A Possible Tax Incentive in Latvia: Introduction of Intellectual Property Box Regime

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Abstract
Intellectual Property (IP) Box regime is a relatively new tax incentive targeted at the income deriving from intellectual property and provides either a reduced tax rate or a partial exemption of tax for the income which is generated from IP. Currently eleven EEA member states have introduced an IP Box, mainly in order to incentivise investment in research and development (R&D) and innovation. Latvia currently has one of the lowest rates of investment in R&D amongst all EU member states, thus Latvia should seriously consider the introduction of IP Box, especially since it might positively impact economic growth and success of the country.

Keywords: *Intellectual Property (IP) Box, tax incentive, R&D, Latvia*.

JEL classification: *H25*.

1. INTRODUCTION

1.1. Introduction to the Intellectual Property Boxes

This paper aims at exploring the possibility of introducing Intellectual Property (IP) Box regime in Latvia.

IP Box regime is a relatively new-to-the-world tax incentive – most countries have introduced it in the last ten years – which is aimed at incentivising investment in research and development (R&D) and innovation. IP Box regime is targeted at the income which derives from intellectual property – in most countries patents in particular – and it offers either a reduced tax rate for IP income or a partial exemption of tax for the income which is generated from IP. It has been given the unusual name of a 'Box' regime due to the fact that the pioneering countries, which introduced this tax incentive, had a box to tick in tax forms to be submitted to their

national state revenue offices.[1] IP Boxes vary across countries with regard to what type of IP qualifies in order to receive the tax benefit, whether only existing or also acquired IP qualifies, what type of income qualifies and a number of other factors. Therefore, a common reader may have heard such names for this regime as a Patent Box (in countries where only patents qualify for the tax relief, for example, the UK), License Box (in countries where the qualifying IP has to be licensed, for example, the Swiss Canton of Nidwalden) and Innovation Box (in countries where the regime has gone as far as to include products and services that cannot be registered as patents or trademarks, for example, the Netherlands).[2] For uniformity, all of these regimes will be included in the term 'IP Box' in this paper.

Currently even such large players of the world's economy as China have adopted IP Box regime. Eleven European Economic Area members have IP Boxes, of which nine are European Union (EU) member states.[3] Due to the limited scope of this paper and special circumstances underlying tax incentives in Europe (such as the free movement of goods, services and workforce as a general principle of EU) that distinguish European countries from the rest of the world, the paper will focus on the EU context.

1.2. Reasons underlying the introduction of IP Boxes

The two main reasons underlying the introduction of IP Boxes in as many as eleven countries in Europe are, first, the need for the EU member states to comply with EU general strategic plans (currently – Europe 2020, in the past – Lisbon Strategy and objectives developed in Barcelona summit) and, second, the realization that R&D and innovation are significant factors for the overall national economic growth and success.

The underlying objective of the Lisbon Strategy – a plan for the development of EU's economy between years 2000 and 2010, which was adopted already fourteen years ago – was to make the EU the most competitive economy in the world by focusing on innovation and research and development (R&D) and by making EU's economy increasingly more and more knowledge-based.[4] In line with the Lisbon Strategy there were further objectives developed in the EU summit that took place in Barcelona in 2002, of which one of the most notable ones was to raise investment in the EU to 3% of EU's GDP by 2010.[5] This aim was repeatedly

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[1] ATKINSON, ROBERT D. – ANDES, SCOTT: Patent boxes: innovation in tax policy and tax policy for innovation, report by *The Information Technology and Innovation Foundation*, 2011.

[2] EVERS, LISA – MILLER, HELEN – SPENGEL, CHRISTOPH: Intellectual Property Box Regimes: Effective Tax Rates and Tax Policy Considerations, in *ZEW (Centre for European Economic Research) Discussion Paper*, No. 13-070 (2013).

[3] Source for statistics: Ibid.

[4] Lisbon European Council on 23rd and 24th of March 2000. Presidency conclusions. Available at: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/00100-r1.en0.htm [cit. 2014-09-20].

[5] Barcelona European Council on 15th and 16th of March 2002. Presidency conclusions.

included in the current EU's strategic plan, namely Europe 2020, due to not having been achieved.[6] Therefore, EU member states have had to invent new strategies and incentivises that would help them to comply with these requirements since their low investment indicators proved that the situation will not change without a suitable government interference.

