Belgium: Patent Income Deduction

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This article illustrates the technical aspects of the Belgian Patent Box rules established by the Law of 27 April 2007

1. Introduction

Belgium offers a full range of research and development (hereafter R&D) tax incentives. These tax incentives, together with Belgium's central location, good logistical infrastructure and highly qualified workforce, are a key factor to the country's reputation as an ideal R&D location.

The most important tax incentive for R&D is the *"Patent Income Deduction"* (hereafter PID). The PID regime was established by the Law of 27 April 2007, which introduced Articles 205/1 through 205/4 in the Belgian Income Tax Code (hereafter ITC). Under this regime, Belgian companies may deduct 80% of their gross patent income from their tax base. With a general statutory corporate tax rate of 33.99%, this deduction results in an effective tax rate on patent income of 6.8%.

The PID regime was introduced to stimulate patent ownership and consequently boost domestic technological innovation, which is an important factor contributing to long term economic growth**[1]**. Further, the PID intended to increase Belgium's level of competitiveness compared to economically similarly situated jurisdictions like Ireland, the Netherlands and Luxembourg, which had introduced modernized tax facilities to attract R&D activities.

An overview of the PID regime is provided below.

2. Scope of the Patent Income Deduction (PID) – Qualifying companies

2.1. Belgian taxpayer

The PID regime is applicable to R&D activities in all business sectors, as long as the taxpayer is subject to Belgian corporate income tax either as a resident (*i.e.* domestic company) or as a non-resident (Belgian permanent establishment [PE] of a foreign company).

2.2. Owner of a patent

The Belgian company applying for the PID has to be the (co-) owner, the (co-)usufructuary of the patent or the (partial) licensee of the rights on the patent. A Belgian PE can benefit from the PID regime if the patent has been allocated to it.

Patent ownership is a crucial qualification requirement. Therefore, a company carrying out R&D activities on a contractual basis and in the name of or on account of another party cannot benefit from the PID. Similarly, after alienation of the patent, the former patent holder can no longer benefit from the PID. The income realized from the alienation of the patent is thus fully taxable**[2]**.

2.3. Patent developed or improved in a *"research centre"*

The PID can only be claimed if the patent has been (fully or partly) developed or acquired and improved by the Belgian company through a *"research centre"*. The ITC provides that a *"research centre"* should qualify as a *"branch of activities"* of the company. According to the Belgian tax administration, the latter term – which is not defined in Belgian tax law – is understood as *"the entirety of components assigned to a branch of the company and which forms a technical and independent undertaking, i.e. an entirety able to function by its own means"*. It has been further clarified that the *"research centre"* does not need to be completely separate from other activity branches of the company. It can, for instance, make use of centralized services of the company without jeopardizing its *"research centre"* status. There is also no requirement of a minimum number of employees exclusively assigned to the *"research centre"* to develop patents. Further, the *"research centre"* does not need to be located in Belgium, as long as it is a branch of activities of a Belgian company, owning the (abroad) developed patent.

The *"research centre"* criterion is undeniably difficult to apply. In practice, however, taxpayers can derive a level of certain-

ty by requesting an administrative ruling on whether a specific fact pattern would satisfy the *"research centre"* criterion. Especially with regards to small and medium enterprises (hereafter SMEs) – which by their inherent smaller scale of operations are disadvantaged compared to multinational enterprises (hereafter MNEs) – the tax administration has interpreted the term *"research centre"* rather liberally as *"the need for a minimum level of economic substance in Belgium"*.

This administrative tendency has recently been codified in the Law of 13 June 2013 implementing measures of the *"Fiscal Recovery Plan of 2012"*. As a result, as of assessment year 2014 SMEs will no longer have to fulfill the *"research centre"* criterion to benefit from the PID regime.

3. Qualifying patents and other intangibles

3.1. Patents, patent licenses and supplementary certificates of protection

According the ITC, the PID applies to *"patents, patent licenses and supplementary certificates of protection"***[3]**. The concept of *"patent"* typically refers to the right to exclude, for a limited period of time, others from using an invention. Belgian IP law defines a *"patent"* as the exclusive and temporary right granted to use any invention that is new, that is based on the inventor's activity and that can be applied in the field of industry**[4]**.

Apart from patents, the PID regime also applies to *"supplementary certificates of protection"*. These are intellectual property rights granted for the development of medicinal products and engineered plant protection products**[5]**.

The PID regime does not apply to other types of IP rights, such as trademarks, designs, copyrights and know-how**[6]**.

The PID regime is not restricted to Belgian and European patents only. The regime is also applicable to the patent income of foreign patents included in the Belgian tax base.

3.2. *"Developed or improved"* in-house

To benefit from the PID regime, the patents need to be (totally or partially) self-developed. As mentioned above, for MNEs, this development needs to take place in a so-called *"research centre"*.

