

# IP companies and substance: no-fly zones?

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To achieve a balanced risk-return, substance should be addressed from a corresponding country/OECD perspective

Intellectual Property (“IP”) generally represents between 40 percent and 80 percent of ‘value-add’ of MNEs, therefore making it attractive for MNEs to reduce their global effective tax rates by locating IP in a low tax or tax advantaged jurisdiction. This has created a ‘race to the bottom’ mentality amongst some tax jurisdictions with regard to tax rates and substance thresholds in a bid to attract investments and tax revenue. Fast running out of patience with this opportunistic behaviour, the OECD and many tax authorities are now taking significant steps to address this.<sup>1</sup>

Although many favourable jurisdictions have put substance requirements in place and, under increased pressure from the OECD, are adopting exchange of information rules,<sup>2</sup> substance in light of transfer pricing risk management should more appropriately be addressed by MNEs from a corresponding country/OECD perspective, to achieve a balanced risk-return.

With this balanced approach as the end goal, this paper sets out:

- Key tax reference points in relation to how this will be viewed from a tax residency/CFC perspective; substance requirements in general terms;
- OECD transfer pricing references, which can be regarded as a common denominator when assessing the substance thresholds applied by its members;
- Practical guidance to consider when setting up an IP management company in a favourable tax jurisdiction as well as some practical steps to manage the related tax and transfer pricing risks; and
- Country survey of various popular IP holding host destinations: Hong Kong, Luxembourg, Madeira, Mauritius, Singapore, Switzerland and United Arab Emirates.

## I. Tax references

### A. Effective place of management

Tax authorities will focus in the first place on the effective place of management/the central management and control profile of the company. If the facts and circumstances are at odds with the legal set-up, anti-abuse legislation provides for a substance over form approach. Typical examples are found in Anglo-Saxon cases like the Laerstate BV court case, brought before the UK Tribunal in 2009.<sup>3</sup> In that case the Tribunal determined that since Laerstate BV was both a UK and a Dutch resident, a tiebreaker rule had to be applied. The relevant test under this rule should be the so-called “effective place of management”, being the ultimate test if the incorporation in one country (“the Netherlands”) differs from central management and control in the other country (“UK”). In this case the effective place of management was decided to be in the UK. The Tribunal said that:

“there is no assumption that central management and control must be found where the directors meet. It is entirely a question of fact where it is found. Where a company is managed by its directors in board meetings it will normally be where the board meetings are held. If the management is carried out outside board meetings one needs to ask who is managing the company by making high level decisions and where, even where this is contrary to the company’s constitution.”

The borderline is between directors making the decision and not making any decision at all. As the Tribunal put it: “An objective way of testing whether this is the case is to ask whether the directors have the absolute minimum amount of information that a person would need to have in order to be able to make a decision at all on whether to agree to follow the shareholders wishes or to decide not to sign.”

IP management was not at stake in this case but one could imagine similar case studies relating to central management and control of IP in low-tax jurisdictions.

Another set of anti-abuse rules can be found in Controlled Foreign Corporation (“CFC”) law introduced by major industrial countries whose legislation has outlined the conceptual framework for passive income components allocated and taxed by low-tax countries. For example under UK tax law a CFC is defined as a company, which is a resident outside the UK, while being controlled for 50 percent or more by a UK company. A CFC is subject to a lower level of taxation, being less than three quarters of the corresponding UK tax. A couple of exemptions are foreseen; amongst others motive testing (no tax avoidance reason), acceptable distribution policy and trading companies.

The UK government has presented proposals to change the contents of the present law,<sup>4</sup> focusing on a country-by-country assessment. Further the emphasis will be on ‘artificial diversion’ as opposed to ‘income genuinely earned overseas’.

As an example reference can be made to the Association of British Travel Agents (ABTA) court case, which concentrated on the motive test. This case involved captive insurance companies, set-up by ABTA to cover tour operators and travel agents insurance claims. The motive test focused on tax saving obtained by setting up captive insurance companies in Guernsey versus cash flow and administrative advantages. As motive testing under UK CFC law follows a two-tier threshold, namely a transaction leg and a diversion of profits leg, both legs were considered by the Commissioners.

The payment of premiums was judged as being fully separate from the contributions made by respective members to ABTA and ABTA had a real choice between either meeting claims from an in-house fund or paying premium to a captive. Therefore, the tax deductibility on this basis was not disputed. However in the Commissioners’ view there had clearly been a diversion of profits from the UK, since a UK resident could have earned the profits itself. It was established that one major reason, which was not incidental to the existence of the captives, had been to avoid UK tax.<sup>5</sup>

## B. Substance requirements in IP host countries

Typically in order to legitimately transfer IP to a particular jurisdiction certain threshold substance rules – defined by IP hosting locations – must be satisfied in order to demonstrate that the entity is acting as a profit centre as well as an investment centre. An investment centre only would be entitled to a royalty in relation to the IP, whereas a profit centre may be entitled to other residual profit relating to managing open (trade) positions as a matchmaker. Such requirements generally include:

- payroll requirements/Number of FTEs;
- minimum capital requirements;
- minimum revenue thresholds;
- minimum amount of investments/spending;
- reporting requirements;
- requirements in relation to activities/number of activities; and

- others.

For a detailed overview of these requirements per IP hosting location, please refer to section IV. and Appendix A.

## III. OECD references:

A balanced proposition in the context of a transfer pricing/value chain analysis perspective

The starting point in an assessment of substance is that the intercompany agreement between the parties is the leading indicator. This is reflected in both in Article 9 of the OECD Model Tax Convention as well as Chapter 9 of the OECD Guidelines where the concept of ‘control over risk’ is developed.<sup>6</sup>

### A. Control over risk

In determining an IP holding location, it is critical that the entity deemed to be the owner<sup>7</sup> of the IP is also considered to be in control of the management of the IP and that it has the financial capacity to bear the risk of decisions associated with investing in IP. Without these critical elements being established, tax authorities will raise questions over the commercial substance of the arrangement.

Paragraph 1.49 of the OECD Guidelines is the starting point for this analysis and provides that “In arm’s length transactions it generally makes sense for parties to be allocated a greater share of those risks over which they have relatively more control”.