But, of course, a mere desire to comply with EU strategic plans has not been the main reason for the creation of IP Boxes. European countries that have introduced the new tax regime have not done so simply in order to raise investment in R&D to some arbitrary number. Most of the economic models and theories show that the raise in R&D and innovation practices leads to a number of positive changes in national economies, such as increase in high-skilled jobs, manufacturing of high-value products, supply of sophisticated services and others, which subsequently lead to an economic growth. This view is supported by the Organisation for Economic Co-Operation and Development (OECD).[7] Additionally, some economists, for example R. D. Atkinson, go as far as to claim that in fact every modern tax code should explicitly focus on creating opportunities for the increase in investment in R&D and innovation.[8]

1.3. Advantages and disadvantages of IP Boxes

The main advantage of IP Box lies in its difference with other R&D incentivises, such as R&D tax credits and direct R&D funding. IP Box affects the 'output' side of the research conducts – company's income deriving from IP – while tax credits and direct funding affects the 'input' side – company's expenditures related to R&D. Hence, IP Boxes incentivise firms to commercialize their IP rather than merely conduct research and innovation projects that do not lead to a creation of products or services that can be sold. The commercialization of IP positively impacts other processes in nation's economy – usually registered parents are further manufactured which leads to an increase in production of high-value products, raise in high-wage jobs and other factors that helps shifting national economy to a knowledge-based one. Non-commercialized R&D activities do not necessarily lead to the same results.

Further, IP Boxes help to reduce the financial risks that firms incur when they want to invest in innovation. Investing in R&D projects is risky since the outcome of the research cannot be predicted beforehand. Therefore, R&D and innovation

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Available at: http://ec.europa.eu/invest-in-research/pdf/download_en/barcelona_european_council.pdf [cit. 2014-09-20].

[6] Europe 2020: a strategy for smart, sustainable and inclusive growth. Communication from the Commission. Available at: http://ec.europa.eu/eu2020/pdf/COMPLET%20EN%20BARROSO%20%20%20007%20-%20Europe%202020%20-%20EN%20version.pdf [cit. 2014-09-20].

[7] ANDREWS, DAN – DE SERRES, ALAIN: Intangible Assets, Resource Allocation and Growth: A Framework for Analysis, in *OECD Economics Department Working Papers*, No. 989. 2012.

[8] ATKINSON, ROBERT D.: Effective Corporate Tax Reform in the Global Innovation Economy, report by *The Information Technology & Innovation Foundation*, 2009.

needs government-supported tax incentives more than many other business fields. IP Box is a successful tool which encourages firms to undertake investing. R&D tax credits and direct funding may have the same advantage, however they encourage investing in earlier stages of research while IP Boxes – in later stages of research. Therefore, these tax initiatives can successfully co-exist.

Another advantage is that, being first and foremost a tax incentive, which in some countries attains a rather high level of complexity, IP Box impacts not only investment in innovation and R&D in the country, but also creates a different climate for the operation of R&D and innovation companies and changes country's tax profits both in structure and in size. Therefore, a considerable amount of changes take place in country's economy when it opts for the introduction of IP boxes affecting both public and private sector. Together with a favourable corporate income tax rates, appropriate climate for the registration of new companies and a number of other factors, IP Boxes helps European countries to attract foreign companies and their subsidiaries, compete with offshore systems and with such knowledge-based economies as China, the USA and Canada, overall proving to be noticeable players in the international tax competition.

The aforementioned advantage, however, shows one of the disadvantages of the IP Box, which is that IP Box is only one factor of a series of elements which lead to the economic growth and success of a country. When introducing IP Box regime, governments must also think of other changes needed in state's legislation, administrative and economic structure, etc., which would make the particular country convenient for R&D and other business conducts.

Another disadvantage lies in the limited application of the IP Box. In most countries only income deriving from registered patents is eligible for the reduced tax, although including software, business know-how, secret manufacturing processes and other forms of IP would be far more beneficial for the overall economic success and interests of the society in the country.