The term *"totally or partially"* suggests that patents that are co-developed by related or unrelated parties are also eligible for the PID. Also, the law does not preclude the reliance on third party contract researchers to carry out research for the account of the company. In theory, this means that the company or its research centre could outsource all R&D activities. It is believed that in order to retain a *"minimum of economic substance"* required for the PID to apply, the company or its research centre should at least be able to perform supervisory and managerial activities on the R&D operation on its own.

For patents and patent licenses acquired from third parties, the law requires that the patented goods or processes have to be *"improved"* by the company. The improvement does not need to lead to additional patents. However, *"improvement"* implies that the company is able to demonstrate that its R&D activities have resulted in added value to the patent. Proper documentation of the improvement is thus required and, in any case, an advanced ruling can be requested from the tax administration.

4. Calculation of the Patent Income Deduction (PID)

Article 205/1 ITC provides that *"the profits during the taxable period shall be reduced by 80% of the patent income"*. Accordingly, the PID is equal to 80% of the amount of: *(1)* the total of the remuneration for patent licenses granted to third parties; *(2)* plus the total of the patent remuneration included in the sales price of patented products and services; *(3)* less the amount of remuneration due and depreciation on patents acquired from third parties.

4.1. Remuneration for patent licenses (royalties)

The first category of patent income to which the PID applies is the arm's length remuneration received for the licensing of patents to related or unrelated companies, operating within the territorial scope and paying remuneration within the temporal scope of the qualifying patent**[7]**. Income on sub-licenses qualifies for the PID, but income or capital gains from the transfer of ownership rights regarding the patent does not.

The nature of the remuneration can include variable remuneration (*e.g.* royalties as a percentage of sales of patented products) as well as fixed remuneration (*e.g.* fixed advanced payments).

To the extent that the remuneration earned on a license agreement relates also to other non-qualifying IP rights, the PID is calculated on a pro rata basis**[8]**.

4.2. Remuneration included in the sales price (*"embedded royalties"*)

The PID regime also applies to companies that produce and sell patented products and services, rather than licensing the patent to another company. Therefore, remuneration

"embedded" in the sales price also qualifies for the PID. To this extent, the ITC includes in the base for the PID calculations an amount (at arm's length) of *"fictional"* royalties due by a third party buying patented products, corresponding to the amount of royalties that would have been paid if the third party had actually produced the goods or provided the services on the basis of a license agreement**[9]**.

The same holds true for the provision of services and patent remuneration embedded in a service fee. An example is the manufacturing fee charged by a contract manufacturer that uses its own patented technology in the manufacturing process. Included in the base for the PID calculation is the hypothetical fee that would be paid by the third party for the right to use the patented technology in order to render the same service.

4.3. Patent income required to be included in the tax base

The ITC explicitly requires that the patent income (both *"actual royalties"* and *"embedded royalties"*) eligible for the PID has to be included in the Belgian tax base**[10]**. As a consequence, the PID regime will not be available for Belgian resident companies if the patent income is attributable to a foreign permanent establishment whose profits are exempt under application of a double taxation convention. *Vice versa*, a Belgian permanent establishment can only benefit from the PID regime if the patent income is attributable to it. This attribution of the patent income to a Belgian head office or permanent establishment becomes particularly relevant where the R&D takes place in a *"research centre"* outside Belgium.

4.4. Deduction for remuneration and depreciation of acquired patents

In order to prevent abuse, income derived from patents that are acquired from third parties and improved by the company needs to be reduced by the remuneration payable to the third party for the transfer of the patents. Similarly, depreciation costs on the acquired patents need to be deducted from the PID base**[11]**.

The above provision aims at preventing *"double dipping"* as it prevents companies from acquiring patents, subsequently granting licenses and claiming the PID while at the same time deducting from other income the remuneration paid for the acquired patents. The provision also prevents cascading of patent licenses to abuse the PID. At each stage of the cascade (*i.e.* licence and sub-licence), only the net margin (*i.e.* gross patent income minus patent acquisition cost) is eligible for the PID.

An explicit reference to the arm's length principle is included in the Law to prevent related parties from artificially lowering the amount of remuneration paid to acquire patents from related parties. In such cases, the PID base will be reduced by reference to the arm's length remuneration or depreciation amount**[12]**.

This requirement of deducting remuneration and depreciation does not apply to self-developed patents. R&D expenses related to the *"from scratch"* development of patents are not to be deducted from the PID base.

4.5. Final calculation technicalities

There is no maximum amount of patent income eligible for the PID: 80% of a company's qualifying patent income can be deducted. Business expenses in relation to R&D remain fully deductible from the company's taxable profits. As indicated above, application of the PID results in an effective tax rate on the patent income of 6.8% (*i.e.* the statutory tax rate of 33.99% on 20% of the gross patent income).