“Control” in this context is elaborated on in paragraph 9.23 where it is defined as “the capacity to make decisions to take on the risk (decision to put the capital at risk) and decisions on whether and how to manage the risk, internally or using an external provider. This would require the company to have people – employees or directors – who have the authority to, and effectively do, perform these control functions”.

The following sections of Chapter 9 then explain that this does not necessarily require that the function in all cases is actually fully performed by the employees or directors, as long as they are able to assess the performance of the outsourced function on a day-to-day basis. Failure to demonstrate this may lead to a tax administration challenging the arm’s length nature of such a risk allocation.

An example provided in paragraph 9.26 OECD Guidelines is the following.

A principal hires a contract researcher to perform research on its behalf, with the principal owning the outcome of the research and the contract researcher being remunerated irrespective of whether the research is successful.

“Although the day-to-day research would be carried on by the scientific personnel of the contract researcher, the principal would be expected to make a number of relevant decisions in order to control its risk, such as: the decision to hire (or terminate the contract with) that particular contract researcher, the decision of the type of research that should be carried out and objectives assigned to it, and the decision of the budget allocated to the contract researcher. Moreover, the contract researcher would generally be required to report back to the principal on a regular basis, e.g. at predetermined milestones. The principal would be expected to be able to assess the outcome of the research activities. The contract researcher’s own operational risk, e.g. the risk of losing a client or of

suffering a penalty in case of negligence, is distinct from the failure risk borne by the principal.”

A related aspect is whether the risk bearer has the financial capacity to bear the risk in question. Paragraph 9.29 OECD Guidelines explains that

“where risk is contractually assigned to a party (hereafter “the transferee”) that does not have, at the time when the contract is entered into, the financial capacity to assume it. . . doubts may arise as to whether the risk would be assigned to this party at arm’s length.”

Another example is provided in paragraph 9.31 of the OECD Guidelines:

“Assume that Company A bears product liability towards customers and enters into a contract with Company B according to which the latter will reimburse A for any claim that A may suffer in relation to such liability. The risk is contractually transferred from A to B. Assume now that, at the time when the contract is entered into, Company B does not have the financial capacity to assume the risk, i.e. it is anticipated that B will not have the capacity to reimburse A, should a claim arise, and also does not put in place a mechanism to cover the risk in case it materialises. Depending on the facts and circumstances of the case, this may cause A to effectively bear the costs of the product liability risk materialising, in which case the transfer of risk from A to B would not be effective. Alternatively, it may be that the parent company of B or another party will cover the claim that A has on B, in which case the transfer of risk away from A would be effective (although the claim would not be reimbursed by B).”

In such a case it would be difficult for a tax authority to accept that there was a valid transfer of risk from Company A to Company B and the commensurate allocation of profit for such activity/risk is unlikely to be accepted.

The position of the OECD in relation to allocation of risk has been mirrored by tax authorities to date in their own local business restructuring rules. For example: paragraphs 103 – 108 of *TR 2011/1 Income tax: application of the transfer pricing provisions to business restructuring by multinational enterprises*, issued by the Australian Taxation Office.

Failing to meet substance requirements is, according to the OECD, one of the exceptional factors which may allow a tax administration not to recognise the parties’ characterisation or structuring of a transaction or arrangement. See paragraphs 9.168 to 9.170 OECD Guidelines below.

9.168 Paragraphs 1.64-1.69 explicitly limit the non-recognition of the actual transaction or arrangement to exceptional cases. This indicates that the non-recognition of a transaction is not the norm but an exception to the general principle that a tax administration’s examination of a controlled transaction ordinarily should be based on the transaction actually undertaken by the associated enterprises as it has been structured by them.<sup>8</sup> The word “exceptional” in this context is similar in meaning to “rare” or “unusual”. It reflects that in most cases it is expected that the arm’s length principle under Article 9 can be satisfied by determining arm’s length pricing for the arrangement as actually undertaken and structured.

9.169 In accordance with paragraphs 1.64-1.69, it may exceptionally be appropriate for a tax administration not to recognise the parties’ characterisation or structuring of a transaction or arrangement where, having regard to all of the facts and circumstances, it concludes that:

- The economic substance of the transaction or arrangement differs from its form (Section C.2); or
- Independent enterprises in comparable circumstances would not have characterised or structured the transaction or arrangement as the associated enterprises have, and arm’s length pricing cannot reliably be determined for that transaction or arrangement (Sections C.3 and C.4).

Both of these situations are instances where the parties’ characterisation or structuring of the transaction or arrangement is regarded as the result of conditions that would not have existed between independent enterprises (see paragraph 1.66).

In paragraph 9.170 the OECD provides guidance on the determination of the substance of a transaction or an arrangement:

9.170 The economic substance of a transaction or arrangement is determined by examining all of the facts and circumstances, such as the economic and commercial context of the transaction or arrangement, its object and effect from a practical and business point of view, and the conduct of the parties, including the functions performed, assets used and risks assumed by them.

In paragraph D.2 of chapter 9 of the OECD Guidelines an example on “brand names” is given concerning the transfer of valuable intangibles to a shell company and the consequences of the recharacterisation.

9.190 An MNE manufactures and distributes products the value of which is not determined by the technical features of the products, but rather by the brand name and exposure. The MNE wants to differentiate itself from its competitors through the development of brand names with great value, by implementing a carefully developed and expensive marketing strategy. The brand names are owned by Company A in Country A. The development, maintenance and execution of a worldwide marketing strategy are the main value driver of the MNE, performed by 125 employees at Company A’s head office. The value of the brand names results in a high consumer price for the products. Company A’s head office also provides central services for the group affiliates (e.g. human resource management, legal, tax). The products are manufactured by affiliates under contract manufacturing arrangements with Company A. They are distributed by affiliates who purchase them from Company A. The profits derived by Company A after having allocated an arm’s length remuneration to the contract manufacturers and distributors are considered to be the remuneration for the intangibles, marketing activities and central services of Company A.