Further, the disadvantage of IP Box regime in EU member states is that it would be beneficial for the countries to require that R&D and innovation activities which are related to the income that enjoys the reduced tax rate are performed in the particular country.[9] However, due to the EU principle that requires a free movement of goods, services and workforce, it cannot be done. This reduces the overall benefits of the IP Box in a single EU member state while not affecting the positive effects of IP Boxes on the whole EU and EEA economy.

Lastly, there is an ongoing debate in the EU Code of Conduct group discussing whether IP Boxes constitute state aid, which is prohibited by Article 107 under the Treaty on the Function of the EU. While it is unlikely that IP Boxes will be regarded as a state aid in the EU, the countries considering to introduce this tax regime have to consider the risks this might create.

[9] ATKINSON, ROBERT D. – ANDES, SCOTT: Patent boxes: innovation in tax policy and tax policy for innovation, report by *The Information Technology and Innovation Foundation*, 2011.

1.4. Introducing IP Box in Latvia

This paper focuses on trying to confirm the hypothesis that the introduction of IP Box regime in Latvia would increase the investment in R&D and innovation and would positively impact other components that pattern the overall economic success of the country.

Latvia aims to reach 1.5% of its GDP large investment in R&D by 2020, as is set out in the Guidelines on National Industrial Policy of Latvia 2014-2020.[10] Yet the indicator in 2012 has only been 0.66%[11], thus not reaching even half of this aim. As of July 1, 2014 Latvia has introduced R&D tax credit, which is the only R&D related tax incentive in the country. While it will take years to observe the impact of this tax initiative, the experience of other European countries suggest that the new incentive will not be sufficient to help Latvia achieving its goals.

Additionally, together with relatively low corporate income tax (CIT) rate of 15%, residence permit initiative and other government supported strategies, the introduction of IP Box may positively impact the operation of both local and foreign companies in Latvia. These allegations will be analysed in the third Section of this paper.

The rest of the paper is organized as follows: Section 2 overviews selected existing IP Boxes in Europe, thus allowing to observe different aspects of the tax regime that shall be considered when opting for IP Box in Latvia. Section 3 consists of the analysis about the possible introduction of IP Box in Latvia and Section 4 is constituted of concluding remarks.

2. OVERVIEW OF SELECTED IP BOXES IN EUROPE

2.1. Selected countries and introductory remarks

Malta, The United Kingdom and the Netherlands have been chosen as the three EU member states to overview in this section, each selected due to a certain distinct feature of each country's IP Box regime that distinguish it from others. Malta's IP Box tax rate is 0%, The United Kingdom's IP Box can be regarded as a 'typical Patent Box', while the IP Box regime in the Netherlands includes a wide range of IP thus being considered an 'Innovation Box' and having achieved a new level of this tax incentive.

2.2. Malta

Malta's IP Box rate of 0% comes of little surprise since the country is generally

[10] Nacionālās industriālās politikas pamatnostādnes 2014.-2020. gadam [the Guidelines on National Industrial Policy of Latvia 2014-2020], Ministru kabineta 2013. gada 28. jūnija rīkojums Nr. 282.

[11] Provisional. Eurostat table on Gross Domestic Expenditure on R&D. Available at: http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=0&language=en&pcode=t2020_20&tableSelection=1 [cit. 2014-09-20].

recognized as being a tax haven.[12] Malta's CIT rate is 35%, however the country has an imputation system of taxation in place. This means that most of the Maltese companies can apply for a tax refund that makes the national CIT rate turn in an effective rate of only 5%, which is the lowest CIT rate in the EU.[13] Thus, a tax exemption for IP, which was introduced in 2010, seems to be yet another Maltese incentive to make the country into one of the most attractive tax jurisdictions in the world.

Types of IP that qualify for the tax exemption under IP Box regime include patents, as well as copyrights and trademarks associated with the qualifying patents. Therefore, software and databases are exempt from CIT in Malta which is rarely a case in other countries where IP Box regime has been introduced. The main requirement for a patent to qualify for IP Box tax rate is that it shall be a product of either a fundamental, industrial or experimental research. However, the corresponding R&D associated with the creation of a patent can take place anywhere in the world. In addition, the patent can be registered in countries outside of Malta as well, provided that it can be patentable under Maltese laws. Further, Malta's IP Box applies also for those patents, copyrights and trademarks which were registered before the introduction of the new tax incentive and, in addition, companies that have acquired their IP rather than created it themselves, can apply for the tax exemption as well. As regards the qualifying income, the provisions of Maltese law states that "royalties and similar income" deriving from IP can be exempt from CIT, thus allowing companies to apply 0% tax rate to an income which is generally interpreted in a rather broad way.[14]

