

TEI Tax Summit 2016

Asia Pacific

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Session 4: What Do You Mean?

The Evolution of the Definitions of IP and Royalties in Asia



Speakers:

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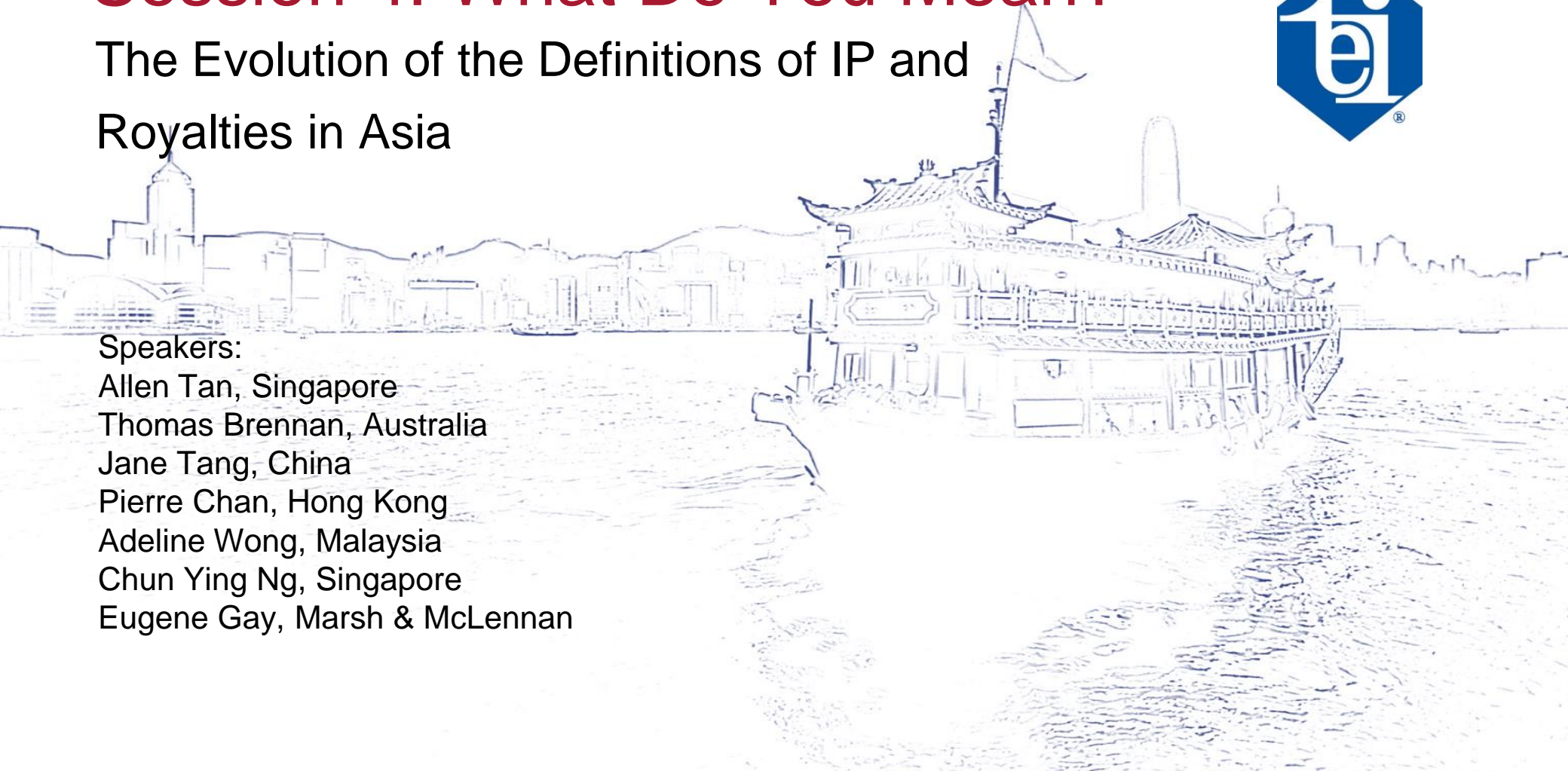
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Introduction