9.191 Then a restructuring takes place. The brand names are transferred by Company A to a newly set up affiliate, Company Z in Country Z in exchange for a lump sum payment. After the restructuring, Company A is remunerated on a cost plus basis for the services it performs for Company Z and the rest of the group. The remuneration of the affiliated contract manufacturers and distributors remains the same. The excess profits after remuneration of the contract manufacturers, distributors, and Company A head office services are paid to Company Z. From the comparability analysis the following conclusions can be drawn:

- There is no reliable evidence from uncontrolled comparable transactions of the ownership of brand names and attached risks being attributed between independent enterprises in the same manner as in the controlled transaction between Company A and Company Z.
- Company Z is managed by a local trust company. It does not have people (employees or directors) who have the authority to and effectively do perform control functions in relation to the risks associated with the strategic development of the brand names. It also does not have the financial capacity to assume these risks.
- High ranking officials from Company A’s head office fly to Country Z once a year to formally validate the strategic decisions necessary to operate the company.

These decisions are prepared by Company A's head office in Country A before the meetings take place in Country Z. The MNE considers that these activities are service activities performed by Company A's head office for Z. These strategic decision-making activities are remunerated at cost plus in the same way as the central services are remunerated (e.g. human resource management, legal, tax).

- The development, maintenance and execution of the worldwide marketing strategy are still performed by the same employees of Company A's head office and remunerated on a cost plus basis. Company A does not have a contractual incentive to maximise the value of the brand names or the market share because it is remunerated on a cost plus basis.

9.192 A full consideration of all of the facts and circumstances warrants a conclusion that the economic substance of the arrangement differs from its form. In particular, the facts indicate that Company Z has no real capability to assume the risks it is allocated under the arrangement as characterised and structured by the parties. Furthermore, there is no evidence of any business reasons for the arrangement. In such a case paragraph 1.65 allows a tax administration to not recognise the structure adopted by the parties.<sup>9</sup>

On another note, demonstrating genuine substance in an IP management company in a favourable tax jurisdiction will in most jurisdictions also be a key test for determining 'beneficial ownership'.

## B. Significant people functions (SPFs)<sup>10</sup>

The concept of SPFs was introduced by the OECD in respect of the attribution of profits between head offices and branches, i.e. Article 7 of the Model Tax Convention. The premise is that the assets and risks in a value chain are allocated to the person/location performing the activities associated with the management of those assets and decision making on the related risks. It provides a framework for attributing assets and risks between a single legal entity, i.e. head office and branch, but the principle also has broader application in providing a threshold test for measuring substance within a group, that may not necessarily be consistent with the legal reality.

In a recent Decree issued by the Dutch Minister of Finance (Besluit Staatssecretaris van Financiën van 15 januari 2011, IFZ2010/457M, Stcrt. 2011, 1375), which was induced by the recent publication of the OECD report on the attribution of profits to permanent establishments, the revision of the commentary to article 7 of the OECD Model Tax Convention in 2008 and the new article 7 OECD Model Tax Convention (including commentary), the Minister provides us with an interesting elaboration on how he interprets both the concept of 'SPF' and 'control over risk' and how they relate to each other.

His analysis is founded on the premise that the risk allocation between related parties (article 9) should as much as possible correspond to the risk allocation between head office and branch (article 7). In his analysis he comes to the conclusion that the SPF are the functions which are connected to the active decision making in relation to the assumption and daily management of risks with regards to the activities of the corporation. According to the PE-Report these are the 'day-to-day' activities which have decisive influence on the management of the corporation.

By stating paragraph 1.49 of the OECD Guidelines: 'In arm's length transactions it generally makes sense

for parties to be allocated a greater share of those risks over which they have relatively more control', the Minister deduces that the concept of 'control' is a very important factor for the risk allocation as generally constituted between unrelated parties.

The Minister of Finance concludes his elucidation by formulating a cautious relation between the two concepts and states that the activities of parties who exercise control could have a slightly different character to the activities of parties performing the SPF, as the former may be more remote from the 'day-to-day' activities. See paragraph 9.25 OECD Guidelines for an example illustrating that an investor who gives to another person the authority to make all the day-to-day investment decisions does not necessarily transfer the investment risk to the person making these day-to-day decisions.

Whilst acknowledging that these two concepts may cause a different interpretation in their application, the Minister of Finance, for reasons of aligning both concepts, realises that there is a considerable overlap in the application of both concepts and that they are comparable.

## C. E-commerce

Guidance on the use of tax havens in the context of e-commerce is provided in the OECD Tax Policy Study: *E-commerce: Transfer Pricing and Business Profits Taxation*.<sup>11</sup>

Paragraph 51 provides that "The use of tax havens may increase because of the facility provided by the Internet to integrate functions/people located wherever business chooses". This is one example of the concern of tax authorities that the emergence of new intangibles such as those based around the internet can give rise to a greater tendency to use tax havens or tax advantaged jurisdictions as a location for such IP.

It is also identified in Paragraph 53 that "some tax administrations have attempted to counter the effect of the use of tax havens by introducing controlled foreign corporation rules. Any increased use of tax havens as a result of electronic trading may therefore lead to an increase in the need for and the number of countries, having such rules. The scope of 'active business' income that is subject to tax under these rules may also be extended."<sup>12</sup>

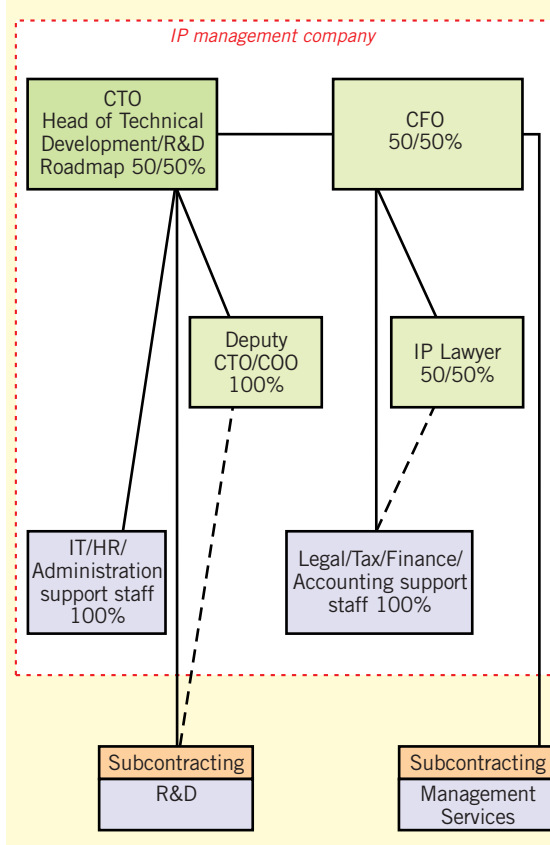
## D. An illustration

The following provides some guidance on the type of substance from a payroll, operational and decision viewpoint that may be considered appropriate from an OECD perspective. The chart represents an IP management company of a typical technology corporation, acting as an investment centre.