The PID is one of several *"computations"* that need to be applied in sequence in order to compute the taxable income. The PID takes place after the deduction for dividends received (cf. the participation exemption), but before the notional interest deduction and the deduction of carry-forward losses**[13]**. This means that in case of insufficient profits (*e.g.* after applying the deduction for dividends received), all or part of the PID can end up remaining unused**[14]**. The unused portion may not be carried forward or back.

5. Conclusion

It is clear that the PID constitutes an important tax facility, contributing to make Belgium an attractive location for R&D activities. While the PID qualification requirements are quite strict on some points (like the restriction to patents only and the requirement of a *"research centre"*), if the conditions are fulfilled, the benefit of a tax cut on patent income of 80% is substantial. Together with a range of other tax incentives (like a partial exemption of withholding tax on wages paid to scientific researchers, the facility of activation and depreciation of R&D costs and the increased investment deduction or tax credit for R&D investments), the PID is a clear demonstration of Belgium's recent policy to move towards establishing a tax-friendly R&D climate.

Whereas the PID regime had only limited success in its early years, the measure is now getting speed. The number of companies applying for the PID remains relatively low. Based on information published by the Tax Administration in

June 2012, only 97 companies applied for the PID. The low number isn't necessarily a sign of *"much ado about nothing"*. Because Belgium has a large contingent of domestic SMEs, it is expected that there will be an increased access to the PID regime as soon as the *"research centre"* requirement will be removed for these companies in 2014.

The low number of companies applying for the PID might also be evindence of the fact that the facility is not serving as a tax planning tool for MNEs facilitating the routing of royalty income through Belgium at a low tax rate. The *"research centre"* criterion, the requirement of development or improvement of patents and the Tax Administration's guideline of *"minimal economic substance"* make the PID unsuitable for this kind of tax planning. In the current and future debate regarding base erosion and profit shifting (BEPS), this can only be seen as a good thing**[15]**.

Elenco delle fonti fotografiche:

http://travel-destination.net/news/wp-content/uploads/11404.jpg [05.10.2013]

http://1.bp.blogspot.com/-B-wmSDRY-os/TiqPUE5BSkI/AAAAAAAA-CuQ/UbVIL2cFYIA/s640/best-picture-gallery-Atomium-brussels-belgium-Squonk11.jpg [05.10.2013]

[1] This policy was in line with the objectives of the EU Lisbon Strategy (2000) and the relaunch of the Lisbon Strategy (2005) according to which the Member States of the European Union expressed their commitment to increase the amount of investment in R&D to up to 3% of the aggregate of the GDP in the EU (cfr. EU Commission, COM[2005]24, Working together for growth and jobs – A new start for the Lisbon Strategy, p. 20).
[2] Cfr. art. 205/2, para. 2(1) ITC.
[3] Cfr. art. 205/2, para. 2(1) ITC.
[4] Cfr. art. 3 of the Law of 28 March 1984 on patents.
[5] Cfr. EU Council Regulation No. 1768/92 and EU Council Regulation No. 1610/96.
[6] The Luxembourgish PID regime, introduced by the Law of 21 December 2007, is roughly similar to the Belgian regime, introduced less than 8 months before. One of the main differences, however, is its material scope. Whereas the Belgian PID regime only applies to patents, the Luxembourgish regime also applies to software copyrights, trademarks, designs and registered internet domains.
[7] Cfr. art. 205/2, para. 2(1) ITC.
[8] Cfr. art. 205/2, para. 2(3) ITC.
[9] Cfr. art. 205/2, para. 2(2) ITC.
[10] Cfr. art. 205/2, para. 2(1) ITC in fine and art. 205/2, para. 2(2) ITC in fine.
[11] Cfr. art. 205/3, para. 1 ITC.
[12] Cfr. art. 205/3, para. 2 ITC and art. 205/3, para. 3 ITC.
[13] Cfr. arts. 74-79 of the Royal Decree executing the ITC (hereafter RD/ITC).
[14] Cfr. art. 771 RD/ITC.
[15] It should be reminded that Action 5 of the BEPS Action Plan, published by the OECD in July 2013, specifically aims at countering harmful tax practices that take the form of across the board tax rate reductions on particular types of income from the provision of intangibles. It is provided in the Action Plan that in the revamped debate on harmful tax practices, the emphasis will be on *"transparency and substance"* (cfr. OECD [2013], Action Plan on Base Erosion and Profit Shifting, OECD Publishing, pages 17-18, available at: http://dx.doi.org/10.1787/9789264202719-en [05.10.2013]). Since the Belgian rulings are published and readily accessible online (cfr. http://www.ruling.be [05.10.2013]) and given the emphasis of the Legislator and Tax Administration on *"minimal economic substance"*, one might conclude that the PID regime is not a *"harmful tax practice"*, and may be qualified as a *"fair tax competition"*.