The Spanish IP Box Regime

Roberto Bernales Soriano
Principal Research Associate, IBFD
r.bernales@ibfd.org

This article illustrates the technical aspects of the Spanish IP Box regime applicable for tax periods starting as from 1. January 2008

1. Introduction

In July 2007, the Spanish legislator introduced a new tax incentive (the IP Box Regime) in order to stimulate the innovation and the creation of knowledge to be used within a business activity, and the licensing of that knowledge to third parties. The tax incentive is applicable for tax periods starting as from 1. January 2008[1]. The present article summarizes the patent box regime that exists in Spain, and also deals with the specificity of the same tax incentive in the Basque Country. At the moment of writing this article, the Spanish Parliament is discussing the amendment of the tax regime. Thus, at the end of the article there is a summary of how the regime will possibly be in the next future.

2. The tax incentive under the general corporate income tax law in Spain

2.1. Qualifying income

The tax incentive consists on a reduction of 50% of the taxable base corresponding to the income derived from the assignment of the use or exploitation of certain intangibles. The regime does not cover the sale of the assets, *i.e.* capital gains are not covered by the incentive. Furthermore, the difference between operating leases or financial leases may be relevant, since in the case of a financial leasing the assignment could be understood as an economic transfer of the asset, thus not covered by the partial exemption.

2.2. Qualifying assets

The intangible assets covered by the partial exemption are patents, designs or models, plans, secret formulas or processes, and rights on information concerning industrial, commercial or scientific experiences. The items included in the tax incentive are not exactly the same as the intangible rights defined and protected under the Spanish commercial law. Patents and the so called *"utility models"* are defined and protected under Law 11/1986, of 20 March 1986 on Patents[2]. Furthermore, industrial designs are also protected under Law 20/2003 of 7 July 2003 on the Juridical Protection of Industrial Design[3].

The tax incentive is independent from the possibility for the intangible to be recorded in a public register in order to be legally protected, and it does not depend either on the actual registration of the intangible in the case that registration is possible.

The other intangibles referred to as *"rights on information concerning industrial, commercial or scientific experiences"*, which may benefit from the tax incentive, are not defined in the law and are included within the concept of know-how as it is understood in the Commentaries to the OECD Model Tax Convention on Income and on Capital (hereafter OECD Model[4]. Income derived from technical assistance is not covered by the exemption since the object of this type of contracts is to provide a service and there is not an assignment of technology to the transferee[5]. This is the reason why, according to the Spanish tax administration, income derived from the assembly and installation of new industrial plants is not subject to the partial exemption[6].

According to the regulation of the incentive, in no case the partial exemption shall be applicable to income from licensing (of the use or exploitation of) trademarks, literary, artistic or scientific works, including cinematograph films, these being the intangibles protected under the Spanish Intellectual Property Law[7]. Other assets not eligible for the incentive are:

- personal rights eligible for assignment, such as image rights,
- software, industrial, commercial or scientific equipment, and
- any other right or asset not expressly listed in the Law.

Therefore, where the assigned intangibles include assets not covered by the exemption, the taxpayer must disaggregate the part of the income attributable to those assets, which remains ordinarily (fully) taxed.

2.3.
Qualifying taxpayers

The entity transferring the intangible assets must be the creator of those assets. There may be the case that the entity has hired another entity to carry out the activity resulting in the production of the intangible. However, provided the hiring entity has taken the risk and benefits, together with the supervising direction of that activity, that is considered as the creator of the intangible. Assuming the risk in this type of transaction is thus the key factor in order to be considered as the creator of the intangible.

The licensee must employ the rights to use or exploit the intangibles in an economic activity, *i.e.* the production of goods or the provision of services for the market, including the transferor of the intangibles, with certain limitations (see below).

Finally, the licensee may be resident in Spain or abroad (see however the antiabuse rules below).

2.4.
Accounting, records and consolidation regime

The tax incentive implies that only 50% of the income accrued and booked in the tax year is included in the taxable income, *i.e.* a negative permanent tax adjustment must be done to the accounting income, since this adjustment is not reversed in the future even in the case that the licensor sales the intangibles after enjoying the tax incentive.

The exemption is applicable even where it results in a tax loss, which, according to the general rule, may be carried forward in the following eighteen years.

According to the interpretation of the tax administration**[8]**, the cost of the assigned intangibles includes the R&D expenses incurred in order to obtain the assets, whether they are activated as an immovable asset within the accounting records or not. Thus, the application of the incentive is not subject to the classification as investment or expenses or accounting purposes, *i.e.* it is not needed that the intangible is considered as an immovable asset within the accounting records of the entity. Therefore, if the accounting rules provide that the cost of an intangible should be booked under the profit and loss account (hereafter P&L) as an expense, without being activated as an asset, this would not impede the application of the regime.

