Dig into the Intel on IP Income

Understanding the Tax Considerations of IP Income and the New IP Development Incentive

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Intellectual property (IP) is often one of the most valuable and enduring assets that businesses hold. As with other major assets, businesses need to protect their IPs and consider their tax implications.

While IP planning is not new for multinational enterprises (MNEs), it was not until a few years ago that the topic gained greater attention from the authorities and the global media. Tax authorities were concerned that profitable MNEs were using preferential tax regimes or tax havens to artificially shift their profits, generally from a high tax jurisdiction (where the profits were generated) to a low tax jurisdiction (where the profits were booked), resulting in lower tax collection in the former.

Since then, the Organisation for Economic Co-operation and Development (OECD) has carried out the Base Erosion and Profit Shifting (BEPS) project, which provides recommendations on how profits should be taxed where economic activities generating such profits are performed and where value is created. Meanwhile, tax authorities worldwide have stepped up their scrutiny on businesses' IP structures, and IPs held by companies in tax havens are now immediate red flags to tax authorities. Yet, IP planning is not a thing of the past. In fact, it is now more critical than ever for businesses to ensure that their IP structures are well planned and supportable by genuine commercial substance.

In choosing the ideal IP location, traditional factors such as functions and operations, cost drivers, tax consequences, and qualitative factors (such as the perception of risks) remain important considerations. In addition, businesses should also review their operating models to ensure alignment between the DEMPE (Development, Enhancement, Maintenance, Protection and Exploitation) functions performed and the level of profits attributed. Mere legal ownership and funding of the development of an IP do not entitle a company to the returns derived from the IP.

Against this backdrop, Tan Bin Eng, Partner, Business Incentives Advisory; Stephen Lam, Partner, Transfer Pricing, and Johanes Candra, Associate Director, Business Incentives Advisory, Ernst & Young Solutions LLP, shared their insights on the various tax considerations surrounding IP Income developments on existing incentives and the new IP incentive regime in Singapore, at a recent Tax Excellence Decoded (TED) session organised by the Singapore Institute of Accredited Tax Professionals (SIATP).

Traditional Considerations for IP Planning in Singapore

There are numerous tax incentives and schemes available in Singapore relevant to businesses for IP planning purposes. Traditionally, this includes the writing-down allowances, Approved Royalties Incentive, Development and Expansion Incentive under the Headquarters Programme (DEI-HQ), and Pioneer Service Incentive (PC-S).

WRITING-DOWN ALLOWANCE

Writing-down allowance is granted on capital expenditure incurred in acquiring qualifying IP rights under Section 19B of the Income Tax Act (ITA). This is essentially a tax depreciation for the purchase of certain IP assets as defined by the ITA, such as patents and copyrights. Other IP assets, such as customer list and information on work processes, are not covered under the ITA and hence no writing-down allowance may be claimed.

APPROVED ROYALTIES INCENTIVE

The Approved Royalties Incentive reduces the withholding tax rate on royalty payments to foreign parties to access advanced technology and know-how.

DEI-HQ AND PC-S

The DEI-HQ was introduced with the objective of encouraging businesses to use Singapore as base for conducting headquarters management activities to oversee, manage and control their regional and global operations and businesses.

Businesses would generally require a substantial level of regional or global headquarters activities in Singapore to apply for this incentive. Similar to the DEI-HQ, the PC-S was also introduced to attract MNEs to place significant level of activities in Singapore, although it is typically reserved for first movers in the relevant industry.

Both the DEI-HQ and PC-S offer tax concessions for supported projects. The DEI-HQ provides a concessionary tax rate of 5% or 10%, while the PC-S provides a tax exemption on qualifying income. Prior to 1 July 2018, IP income can be covered under both the DEI-HQ and PC-S.

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New IP Incentive in Singapore

It was announced in Budget 2017 that IP income would be removed from the scope of DEI-HQ and PC-S for new incentive awards approved on or after 1 July 2018. IP income derived from 1 July 2018 could be covered under the new IP Development Incentive (IDI).