2.3. The United Kingdom

The United Kingdom (UK) opted for the IP Box regime as recently as in April 2013. The reduced tax rate is 10% which is 11 percentage points less when compared to a CIT rate, which is currently set at 21%.[15] However, the new tax incentive is being introduced gradually in five phases allowing companies to apply 10% tax rate to only 60% of income deriving from IP in 2013 and then raising this percentage by 10% every year up until 2017 when firms will be able to apply the reduced tax rate to all income qualifying for the IP Box tax rate.

The types of IP qualifying for the reduced tax rate are patents that are registered in European patent offices, supplementary protection certificates and veterinary, medical and plant protection certificates. The UK has chosen a "development" and "active ownership" conditions for the companies that tend to apply a reduced tax rate for their income deriving from IP, namely, firms must have played a certain role in the development of a patent thus acquired IP cannot qualify for a 10% tax rate. The UK hopes to incentivise actual R&D and innovation

[12] While there is no universal list of tax havens to support this allegation, this claim is not only supported by a general belief amongst tax advisers but also by surveys and working papers by OECD and other international organisations.
[13] Malta: The IP and R&D jurisdiction. Deloitte Malta. August, 2012.
[14] Ibid.
[15] Source: IBFD Tax Research Platform.

activities with these requirements rather than promote simple buying and selling of IP from company to company in order to reduce the tax burden. Although firms that can benefit from this tax incentive generally have to be either UK-based or UK permanent establishments, the patents can also be owned by non-UK resident companies in case if the firm is a member of a group, in which another firm owns the patent. Thus, benefits of the UK's IP Box can be used not only by local, but foreign firms as well. In the same way as Malta's IP Box, the UK's tax incentive is applicable not only to patents registered after the introduction of IP Box, but also before 2013. Further, similarly to Malta's IP Box, the UK's IP Box regime also maintains a broad definition of qualifying income stating that all relevant income deriving from IP qualifies for the reduced tax rate. The calculation of the qualifying income differs from Maltese one, though, since in the UK IP Box tax rate applies to net income, which is calculated using a specific formula which is stated in the provisions of national law.[16]

2.4. The Netherlands

The Netherlands introduced its IP Box regime in 2007 when it in many ways resembled the UK's 'typical Patent Box' with the reduced tax rate being set at 10% and patents being the main type of qualifying IP. However, in 2010 the Netherlands decided to further develop the new tax incentive by making it even more attractive to R&D and innovation firms. IP Box tax rate was reduced to 5% and new types of qualifying income were included thus making the Netherlands IP Box into what is now known worldwide as an 'Innovation Box'. This IP Box rate is one of the lowest in the world, in addition being 20 percentage points less than current the Netherlands CIT.

Types of IP qualifying for IP Box tax rate are patents that are registered anywhere in the world and IP which has resulted from R&D activities but cannot be patentable according to universal standards, for example, software, trade secrets, manufacturing processes, scientific models and others. For such intellectual property R&D certificate, which is granted by the authorities of the Netherlands, must be gained. While both resident and non-resident companies can use benefits of the regime, the IP Box is aimed at local firms more than foreign since there is a requirement that a Dutch company is responsible for most of R&D activities associated with the patent or non-patentable IP. In addition, in case of non-patentable IP, at least half of respective R&D activities must be conducted in the Netherlands rather than abroad. Thus, the Netherlands has aimed to incentivise local R&D and innovation development with the introduction of their IP Box. Unlike in Malta and the UK, there is a time limit set for qualifying IP in the Netherlands – it must have become a business asset after the end of 2006; IP registered before the end of 2006 cannot qualify for the reduced tax rate. Further, similar to the case of UK's IP Box, the net income deriving from IP is taxed at a reduced rate of 5%.[17]

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[16] Guidance on the Patent Box Regime. Patentise. December, 2012.

[17] European Patent Box Regimes. Japan External Trade Organisation. Pricewaterhouse Coopers LLP. April, 2013.