However, the intangible must be considered as an asset of the licensor, *i.e.* the licensor must have the juridical and economic property of the intangible. This is the reason why only income from an operating leasing may enjoy the partial exemption and not the income from a financial leasing. In the case of a financial leasing, the transaction would be treated for accounting and tax purposes as an asset sale and not as a temporary transfer or assignment thereof**[9]**.

Where the same assignment contract includes ancillary services, the contract must separatly indicate the consideration for those services, so that the exemption only applies to the income derived from the licensing of the assigned intangibles. This rule is strictly applied by the tax administration, which has disregarded the application of the exemption in cases where the taxpayer has claimed that there was no separation because of reasons of competitiveness and confidentiality and even where the accounting included the different types of income derived from the assignment contract**[10]**.

The entity must keep the necessary accounting records in order to determine the income and expenses (directly and indirectly) related to the licensed assets. The incentive is applicable on the gross income derived from the licensing, disregarding the expenses incurred to obtain such income.

In the case of entities that are taxed under the tax consolidation regime, income and expenses arising from the transfer shall not be subject to elimination in order to determine the taxable amount of the tax group.

2.5.
Limitations on the application of the tax incentive

The reduction does not apply as from the tax period following the one in which the proceeds from the licensing of each asset, which have been entitled to reduction (calculated from the start of the licensing), exceed six times the cost of creation of the asset. If the reduction of the tax base is not applied by the taxpayer in the relevant fiscal year, the incentive is lost for that year, *i.e.* the non deducted amounts may not be carried forward.

The asset may be sold before the reduction reaches the above limit without affecting the application of the incentive.

Example: Company X created an intangible within its R&D department at a cost of EUR 1'000'000. Company X licenses the intangible to Company Y for 15 years in exchange of a royalty of EUR 700'000 per year. Company X activates the intangible as an immovable asset and decides to depreciate it during the licensing period. Further, the costs associated to the intangible for Company X are EUR 10'000 per year. We assume that the taxable year coincides with the calendar year.

Company X: In the tenth year, the income from the licensing (EUR 7'000'000) amounts to (in fact, exceeds) six times the cost of creation of the intangible (EUR 6'000'000). This means that during the first 10 years of the contract the taxable income derived from the license will be EUR 350'000 per year (50% x 700'000). From the following year until the end of the contract, the taxable income will be EUR 700'000 per year. During the whole period of the contract, the deductible expenses will be the depreciation costs (EUR 1'000'000/15=66'666.67 per year), plus the associated costs (EUR 10'000). Provided a corporate income tax rate of 30%, the first 10 years the tax due would be 30% x (350'000 – 76'666.67) = EUR 81'999.99 (82'000).

Company Y will have a tax deductible expense of EUR 700'000 per year during the whole contract.

2.6. Double taxation relief

The income reduction must be taken into account for the purpose of determining the amount of the tax payable when applying the ordinay tax credit to avoid international double taxation. In fact, where the transferee is not resident in Spain and the income has already been taxed abroad it is necessary to calculate the taxable income (based on the net income) in order to estimate the tax credit for the elimination of double taxation**[11]**.

Taking the example in the previous section and provided that the licensee is not resident in Spain and that the foreign jurisdiction taxes the royalties paid to non residents by means of a withholding tax on the gross income of 20%, the result would be as follows.

Company X would be taxed in Spain in the same way as seen in the previous section. However, in order to apply the double taxation relief on the royalties, it is necessary to compare the taxes paid abroad with the taxes to be paid in Spain on those royalties. During the first 10 years, the tax due in Spain is EUR 82'000, and the tax paid abroad is 20% x 700'000 = EUR 140'000. This means that Company X may only benefit of EUR 82'000 as a tax credit for the double taxation during the first 10 years of the contract. During the last five years the tax due in Spain will be 30% x 623'333.33 = EUR 187'000, which means that Company X will deduct from its taxes to be paid in Spain the whole amount of the taxes paid abroad.

2.7. Antiabuse rules

As we have said before, the licensee must use the rights to use and exploit the intangible assets carrying on an economic activity, *i.e.* the use of the assets must result in the production of goods or provision of services to the market (including the licensor). However, where the licensor and licensee are related parties, in order to avoid double dippings, the partial tax exemption will not apply where the delivery of goods or the provision of services arising from the use of the intangible asset generate tax deductible expenses for the licensor.

