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CFC Aspects of Intellectual Property

1. Controlled foreign company rules on passive income from royalties

The issue addressed in this chapter concerns the extent to which controlled foreign company legislation should apply to income arising from the development and exploitation of intellectual property (if, at all). It examines this issue in general terms, and with particular reference to the European Union.

2. The impact of CFC rules

Controlled foreign company (CFC) rules are anti-avoidance measures designed to combat the diversion of income into low tax jurisdictions, or the deferral of the remittance of income by leaving it in low tax jurisdictions.[1] CFC rules owe their origin to

[1] Whether CFC legislation targets only the diversion of income or also the deferral of income depends very much on the nature of the tax regime of the resident parent of the CFC. Where the tax regime of the parent taxes dividends from overseas subsidiaries (possibly with a foreign tax credit), then tax deferral can be achieved by leaving income offshore in a low tax jurisdiction. Where, by contrast, dividends from foreign subsidiaries are exempt, then deferring taxation of dividends in the hands of the parent is generally neutral for tax purposes. The United Kingdom, for example, previously taxed dividends from foreign subsidiaries so that the original UK CFC rules targeted both income diversion and income deferral. Following the move towards a more territorial tax system and the introduction of a dividend exemption for most dividends from subsidiaries, new legislation has been introduced in the Finance Act 2012 which targets only income diversion rather than income deferral. Since more countries now operate an exemption

the United States and the introduction of rules on "Sub-part F" income.[2]

Views differ on the desirability of CFC legislation. By no means every major country, whether OECD member country or Member State of the European Union, has such legislation.[3] The European Commission has commented on CFC legislation as follows:

> "The main purpose of CFC rules is to prevent resident companies from avoiding domestic tax by diverting income to subsidiaries in low tax countries, and – as the ECJ has recognised – CFC rules are in general apt to achieve that purpose."[4]

Where CFC legislation exists, it generally operates first by identifying controlled subsidiaries located in low tax jurisdictions.[5] Once the controlled company is identified, the legislation then operates by reference either to the entire income of the entity in the low tax jurisdiction (sometimes referred to as an "entity approach") or by targeting certain particular types of income that are particularly susceptible to diversion into a low tax jurisdiction (sometimes referred to as the "tainted income approach"). This income, which for the purposes of the legislation is regarded as having been artificially diverted out of the tax net of the parent company, is then brought back into that tax net in one of two ways. One way is to simply attribute that income to the parent and tax it, on a current basis, as if it were the income of the parent. The second way is to treat the CFC as if it had declared a dividend, and to tax the parent on the receipt of that dividend on a current basis.

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system for foreign dividends, the issue of income diversion is the main concern of CFC legislation, and this chapter will refer simply to income diversion.

[2] There is a very good discussion of CFC legislation in OECD, *Controlled Foreign Company Legislation*, OECD, Paris, 1996.

[3] The Netherlands, for example, is a notable example of a country that has not introduced such legislation.

[4] Commission Communication on anti-abuse measures in the area of direct taxation – within the EU and in relation to third countries, COM(2007) 785, 10 December 2007, section 3, p. 6.

[5] For this purpose, low tax is generally defined as below a percentage of the tax that would have been levied in the parent jurisdiction, for example, below 50% or below 75% of the tax in the parent's jurisdiction. Some countries' CFC legislation applies only to controlled companies – in other countries to all other types of entities (such as partnerships or trusts) as well. The focus here is on controlled companies.

Most CFC legislation allows a group to defend itself against the tax charge by pointing to *bona fide* commercial reasons or valid motives for the existence of the CFC in that jurisdiction. Most such legislation also seeks to avoid double taxation by attributing to the parent both the income of the CFC and also any foreign tax paid on that income.[6]

Within the European Union, twelve Member States have CFC rules or equivalent rules.[7] In addition, the Draft Directive on the Common Consolidated Corporate Tax Base (CCCTB) contains CFC provisions.[8] In the Draft Directive, these provisions are as follows:-

> "Article 82
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> Controlled foreign companies
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> 1. The tax base shall include the non-distributed income of an entity resident in a third country where the following conditions are met:
>
> (a) the taxpayer by itself, or together with its associated enterprises, holds a direct or indirect participation of more than 50% [...];
>
> (b) under the general regime in the third country, profits are taxable at a statutory corporate tax rate lower than 40% of the average statutory corporate tax rate applicable in the Member States, or the entity is subject to a special regime that allows for a substantially lower level of taxation than that of the general regime;
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> (c) more than 30% of the income accruing to the entity falls within one or more of the categories set out in paragraph 3;
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> [...]