- Significance of definitions of IP and royalties in IP-related planning:
 - Onshoring of IP
 - Licensing model versus reseller model
 - Cost-sharing model

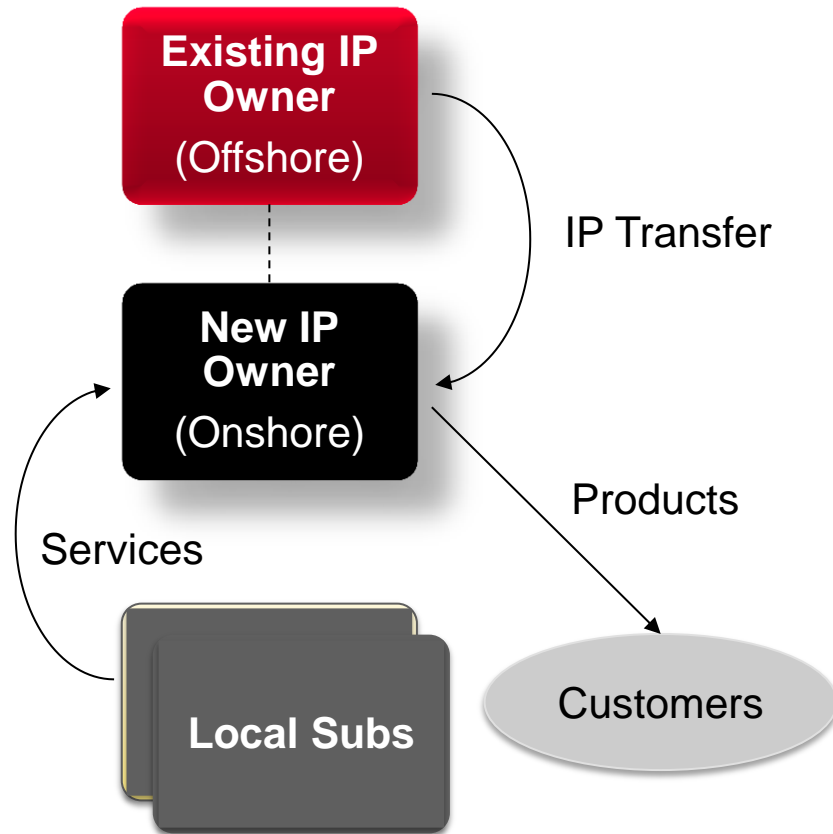
Definitions of IP

- Definition of “intangibles” for transfer pricing purposes (BEPS Action 8)
 - Something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and **whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances.**
 - Distinct from concept of intangibles for the purposes of definition of royalties – these are two distinct notions that do not need to be aligned.

Definitions of Royalties

- Definition of “royalties” under Article 12(2) OECD Model Tax Convention
 - “The term “royalties” as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience”
- OECD Commentary
 - Cf. transfer of full ownership of an element of property
 - Cf. payment for provision of services
 - Software payments

Onshoring of IP



- Effective tax rate
 - Patent box regime or tax incentives?
 - Substance requirements?
- Tax amortisation on acquisition of IP?
- Deduction of R&D expenses

Onshoring of IP – Singapore

- Reducing tax rate through tax incentives
 - Examples:
 - Pioneer incentive – 0% corporate tax rate
 - Development and Expansion Incentive (DEI) – 5 to 15% corporate tax rate
 - Scope of qualifying income on IP is specified under incentives
 - May include royalty and/or sales income
 - Subject to economic conditions, e.g. specific headcounts and functions requirements

Onshoring of IP - Singapore

- Writing-down allowances on acquisition of IP
 - Legal versus economic ownership
 - Restricted to the following: patents, copyrights, trademarks, registered design, geographical indication, lay-out design of integrated circuit, trade secrets or information that has commercial value and the grant of protection of a plant variety
 - Exclusions:
 - Goodwill and marketing intangibles
 - Customer information, e.g., a list of customers and requirements of those customers
 - Information on work processes, e.g., SOPs, other than industrial information or a technique that is likely to assist in the manufacture or processing of goods or materials