The resoning behind this rule is that the entity creating the intangibles could directly use them in its own production processes to provide goods or services to the market. However, the income derived from those transactions would not benefit from the incentive. The entity could indirectly use those intangibles by interposing a related entity to which it transferred the intangibles that would be used to provide goods and services which are subsequently acquired by the transferor. However, the incentive is applicable where the intangible is used by the licensee for the delivery of goods or provision of services to other related parties other than the licensor.

According to the tax administration, in the case of the transfer of assets that form a branch of activity which creates intangibles to a new entity, income derived from the assignment of assets to the contributing entity may enjoy the partial exemption, provided that those assets have been created by the new entity after the transfer of the branch of activity. Thus, income derived from the transfer of assets which were part of the branch of activity contributed to the new entity, may not be exempted where they are assigned to the contributing entity**[12]**.

As stated before, the licensee may be resident in Spain or abroad. However, it may not be resident in a country or territory that qualifies as a *"no tax territory"* or as a tax haven. According to Spanish legislation, *"no taxation territories"* are those that do not apply a tax identical or similar to the Spanish Corporate income tax or the Non-Residents income tax. Tax havens are those territories listed in Royal Decree no. 1080/1991, as amended by Royal Decree no. 116/2003. However, any listed country ceases to be considered as a tax haven where there is a double tax treaty with an exchange of information clause (provided that the agreement does not provide for a level of exchange of tax information that is insufficient for the purposes of this provision); or where there is an exchange of information agreement (provided that such agreement provids for a level of exchange of tax information that is sufficient for the purposes of this provision).

2.8. R&D tax credit

The patent box regime is compatible with the R&D tax credit (*i.e.* a credit equal to 25% of R&D expenses incurred in a tax year). If the expenses incurred in a tax year (whether in Spain or another EU Member State) exceed the average amount of expenses incurred in the preceding 2 years, the rate of 25% applies to an amount equal to the average, while a rate of 42%

applies to the excess. In addition, R&D activities may benefit from a credit equal to 17% of the costs relating to payroll and 8% of the costs relating to investments in tangible (other than immovable property) and intangible assets used in the project. This tax credit (together with other applicable credits) is limited to the 25% of the tax due. Unused credits may be carried forward for 15 years.

3.
The Patent Box regime in the Basque Country

Due to historical reasons, the historical territories recognized in the Spanish Constitution, *i.e.* Biscay, Guipuzcoa, Alava and Navarra, may establish their own tax regime, subject to certain limits. Thus, the tax system of the autonomous region of the Basque Country and the autonomous region of Navarra are different from the regime prevailing in the rest of Spain. In the case of the Basque Country, its taxes are governed by the so called "*Economic Agreement*" between the State and the Basque Country. The historical territories that formed the Basque Country (Bizkaia, Guipuzcoa and Alava) have a similar legislation and they have regulated the incentive of the Patent box regime in the same way. Navarra, has also included the same incentive but it has followed the regulation of the rest of Spain. The specific characteristics of the Basque regime are summarized below.

3.1.
The tax incentive

The incentive consists of a partial exemption of the income derived from the licensing of certain intangible rights, which depends on whether the intangibles have been developed by the taxpayer or have been acquired from third parties:

- where the licensed intellectual property (IP) rights have been developed by the licensor, 60% of the income is tax exempt;
- where the licensed IP rights have been acquired from third parties, 30% of the income is tax exempt. The acquisition may have been made from a related party.

One remarkable characteristic of the incentive regime in the Basque Country is that the exemption is not limited by any term or amount. In both cases, the exemption applies to the gross income so the costs and expenses derived from the acquisition or development of the IP rights are fully deductible. The exemption does not apply:

- where the licensing implies a transfer of the IP rights. This means that capital gains from the transfer of IP rights are not covered by the exemption. However, under other articles of the Basque regulations they may be exempt if the gains are reinvested in certain assets;
- where the licensing is not temporary (*i.e.* perpetual licensing are not covered by the exemption).

3.2.
Intangibles covered by the incentive

As a general rule, all rights derived from the IP and Industrial Property of the licensor may benefit from the incentive unless they are expressly excluded. A remarkable difference, as compared to the regime in the rest of Spain, is that trademarks and trade names may benefit from the incentive. This may be an interesting feature of the regime for franchising companies which usually derive their income from licensing their know-how and trademarks.

3.3.
Qualified taxpayers

In order to qualify for the tax incentive, the taxpayers must be:

- entities resident of Spain, provided they are domiciled in the Basque Country, or
- permanent establishments located in the Basque Country, of foreign entities.

Where the turnover of the entity or permanent establishment in the previous year exceeds EUR 7 million, at least 25% of the transactions of the taxpayer must be carried out within the Basque Country.

