



Forum on Harmful Tax Practices
Organisation for Economic Co-operation and Development
2, rue Andre Pascal
75775 Paris Cedex 16
France

FHTP@oecd.org

20 February 2015

Comments on the Explanatory paper regarding the Agreement on Modified Nexus Approach for IP Regimes following the progress made under Action 5 of the BEPS Action Plan

Thank you for the opportunity to provide comments on the practical implementation of the nexus approach following the release of the *Explanatory paper: Agreement on Modified Nexus Approach for IP Regimes* on 6 February 2015.

PricewaterhouseCoopers LLP (PwC), on behalf of its international network of Member Firms, welcomes the consideration given by the OECD FHTP on the practical implementation issues of the nexus approach.

We understand the work on implementation will be finalised by the 30 June 2015 and we would strongly support and welcome further public consultation on key issues between now and 30 June 2015. Many of the key issues in point are very practical in nature and therefore input and consultation with business should facilitate rules that are workable and can be applied in practice. In our view, this more consultative approach covering all key issues will help to achieve the overarching goals and intention of BEPS Action 5.

We acknowledge that the Modified Nexus Approach has been endorsed by all OECD and G20 countries. That said, we do have concerns that a large number of businesses which can clearly demonstrate development and ownership of valuable patents and substantial R&D activity in a relevant territory will, nonetheless, obtain little or no benefit from IP regimes intended to incentivise the development of patented IP. This is due to the mechanical formula adopted which, when applied on an entity by entity basis, can lead to restrictions that go far beyond the substantial activities principle stated in BEPS Action 5.

Detailed Comments:

- 1. Developing more detailed guidance on how businesses can track expenditure and income to show that the nexus approach is being correctly applied.**

PwC agrees with the OECD FHTP that an acceptable approach to the tracking and tracing of R&D expenditure is required and any such approach must be practical for businesses and tax authorities alike to implement.

PricewaterhouseCoopers LLP, 7 More London Riverside, London, SE1 2RT
T: +44 (0) 20 7583 5000, F: +44 (0) 20 7212 7500, www.pwc.co.uk

PricewaterhouseCoopers LLP is a limited liability partnership registered in England with registered number OC303525. The registered office of PricewaterhouseCoopers LLP is 1 Embankment Place, London WC2N 6RH. PricewaterhouseCoopers LLP is authorised and regulated by the Financial Conduct Authority for designated investment business.



Modified Nexus must be practical across a broad spectrum of businesses (large and small, complex and more straight forward). Modified Nexus potentially imposes significant administrative or systems requirements to track and trace expenditure and income. We believe that overly prescriptive tracking requirements that would work for all businesses would be virtually impossible to design. It is therefore necessary to design requirements that are flexible enough to accommodate different businesses whilst providing a clear framework to ensure IP regime benefits are commensurate with R&D activities. Our experience of R&D tax credit regimes (which are inherently more straightforward than Modified Nexus) is that there needs to be scope for claims to be approached in a number of different ways, using 'best available' information. Indeed, such claims based on 'best available' information, could be used as part of R&D tracking and tracing requirements, thus minimising the administrative burden for companies.

In considering tracking and tracing PwC would comment as follows:

Tracking of expenditure

In our experience, R&D can often involve a large numbers of projects undertaken across multiple R&D sites globally and can involve very long R&D cycles over many years. R&D efforts range from very early blue sky research and experimental development right through to the development of product prototypes. A business will not necessarily know what products will be produced or patents registered at the time that a significant proportion of the related R&D is being undertaken.

It is because of the number of variables, influencing factors and inherent complexities that the linkage between R&D, successful outcomes and later income generation (that could be indirectly by way of many different products) presents such a challenge.

In this context, our comments are as follows:

- Noting particular challenges with the identification of historical R&D expenditure, the option of using current year R&D spend or 3 year average spend as a proxy for historical spend would be welcomed. Indeed, this further incentivises current R&D activities.
- The ability to track expenditure at different levels (e.g. entity, division, line of business, or product) would also be welcomed to accommodate businesses of different sizes and operating structure to benefit under Modified Nexus. This could be subject to the requirement that the methodology be consistent over time.
- We would also support tracking of R&D expenditure on a representative sample basis, whereby a company groups its products into relevant categories and applies an appropriate nexus fraction that is determined for each category. This should be subject to just and reasonable requirement (see below).
- We propose that the chosen method of tracking and tracing must result in qualifying IP income that is 'just and reasonable'. This test would not be met if the tracking results in inflated claims and an alternative tracking basis would be required.



