THE DUTCH INNOVATION BOX

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The Dutch Innovation Box is a preferential corporate income tax regime to promote research and development and innovative companies in The Netherlands. Recently there have been domestic and international developments which might have an impact on the Dutch Innovation Box. This article is aimed at on the one hand explaining the Dutch Innovation Box system and on the other hand describing the recent developments which might affect the future of the Dutch Innovation Box.

The Dutch Innovation Box Explained

The Dutch Innovation Box represents a special corporation tax rate (or “box”, as it is called in the Netherlands) which allows for eligible income to be taxed at an effective rate of 5% rather than the top rate of 25%. This in turn enables profit exemption for up to 80% to be obtained. A budget in the amount of €625 million has been earmarked for 2014 to be spent on tax relief for companies whilst applying The Dutch Innovation Box. The Dutch Innovation Box regime was launched on 1 January 2010 and applies to income derived from patents or from projects carried out in the context of the Research and Development (Promotion) Act of the Netherlands.

The grant scheme by virtue of the Research and Development (Promotion) Act is all about subsidising in-house staff involved in research and development work, to wit technological-cum-scientific research or the development of technologically new physical products or production processes including that of technologically new software. The development work has to qualify as technologically new. It is completed as soon as the product or process by means of a prototype or model has been shown to work.

The option is available of applying for the Dutch Innovation Box in the context of filing one’s corporation tax return. The optimum use of the Dutch Innovation Box scheme is far from straightforward, however, one of the reasons being that certain key concepts – “research and development asset” and “innovation-derived profit” among them – have not been explicitly defined by the legislator.

(1) Section 12b, Netherlands Corporation Tax Act

(1) In the event of the tax payer having produced either an intangible asset in connection with which he (it) has been granted a patent (“Patent Asset”) or an intangible asset having followed on from research and development work in connection with which he (it) has been issued with a Research and Development Certificate as defined in the Salaries Tax and National Insurance Contributions (Reduced Remittances) Act of the Netherlands (“Research and Development Asset”), a decision accordingly by the tax payer in question when filing his (its) corporation tax return for a particular year will result in consideration being given for a H/H portion only (with H representing the top tax rate as defined in Section 22 below for the year during which the income were enjoyed) to any income deriving from the relevant Asset with effect from the relevant year, with due observance of the threshold defined in subsection (5) hereinafter. The opening sentence of the present subsection shall apply only where the balance of the income has turned out positive.

(2) The present Section shall apply only to intangible assets whose expected incomes to a significant effect derive from patents having been granted to the tax payer and to Research and Development Assets.

(3)...

(4) The present Section shall not apply to any such (trade) marks, logos and equivalent assets as the tax payer may have produced.

(5)...

(2) Decree by Finance Ministry

Below please find the highlights of the Dutch Finance Ministry’s most recent Dutch Innovation Box decision (Decree dated 1 September 2014, no. BLKB2014/1054M, Netherlands Government Gazette 2014, 25141).

2(1) Intangibility of Asset

The application of the Dutch Innovation Box hinges on the term of “intangible asset”, and yet the parliamentary debate on the subject has failed to yield an unambiguous definition of this pivotal term. However, a literature search will produce certain common elements to hold on to in getting to grips with “intangible asset” as per the Dutch Innovation Box scheme, such as separability, identifiability, transferability and repeatability. Ultimately it will be the relevant facts and circumstances which will be decisive.

Patented knowledge and applications often come under the scope of Section 12b of the Netherlands Corporation Tax Act, whereas knowledge and experience as such – even though know-how can represent an intangible asset – usually do not. It is because of this that data bases, share points and smart check lists more often than not will not be accepted for Dutch Innovation Box purposes, in addition to which the provisions of subsection (4) of Section 12b of the Corporation Tax Act explicitly rule out (trade) marks, logos and equivalent assets.
2(2) Self Produced

A second requirement alongside that of the intangibility of the asset is that the taxpayer itself should have produced the asset: Rather than merely owning the intangible asset, the taxpayer itself should have developed it at its own risk and expense. There should therefore be enough prominent functions on tap at the taxpayer’s own level to render the intangible asset assignable to said taxpayer. The taxpayer should have decision-making powers as well as being in a position functionally to preside over the research and development activities in order for the intangible asset to be regarded as being self-produced.