Onshoring of IP - Malaysia

- Reducing tax rate through tax incentives
 - Prepackaged incentive
 - Up to 100% income tax exemption for 15 years
 - Principal Hub incentive
 - Up to 100% income tax exemption for 5 years (possible extension for additional 5 years)
 - Must carry out at least 3 qualifying activities, including 1 strategic service – IP management considered a strategic service
 - Must have substance in Malaysia
 - Pioneer status / Investment tax allowance
 - Up to 100% income tax exemption for 5 years / 100% allowance on qualifying capital expenditure within 10 years

Onshoring of IP - Malaysia

- Scope of qualifying income on IP is specified under incentives
 - May include royalty and / or sales income
- No amortisation available for acquisition of IP
 - Save for cost of acquisition of proprietary rights by Malaysian manufacturing companies
- Amortisation not necessary if 100% income tax exemption is available
- Double deduction available to inhouse R&D companies for approved research.

Onshoring of IP – Hong Kong

- Acquisition of ownership of IP
 - Deductions:
 - Patent and know-how (including information on work processes)
– upfront deduction for acquisition cost
 - Copyright, registered design and registered trademark– tax amortisation of acquisition cost
 - Exceptions:
 - Acquisition of rights from an associate
 - Transfer of economic ownership only

Onshoring of IP – China

- Rarely the IP owner, mainly the limited risk service provider to and licensee of offshore IP owner
- Royalty deductibility requirements on the offshore IP owner
 - Economic substance and control
 - Tax haven company with no substance highly suspect
- Constantly developing IP-related transfer pricing concepts
 - Diminishing return of ongoing license of same IP
 - Inherent function, substance and location savings of onshore marketing and R&D services