2.5. Comparison of selected IP Boxes

It can be deduced from the descriptions above that while each of the selected countries has incorporated certain special features and focus areas into their IP Box regimes, all three IP Boxes maintain similar fundamentals.

First of all, IP Box tax rate is significantly lower than CIT rate in all selected countries. Secondly, all of selected IP Boxes focus on IP that is associated with R&D activities and innovation rather than IP of any kind. In this respect the UK and the Netherlands have additional requirements regarding the location of qualifying companies in order to primarily foster local R&D. Thirdly, all three countries have a relatively wide definition for the qualifying income and have chosen not to put a cap on the amount of income that can benefit from the IP Box tax rate thus making this tax incentive accessible for more companies than might seem from the first sight.

However, selected IP Boxes reveal differences as well. Malta has opted for an extreme IP Box regime offering a full tax exemption for the qualifying IP, in addition not putting any constraints on the location where patents are registered and where the respective R&D activities take place. Further, the UK's IP Box is being introduced in phases, has a special formula for a calculation of the qualifying income and requires companies to have actively taken part in the creation of qualifying IP. Finally, the Netherlands has chosen to include non-patentable IP in its tax incentive, focus its IP Box on local firms more than foreign and, unlike Malta and the Netherlands, does not qualify all IP regardless of the registration of it in the patent office.

3. INTRODUCING IP BOX IN LATVIA

3.1. Current taxation and protection of IP

Currently there is no special taxation of income deriving from IP in Latvia, thus the respective income is taxed at a corporate income tax rate, which is 15% for both resident and non-resident companies except for companies that qualify for a micro-enterprise status. Micro-enterprises (which are firms with a turnover of less than 100 000 EUR a year that in addition to this rule have to comply with other requirements stated in national law) have to pay a micro-enterprise tax at a rate of 9% of company's turnover instead of a CIT. Latvia's CIT is the third lowest in the EU with EU's average corporate income tax rate being set at 22%.[18] The average IP Box tax rate in EU countries is 8% with two countries – France and Spain – having IP Box rate equal to Latvia's CIT rate.[19] Thus, on EU scale Latvia's tax regime can be regarded as attractive for the income deriving from IP in spite of having no special tax incentive for that.

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[18] Source: IBFD Tax Research Platform. EU's average CIT was calculated without surcharges; in countries where several CIT rates are applied, the most widely applicable rate was used in calculation.

[19] EVERS – MILLER – SPENGEL: op. cit.

While having no tax incentive for the income deriving from IP, Latvia has an initiative regarding R&D expenditures, which essentially is a R&D tax credit in its nature. Firms can subtract three times of their investment in R&D activities from the income that is liable for a corporate income tax. This initiative came into force only as recently as in July 2014 with R&D tax credit being only half of its current size before this date. Amendments in the Law on Corporate Income Tax not only included raise in R&D tax break but also clarified definitions and scope of R&D activities thus showing that Latvian government is increasingly placing focus on how to incentivise innovation in the country.

Patents, trademarks and designs can be registered in the Patent Office of the Republic of Latvia and are protected by national laws. These types of IP are protected by Law on Patents, Law on Trademarks and Indications of Geographical Origin, Law on Designs and several regulations issued by the Cabinet of Ministers. In addition to this, IP in Latvia is protected by provisions of international conventions that Latvia is a party to. Thus, applicants may file international application for the protection of their invention by using the Patent Cooperation Treaty (PCT) system, by filing an application to the European Patent Office (EPO) or the Office for the Harmonisation in the Internal Market (OHIM), or using other international means. Additionally, as an EU member state, Latvia has to conform to the general principles of the Union, such as free movement of goods and services, and thus has to protect IP registered in other EU member states in the same way as nationally registered IP.

3.2. Current development of R&D and innovation

According to the Guidelines on National Industrial Policy of Latvia 2014-2020, which have been set out by the Ministry of Economics of the Republic of Latvia, Latvia's plan is to support and complement the general objectives of EU, which were described in Section 1 of this paper. Latvia intends to increasingly shift its economy to knowledge-based one by modernizing its industry and producing sophisticated goods and services.[20] As was described in Section 1, reaching an overall 1.5% large investment of national GDP in R&D and innovation fields by 2020 would be a positive indicator which would show that Latvia's economy is successfully growing and developing in the planned way.