As before, it will be the relevant facts and circumstances which will be decisive, e.g. the shouldering of responsibility on the basis of substantive expertise in respect of choices made by the taxpayer itself during the course of the research and development process, or elements such as planning, budgeting, performance measurement, remuneration, adjustment/redefinition of spheres of activity, identification of commercially viable areas and assessment of the likelihood of the research turning out successful (or not). The bottom line is that any taxpayer-owner of a particular intangible asset that lacks the functional scope for running the associated research and development activities on the basis of its own substantive expertise will not be accepted for application of the Dutch Innovation Box scheme.

2(3) Patent Assets and Research and Development Assets

Only self-produced “Patent Assets” and “Research and Development Assets” – both of which types of asset are aimed at promoting (technological) innovation – rather than all self-produced intangible assets come under the scope of the Dutch Innovation Box regime.

A “Patent Asset” is any intangible asset in respect of which the relevant taxpayer has been granted a patent. The definition of “patent” as per Sections 2 and 53 of the Netherlands Patents Act 1995 serves as the guiding principle in this respect. The Dutch Innovation Box scheme is open to Dutch-issued patents and to equivalent patents issued in other countries. Plant breeder’s rights are likewise regarded as patents. Patent Assets are moreover required to a significant degree (30% or over) to be patent-dependent where their expected income are concerned.

Research and Development activities in respect of which the taxpayer has been presented with a Research and Development Certificate can culminate in a Research and Development Asset. There has to be a direct causal connection between the intangible asset and the Research and Development activities. Research and Development Certificates are issued by RVO, the National Enterprise Agency of the Netherlands, for activities which have been proven to (a) pertain to technological-cum-scientific research, (b) involve technologically new products, production processes or software being developed, (c) entail analyses of the technical feasibility of Research and Development projects, or (d) relate to technological research aimed at improving the physical production process or software.

2(4) Asset Derived Income

The application of the Dutch Innovation Box regime is confined to such income as are attributable to a self-produced intangible asset for which a patent has been granted or a Research & Development Certificate has been issued. “Income” in this context is to be interpreted from an economic perspective and in addition to royalties may also include other benefits such as (part of) sales proceeds, or (part of) reduced (production) costs owing to the successful rationalisation of internal (production) processes. No allowances are made for amounts received by virtue of the Research and Development Allowance regime. “Income” additionally is to be interpreted in an algebraic sense, in that they can be positive or negative.

2(5) Attributable Income

Determining which income is attributable to the Dutch Innovation Box is a tailor-made exercise which calls for an individual approach instead of use being made – including at sector level – of standard computation rules or fixed percentages. Different economic approaches are wielded in practice depending on the facts and circumstances in question. It mostly involves methods derived from the arm’s length premise geared to determining which income qualify for application of the Dutch Innovation Box.

The characteristics and prominence of Patent Assets and Research and Development Assets as part of the taxpayer’s business processes are key to selecting one’s modus operandi. A single modus operandi may thus combine multiple allocation methods being used for multiple assets. A functional analysis and the documentation based on Section 8b(3) of the Netherlands Corporation Tax Act may be helpful in selecting a particular modus operandi, as the relevant functions, assets and risks described there underpin the calculation of income that are attributable to the intangible assets. International standards such as the OECD Guidelines can be applied in this context. As the customary scenario will involve more than one function, asset and risk at a time, it will not be possible in practice to attribute 100% of the entire income to the Dutch Innovation Box.