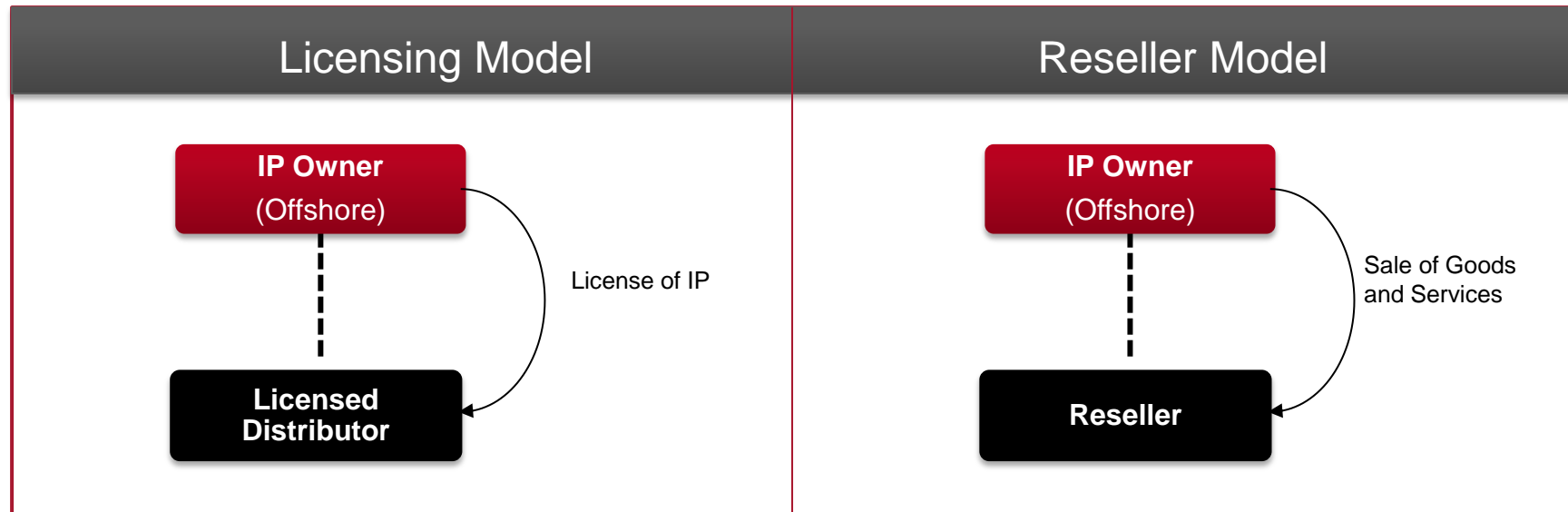
Onshoring of IP – China

- Onshoring more relevant to China groups or in respect of China-registered IP (trademarks, copyrights, etc.)
 - China ownership of China-registered IP that will result in China marketing intangibles as alternative to inbound licensing and outbound marketing services model
 - Structuring to benefit from high new technology enterprise (HNTE) qualification for 15% enterprise income tax rate
- Acquisition of IP
 - No source rule on assignment of IP, technical uncertainty on income tax position for cross-border IP assignment
 - Acquired IP generally amortizable, except for acquired goodwill
- Self-development of IP
 - Super deduction of R&D expenses
 - VAT refund incentive for sale of self-developed products

Onshoring of IP – Australia

- IP related tax incentives
 - R&D tax incentive designed to encourage R&D activities which benefit Australia
 - Only applies to expenses incurred in “eligible” R&D activity
 - Certain internal software development, licensing and patenting and reproduction activities are excluded
 - In most cases, eligibility is restricted to Australian R&D entities which are the major beneficiaries of the R&D activities conducted

Licensing or Reseller Model



- Withholding tax consequences of payment to IP owner
 - Characterisation of embedded royalty in the price of goods and services

Licensing or Reseller Model – Singapore

- Payments subject to withholding tax
 - “Royalty or other payments ... for the use of or the right to use any moveable property”
 - “Any payment for the use or the right to use scientific, technical, industrial or commercial knowledge or information”
 - Exclusion (w.e.f. 28 Feb 2013) – “copyrighted article” vs “copyright right” approach:

“the use of or the right to use software, information or digitised goods, not being a right to commercially exploit in one form or another the copyright in such software, information or digitised goods such as the right to —

 - (i) reproduce, modify or adapt, and distribute the software, information or digitised goods; or
 - (ii) prepare a derivative work based on the software, information or digitised goods for distribution” (Section 12(7A)(c), Income Tax Act)

Licensing or Reseller Model – Malaysia

- Payments subject to withholding tax
 - Royalty defined as –
 - “(a) any sums paid as consideration for the use of, or the right to use-
 - (i) copyrights, artistic or scientific works, patents, designs or models, plans, secret processes or formulae, trademarks, ... or other like property or rights;
 - (ii) know-how or information concerning technical, industrial, commercial or scientific knowledge, experience or skill;
 - (b) income derived from the alienation of any property, know-how or information mentioned in paragraph (a) of this definition.”
 - Broad interpretation of royalty

Licensing or Reseller Model – Malaysia

- Shrink-wrapped software – Royalty payment vs purchase of goods
- Guidelines on Taxation of E-Commerce:
 - Payment for use of copyright vs purchase of product
 - No specific adoption of the OECD's rights-based approach
- Recent Malaysian cases:
 - *Mudah* case – Payment for the purchase of software not a royalty (case currently on appeal)
 - *Thomson Reuters* case – Distribution fee not a royalty; services do not involve any special commercial knowledge

Licensing or Reseller Model – Hong Kong

- Payments subject to withholding tax:
 - Use or right to use in Hong Kong any patent, design, trade mark, copyright material, secret process or formula or other property of a similar nature, or for imparting or undertaking to impart knowledge connected with any such property
 - Use or right to use outside Hong Kong also caught if licence payment is deductible in Hong Kong
 - Standard rate of 4.95%
 - Full rate of 16.5% if the IP owner is an associate and the IP was owned by a person carrying on business in Hong Kong at anytime
 - Exception for products and services: where there is no right to reproduce, modify, adapt or otherwise exploit IP

Licensing or Reseller Model – China

- Interplay of income tax, turnover tax, customs valuation, customs duties and foreign exchange controls considerations
- License model
 - 10% withholding tax and 6% VAT
 - Deductibility / transfer pricing scrutiny and occasional remittance issue during tax recordal process
 - Careful structuring to ensure license fees will not be added to import value of products subject to import VAT and import customs duties