Some useful guidance in relation to the payroll, operational and decision making authority of the above FTEs could include:

- To be on the safe side from a corresponding country substance point of view (PE, CFC, etc.), the key decision making person in relation to the IP, e.g. Chief Technical Officer/Chief Scientific Officer (CTO/CSO) for technology based IP, should be the employee or Director of the IP company and should preferably be 100 percent (but at least 50 percent) on the payroll of the IP company.

**Chart: Representation of an IP management company**



- In the case of a 50 percent split payroll, in general it is to be recommended that the Director should decide as chairman of a technical/scientific committee on the IP/R&D roadmap and be assisted by a deputy Director (100 percent payroll), who under clear instructions/guidelines from the Director is managing the day-to-day business in the IP company;
- The Director should be assisted by one or more of the following (at least 50 percent on the payroll of the IP company):
  - Chief Financial Officer (CFO) – responsible for decisions relating to finance/financial performance of the company and thereby supported by an IP lawyer
  - Chief Legal Officer (CLO) – responsible for decisions relating to legal issues relating to the IP and supported by an IP lawyer, responsible for IP-related legal issues (e.g. registration, protection, exploitation).
- The Director will manage in his capacity as director/employee of the IP company any subcontracted services; and

- Support staff (100 percent payroll) should be at the disposal of the IP company for managing the day-to-day activities of the IP company (e.g. admin, finance, accounting, legal).

**E. Practical tips on physical presence of IP company's management team**

Through involvement in numerous restructuring projects for MNCs, seeking to centralise IP in key locations, the following 'rules of thumb' have emerged:

- The Director preferably makes decisions on behalf of the IP company when physically present in the country of residence of the IP company; business travel as usual should not interrupt decision making on behalf of and for the risk and account of the IP company;
- CFO should make decisions on behalf of the IP company while physically being present in the country of residence of the IP company (except for registration of IP in other countries). However, when travelling or working abroad they can make a decision on behalf of the IP company.
- Keep track of physical presence relating to above mentioned decisions and keep records of the decision making process and presence (minutes of (board)meetings, signed documents, travel documents, hotel bills and phone bills).
- IP registration/patent applications must be signed in the name of the IP company. Governing law and physical presence will depend on the requirements of the registration office; and
- All other contracts (e.g. IP policy, group wide pricing policy, NDAs, subcontracting agreements) must be in the name of the IP company and signed when physically present in the IP company's country or alternatively – within the IP Policy and guidelines issued by the IP company – be digitally confirmed irrespective of the location of the decision maker.
- Key decision makers (i.e. Director, CFO and IP Lawyer) do not make decisions which are legally binding on the IP company, when they are not physically present in the country of residence of the IP company, except when compliant with a written authorisation process;

**IV. Favourable IP locations**

Table 1 visualises some of the more popular IP holding locations and their key attributes as well as the substance requirements both from the country itself as from the perspective of the countries typically utilising such regimes.

**Table 1: favourable IP locations**

Jurisdiction	IP regime	Tax rate	Substance requirements	Key countries utilising regime
Dubai	None	0 %	Not defined	Unknown

**Table 1: favourable IP locations – Continued**

<b>Jurisdiction</b>	<b>IP regime</b>	<b>Tax rate</b>	<b>Substance requirements</b>	<b>Key countries utilising regime</b>
Hong Kong	No specific regime	16.5 % (onshore) or 0 % (offshore)	Not clearly defined in Hong Kong. From China perspective, need to demonstrate that any offshore holding location has a "commercial nature"	China, US, Europe
Luxembourg	IP tax regime provides exemption of 80 % of the net positive income from the use or the right to use certain IP rights; other benefits defined in Appendix A	20 % of net income from IP taxed at 28.59 % (effective tax burden of roughly 5.72 %)	Various requirements to benefit from IP tax regime, including that the IP must have been created or acquired after 31 December 2007; Substance requirements not defined	EU countries
Madeira	None	4 % until 2012 and 5 % for 2013 to 2020	At least one employee/director on payroll; if less than 6 employees, investment of at least EUR 75,000 in Madeira	EU Countries
Mauritius	Global Business Company 1 (GBC1) structure and a Regional Headquarter Scheme (RHS)	15 % (general corporate tax rate). GBC1 - 3 % and RHS 0 % for first 10 years	None	South Africa, India
Singapore	Development and Expansion Incentive offering a reduced tax rate of 5 % or 10 % on incremental income; Writing down allowances for legal and economic transfer of IP over 5 years	17 % (reduced rates of 5 % or 10 % under various incentives)	Strict requirement for incentives regarding business spending, employment and IP valuation	All, China, Indonesia, India
Switzerland	May be eligible for special tax status at Canton Level	See Appendix A	Some treaty abuse rules in place (refer Appendix A) - exempt if company employs at least one qualified FTE engaged in activities beyond the mere passive administration of the company assets	Multinationals which are not subject to CFC legislation in their home country or where CFC legislation allows these multinationals to defer income tax over earnings realized by their wholly owned low taxed Swiss resident

Further details on the above criteria and substance requirements are contained in Appendix A.

## V. Conclusion and recommendations

The ‘race to the bottom’ by certain governments, has tempted some multinationals to allocate their IP - generally representing between 40 percent and 80 percent of ‘value-add’ – to these tax favourable locations.

