinion that its corporate tax rate was fair (enough).

The use of words such as "*erode*" and "*distorting*" suggests that there exists a kind of natural or minimal tax base for a country, for if it does not exist, it cannot be eroded and/or distorted. The existence of such a natural or minimal tax base, however, cannot be objectively established and if it does seem to exist, it is in the eyes of the beholder only.

As a consequence, the word "harmful" as used in the context of "*the OECD's work in the area of harmful tax practices*" has no objective meaning either, as it is not used with reference to a stable, objectively determined or determinable notion, but rather with reference to a whole set of not stable and not objectively determined or determinable notions. In other words, the "harmfulness" of the "tax practices", as described in the OECD 2015 Final Report, can only be subjectively determined.

Comparable comments can be made about the remainder of the October Report's text, quoted above. For the sake of the length of this article, I will refrain from doing so. We can, however, now clearly conclude that the October Report uses the notion "harmful" in the context of "harmful tax practices" in a different way than the Primarolo Group did in their 2007 Communication to the Dutch government.

This study of semantics is important because if true "harmfulness" does not exist, none of the measures proposed in the October Report can be said to combat this "harmfulness". In other words, all of these measures, as far as they have not yet been codified in hard laws elsewhere (*e.g.* standing EU Law), lack a clearly defined reference point. Without such a clearly defined reference point the interpretation and the execution of these measures is unclear. It is a classic example of arbitrariness.

And still the OECD did not abstain from writing the quoted text in its October Report. Why did it do such a thing? I am only able to contrive one possible answer to this question and that the OECD was forced to do so. By whom could the OECD be forced to write down the aforementioned text, do you ask? Once again, I am only able to think of one possible answer to this question. The OECD can only be forced to do such a thing by a person or an entity that has more bargaining power than the OECD itself and that wants to use the OECD as its conduit to impose this bargaining power on others. The only persons or entities that are capable of acting in this manner are the large Member States of the OECD, acting in unison. On whom, do you ask, would these large Member States of the OECD want to impose their bargaining power? Again, I am only able to devise one possible answer to this question and that is that the large Member States of the OECD want to impose their bargaining power on the small Member States of the OECD. When one restricts itself geographically to Western Europe, these small OECD Member States are in any case: The Netherlands, Belgium, Luxemburg, Denmark, Switzerland, the Republic of Ireland and Austria. Seen in this light, the October Report is only the latest, thinly disguised attack on the tax sovereignty of the aforementioned small OECD Member States, despite the quoted text trying to tell us otherwise.

In this light, it is remarkable that the European Commission (and the Code of Conduct Group for Business Taxation) came to embrace the approach of the OECD, in the way as described in Section I, letters D and F of this contribution. Why did the European Commission (and the Code of Conduct Group for Business Taxation) do such a thing?

The only possible answer to this question is, in my opinion, that the European Commission has been forced to do so by entities that have more bargaining power than the European Commission itself and that want to use the EU as a conduit to impose this bargaining power on others. The only entities that are capable of acting that way are the large Member States of the EU, who are, indeed, in part the same as the large Member States of the OECD, acting in unison.

And on whom would these large Member States of the EU want to impose their bargaining power? I am only able to contrive one possible answer to this question and that is that the large Member States of the EU want to impose their bargaining power on the small Member States of the EU.

[21] OECD (footnote 3), points 2-3, pages 11-12.

When one restricts itself geographically to Western Europe, these smaller Member States are, once again, in any case: The Netherlands, Belgium, Luxemburg, Denmark, The Republic of Ireland and Austria. This bargaining power will also be imposed on the non-EU Member State of Switzerland[22].

In this imposition, the notion of "harmfulness" is crucial. With regard to the October Report, I have argued that it uses the notion "harmful" in the context of "harmful tax practices" in a different way than the Primarolo Group did in the year 2007 vis-à-vis the Netherlands. The European Commission (and the Code of Conduct Group for Business Taxation) has decided to follow the October Report to the letter.

The answer to the question "how is it possible that the same institution declared, in 2007, the legitimacy of the Dutch IP-regime and, in 2015, the same Dutch IP-regime was classified as harmful?", is that the notion "harmful" in the expression of "not harmful" as used by the Primarolo Group ("not incompatible" with standing EU Law) in the year 2007, is a completely different one than the notion "harmful" in the line *"[t]he Commission will continue to provide guidance to on how to implement patent box regimes in line with the new approach so as to ensure that they are not harmful, [...]"* as used by the European Commission and the Code of Conduct Group for Business Taxation in the year 2015[23]. The latter notion "harmful" lacks any kind of objective meaning and is, for that reason, solely a tool of arbitrariness. Only by using this latter yardstick as a measuring instrument, is it possible to come to the conclusion that the Dutch Innovation Box is "inconsistent" and "harmful".