However, current indicators of the development of R&D and innovation in Latvia are one of the worst in EU. Only three EU member states currently have a lower rate of gross domestic expenditure on R&D than Latvia with Latvia's investment in R&D being only 32% of the overall EU indicator.[21] Latvia has the lowest share of government budget appropriations or outlays on R&D in the EU with Latvia's rate set at only 0.4% while overall EU's rate having been 1.42% in

[20] Nacionālās industriālās politikas pamatnostādnes 2014.-2020. gadam.

[21] Indicator for year 2012. Eurostat table on Gross Domestic Expenditure on R&D. Available at: http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&plugin=0&language=en&pcode=t2020_20 [cit. 2014-09-20].

2012.[22] Latvia has the second lowest indicator of R&D personnel in the EU not reaching even half of the overall EU rate.[23] Total researchers in business enterprise sector in Latvia constitute only 14% of all researchers in the country thus showing that R&D activities take place mainly in government and higher education sectors rather than corporate sector. In comparison, the respective indicator in the EU is much higher – 37%.[24] Thus Latvia is generally unable to compete in R&D and innovation fields with not only those EU countries that have introduced IP Box regime, R&D tax credits or other R&D related initiatives but also with other EU member states regardless of their R&D tax incentives.

As regards the products of R&D, that is, essentially the creation of intellectual property, Latvia ranks 34 out of 143 in the Global Innovation Ranking 2014.[25] Latvia ranked 49 in relation to patent grants, 55 with regard to trademark registration and 43 in industrial design registration in 2012[26], lagging behind 8 out of 9 EU countries that have introduced IP Box regime and, in addition to that, also most of other EU member states.

Additionally, there are few other indicators which show negative aspects of the development of R&D and innovation in Latvia, for example, only 15 out of 150 Latvian scientific institutes were acknowledged to be competitive on a worldwide basis in a recent assessment conducted by the Ministry of Education and Science.[27]

However, several indicators show that Latvia has the necessary resources to be able to develop its R&D and successfully compete with other EU member states. The share of the population aged 30-34 years who have successfully completed university or university-like education is higher in Latvia than in the EU on average and even exceeds Europe 2020 target[28], which means that the population of Latvia is highly-educated and thus can offer a suitable workforce for innovation related fields. Slowly but steadily Latvia presents itself on the

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[22] Eurostat table on Share of government budget appropriations or outlays on research and development. Available at: http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&plugin=1&language=en&pcode=tsc00007 [cit. 2014-09-20].

[23] Indicator for 2012. Eurostat table on Research and development personnel, by sectors of performance. Available at: http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&plugin=1&language=en&pcode=tsc00002 [cit. 2014-09-20].

[24] Indicator for 2011. Eurostat table on Total researchers, by sectors of performance. Available at: http://epp.eurostat.ec.europa.eu/tgm/refreshTableAction.do?tab=table&plugin=1&pcode=tsc00003&language=en [cit. 2014-09-20].

[25] The Global Innovation Index 2014. Available at: http://www.globalinnovationindex.org/content.aspx?page=data-analysis [cit. 2014-09-20].

[26] WIPO statistical country profiles: Latvia. Available at: http://www.wipo.int/ipstats/en/statistics/country_profile/countries/lv.html [cit. 2014-09-20].

[27] Zinātnisko institūciju novērtējums [Assessment of scientific institutes in Latvia]. Available at: http://izm.izm.gov.lv/ZI-novertejums.html [cit. 2014-09-20].

[28] Indicator for 2013. Eurostat table on Tertiary educational attainment by sex, age group 30-34. Available at: http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&plugin=0&language=en&pcode=t2020_41 [cit. 2014-09-20].

international scene as a country with rapidly growing business area of information technologies (IT) – Latvia has the sixth fastest average Internet connection speed in the world[29] and its potential in IT has been recognized by global technology services, banks and consultant companies which set up their outsourcing centres in the country.