IP INCOME CARVE-OUT FROM DEI-HQ AND PC-S

Under the legislation, IP is defined as a right conferred by any patent, copyright, trademark, registered design, geographical indication, layout design of integrated circuit or the grant of protection of a plant variety, while IP income is defined as royalties or other income derived from an IP right if it is receivable as consideration for the commercial exploitation of the right.

To assess whether they are impacted by the IP income carve-out from DEI-HQ and PC-S, businesses need to consider the following:

- Is the company currently enjoying (or applying for) the DEI-HQ or PC-S?
- When was the DEI-HQ or PC-S incentive award (or extension) approved?
- Does the company own any IP (including licensing-in of IP)?
- Does the company derive IP income?
- Is the IP income attributable to new or existing IP assets?

Essentially, for companies whose DEI-HQ or PC-S awards were approved or extended before 1 July 2018, income from existing IP rights will continue to be covered under the scope of the respective incentives until 30 June 2021 or upon expiry of the incentives, whichever is earlier. However, any IP rights that comes into ownership of the company on or after 1 July 2018 (or after 16 October 2017 but before 1 July 2018 as a result of an acquisition by the company from a related party where the main purpose or one of the main purposes of the IP acquisition is to avoid income tax in Singapore or elsewhere) will be carved out and IP income derived effective 1 July 2018 and onwards from such IP rights (termed as "new IP assets") will not be covered under the DEI-HQ or PC-S.

For companies with PC-S or DEI awards approved or extended on or after 1 July 2018, IP income derived on or after the first day of the incentive, whether from existing or new IP assets, will be excluded.

ASCERTAINING IP INCOME: EXISTING OR NEW IP

For companies whose DEI-HQ or PC-S awards were approved or extended before 1 July 2018, during the transitional period, businesses would need to ascertain whether their IP income arises from existing IPs or new IPs. Depending on the type of information available, the company may choose the most appropriate of the three methodologies – the direct identification method, the predominance test and the proxy test.

The direct identification method is suitable when the company is able to distinguish the income streams arising from the new IP or existing IP. If the company is unable to do so, a predominance test may be used to determine whether the IP income is predominantly derived from an existing or new IP. Under the predominance test, the entire IP income will be covered under the existing incentive if the IP income is predominantly derived from existing IP. Conversely, the entire IP income will be excluded if the IP income is predominantly derived from new IP.

If neither the direct identification method nor the predominance test is feasible, a proxy test may be used. If the percentage of the new IP rights owned by the company in the basis period is 80% or more (of the total IP rights for that specific IP income stream), all of such income is treated as derived from the new IP. On the other hand, none of such income will be treated as derived from new IP if the percentage of the new IP owned by the company in the basis period is less than 20%. Should the percentage of the new IP owned by the company in the basis period is 20% or more but less than 80%, that same percentage of such income is treated as derived from new IP (and the remainder is treated as derived from existing IP).

INTELLECTUAL PROPERTY DEVELOPMENT INCENTIVE

Based on the draft Income Tax (Amendment) Bill 2018 that was released for public consultation, under the IDI, a concessionary tax rate of 5% or 10% (subject to step-up) will be granted on specified income derived from qualifying IP assets, after applying a modified nexus ratio. Based on the OECD's guidelines, a modified nexus ratio is the amount of qualifying R&D expenditure incurred in proportion to overall R&D expenditure.

The scope of qualifying IP is expected to be narrower under the IDI (as compared to the definition previously used in DEI-HQ and PC-S) as this would be aligned with the OECD BEPS Action 5 report. Accordingly, IP income that was previously incentivised under the PC-S or DEI may or may not be covered under the IDI.

Given the recent changes to IP incentives in Singapore, companies (particularly those that are currently enjoying incentives on their IP income or have new IP assets) should evaluate early the potential impact to their organisations. In aligning with international developments, businesses must be mindful that their IP structures are supportable by genuine commercial substance.

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