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[6] There is an important issue here which is not discussed further in this chapter and that is the relationship between the CFC tax charge and provisions in a double taxation convention. Put very basically, the argument can be made that the double taxation convention may well provide that the income of the controlled subsidiary is taxable only in the jurisdiction where that subsidiary is resident. Thus, there is a potential conflict between provisions in the double taxation convention and CFC legislation. This conflict has been resolved differently in different countries: contrast, for example, the UK decision in *Bricom Holdings Ltd v. IRC* [1997] STC 1179 and the decision of the French Conseil d'État in *Re Schneider Electric* (2002) 4 ITLR 1077.

[7] These are Denmark, Estonia, Finland, France, Germany, Hungary, Italy, Lithuania, Portugal, Spain, Sweden and the United Kingdom.

[8] See Proposal for a Council Directive on a Common Consolidated Corporate Tax Base, COM(2011) 121/4, and see also the Working Document of the CCCTB Working Group, CCCTB/WP065/doc/en of 26 March 2008 where the potential CFC rules were discussed.

3. The following categories of income shall be taken into account for the purposes of point (c) of paragraph 1, in so far as more than 50% of the category of the entity's income comes from transactions with the taxpayer or its associated enterprises:
(a) [...];
(b) royalties or any other income generated by intellectual property;
(c) [...]."

It will be seen that this draft provision would include within the tax base of the parent company and subject to tax the income of a subsidiary in which the parent holds a direct or indirect participation of more than 50%, where that income is taxed at lower than 40% of the average statutory rate applicable in Member States (or income subject to a special regime of substantially lower levels of taxation). The categories of income to which the CFC provision in the Common Consolidated Corporate Tax Base applies includes "royalties or any other income generated by intellectual property". Thus, for this purpose, income from intellectual property resulting from R&D would fall within the CFC net.

3. Problems for research and development stemming from CFC rules

In many respects, this draft provision for the CCCTB Directive identifies the problem created for research and development activities by CFC rules.

There are, in a sense, two problems, one more serious than the other.

The first problem arises where a multinational group locates its research and development activities in a particular territory specifically because of a low tax regime for such activities in that territory. This may involve, for example, siting research laboratories in a special technological zone enjoying a special low tax regime. Here, there will be activities on the ground in the low tax zone with perhaps a significant number of personnel engaged in its activities. The income generated by that activity might enjoy a lower tax rate.

The second problem arises where the results of research and development activities – patents, trademarks, copyrights, registered

designs, know-how and any other form of intellectual property – may be "located" in a low tax zone, and the activities of exploiting that intellectual property take place in the zone. This may arise because R&D activities have generated the intellectual property in the zone itself. However, it is more likely to arise where the intellectual property has been generated in another territory (perhaps the high tax territory of the parent of the group), and the intellectual property has then been assigned into the low tax zone and assigned to the controlled foreign company. The latter scenario may very well reflect the type of income diversion against which CFC legislation is specifically targeted.

For example, suppose that a multinational group has a research facility in the home jurisdiction of the group parent, which is a high tax jurisdiction. Research activities take place in that jurisdiction, and the costs (often very substantial) involved in that research and development are deducted from profits for tax purposes in the high tax jurisdiction of the parent company. When that R&D yields results in the form of intellectual property, the intellectual property is then assigned to a controlled entity in a low tax jurisdiction so that income arising from the exploitation of the intellectual property is diverted into that jurisdiction and is received subject to a low tax charge.