3.3. Advantages arising from introduction of IP Box regime and other considerations

It can be deduced from descriptions in the two subsections above that Latvia has a pressing need regarding the introduction of new government-supported strategies that would increase R&D activities, investment in R&D and innovation, raise the number of registered IP and provide solution to other aforementioned issues. While the introduction of IP Box regime is not the only possible strategy to undertake in order to solve these problems, the described ratios and indicators show that it is unlikely that a simpler and narrower incentive would be sufficient in Latvia's case. Although the advantages of IP Boxes were already discussed in Section 1, it is important to emphasize in the case of Latvia that this special tax incentive not only has direct but also indirect effects which can positively impact economic and social components of the country. The key feature of IP Box incentive is that it is focused on commercialization of IP and increase in income deriving from it. Thus, the introduction of IP Box can, as an example, make Latvia's country image more attractive, increase regulatory quality, incentivise formation of subsidiaries and branches of foreign companies in Latvia, spur manufacturing of products which have been registered as patents through regime, etc.

Thus, even though Latvia's CIT rate is one of the most competitive ones in the EU, Latvia remains to be amongst the countries with high shadow economies. In the World Bank's report Latvia was listed as 53rd smallest shadow economy amongst 120 economies in the world between 1999 and 2007, thus indicating that it has one of the highest shadow economies amongst EU member states.[30] Therefore, one can create such a model: even if Latvia chose to introduce an IP Box with a relatively high tax rate when compared to its CIT rate, for example, half of the current CIT rate, that is, 7.5%, then Latvia's IP Box rate would be the sixth lowest amongst EU IP Box rates (see Figure 1 below). Hence, one can predict that such tax regime would incentivise compliance with tax regulations on a local level and would attract foreign investment from other EU member states.

[29] Akamai's State of the Internet. Q1 2014 Report. Volume 7, number 1. Available at: http://www.akamai.com/dl/akamai/akamai-soti-q114.pdf?WT.mc_id=soti_Q114 [cit. 2014-09-20].

[30] SCHNEIDER, FRIEDRICH – BUEHN, ANDREAS – MONTENEGRO, CLAUDIO E.: Shadow Economies All over the World. New Estimates for 162 Countries from 1999 to 2007, in *Policy Research Working Paper*, No. 5356. (2010).

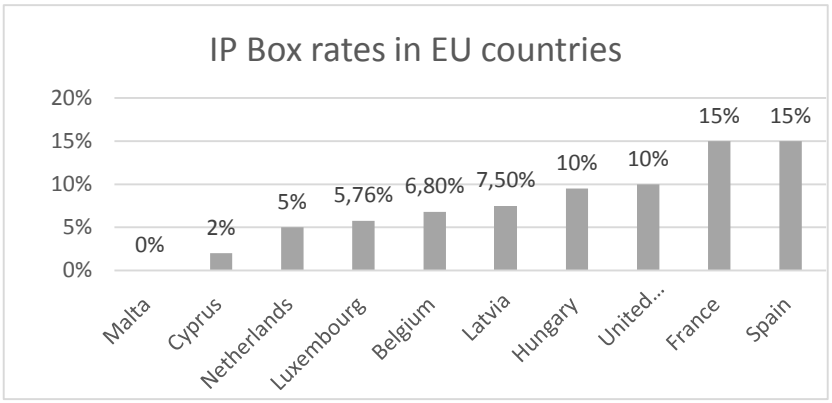

Figure 1: IP Box rates in EU countries. Latvia does not have an IP Box regime and is included in the graph for comparative purposes.[31]

Further, the introduction of IP Boxes would require changes in legislation. While at first this might seem like a burden to businesses since they would have to comply with new provisions of law, it could be a great possibility for Latvia to increase its regulatory quality and enforcement of the rule of law. It would be an opportunity to clarify the regulatory framework regarding R&D and innovation and, in addition to this, also related fields, for example, ones regulated by the Commercial Law, Law on the Micro-enterprise Tax, Law on the Corporate Income Tax and others since the tax system would change. Regulatory quality and enforcement of the rule of law have long been known as important factors which companies consider when choosing a certain business action or overall strategy. Figure 2 (see below) shows that all EU member states that have IP Box regime, except for Hungary, have higher Worldwide Governance Scores in both of these areas than Latvia. Thus, if Latvia opted for an IP Box and, in addition, managed to raise firms' beliefs in Latvia as a country with a clear and trustable system of legal enactments, companies would be incentivised to undertake investment in R&D that they would not have had undertaken without the new regulations.