The majority of OECD countries have been supporting initiatives to put a stop to some of the opportunistic behaviour.<sup>13</sup>

Although many favourable jurisdictions have put substance requirements in place and, under increased pressure from the OECD, are adopting exchange of information rules,<sup>14</sup> substance in light of transfer pricing risk management should more appropriately be addressed by MNEs from a corresponding country/OECD perspective, to achieve a balanced risk-return.

With this balanced approach as the end goal, this paper has addressed:

- Key tax reference points: tax authorities have introduced various ways to counteract opportunistic behaviour of IP companies, e.g. by introduction of strict substance requirements and/or CFC legislation.
- OECD transfer pricing references: corresponding tax authorities, through the publication of the ‘control over risk’ and the ‘significant people function’ concepts, are now allowed to take a more economic view on ‘substance requirements’ rather than purely looking at the relevant intercompany legal agreements. A more economic ‘risk/reward’ balance is being introduced, i.e. no functions/no risk attributable to the IP companies can seriously undermine the positioning of ‘intangibles’ in the statutory/tax books of IP companies.
- The article has provided – through OECD and specific cases – a practical guidance to consider ‘substance’ when setting up an IP management company in a favourable tax jurisdiction. An active management role and responsibility at the level of the IP companies cannot be left out when creating a sustainable and tax defensible set up of IP companies.
- A country survey – United Arab Emirates, Hong Kong, Luxembourg, Madeira, Mauritius, Singapore and Switzerland – is also putting the local ‘substance’ requirements in the context of the perspective taken by OECD and other countries with less favourable tax rates.

IP Companies require a minimum level of ‘substance’ to anchor their IP ownership and corresponding royalty flows in that country. The interpretation of ‘substance’ has been moving from a pure ‘legal interpretation’ to a more ‘substance over form’ interpretation.

## Appendix A

### A. Hong Kong

#### What is the IP holding regime?

Hong Kong does not have any specific IP holding regime in place. The attractiveness of Hong Kong as an IP holding location is derived primarily from the low tax corporate tax rate, strong infrastructure and source-based taxation system.

Recent legislative proposals have been introduced to encourage Hong Kong’s status as an IP centre, with a five year amortisation allowed for the purchase of copyrights, registered designs and registered trademarks. Valuation and legal costs associated with the purchase will be deductible, and furthermore the requirement that the IP is for “use in Hong Kong” has been removed.

Whilst Hong Kong does not tax “offshore” income, in the case of IP holding companies, the view of the courts is often that if the decisions relating to the transfer and management of IP are made in Hong Kong, then the resulting income will be considered to have a Hong Kong source and be taxable in Hong Kong.

#### What tax rate is applicable?

Income derived from the active management of IP, assuming it is considered to have a Hong Kong source, will be taxed at the normal corporate tax rate of 16.5 percent.

#### Which countries generally take advantage of this regime?

A significant amount of investment into China from all over the world is channelled through Hong Kong. The geographic proximity, the well developed infrastructure and political/economic stability, as well as the low tax rate and source-based tax system, have made it an attractive destination for an intermediate holding company.

This has taken two forms:

1. Hong Kong is often used as a regional headquarters for MNCs to actively manage their operations in China and the region and can include substantial FTEs involved in sourcing/procurement, finance, R&D, logistics etc;
2. At the other end of the spectrum, Hong Kong has historically been used to “book” profits of MNCs without due regard to commercial substance, transfer pricing and tax laws.

#### What are the substance requirements to demonstrate the ownership of IP and entrepreneurial activity?

Various legislative developments in China including:

- Circular 2 (Implementation Measures for Special Tax Adjustments);
- Circular 82 (Recognition of Overseas Incorporated Domestically Controlled Enterprises as PRC Residents Based on the Effective Management Criteria); and

- Circular 601 (Notice Regarding Interpretation and Recognition of “Beneficial Owner” Under Tax Treaties)

have sent a very clear signal that China is conscious of the use of offshore jurisdictions in relation to investments into or out of China. Detailed disclosures on the tax return enable such payments to be easily detected by the Chinese tax authorities and investigated further.

The crux of these developments relates to demonstrating that the structure has a “commercial nature” which is another term for substance. Information to be provided includes notarisation of offshore registration, office lease, employment certificate and proof of tax resident status. This would indicate that the pure offshore “tax haven” countries are less likely to be tolerated while presence in Hong Kong, if supported by genuine substance and decision making, will be respected.<sup>15</sup>

## B. Luxembourg

### What is the IP holding regime?

Luxembourg IP Tax Law<sup>16</sup> offers an attractive regime for the holding of intellectual property through a Luxembourg company certainly taking into account that Luxembourg has an extensive tax treaty network and that Luxembourg companies can benefit from the EU directive on royalty payments.

The Luxembourg IP regime is applicable to IP rights (patents, trademarks, design, models, copyright related to software and domain names) acquired or created after December 31, 2007. The main benefits of the IP tax regime are the following:

- exemption of 80 percent of the net positive income from the use or the right to use certain IP rights;
- notional deduction equal to 80 percent of a deemed net income applicable for self-developed patents used by the taxpayer in its own activity;
- exemption of 80 percent of the net capital gain realised upon disposal of qualifying IP; and
- 100 percent exemption from net wealth tax on qualifying IP rights.

### What tax rate is applicable?

The intellectual property and R&D regime allows Luxembourg IP holding companies to get around 5.72 percent effective tax rate on IP income and offers an attractive R&D incentive. Only 20 percent from the net income out of IP will be taxed at 28.59 percent which provides an effective tax burden of roughly 5.72 percent.

### Which countries generally take advantage of this regime?

Base on its geographical location (at the heart of Europe), Luxembourg has long a established reputation as a favoured location for a wide range of international companies with diverse business models from a variety of sectors and offers one of the most attractive frameworks for R&D and Intellectual Property in Europe.

Apart from the specific IP exemption regime, companies, private research organisations or public organisations can therefore benefit, amongst others, from incentives ranging from 25 percent to 100 percent (generally subsidies or interest-rate subsidies) to finance an R&D project.