(In parenthesis, it might be noted that the intellectual property may be transferred at a time when its value is still quite low as the potential for exploiting the intellectual property is not yet known. Thus, for example, a patent for a medicine might be transferred at a time when testing the medicine is not yet complete or licensing has not been authorised, so that the potential earnings from the medicine cannot be accurately estimated. The consequence is that the nascent intellectual property can be disposed of by the parent without a substantial charge to tax as the market value put on the untested IP is low. Only with hindsight can one see how valuable the IP has proved to be.)

On the one hand, this assignment of intellectual property developed in another jurisdiction may be seen as a classic example of income diversion to which CFC legislation is traditionally targeted. On the other hand, the multinational group might be regarded as perfectly entitled to organise its activities so that income from the exploitation of intellectual property accrues to whichever member of the group it chooses, even to a member that enjoys a preferential tax treatment.

This problem has been particularly exacerbated by the introduction of special, low tax regimes for income arising from intellectual property, such as "patent box" regimes.[9]

Thus, the issue regarding CFC legislation and research and development is the extent to which that legislation should apply to R&D activities carried out in low tax jurisdictions, and to income arising from the exploitation of the intellectual property arising from research and development where the exploitation is managed out of a low tax jurisdiction.

4. European Court case law on CFC rules

It is appropriate at this point to turn to the position of CFC rules under European Union law, as determined from the case law of the European Court of Justice (ECJ).

The leading case in this area is *Cadbury Schweppes Plc v. CIR.*[10] This case concerned a scenario very distant from that of carrying out or exploiting research and development. The taxpayer was the UK-resident, parent of a multinational group, and two subsidiary companies in the group involved in treasury management were located in the Irish International Financial Services Centre in Dublin. In the IFSC these subsidiaries enjoyed a low rate of tax on their profits. When the UK Revenue authorities sought to apply the original UK CFC legislation to the income of these subsidiaries, the parent taxpayer responded that these rules infringed its freedom of establishment. Had the parent company established its treasury management subsidiaries in the United Kingdom, the profits of those subsidiaries would have been taxed in those companies, but the parent would not have had the income or the subsidiaries attributed to it for tax purposes. The tax charge arose, therefore, only because the subsidiaries were located outside the United Kingdom in a low tax jurisdiction.

The ECJ first confirmed that the fact that the group sought to profit from tax advantages available in another Member State could not

[9] See, for example, the patent box provisions introduced in the United Kingdom in the Finance Act 2012.

[10] ECJ C-196/04, *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue*, ECR 2006, I-07995.

of itself deny the parent company the benefit of the European Treaties. The CFC rules, in principle, restricted the freedom of establishment.

However, the UK rules could be justified on grounds that they countered tax avoidance provided that they targeted "wholly artificial arrangements, which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out in national territory."[11] The ECJ referred the matter back to the national court to determine whether or not the UK CFC rules satisfied that requirement and could be justified or not.[12] The ECJ added the following:

> "In order to find that there is such an arrangement, there must be, in addition to a subjective element consisting in the intention to obtain a tax advantage, objective circumstances showing that [...] the objective pursued by freedom of establishment [...] has not been achieved [...]."
> "The incorporation [of the subsidiary] must correspond with an actual establishment intended to carry on genuine economic activities [...]."
> "[...] that finding must be based on objective factors which are ascertainable by third parties with regard, in particular, to the extent to which the CFC physically exists in terms of premises, staff and equipment."
> "[...] a fictitious establishment not carrying on genuine economic activity in the territory of the host Member State, the creation of that CFC must be regarded as having the characteristics of a wholly artificial arrangement." [13]

The difficulty created by the *Cadbury Schweppes* decision is to identify what activities carried out by a controlled foreign company are "wholly artificial" such that they can be the valid target of CFC legislation, or whether such legislation goes too wide and restricts the exercise of the freedom of establishment. This turns on the extent to which the subsidiary has an actual establishment intended to carry

[11] ECJ C-196/04, *Cadbury Schweppes...*, para. 55.

[12] In fact, the case was settled and there was no final determination of the outcome in the UK courts.

[13] ECJ C-196/04, *Cadbury Schweppes...*, paras 64, 66–68, respectively.

on genuine economic activities, and the extent to which the CFC physically exists in terms of premises, staff and equipment.