[31] Source: EVERS – MILLER – SPENGEL: op. cit.

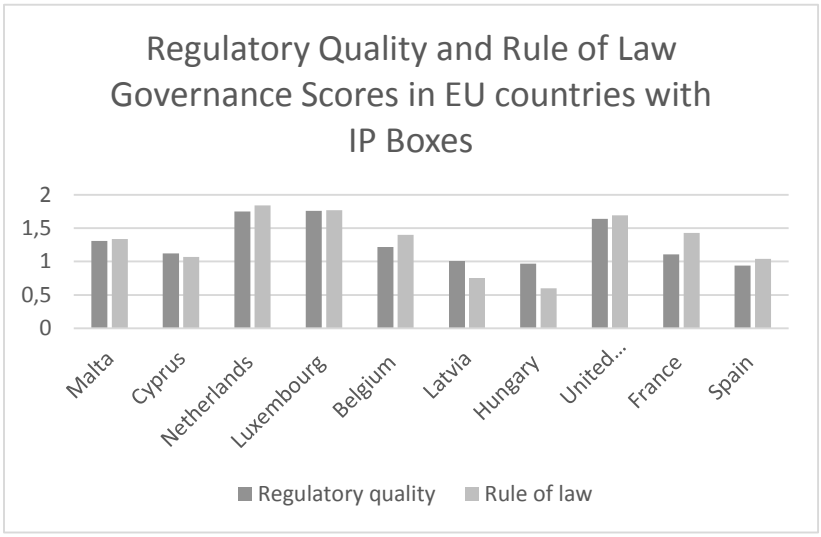

Figure 2: Regulatory Quality and Rule of Law Governance Score in EU countries with IP Boxes (in the range -2.5 to 2.5; data for year 2012). Latvia does not have an IP Box regime and is included in the graph for comparative purposes. Source: Worldwide Governance Indicators.[32]

However, it must be noted that the scope of this paper and available statistical data does not allow to unambiguously state that the introduction of IP Box in Latvia would be advantageous and lead to positive effects described in this paper. IP Boxes are too new of an incentive to give enough statistical data which would either prove or reject the hypothesis that it raises investment in R&D and is a more effective incentive than R&D tax credits, direct funding or others. Additionally, the quantitative considerations regarding possible correlation with other positive effects on Latvia's economy arising from the introduction of IP Box regime maintain certain ambiguities as well. Nevertheless, none of the EU countries that have introduced the IP Box regime in the recent years has opted for a termination of it or publicly called it an unsuccessful tax incentive, therefore it remains to be a tax initiative to consider also for Latvia.

4. CONCLUSION

IP Box is a relatively new tax incentive which offers a reduced tax rate for IP income or a partial exemption of tax for the income which is generated from IP and is aimed at incentivising investment in R&D and innovation. Currently eleven countries in Europe have introduced this special tax regime with the reduced tax rates ranging from 0 to 15%, thus in most of the countries being set at significantly

[32] Available at: http://info.worldbank.org/governance/wgi/index.aspx#reports [cit. 2014-09-20].

lower rates than national CITs. Unlike other R&D and innovation related incentives, IP Boxes are targeted at the income rather than expenses thus incentivising commercialization of IP, which is the driver for economic growth and success since it positively impacts employment and manufacturing of high-value products.

In most of EU member states, the application of IP Box tax rate is limited to patents, however some countries offer this tax incentive to trademarks, designs and non-patentable IP as well. Some countries, such as the Netherlands and the UK, have put constraints on the location of companies that can apply for the reduced tax rate in order to incentivise local R&D. However, this can only been done to the extent that does not violate the principles of free movement of goods, services and competition in the EU.

The introduction of IP Box in Latvia would be beneficial since all R&D related indicators in Latvia are on average much lower than in the EU. Latvia aims to reach investment in R&D in the amount of 1.5% of national GDP by 2020, however the only nation-wide initiative related to innovation has been R&D tax credit, which was introduced only this year. Thus Latvian government has to take a rapid action in order to achieve its own plans. It is very likely that the introduction of IP Box in Latvia would positively impact national economy by attracting foreign investment, raising belief in a fair tax system and regulatory quality, creating new R&D related workplaces and developing knowledge-based manufacturing.

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