2(5)(1) “Authorised OECD Approach”

Profit allocation to the permanent establishment in the Netherlands of a non-Dutch based body or to the non-Dutch based permanent establishment of a Dutch-based body in accordance with the “authorised OECD approach”, the point of departure for the allocation of the income to the Dutch Innovation Box being the portion of the profit being attributed to the Dutch portion of the enterprise.
2(5)(2) “Per Asset” Method

It is permissible to use the “per asset method” where the production costs and proceeds of a Patent Asset or Research and Development Asset are individually identifiable. This method involves the production costs and proceeds being calculated for each Patent Asset or Research and Development Asset individually, after which it is determined what portion of the income should be attributed to the Dutch Innovation Box.

2(5)(3) “Paring” Method

At enterprises whose Research and Development function ranks as a core function and whose Patent Assets and Research and Development Assets enjoy relatively great prominence, use is often made of the “paring” method when determining the income derived from said Patent Assets and Research and Development Assets. This method involves the functions within an enterprise being classified as support and routine functions of the one part and core functions of the other. The next step consists in part of the enterprise’s operating profit being allocated to the support and routine functions, more often than not on the basis of some cost-related method or other. The residual profit is then divided between the core functions on the basis of proportionality to the degree of prominence each of these functions enjoys.

2(5)(4) Cost Related Method

At enterprises whose Research and Development function and Patent Assets and Research and Development Assets are considered to be secondary or auxiliary rather than taking centre stage, use is often made of the cost-related method when determining the income to be attributed to the Dutch Innovation Box. This method involves the income being calculated on the basis of the sum total (inclusive of overheads) of costs incurred in connection with the Patent Assets or Research and Development Assets. The next step consists in an increment being calculated in the amount of 8% to 15% of costs depending on the facts and circumstances of the case, the precise level of the increment being based on what a third party would be prepared to pay for the activities in question.

2(5)(5) Fixed Fee Method

Finally, the fixed-fee method is available to be used by businesses whose income associated with the application of the Dutch Innovation Box are outweighed by the administrative charges involved in calculating the attributable income. It is essential that the business in question should have produced a Patent Asset or Research and Development Asset either during the year in question or during the two preceding years. The fixed-fee method involves 25% of the taxable profit, to a maximum of € 25,000.00 (twenty-five thousand euros only), being earmarked as positive innovation income to be attributed to the Dutch Innovation Box. A choice in favour of the fixed-fee method involves the full complement of intangible assets that qualify, which stops any other method additionally being used where the same year is concerned. The choice in favour of application of the fixed-fee method can be made annually. The customary method of having the income qualify for application of the Dutch Innovation Box will still be available even if the entrepreneur in question in subsequent years cannot or does not opt to stay with the fixed-fee method.

2(6) Determination of Arm’s Length Remuneration

The attribution of income to the Dutch Innovation Box is not at all the same as the application of the arm’s length principle in scenarios involving affiliated enterprise. The arm’s length remuneration has to be fixed first in order to be able to determine what portion of the remuneration should be taken as qualifying as income in an Dutch Innovation Box application context. This should not, however, be taken to detract from the fact that the allocation method used in determining the Dutch Innovation Box income must be taken into consideration in conjunction with Section 8b of the Netherlands Corporation Tax Act and the ensuing regulatory framework.

2(7) 5/H Portion Only to be Taken into Consideration

The Dutch Innovation Box has been designed as a tax base reduction in that only part of such income as qualify for application of the Dutch Innovation Box is factored into the equation where the (corporation) tax base is concerned. The legislator has included a formula to reflect this and stipulated that allowances are to be made in determining the tax base for a 5/H portion only (with H representing the statutory tax rate).

2(8) Positive Balance of Income

The application of the Dutch Innovation Box is confined to income derived from Patent Assets and Research and Development Assets whose balance has turned out positive. “Innovation losses” if any are to be taken to the tax base in their entirety. Any such innovation loss will, however, cause the threshold amount to go up, so that on balance only positive innovation profits will be eligible for Dutch Innovation Box application.

(3) Dutch Innovation Box Case Law

The only Dutch Innovation Box case law available deals with a company which tried to apply the Dutch Innovation Box, whereby it was not the legal owner of the Intellectual property. The Court ruled:
As no intangible asset for which a patent has been granted has been produced by the Plaintiff, the latter has failed to satisfy one of the conditions for qualifying for application of Section 12b(1) of the Netherlands Corporation Tax Act. The Plaintiff’s motivation in support of the set-up it its choice has done nothing to change this.

