

## Will the patent box break BEPS?

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*Tax Notes International [published an article on patent boxes yesterday](#). This got bounced around the Tax Justice Network senior adviser network and I thought I might blog it this morning, but Alex Cobham got there first, so with his permission I share this, [from his Uncounted blog](#):*

The UK has successfully defended the 'patent box' against the charge that it is a major avenue for multinational corporate tax abuse. Now everybody wants one, even though the evidence suggests that only multinationals will benefit.

Will countries take the last chance for productive cooperation offered by BEPS; or will the patent box end up as the paradigmatic case of rich countries 'competing' themselves down (and taking developing countries with them)?

[I'm grateful to Prof. Sol Picciotto, TJN senior adviser and coordinator of the [BEPS Monitoring Group](#), for flagging this issue, and for commenting on a draft.]

### Where things stand

*The term 'patent box' is being used more widely than for patent incentives alone, to reflect a range of preferential tax treatments for intellectual property (IP). Such preferential regimes fall under Action 5 of the OECD's Base Erosion and Profit Shifting (BEPS) [Action Plan](#), which aims to 'Counter harmful tax practices more effectively, taking into account transparency and substance', requiring inter alia 'substantial activity for any preferential regime'.*

*The first Action 5 report suggests three helpful questions for considering whether a preferential regime such as the patent box is harmful:*

- \* Does the tax regime shift activity from one country to the country providing the preferential tax regime, rather than generate significant new activity?*
- \* Is the presence and level of activities in the host country commensurate with the amount of investment or income?*

*\* Is the preferential regime the primary motivation for the location of an activity?*

*In general, pre-BEPS patent box regimes would yield the answers 'Yes', 'No', 'Yes': that is, they are indeed 'harmful'.*

*But when BEPS got underway and a number of countries saw their measures to attract profit-shifting come under increasing pressure, the UK led a vigorous defence of the patent box (supported by other then-users, Luxembourg, Netherlands and Spain).*

*Eventually, however, the UK was forced to give a little ground, in the face of some combination of the logic of the BEPS process, in the initiation of which the UK had played a significant role, and pressure from Germany, where finance minister Schäuble has been an implacable opponent.*

*As Ajay Gupta's handy piece in [Tax Notes International \(\\$\)](#) explains, Anglo-German agreement in November 2014 followed the OECD's September 2014 paper looking at three possible approaches to requiring 'substantial economic activity' in relation to the patent box:*

*\* Value creation (tax benefits apply only if specific criteria for development activities taking place in the jurisdiction are met);*

*\* Transfer pricing (the UK's preferred approach, requiring the assessment of functions, assets and risks); and*

*\* Nexus (the OECD's preference, limiting 'tax benefits to the fraction of IP income equal to the ratio of qualifying research expenditures to aggregate expenditures incurred to develop the IP asset').*

*Two things about the OECD's preference are striking. First, what it means: that even with the BEPS context of defending the arm's length principle and separate accounting against alternatives such as unitary taxation with formulary apportionment, the OECD came out clearly against relying only on a transfer pricing approach to IP. As critics such as the BEPS Monitoring Group have pointed out, allocating profits according to 'functions, assets and risks' is inherently subjective and discretionary, so liable to abuse and likely to produce conflict.*

*Second, the OECD paper set the context for the [UK to retreat](#), at least a little. The Anglo-German compromise, which was immediately taken up [by the OECD](#), was a modified nexus approach: nexus, but as Gupta puts it, 'allowing a taxpayer to increase its qualifying expenditures above its self-incurred research expenditures by up to 30 percent, a so-called uplift, to reflect expenditures for research activities outsourced to related parties and IP acquisition costs.' The UK also bought some time, with June 2016 the last date to introduce new, non-conforming provisions, and June 2021 the date for their elimination, as well as some opportunities to 'grandfather' existing provisions.*

*It should also be pointed out that the BEPS project is likely to propose only a toothless monitoring mechanism, through the Forum on Harmful Tax Practices. This consists of government representatives, and operates in total secrecy. The Forum has been in existence for some 15 years and has been largely ineffective — not surprising, as governments have little incentive to oppose a tax break which they themselves support, or might want to introduce. The ‘nexus’ test will require companies to introduce a ‘track and trace’ procedure to prove their expenditures, but this will presumably be checked only by the country providing the tax break. This is a recipe for [sweetheart deals](#) as we have already seen with Ireland’s tax breaks for Apple and others, and the Lux Leaks revelations.*

## *Where things are headed*

*Gupta, and in [a related piece \(\\$\)](#) his colleague Marty Sullivan, identify the major impacts of the UK-German agreement. Above all, the patent box has been established as a ‘winning’ BEPS strategy: that is, as a mechanism to attract profit-shifting which is acceptable.*

*Hardly surprising, therefore, that there is now a stampede to introduce such tax breaks, each one tailored slightly differently.*

*Current providers already include Belgium, Cyprus, France, Hungary, Ireland, Luxembourg, Malta, Netherlands, Spain and of course the UK. Italy is introducing one (which will especially benefit sectors such as luxury goods and fashion), as well as Switzerland (presumably aimed at watches and cuckoo clocks). There is now also active discussion in the United States about joining the bandwagon. As Gupta puts it:*

*Don’t look now, but the United States just signaled its willingness to enter a race with the European Union for attracting technology investment – a race that will surely end with multinational enterprises walking away with the top prize. As EU jurisdictions fall over each other to adopt patent box regimes and the OECD seems ready to endorse a modified nexus approach for testing the validity of these regimes, the U.S. Senate Finance Committee’s international tax reform working group has recommended the enactment of its own preferential structure for taxing intellectual property income.*

*Sullivan, meanwhile, reviews the latest academic research carried out for the European Commission. His conclusion? With my emphasis:*

*Before Congress adopts a multibillion-dollar tax incentive like a patent box, it should have some inkling as to whether it is effective at increasing research. So far the evidence is very sparse, and what little evidence does exist is not favorable. Yes, a U.S. patent box would be likely to increase patent registrations in the United States. But in most cases that would just be legal maneuvering without any corresponding increase in the stuff we really want: scientists doing research and inventors inventing inside our borders.*

While the BEPS Action Plan reflects the need for countries to coordinate further to avoid such an outcome, the modified nexus approach simply confirms the futile notion of ‘competition’ on tax, locking in a race to the bottom. As the [BEPS Monitoring Group](#) noted presciently in February:

*The OECD approach will simply legitimize ‘innovation box’ regimes and hence supply a legal mechanism for profit shifting, encouraging states to provide such benefits to companies. It will be particularly damaging to developing countries, which may be used as manufacturing platforms, while their tax base will be drained by this legitimized profit-shifting. Such measures should simply be condemned and eliminated.*

### **Last chance saloon**

*All is not yet lost. The OECD has not finally committed to the modified nexus approach, and the US has not yet taken the step to become a patent box ‘competitor’, which would surely make any global step back impossible in the short-medium term at least.*

*What would it take for the rich countries to save themselves from the more aggressive struggle for each others’ tax base that BEPS was supposed to redress? Or to limit the extent to which international rules support developing country revenue losses (which are indeed substantial)?*

*Well, the fine details are still under discussion at the OECD: What chance a piece of genuine international leadership from the UK or US, or a rethink by Germany or others on the acceptability of modified nexus versus complete elimination?*