As a result, it is reasonable to conclude that European and non-European companies use or make use of the Luxembourg IP regime for its royalty flows across Europe and further jurisdictions where Luxembourg has a double tax treaty convention in force.

### What are the substance requirements to demonstrate the ownership of IP and entrepreneurial activity?

According to the Luxembourg IP regime, in order to get access to the IP regime the following conditions need to be fulfilled:

- the IP must have been created or acquired after December 31, 2007;
- the expenses in connection with the IP must be recorded as an asset in the balance sheet for the first book year for which the application of the regime is demanded; and
- the IP may not have been acquired from a person who is qualified as an “affiliated company”.

The concept of affiliated company has been clarified by the draft law. Company X is considered an affiliated company to company Y if:

1. Company X directly holds a participation of 10 percent in the share capital of Y;
2. Company Y directly holds a participation of 10 percent in the capital of X; or
3. 10 percent or more of the share capital of X and Y are directly held by the same company.

### What other restrictions are in place?

Substance requirements in line with Limitations of Benefits (LOB) (insofar “active business”/ “active management” is required to get through LOB) clauses provided in double tax treaty conventions in force, i.e. LUX-US and OECD Transfer Pricing Guidelines when applicable.

## C. Madeira

### What is the IP holding regime?

There is no special IP holding regime in Madeira. The profits derived from the IP will be included in the taxable basis of the Madeira Company and taxed applying the reduced tax rates.

As Portuguese Tax Treaties are applicable to Madeira companies, royalties may benefit from a reduced withholding tax.

### What tax rate is applicable?

Four percent until 2012 and five percent for 2013 to 2020.

The reduced rates are limited to the following thresholds, depending on the number of employees (or directors):

1. €2 million of taxable income – one or two employees

2. €2.6 million of taxable income – three to five employees;
3. €16 million of taxable income - six to 30 employees;
4. €26 million of taxable income - 31 to 50 employees;
5. €40 million of taxable income - 51 to 100 employees; and
6. €150 million of taxable income - more than 100 employees.

If the taxable income is greater than the limit, the excess will be taxed at a rate of 20 percent.

#### **Which countries generally take advantage of this regime?**

EU countries, particularly Spain. Nevertheless, some countries try to discourage the attractiveness of Madeira to their own residents by other indirect means. For example, Spain has approved a reduction of 50 percent on the taxable base of the incomes derived from the transfer of the right to use or exploitation of certain intangible assets.

#### **What are the substance requirements to demonstrate the ownership of IP and entrepreneurial activity?**

Companies that wish to benefit from the reduced rates must start their activities within a deadline of six months in the case of international services, and within one year in the case of industrial or shipping activities, effective from the date of licensing. Furthermore, they must comply with one of the following requirements of eligibility:

The company must have on its payroll (full-time or part-time) at least one employee or director.

If the company has less than 6 employees (or directors), during the first two years of activities, it has to invest a minimum of EUR 75,000 on the acquisition of tangible or intangible fixed assets located in Madeira.

### **D. Mauritius**

#### **What is the IP holding regime?**

There are no formal incentive regimes for IP holding companies. However, with its Global Business Company 1 (GBC1) structure and a Regional Headquarter Scheme (RHS) attracting income tax at three percent and zero percent for the first 10 years respectively, Mauritius has attracted a number of Multinationals to house their regional headquarters.

#### **What tax rate is applicable?**

The general corporate tax rate applicable is 15 percent. However, under the GBC1 and the RHS corporate income tax is three percent and zero percent for the first 10 years respectively. There is no capital gains tax in Mauritius and Mauritius does not have any exchange controls. This could be one of the factors to be considered while deciding to set up an IP holding Company in Mauritius. The complexities of IP protection laws and the treaty network also play a determining role.

### **RHS**

In March 2000, Mauritius introduced a Regional Headquarter Scheme (RHS) which offers a tax holiday for 10 years on foreign sourced income, no exchange controls, no withholding taxes on dividends and interest, no capital gains tax and expat benefits.

Participation in the RHS is restricted to a company being registered in Mauritius with a minimum capital of 1 Million MRs (US\$ 34k) and providing at least two types of headquarter services to any related corporation in any other country which belongs to any regional organisation of which Mauritius is also a member.

Currently, Mauritius is a member of the Southern African Development Community (SADC), the Common Market for Eastern and Southern Africa (COMESA) and the Indian Ocean Rim Association for Regional Co-Operation (IOR-ARC).

The list of headquarter services that may be offered by the regional headquarter company are wide and includes research and development, business planning and control, procurement of raw materials and components, treasury management, data processing and logistical etc.

Because Mauritius is considered to have a stable political system with a strong presence of international banks, the RHS is an attractive alternative.

#### **Which countries generally take advantage of this regime?**

##### **■ India:**

In accordance with the India-Mauritius Treaty, gains arising from the movable property are taxed in the country of source (India) only if it forms part of the business property of the permanent establishment. This generally favours to use Mauritius as an intermediate holding company jurisdiction for holding of assets. As per the Indian domestic tax provisions, capital gains tax is payable on the transfer of assets located in India. It may be further noted that Indian jurisprudence provides that “rights” generally constitutes a capital asset. Accordingly the transfer of “rights” located in India would trigger taxation of the income as capital gains. In the absence of a permanent establishment or fixed base in India, a Mauritius tax resident would not be liable to tax in India, on the sale of moveable property situated in India.

#### *What are the substance requirements to demonstrate the ownership of IP and entrepreneurial activity?*

There is no specific guidance. However, Indian Courts have been emphasising the need for commercial substance to be considered in structures. To illustrate:

- In the case of Vodafone – Hutchinson, the High Court held that the Indian Revenue was well within its jurisdiction to examine the taxability of offshore transactions that enabled Vodafone International Holdings, a Dutch company, to acquire control in the Indian telecom business of Hutchison Telecommunications International Ltd., Cayman Islands. It held that the transaction involved a transfer of

rights and entitlements based in India and should not be construed as mere transfer of shares of a foreign company.

