TAXeNEWS

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A Swiss license box solution

The intermediary report on the Corporate Tax Reform III project by the Confederation and the cantons, which was published on 17 May 2013 (cf. our Corporate Tax Reform III TAXeNEWS published the same day), outlines the ways by which Switzerland's tax competitiveness and attractiveness as a business location can be maintained and reinforced. Consequently, Switzerland pursues a mix of measures, including the introduction of new, internationally accepted rules for taxing mobile activities, the reduction of cantonal income tax rates, and the elimination of specific current tax obstacles.

This TAXeNEWS edition sheds light on a measure that is often pondered in the context of Corporate Tax Reform III: the so-called license box.

Which economic considerations drive the license boxes?

The treatment of income from intellectual property is very much in the focus of the tax policy debates. The reason is that license boxes enable an internationally accepted and attractive taxation of income from intellectual property rights in the context of global fight for high-value added jobs and tax revenues.

States with license box solutions provide resident companies with an economic advantage thanks to reduced taxation of income arising from specific intellectual property rights or the underlying intangible assets (hereafter referred to as IP income). This generates incentives for companies to hold and exploit existing intellectual property rights and to develop new innovative products, processes, services and related activities in a tax attractive environment. In Switzerland the canton of Nidwalden as the first and until now only canton implemented a license box solution which became effective on 1 January 2011. On the same day Liechtenstein also introduced a license box rule in its new tax law.

From a legal perspective it is interesting to note that Liechtenstein did submit its license box regulation for formal examination by the EFTA supervisory authority (ESA). The Brussels-based authority found in its decision of 12 December 2012 that the Liechtenstein measure is compatible with EEA state aid legislation. The ESA in its evaluation had to apply the same criteria as the EU commission does when examining EU-internal rules. Liechtenstein, together with Spain, is the only country in the European Economic Area whose license box rule successfully underwent a formal notification procedure. This increases the legal and planning certainty of its license box solution.

Mechanics of a license box solution

Regardless of specific characteristics, most license boxes function in a similar way. The relevant IP income is generally determined by taking the arm's length gross IP revenues and deducting related actual costs. If the result is positive, an additional notional deduction can be applied to arrive at a reduced taxable base, or a reduced income tax rate is applied directly on the respective net relevant IP income.

With this mechanism, the effective tax charge on IP income can be significantly lowered: in Belgium to 6.8%, in Liechtenstein to 2.5%, in Luxembourg to 5.84%, in Nidwalden to 8.8%, in the Netherlands to 5%, or in the UK to 10%.

Regarding the question as to which intellectual property rights or which income categories qualify for the application of a license box scheme, the answers can differ considerably.

The canton of Nidwalden referres to Article 12 of the OECD model tax convention and includes a broad catalogue of qualifying intellectual property rights. Liechtenstein favors patents as well as protection certificates, samples, trademarks, designs, software and technical and scientific databases. The catalogue of qualifying intellectual property rights of other states can be more narrowly defined or can also include topography, plans, secret formulas or processes, know-how and so-called research and development certificates. In addition to technological intellectual property rights, which are usually covered by patents, license box regulations may also include trademarks. This is the case in Nidwalden and – with the explicit permission of the ESA – also in Liechtenstein.

IP income can be categorized in five income groups:

1. Sales income (embedded income);
2. License fees;
3. Proceeds from sale of IPs;
4. Compensation for infringement damages; and
5. Other compensation.

For a company, it should make no difference whether profits from intellectual property rights arise from licensing or from the sale of products which include protected intangible assets (embedded income).

If intellectual property rights are self-utilized, current license box solutions (with the exception of the canton of Nidwalden) allow for notional royalties. The main objective of notional royalties is to allow the use of license boxes for companies that use intellectual property rights for their own purposes without deriving any income that would fit into one of the categories above.

Notional royalties arise primarily from patents used in the production process of legally unprotected products. Notional royalties can also arise from patents for the provision of services. For example, notional royalties can be used for the sale of roasted coffee beans if e.g. a patented measuring instrument is used in the roasting process to increase quality. In such a case, license box regulations would allow that an arm's length - share of sales revenues from the roasted coffee beans can be attributed to the license box, even if the product itself is not patentable.

According to the intermediary report on CTR III, in the context of a Swiss license box solution, measures should further be examined, which may provide a tax reduction also for wholesale trading income. A combined solution of this kind could make a license box solution available also for companies with high-value adding functions, personnel and infrastructure but which lack ownership of formal intellectual property rights.