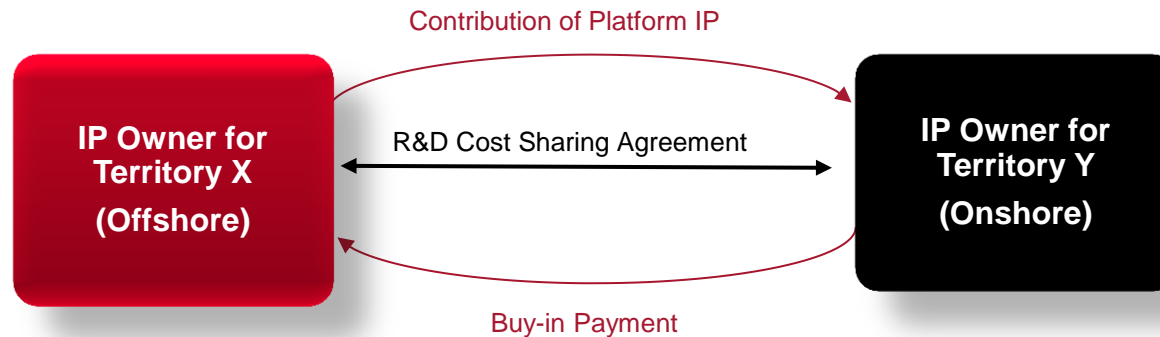
Licensing or Reseller Model – China

- Reseller model
 - One import price payable to offshore seller
 - Import VAT and import customs duties apply to entire import price
 - No separate license fee and no withholding tax
 - Commonly adopted to avoid business tax on license fee before VAT pilot reform
 - Continue to have practical benefits of avoiding transfer pricing scrutiny of royalties, possibly also brand building and marketing activities

Licensing or Reseller Model – Australia

- Australian Tax Office has historically been keen to argue for an embedded royalty in purchase price of goods or services
 - Critical to clearly demonstrate whether the reseller arrangement provides for any “right to use” intellectual property or know-how
 - Legal form of arrangement will not be respected if it does not correspond with substance
 - Access to and use of marketing intangibles very sensitive, particularly in light of Australian MAAL which targets sales and marketing support activities

Cost-Sharing Model



- Deductibility of cost-share payments
- Tax consequences of buy-in payment –
 - Characterised as royalty attracting withholding tax?
 - Characterised as capital payment – tax amortisation?

Cost-Sharing Model

- Definition of Cost Contribution Agreements for transfer pricing purposes (BEPS Action 8)
 - A contractual arrangement among business enterprises to **share the contributions and risks** involved in the joint development, production or the obtaining of intangibles, tangible assets or services with the understanding that such intangibles, tangible assets or services **are expected to create benefits for the individual businesses of each of the participants.**
 - A contractual arrangement rather than necessarily a distinct juridical entity or fixed place of business of all the participants.

Cost-Sharing Model – Singapore

- Cost-share payment generally deductible, but subject to “look-through” currently adopted by IRAS, e.g., capital expenditure and stock-based compensation are not deductible
- Buy-in payment – depends on characterisation of contribution of Platform IP
 - Royalty vs capital payment

Cost Sharing Model – Malaysia

- Cost-share payments generally deductible
- Buy-in payment – depends on characterisation of contribution of Platform IP
 - Royalty vs capital payment
- Stamp duty of 1% - 3% on instruments of conveyance
 - Exemption available for transfer of copyright, trademark or other similar rights

Cost-Sharing Model – Hong Kong

- Buy-in payments (capital expenditure) are not deductible in Hong Kong
- Royalty model may work better to allow Hong Kong licensee to claim deduction for royalty payments (subject to withholding tax)
- Specific deduction for R&D expenditure if conducted by the taxpayer itself or by very limited approved institutions in Hong Kong

Cost-Sharing Model – China

- Rare
 - Merge into APA regime
 - State Administration of Taxation approval requirement cancelled in July 2015
- Subject to specific transfer pricing reporting and documentation

Cost-Sharing Model – China (cont'd)

- Cost sharing payments not deductible if
 - Lacks reasonable commercial purpose or economic substance
 - Not arm's length
 - Benefits not commensurate with costs
 - Not compliant with documentation requirement
 - Operation term is less than 20 years from date of agreement
- Buy-in payment regarded as acquisition of IP