- The Indian Authority for Advance Ruling (AAR) has, in the case of Foster Australia Ltd, held that the commercial exploitation of the trade marks aided by the marketing and advertising efforts of Foster's India resulted in creation of valuable intangible asset in India. AAR concluded that the trademark was located in India at the time of transfer and incidence of capital gains would arise in India, even if the mark was not registered in India.
- In the case of Maruti Suzuki, the Delhi High Court has provided guidance on the circumstances under which a legal owner of a marketing intangible, such as a trademark or a brand name, should compensate a licensed affiliate for its promotional efforts that has the effect of enhancing the value of the intangible. The Court held that if the advertising, marketing and promotion expenses, incurred by the Indian affiliate using the trademark/brand name, are more than what a similarly situated and comparable enterprise would have incurred, the owner of the intangible needs to suitably compensate the Indian affiliate for the advantage obtained by it in the form of brand building and increased awareness of the intangible.

It should also be noted that the New Direct Tax Code (DTC) which is to come into effect from April 1, 2012 contains General Anti Avoidance Rules (GAAR). Broadly, the GAAR is a mechanism to prevent taxpayers from entering into any arrangement, the main purpose of which is tax avoidance. The GAAR could be triggered in circumstances where an arrangement has been entered into or is carried on in a manner not normally used for bona fide business purposes, is not at arm's length, abuses the provisions of the DTC or lacks adequate "economic" substance. To prevent the applicability of the GAAR, the taxpayer would be obliged to demonstrate that tax avoidance was not the main purpose of the arrangement under scrutiny. Further, if the GAAR is triggered, it is proposed that the tax authorities would be empowered to disregard the form of the transaction and determine the tax consequences for the taxpayer as if the arrangement had not been entered into. In such cases, the taxpayer would not be eligible to claim benefits under an applicable tax treaty and, hence, would be subject to tax in India based on provisions of the DTC.

#### ■ **South Africa**

*Exchange Control Regulation:* The South African Reserve Bank has to specifically approve any export of any South African owned IP. Only in very exceptional cases and where there are compelling economic reasons that affect the competitiveness of South African companies, only then will South African owned IP be allowed to be exported offshore.

*Controlled Foreign Company Tax Rules:* A CFC is any foreign company which South African residents control either directly or indirectly by holding or exercising more than 50 percent of the participation rights or voting rights respectively.

*Risk Allocation:* South Africa has specific domestic CFC rules with regard to IP. Only royalty income arising from IP which is regularly created, developed or substantially improved in the normal course

of business of that CFC will be exempt from income tax in South Africa. In all other cases, any royalty income earned by any CFC will be subject to income tax in South Africa irrespective of the fact that the CFC may have put its own capital at risk in respect of the IP.

*Payroll:* In order to justify the economic substance of a CFC, one of the requirements is that the CFC or any other company located in the same country and in the same group of companies as the CFC employ on site suitable managerial and operational employees to conduct the primary operations of the business.

## **E. Singapore**

### **What is the IP holding regime?**

The Economic Development Board (EDB) of Singapore offers various tax incentives for MNCs to establish a significant presence in the country. Each of these is based around very transparent guidelines regarding the economic substance of the operations in order to ensure that employment and other economic benefits flow from the incentives in addition to the tax revenue.

For IP these include:

- Development and Expansion Incentive – offering a reduced tax rate of five percent or 10 percent on incremental income from qualifying activities (including acting as an IP hub);
- Writing down allowances for legal and economic transfer of IP over five years;
- Writing down allowances over one year for R&D cost sharing payments;
- Enhanced tax deduction for R&D expenses; and
- Single tax deduction for patenting costs.

### **What tax rate is applicable?**

In the case of the Development and Expansion Incentive five percent or 10 percent is applicable (compared to headline corporate tax rate of 17 percent)

### **Which countries generally take advantage of this regime?**

As the regime is based on economic substance and Singapore is not generally considered as a tax haven, investment and IP movement is generally not constrained by anti-avoidance rules and therefore is not country specific. MNCs from all over the world choose to locate regional or global headquarters in Singapore and in most cases there is sufficient evidence to support a position that this is driven by commercial and operation reasons as opposed to tax avoidance.

### **What are the substance requirements to demonstrate the ownership of IP and entrepreneurial activity?**

Eligibility for the above mentioned incentive is based on a strict application process and adherence to a long list of requirements regarding business spending and employment. To extend the scheme beyond a specified period, criteria such as transferring a minimal value of IP into Singapore can be applied.

## F. Switzerland

### What is the IP holding regime?

In general, Swiss corporations are subject to the Swiss Federal income tax and to the Cantonal/Municipal

income tax. Swiss companies that hold IP may benefit from a special tax status, if they meet certain criteria. Special tax status might be applicable at Cantonal/Municipal level and in some instances at Federal level. A Swiss branch of a foreign corporation may also benefit from certain privileges, as detailed in Table 2:

**Table 2: Possible privileges**

Special tax status at the Cantonal/Municipal level only (holding companies privilege and administrative company privilege)	
Holding company privilege	In order to qualify for the holding privilege: At least two third of asset or income of the company are derived from participations; A business activity is not permitted; Activities of the Swiss company should be limited to administration of the participations; Holding can own IP and derive intra-group license income in certain cases.
Administrative company privilege	In order to qualify for the administrative company privilege: Swiss company should operate based on the key instructions from abroad, i.e. the strategic decisions should not be taken in Switzerland and the activities of the Swiss company should be of mere administrative nature; 80 % of acquired supply and 80 % of derived income should be from foreign sources
Special tax status at the Federal and Cantonal/Municipal level	
Principal company tax status	Swiss companies involved in intra-group production and sales activities abroad may be able to claim that part of the sales profits is exempt.

The applicable tax rates are shown in Table 3.

**Table 3: Swiss tax rates**

Holding company privilege	Effective tax rate: 7.8 %
Administrative company privilege	Exemption of a portion of the income derived by a Swiss company from tax in Switzerland resulting in the combined effective maximum Federal/Cantonal/Municipal tax rate of approx. 9 % - 11 % on profit before tax.
Principal company	Exemption of a portion of the income derived by a Swiss company from tax in Switzerland through a deemed permanent establishment abroad for part of the distribution related income resulting in the combined effective maximum Federal/Cantonal/Municipal tax rate of approx. 5 % - 8 % on profit before tax, depending on the specific circumstances.
Switzerland does not levy royalty withholding tax and has an extensive network of double taxation treaties, in which the local applicable withholding tax is often reduced on payments to Switzerland. Also the interest and royalty EU Directive applies to payments to Swiss companies.	