Comparison of license box schemes in selected countries

Many countries worldwide have adopted license box solutions. A comparison of the license box schemes of Belgium, Liechtenstein, Luxembourg, the canton of Nidwalden, the Netherlands and the UK is outlined below:

Factors	**BE**	**LI**	**LU**	**CH Nidwalden**	**NL**	**UK**
Effective tax rate	0 – 6.8%	2.5%	5.84%	8.8% including federal direct tax	5%	10%
Qualifying IP rights or underlying intangible assets	IP rights: patents, SPCs* *supplementing protection certificates	IP rights: patents, samples, SPCs, trademarks, designs, software, technical and scientific databases	IP rights: patents, SPCs trademarks, designs, domain names, software	Intangible assets: Based on art. 12 OECD model convention	Intangible assets: patent-protected innovations, R&D certificates, sorts protection	IP rights: patents, SPCs, some medical products, sorts protection
Application on purchased IP rights	Yes, but own development required	Yes	Yes, but not from directly associated companies	Yes	Yes, but own development required	Yes, but own development and active ownership required
Requirement of own development	Yes	No	Yes, but limited	No	Yes	Yes
Application on the following income groups:						
– Sales income	Yes	Yes	Yes, for self-developed patents	No	Yes	Yes
– License fees	Yes	Yes	Yes	Yes	Yes	Yes

Factors	BE	LI	LU	CH Nidwalden	NL	UK
– Proceeds from sale of IPs	No	Yes, only sales of IP rights	Yes	Yes	Yes, only sales of intangible assets	Yes, also includes exclusive licenses
– Compensation for infringement damages	Expected	Yes	Yes	Yes	Yes	Yes
– Other compensation	Expected	Yes	Expected	Yes	Yes	Yes
Application on notional royalties	Yes	Yes	Yes	No	Yes	Yes
Application on income before registration of IP rights	No	Yes	Yes	Yes	Yes	Yes
Includes relevant IP loss rules	No	Yes	Yes	Yes	Yes	Yes
Application on profit ceilings	Yes	No	No	No	No	No
Application of specific abuse rules	Yes	No	Yes	No	No	Yes
Application to partnerships	No	Yes	Yes	No	No	Yes
Application to cost sharing agreements	Yes	Yes	Unclear	Yes	Yes	Yes
Application of specific transfer pricing rules	Yes	Yes	Yes	Yes	Yes	Yes
Application on existing IP rights or underlying innovations	No, only IP rights first granted or utilized from 01.01.2007	No, only IP rights created or purchased from 01.01.2011	No, only IP rights created or purchased from 01.01.2008	Yes	No, only intangible assets created or patented from 01.01.2007 and intangible assets created under R&D certificates from 01.01.2008	Yes

Clearly, there are many differences remaining in the setup of license box solutions. As a consequence, accessibility to a license box solution and the tax reduction for a company can vary irrespective of the tax rate applied. A company can benefit from a license box solution for specific income in one country depending on its actual situation, but not in another.

As there is no international harmonization of license box rules, Switzerland would be well-advised to find the optimal combination of relevant factors to meet Swiss objectives. For example, the UK has chosen a particularly interesting mix for its patent box solution, which we will present in an upcoming newsletter.

In comparing the attractiveness of the different license box solutions, the following factors among others are to be considered in addition:

1. The existence of research promotion by direct subsidies or particular input incentives such as super deductions for tax purposes of research and development costs;
2. The presence of a qualified and skilled workforce for developing, managing and exploiting IP rights; and
3. The general level of location costs.

Effect of license boxes of Liechtenstein and the canton of Nidwalden: a case study

The following – simplified – case study demonstrates the effect of the license boxes of Liechtenstein and the canton of Nidwalden:

Income (CHF) **Income qualify for license box if not otherwise indicated**		**LI**		**CH** **Nidwalden**	
	Total	**Regular**	**License box**	**Regular**	**License box**
Sales income Therefrom 5'000 relevant IP income	15'000	10'000	5'000	15'000	0
Royalties	5'000		5'000		5'000
Proceeds from sale of IP	3'000		3'000		3'000
Compensation for infringement damage	1'000		1'000		1'000
Other compensation	1'000		1'000		1'000
Total income	**25'000**	**10'000**	**15'000**	**15'000**	**10'000**
Notional royalty for own use	2'000	-2'000	2'000		
Total		8'000	17'000	15'000	10'000
Applicable tax rate		12.5%	2.5%	13.5%	8.8%
Tax charge		**1'000**	**425**	**2'025**	**880**
Effective tax rate		**5.7%**		**11.6%**	

The Nidwalden license box does not apply to sales income (embedded income) and notional royalties. The fact that the own use of intangible assets is excluded from the Nidwalden license box decreases its attractiveness significantly. Further, the reduced effective tax rate in Nidwalden is still higher than in most competing countries. A further reduction could be attained if a license box solution were also introduced at the federal level in addition to the cantonal level. Further, the exclusion of own use of intangible assets from the Nidwalden license box prevents accessibility for wholesale trading companies and SMEs.

What should be done?

Based on the CTR III project, a sounding procedure is in progress with the cantons and the economy. The scope of income eligible for the license box treatment, the desired level of reduced taxation, as well as the other factors outlined in this TAXeNEWS edition need to be taken into consideration. PwC is actively engaged in these discussions.

The results of this sounding process, the outcome of the on-going negotiations with the EU and the current work by the OECD will, in the coming months, have an impact on the shape that the Swiss license box solution will take.

Crafting a customized, internationally attractive Swiss license box solution will be vitally important and decisive for Switzerland to maintain its strong position as a prosperous place for innovation.

This TAXeNEWS edition is the fourth in a series discussing specific aspects of CTR III.

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