Cost-Sharing Model – Australia

- Cost-share payments are subject to the general rules on deductible business expenses
- WHT will not generally be levied on cost-sharing payments, provided that the substance of the arrangement is demonstrable as a true cost-share
- Buy-in payments may be a capital or revenue expense, depending on general Australian tax principles

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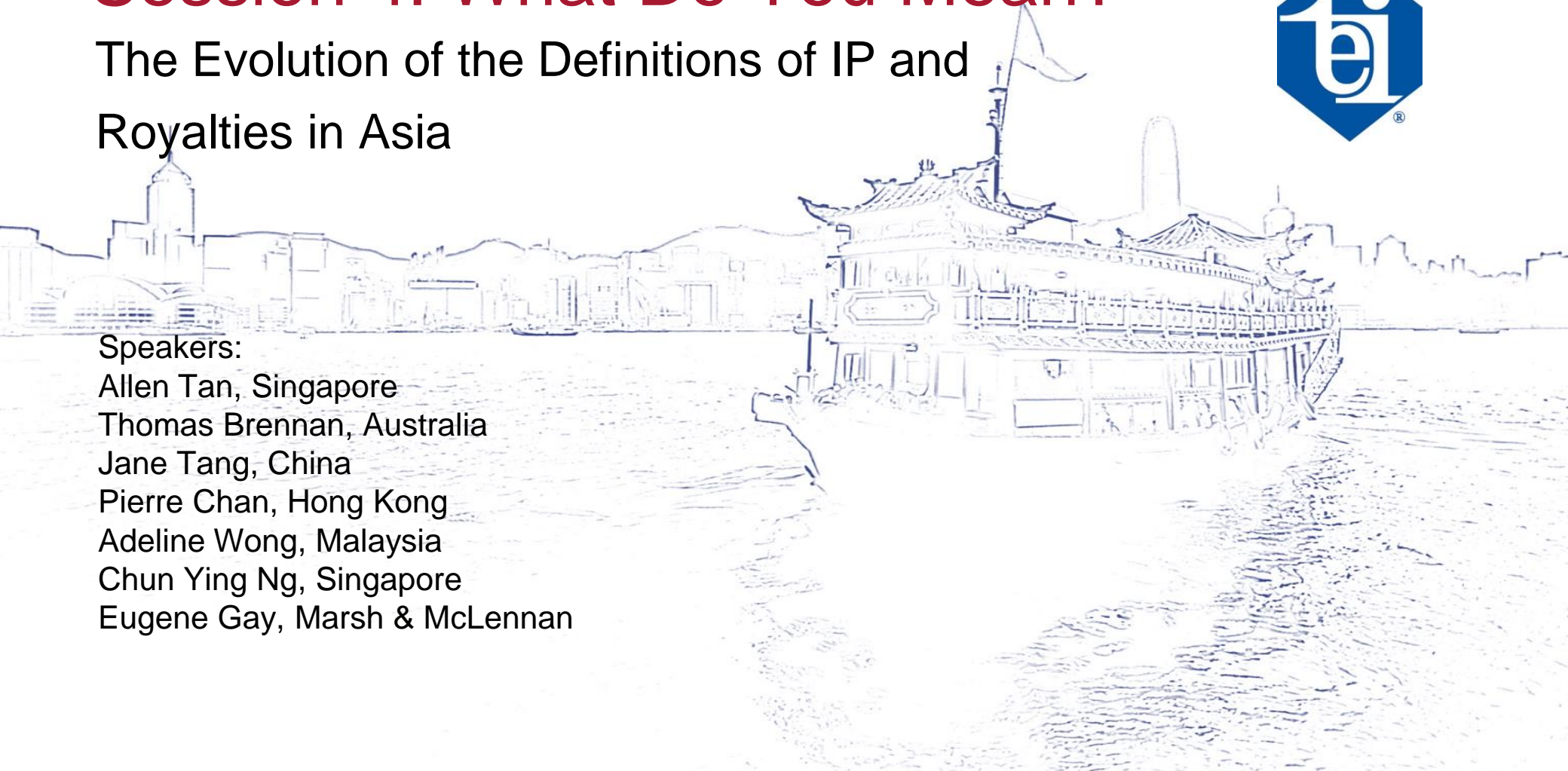
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