Before applying these factors to the carrying out of research and development or the exploitation of intellectual property, mention might briefly be made that *Cadbury Schweppes* is not the only occasion when the ECJ has been called upon to consider CFC rules. A similar decision was reached by the Court in *Test Claimants in the CFC and Dividend Group Litigation v. Commissioners of Inland Revenue*,[14] and a provision equivalent to CFC legislation (a provision that provided for a switchover from exemption to credit) was the subject matter of the decision in *Colombus Container Services BBBA & Co v. Finanzamt Bielefeld-Innenstadt*.[15]

5. Problems for research and development from CFC rules in the European Union

It is now possible to put together the elements of the CFC legislation and the European Union case law on CFC legislation in the context of research and development.

In principle, CFC legislation can only be justified if it targets income arising from research and development or intellectual property exploitation in circumstances where objective factors show that there is a wholly artificial arrangement. In practice, it may be extremely hard to apply this approach.

Taking, first of all, research and development itself. This activity is likely to satisfy the criteria in *Cadbury Schweppes* of a genuine economic activity existing in terms of premises, staff and equipment. It may not take a very large research facility, but a laboratory or similar facility will clearly satisfy the objective criteria of premises, staff and equipment. The logical corollary to this is that it is extremely difficult, if not impossible, for one Member State to target the deliberate location of research and development activities in a specific low tax (or no tax) zone in another Member State. There will be a genuine establishment,

[14] ECJ Case C-201/05, *The Test Claimants in the CFC and Dividend Group Litigation v. Commissioners of Inland Revenue*, ECR 2008, I-02875.

[15] ECJ Case C-298/05, *Columbus Container Services BVBA & Co. v. Finanzamt Bielefeld-Innenstadt*, ECR 2007, I-10451.

and the multinational group has simply taken advantage of a low tax opportunity offered by another Member State.

Put another way around, given the potential advantages to Member States of attracting research and development activities into their territory, there is every incentive for Member States to introduce special, low tax, technological zones which would be immune from the CFC legislation of other Member States.

A much more difficult question arises where intellectual property is managed by, for example, the licensing of the technology and the receipt of royalties from the exploitation of the intellectual property. Here the question is whether there can be a genuine establishment where its purpose is to exploit intellectual property, as well as to take advantage of a preferentially low tax rate. The management of the intellectual property may involve some premises, some staff and possibly some equipment. In terms of staff, there may be agents who are responsible for ensuring the maintenance of different levels of protection for the intellectual property (registering patents, registering trademarks, for example), as well as monitoring the flow of royalties. In terms of equipment, this may be no more than computers and servers for databases. At one extreme, such intellectual property management may be carried out by corporate service providers spending a minimum amount of time on the management of the intellectual property. At the other extreme, a large multinational with a significant investment in intellectual property may have a sizeable department of staff involved in managing and exploiting the intellectual property. Certainly, in the latter case, it may be very hard to contend that there is not a genuine activity of exploiting the IP, even though the location of that activity has been driven very largely by tax considerations.

Once again, there is an incentive for Member States to introduce patent boxes or similar regimes to attract the management of intellectual property to that location.

Here one comes to the real difficulty of determining the application of CFC legislation to the exploitation of intellectual property within the European Union. If relatively minimal activities are sufficient to constitute the exercise of the freedom of establishment, then the likelihood is that the exploitation of intellectual property within the Union will gravitate to those jurisdictions willing to forego tax revenue by introducing a patent box regime.

Potentially, there is the real danger of significant leakage from Member States' tax systems. The heavy expenditure of developing intellectual property may take place in the high tax jurisdictions, where the salaries and other costs can be deducted for tax purposes. However, the exploitation of the resulting intellectual property will almost universally flow to low tax, patent box regimes. The traditional solution to this activity of diverting income flows into a low tax jurisdiction is the application of CFC legislation. However, even the relatively minimal amount of activity involved in managing the intellectual property – maintaining registration, ensuring protection, managing royalty flows – may be sufficient to constitute a genuine exercise of freedom of establishment.

This is, in many respects, the real dilemma for controlled foreign company rules with regard to passive income from intellectual property.