- Businesses often incur significant R&D costs at the very early stages of innovation to set the foundations for future scientific or technological advancement within more focussed projects. Qualifying expenditure therefore should be defined based on a set of broad criteria to allow inclusion of all R&D that has contributed in some way.
- Cost categories included in qualifying R&D should enable alignment with existing in-country R&D regimes.

Cost sharing arrangements

- A significant number of businesses undertake R&D under a cost sharing arrangement. These include both internal group arrangements and a minority involving third parties.
- Our view is that a rule would need to be incorporated within the proposed Modified Nexus Approach to make this work for cost sharing as intended.
- For Modified Nexus to achieve its aims, we propose the nexus limitation applied should be $\text{Local R\&D} / \text{Total R\&D} \times \text{Total global qualifying IP income generated}$. Providing the Local qualifying IP income does not exceed this amount, the claim should not be restricted. If Local qualifying IP income is more than the amount determined by this calculation, the 30% uplift rule should apply.

Tracking of income

- Practical methods for identifying IP income should focus on the commercial income generated through the use or exploitation of technology. Where technologies are developed and exploited on an integrated basis, our view is that it would not be meaningful to seek to split the income between patented and non-patented technologies. This would be highly complex, inherently subjective and would not, in our view, produce a meaningful answer.
- Identification and reporting of income by product / product grouping, whilst challenging for some companies (typically those with high volume, low value products), is generally achievable in our experience. This approach also means that expensive / subjective transfer pricing analysis is avoided that could otherwise preclude smaller companies from claiming.

2. Safeguards to prevent taxpayers from inappropriately using the transitional period to get tax benefits under existing IP regimes.

PwC understands the basis for the FHTP considering safeguards to prevent taxpayers from inappropriately using the transitional period to obtain tax benefits under existing IP regimes. That said, PwC considers that there is relatively limited risk of abuse for regimes which already include an active business test, since qualification is only possible where the IP regime claimant carries on substantive activities.



We understand that a number of Patent offices have been facing backlogs of patent applications for some time now, and companies submitting applications are beholden to the Patent Office when it comes to processing times. Our view is that the grandfathering provisions must apply to patents *filed* before 30 June 2016 rather than granted. This also aligns with the legal form, whereby a patent exists from its filing date, providing it is granted.

3. Developing more detailed guidance on what will be regarded as a qualifying IP asset.

PwC welcomes the inclusion of robust detailed guidance to determine what will be regarded as qualifying IP assets under the Modified Nexus approach. In this respect, PwC recommends the following points are considered when designing such guidance:

- The definition of 'qualifying IP assets' must be robust so that businesses and tax authorities can clearly identify assets that qualify. Assets which are subject to legally enforceable protection (such as EU/local territory Patents, Marketing Authorisations, Plant variety rights and Supplementary Protection Certificates) should form the basis for this definition, as proposed.
- PwC welcomes consideration of broadening this definition to wider IP assets such as copyright derived from R&D activities, for example software or manufacturing know-how. Whilst patents were originally chosen as an easy way to identify innovation, as R&D will now be tracked, significant innovation leading to copyright can be evidenced.
- PwC notes that inclusion of such IP assets within the scope of the Modified Nexus Approach would not be against the policy intent of BEPS Action 5 and would only benefit those enterprises which can demonstrate such assets have been developed with sufficient R&D nexus.
- It is essential that qualifying IP rights should include fully legal ownership, arrangements where a company has economic ownership (for example is entitled to the income) and exclusively licensed IP. These are all ways in which companies obtain rights to IP in third party transactions.

On behalf of the global network of PwC Member Firms we respectfully submit our response to the *Explanatory Paper: Agreement on Modified Nexus Approach for IP Regimes*. For any clarification of this response, please contact the undersigned or any of the contacts below.

Yours faithfully,

A handwritten signature in blue ink, appearing to read 'Adrian Gregory', is written over a light blue horizontal line.

Adrian Gregory
PricewaterhouseCoopers



cc Stef van Weeghel, Global Tax Policy Leader

PwC Contact	Email
Adrian Gregory	adrian.gregory@uk.pwc.com
Angela Browning	angela.browning@uk.pwc.com
Peter Merrill	peter.merrill@us.pwc.com
Philip Greenfield	philip.greenfield@uk.pwc.com
Richard Stuart Collier	richard.collier@uk.pwc.com