Therefore, taken this case law into consideration it can be concluded that there is very limited guidance from the Dutch tax courts at this early juncture in the Dutch Innovation Box existence.

Below please find the verbatim text of (the relevant portions of) Section 12b of the Netherlands Corporation Tax Act followed by a comment on the Dutch Finance Ministry’s most recent Dutch Innovation Box decree.

Recent developments affecting the Dutch Innovation Box

Three developments are worth noting in relation to the Dutch Innovation Box:


2. On November 11th, 2014 Germany and the United Kingdom issued a press statement that they had concluded an agreement aimed at making the British Innovation Box system (or Patent Box system, as it is known in the UK) less susceptible to abuse;

3. Ruud de Smit noted in a column (V-N 2014/53.0) that the Dutch Innovation Box is susceptible to abuse in an international context.

The Netherlands has seemingly brought forward some concerns with regard to the Nexus approach in OECD Action 5. In my view, under the nexus approach as contemplated, a couple of restrictions have been introduced which limit the possibility for innovative companies to benefit from tax relief. The main items which contravene the Dutch Innovation Box are i) that Assets which are eligible for the preferential tax treatment are restricted, ii) a profit apportionment method is applied rather than a transfer pricing method.

Although the Dutch Innovation Box does not apply to trade marks, logos and equivalent assets it does apply to software and non-patentable Assets such as trade secrets. The application of the Dutch Innovation Box to Assets for which a Research and Development Certificate has been granted is the key joint on which the Dutch Innovation Box system is built. Small and medium sized companies use the Dutch Research and Development Certificate program to allow for a reduction of their employment expenses, which makes it possible for small to medium sized companies to invest in innovation. The Dutch Research and Development Certificate program is easily accessible for start-ups and small businesses.

As a benefit for the small and medium sized businesses, any income derived in relation to a Research and Development Certificate can be included in the Dutch Innovation Box. The combination of the wage withholding tax benefit and the corporate tax benefit, makes the Dutch system very attractive for Dutch companies. Especially small and medium sized companies which cannot protect their IP with patents due to i) the costs thereof, ii) the non-patentable nature thereof and/or iii) the fact that disclosure would hinder further development.

In OECD Action 5 the only IP assets that could qualify for tax benefits under an IP regime are patents and other IP assets that are functionally equivalent to patents if those IP assets are both legally protected and subject to similar approval and registration processes, where such processes are relevant. This contravenes the core of the approach in the Netherlands to make the system attractive and accessible to small and medium sized businesses. Limiting the scope of the Dutch Innovation Box, as preferential regime, to only include companies which are large enough to have patentable assets, is in my view not in line with the purpose of why OECD Action 5 plan was initiated. OECD Action 5 main purpose is to address Base Erosion and Profit Shifting. Start-ups and small and medium sized companies are typically not focussed on Base erosion and Profit Shifting, as they are focused on creating a Base and Profit and do not have a diversified organisation from which functions and risks can be divided to make income allocation possible throughout various jurisdictions.

The Dutch Innovation Box system is built on the premises that income of a company could be split between regular income and income pertaining to innovation. The Dutch Innovation Box income is attributed in accordance with the at arms’ length principle. Under the Nexus approach, however, the arms’ length principle is no longer binding as the nexus approach apports income according to a ratio of expenditures. I doubt whether countering harmful tax practices can be done more effectively via a new “income apportionment method” than via the tried and tested arm’s length principle. Adopting profit apportionment may solve some flaws which are inherent to the at arm’s length principle, however, it is my expectation that new flaws will emerge. In addition a fair playing field with consistent tax treatment throughout various jurisdictions would be further away than ever if new methodologies (profit apportionment) are used instead of making the tried and tested methodologies (arm’s length principle) better.