III. The Dutch Innovation Box

Art. 12*b* of the Dutch Corporate Income Tax Code specifies the Dutch Innovation Box. The current Dutch corporate income tax rate is 25%. The Dutch innovation box reduces the taxable base, with regard to income derived from an innovative immaterial asset, to one fifth (1/5) of the regular tax base by exempting four/fifths (4/5) of the regular tax base.

The effective tax rate regarding income derived from an innovative immaterial asset is 5%. This tax rate is considered competitive in comparison with the IP-regimes of other Nation-states. Since the base reduction is granted to each and every corporate tax resident of The Netherlands, the innovation box does not create a privileged – and therefore prohibited – tax regime.

The tax reduction "costed" the Dutch state euro 996 million in the year 2014, euro 1'167 million in the year 2015 and euro 1'235 million in the year 2016. This "cost" will stabilize itself at 7.6% of the total amount of corporate income tax that will be received by the Dutch tax authorities in the year 2017 and in the years to come. The Dutch government has stated that without the Dutch Innovation Box, the Netherlands would be in a worse position than the other Nation-states[24].

There are three main requirements that must be fulfilled in order to get the benefits granted by the innovation box:

a) the innovative immaterial asset must be produced by the corporate taxpayer itself, at its own risk and on its own expense. This, coincidentally, is in agreement with the requirements set by the (modified) nexus approach in the OECD 2015 Final Report;
b) with regard to the innovative immaterial asset, a patent (in the Dutch language: an *octrooi*) or an intellectual property asset that grants protection to plants, flowers or genetic material (in the Dutch language: a *kwekersrecht*) needs to be submitted. It does not matter where or in which way (with or without preliminary examination, examination of the novelty character or not, possibility of opposition or not) the patent has been submitted. Hereinafter the word patent also includes the "*kwekersrecht*".
c) the benefits out of the innovative immaterial asset need to be derived from the patent itself for more than 30% of those benefits. This anti-abuse requirement aims to prevent a patent from merely being a sideshow.

The costs incurred to produce the innovative immaterial asset need to be deducted from the income derived from the innovative immaterial asset before applying the aforementioned partial tax base exemption.

Example[25]: a Dutch company, A NV, produced an innovative immaterial asset and incurred costs of 100 in doing so. Subsequently, A NV sells the innovative immaterial asset at a price of 800.

Benefits	800
Costs incurred	100
Benefits in innovation box	700
Exempted 4/5	560
Taxed 1/5	140 at the regular taxe rate of 25%
Tax	35

Each corporate tax resident is only entitled to one innovation box.

Please note that art. 12, subpart 4 of the Dutch Corporate Income Tax Code explicitly excludes trademarks and logos from the innovation box. So, if a patented drug is sold, it is necessary to split the purchase price into two parts: the part that is paid for the trade mark and the part that is paid for the patent itself. Only the latter part potentially benefits from the innovation box regime.

The Dutch corporate income tax law lacks a clear definition of an innovative immaterial asset and so the help of the Dutch civil code and the International Accounting Standards

[22] Press release dated 14 October 2014, Economic and Financial Affairs 14218/14. The Swiss tax regimes are no longer to be allowed to be contrary to the (European) standards with regard to (harmful) tax competition.

[23] COM(2015) 302 final (footnote 8), chapter 2.3.

[24] Parlementaire behandeling belastingplan 2016. Kamerstukken II 2015/2016, 34.302, point 116, page 6.

[25] Cursus Belastingrecht Vennootschapsbelasting (Kluwer) 2.2.13B.a.

is needed to determine what constitutes an innovative immaterial asset. It is obvious that this potentially leads to discussions about the answer to questions like:

- “what is immaterial and what is material?” and
- “does the asset have the potential to produce economic benefits during more than one year?”.

Like everywhere else, the discussions in the Netherlands about what constitutes “incurred costs” are an old classic. Some guidance is provided by art. 38 of the International Accounting Standards. Over the years, it has become clear that the “costs incurred” are to be established according to the theory of absorption costing (integral cost price) and that, yes, the good old “at arm’s length” principle also needs to be applied to the transfer prices issues that necessarily pop up. The Dutch Tax Authorities are prepared to help taxpayers out and have produced various standard solutions based on cost-plus and profit-split methodologies.

Although the basic rules for the use of the Dutch innovation box are simple enough, the application of these rules is sometimes time-consuming and nerve-racking, to say the least. For tax professionals this will not come as a surprise, but for whoever is after a pot of gold...