Also various arrangements are possible through a Swiss IP branch of a foreign entity.

### Multinationals based in which countries generally take advantage of this regime?

Multinationals which are not subject to CFC legislation in their home country or where CFC legislation allows these multi-nationals to defer income tax over earnings realised by their wholly-owned low taxed Swiss resident. For example, principal companies are

set up by US multinationals to defer US taxation over earnings realised by the Swiss principal. This income may also include IP related income.

### What other restrictions are in place?

The Swiss-internal treaty abuse rules have traditionally put a limit on the level of dividend distributions made by a Swiss company.

Effective as of August 2010, the Swiss Federal tax authorities issued new guidelines on the interpreta-

tion of the Swiss internal treaty abuse provisions. The Swiss internal treaty abuse rules do not apply to an “active” company or to a pure holding company which now also includes the IP holding companies provided the company employs at least one qualified full time equivalent (FTE), engaged in activities beyond the mere passive administration of the company assets.

## G. United Arab Emirates

### What is the IP holding regime?

There are no formal incentive regimes for IP holding companies. One can incorporate a company in the UAE that can hold intangible property. Whilst there are no incentives, the fact remains that UAE is a tax free environment and any income arising out of transfer or licensing of IP is tax free in the UAE.

### What tax rate is applicable?

There are no taxes on income except for foreign banks and oil and gas producing companies. There is no capital gains tax in UAE.

### Which countries generally take advantage of this regime?

Historically, it has been difficult to incorporate a company to own IP in the UAE; however, the commercial and IP laws have evolved in recent years to an extent that now makes the UAE an interesting location to hold IP, specifically from a tax perspective – particularly given the extensive tax treaty network that can be accessed. Since many of the laws are relatively new, the international community has not yet tested this opportunity to a large extent. The UAE is an interesting option for those considering relocating their IP, particularly for their licensing activities in Asia, Middle East, and some parts of Africa.

### What are the substance requirements to demonstrate the ownership of IP and entrepreneurial activity?

Because of the favourable tax environment in the UAE, there are no substance requirements that need to be met locally. Substance in the UAE will always be determined according to the requirements of the corresponding country.

### What other restrictions are in place?

There are no restrictions in place.

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#### **NOTES**

<sup>1</sup> See for example “Tackling aggressive tax planning through improved transparency and disclosure”, OECD February 2011.

<sup>2</sup> For instance Guernsey recently concluded Tax Information Exchange Agreements with various countries. See [www.gov.gg/ccm/navigation/income-tax/latest-additions-and-changes/](http://www.gov.gg/ccm/navigation/income-tax/latest-additions-and-changes/) or see [www.oecd.org/document/7/0,3746,en\\_21571361\\_43854757\\_44261511\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/7/0,3746,en_21571361_43854757_44261511_1_1_1_1,00.html) for all other countries.

<sup>3</sup> *Laerstate BV v HMRC*, 25 November 2009.

<sup>4</sup> See Diane Hay: ‘UK edges towards foreign profits reform’, *International Tax Review*, February 2010.

<sup>5</sup> See Tolley’s Tax Planning 2008/09, vol.I, p. 307/308.

<sup>6</sup> Para 9.11 “contractual arrangements are the starting point for determining which party to a transaction bears the risk associated with it”.

<sup>7</sup> Ownership in most cases can be split into (i) legal ownership position and (ii) an economic interest position. Although (i) it is the prevailing position from a transfer pricing perspective, an excessive investment by (ii) could lead to partial or full sharing of the ‘residual benefits’ between (i) and (ii).

<sup>8</sup> As noted at paragraph 1.53, it is important to examine whether the conduct of the parties conforms to the terms of the contract or whether the parties’ conduct indicates that the contractual terms have not been followed or are a sham. In such cases, further analysis is required to determine the true terms of the transaction and a pricing adjustment might not be the solution.

<sup>9</sup> This is notwithstanding any possible application of general anti-avoidance rules and notwithstanding the question about Company Z’s place of effective management.

<sup>10</sup> See paragraph 16 of the OECD Report on Attribution of Profits to Permanent Establishments, published on 22 July 2010.

<sup>11</sup> OECD Tax Policy Studies Series No. 10, 2005.

<sup>12</sup> See the following articles: ‘Tax havens and tax policy. How should the US tax system treat income earned by multinationals in low-tax jurisdictions?’ *Taxes*, the tax magazine, March 2010, p.3 ff.; ‘The changing role of tax havens - an empirical analysis of the tax havens worldwide’, Rainer Zielke, *Bulletin for international taxation*, vol. 65, nr.1, 2011; ‘The Isle of Man embraces e-commerce’, *International tax review*, Tom Craine, April 2002; ‘Tax-efficient intellectual property; when volatility reigns’, Isabel Verlinden, Patrick Boone, Axel Smits, *PricewaterhouseCoopers*, Belgium, Tax planning international e-commerce, February 2003.

<sup>13</sup> See for example “Tackling aggressive tax planning through improved transparency and disclosure”, OECD February 2011.

<sup>14</sup> For instance Guernsey recently concluded Tax Information Exchange Agreements with various countries. See [www.gov.gg/ccm/navigation/income-tax/latest-additions-and-changes/](http://www.gov.gg/ccm/navigation/income-tax/latest-additions-and-changes/) or see [www.oecd.org/document/7/0,3746,en\\_21571361\\_43854757\\_44261511\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/7/0,3746,en_21571361_43854757_44261511_1_1_1_1,00.html) for all other countries.

<sup>15</sup> See for example Crawford, Martin “Mid-Shore Rising” (*China Economic Review – China Offshore*) Winter 2010, p14.

<sup>16</sup> The Luxembourg government has introduced by a law of December 21, 2007 the Luxembourg IP regime.