The German and the United Kingdom press statement reinforced the nexus approach. Therefore, this approach may become more dominant and if followed by other countries the Dutch Innovation Box system may become susceptible to adjustments. Recently the Dutch State Secretary announced...
that any budget which was earmarked for tax relief for companies whilst applying The Dutch Innovation Box would remain to be earmarked for innovative companies. The question is how this budget would be used.

Last but not least Ruud de Smit noted in a column that in case IP was developed by a Dutch company in a permanent establishment abroad and this IP would be transferred to the Netherlands head office, that the Dutch Innovation Box regime would apply to any income generated thereof. This is indeed the case. Notwithstanding the fact that transferring IP from a permanent establishment to a head office is easier said than done, the State Secretary indicated that the current legislation would be amended to curb the non- (known) existent abuse.

My special thanks goes out to Rocco IJselmuiden, who assisted me with writing this article. The fast pace of the developments compels me to note that this article includes information which is available up to December 10th, 2014.

A VICTORY FOR THE SR&ED TAXPAYER IN TAX COURT’S GENERAL PROCEDURE

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In Les Abeilles Service de Conditionnement Inc., 2014 TCC 313, the Tax Court of Canada ("Court") ruled in favour of the taxpayer and held that the expenses which were mainly salary expenses constituted expenses incurred in carrying out Scientific Research and Experimental Development ("SR&ED") activities on the improvement of its production lines. Justice Jorré speaking for the Court stated in paragraph 4 of his decision that "there is no doubt that the aim of these projects was to increase the efficiency of production and in one case to master a new kind of production. The good news for the SR&ED community was that this was a win under the Court’s general procedure. Informal procedure caps what a taxpayer can claim up to $25,000. Furthermore, informal cases are not truly cases which have precedential value.

Les Abeilles Service de Conditionnement Inc. ("Appellant") is based in Montreal and its business operations include the sub-assembling of mechanical components that are provided by its customer. Once the sub-assembly is completed by the Appellant, it is sent to the customer who then puts the sub-assembly into its "main line" so as to obtain its final product.

The Appellant sought to improve its assembly line functionality in order to stay competitive with overseas assemblers as cautioned by Justice Jorré in paragraph 10 of the decision: “Given the cost of labor in Montreal, this is an operation that could have easily been relocated elsewhere, for example in Mexico or Asia”. The Minister denied SR&ED on the basis that the testing carried out by the Appellant did not constitute overcoming a technical uncertainty and classified the SR&ED work carried out by the Appellant as that of merely routine engineering.

The appeal related to six projects carried out in 2009 by the Appellant. Four projects were denied SR&ED credits. Three of the four projects related to the sub-assembly of components made for Mabe, a company that manufactures General Electric dryers.

The four projects consisted of the following:

a) Project 2007-01: a new method for assembling engine dryers;

b) Project 2007-02: a new method of assembling heating elements for dryers;

c) Project 2009-01: a new method of assembling control flow panels with electric sequencing flow; and

d) Project 2009-02: increasing the efficiency and speed at which the printing finishing line could operate.

Project 2007-01:

This project began in 2007 with the aim to increase the efficiency of production which was measured in terms of the time required to manufacture and adapt the conveyor to accommodate all engine types. In 2009, the main objective was to assemble all different types of engines on the same production line. There was also a goal of assembling an engine every 9 seconds while maintaining the level of quality required by the customer and a maximum of 300 discharges per million subassemblies. The Appellant wished to change the engine model in production without having to stop the production line to change the model to accommodate the different products being assembled. At the end of 2009, all types of engines could be assembled on the same production line. The assembly time was reduced to about 10 seconds per engine. The Appellant invested more than 9,000 hours into the project and claimed expenses of $137,000 in wages and $1,300 in materials.

Project 2007-02:

Discussions surrounding this project began in 2005 with the aim to improve the productivity of the Mabe plant. The Appellant wished to centralize the production of the heating elements onto one line while obtaining a cycle time of 7 seconds and a maximum of 300 discharges per million subassemblies. In 2009, new models of heating elements were required to be added to the production line. There were several issues that arose while