3.4.
R&D tax credit

As it happens in the rest of Spain, the box incentive is compatible with the R&D tax credit provided by corporate income tax regulations of the historical territories of the Basque Country. The tax credit differs from the tax credit available under general Spanish law and amounts to 30% of the R&D expenses of the tax year, plus an additional 20% of the amount of the expenses that exceeds the average of the previous two years. In some specific cases, an additional 20% credit is available, which makes the total R&D tax credit up to 70% of the expenses.

R&D tax credits can offset the total tax due of the tax year. The excess of the tax credit over the tax due may be carried forward indefinitely.

4.
Possible future amendments of the tax incentive

The Law of Support of the Entrepreneur and his Internationalization, currently under discussion in the Parlament, significantly amends the previous regulation of the tax incentive.

The new regulation increases the partial exemption from 50% to 60% of the income derived from the assets defined above, provided that the licensor has contributed to the creation of the licensed intangibles for at least 25% of their cost. Further, the exemption applies to the net income (*i.e.* taking into account depreciation and other expenses directly related to the intangible) and not to the gross income. In cases of assets not included in the balance sheet of the entity, the exemption applies to 80% of the gross income derived from the licensing.

The new regulation extends the incentive to capital gains derived from the final transfer (*e.g.* sale) of the assets to an unrelated party, whether resident or not resident of Spain. Finally, the new regulation eliminates any time or amount limits on the application of the tax incentive.

Regarding the R&D tax credit, the proposed Law amends the previous regulation in order to allow the deduction of the tax credit even where it exceeds the current limit of 25% of the tax, provided the taxpayer limits the application of the credit to the 80% of its amount. In this case, if the tax credit cannot be applied because it exceeds the tax of the tax year, the taxpayer may ask for the refund of the relevant amount. The maximum tax credit applicable under this regime is subject to certain requirements and is limited to EUR 3 million.

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http://upload.wikimedia.org/wikipedia/commons/3/33/Calle_de_Alcal%C3%A1_(Madrid)_04.jpg [05.10.2013]

http://www.bloomberg.com/image/ip3amb6zqJGo.jpg [05.10.2013]

[1] Law no. 16/2007 introduced Art. 23 of the Corporate Income tax law in its current wording (effective for tax years beginning on or after 1. January 2008).
[2] See Law no. 11/1986 on Patents, in particular Art. 4(1) and Art. 143(1) and (2) thereof.
[3] See Art. 2 of Law no. 20/2003.
[4] According to the Commentary to Art. 12(2) OECD Model (Para. 11), *"In classifying as royalties payments received as consideration for information concerning industrial, commercial or scientific experience, paragraph 2 is referring to the concept of «know-how» [...]. The words «payments [...] for information concerning industrial, commercial or scientific experience» are used in the context of the transfer of certain information that has not been patented and does not generally fall within other categories of intellectual property rights. It generally corresponds to undivulged information of an industrial, commercial or scientific nature arising from previous experience, which has practical application in the operation of an enterprise and from the disclosure of which an economic benefit can be derived. Since the definition relates to information concerning previous experience, the Article does not apply to payments for new information obtained as a result of performing services at the request of the payer".*
[5] There is a consolidated case law from the Spanish Supreme Court on the differences between these two types of contracts. This difference is also recognized in the OECD Model Commentaries where it is said that the need to distinguish between payments for the supply of know-how and payments for the provision of services sometimes gives rise to practical difficulties. The following criteria are relevant for the purpose of drawing such a distinction: *(i)* contracts for the supply of know-how concern information that already exists or concern the supply of that type of information after its development or creation and include specific provisions concerning the confidentiality of that information; *(ii)* in the case of contracts for the provision of services, the supplier undertakes to perform services which may require the use, by that supplier, of special knowledge, skill and expertise but not the transfer of such special knowledge, skill or expertise to the other party (see Para. 11.3 Comm. to Art. 12[2] OECD Model).
[6] Ruling of the General Directorate of Taxes of 11 April 2009.
[7] Royal Legislative Decree no. 1/1996, approving the recast text of the Intellectual Property Law.
[8] Ruling of the General Directorate of Taxes of 19 June 2008.
[9] Rulings of the General Directorate of Taxes of 31 March 2011 and 27 April 2012.
[10] Rulings of the General Directorate of Taxes of 12 February 2009, 26 October 2011 and 7 November 2011.
[11] As a general rule, Spanish tax law provides for the ordinary credit method in order to avoid double taxation.
[12] Rulings of the General Directorate of Taxes of 26 October 2011 and 7 November 2011.