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A fresh start for the UK's patent box scheme

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Tax analysis: Now that the UK has reached agreement with Germany about the UK patent box, does this signal a fresh start for the British tax initiative that incentivises profitable exploitation of intellectual property, or will it simply confirm that the scheme is only a ruse for the artificial shifting of profits into low-tax regimes? Peter Denison-Pender, director at MMP Tax Ltd, considers the implications for advisors and their clients.

Original News

Germany and UK agree patent box compromise, LNB News 11/11/2014 102

Germany and the UK have agreed a compromise proposal on patent box regimes. The agreement is based on the OECD's modified nexus approach requiring tax benefits to be connected directly to R&D expenditures, but seeks to address concerns shared by the UK and other countries with revised elements, including: uplift of qualifying expenditure for related-party outsourcing or acquisition costs; transition to closure of existing IP regimes by June 2016 with grandfathering until June 2021; and further work on a tracking and tracing method.

What is the significance of the Anglo-German accord on the UK patent box?

The patent box went live last year and encourages all businesses to commercialise their intellectual property (IP) in the UK by charging just 10% tax on profits from the IP commercialisation. Its impact is far-reaching--the revenue from any product containing any component of eligible intellectual property is eligible for inclusion in the patent box profit and tax computation.

However, the UK scheme has been the subject of international tax scrutiny, led by Germany. This scrutiny led to fears that the scheme would have to be abandoned by the UK government. A compromise deal was agreed between the UK and Germany on 11 November 2014 which will lead to reform of the patent box but will also guarantee its future within the UK tax structure, thereby giving long-term beneficial tax incentives to UK companies that invest in and commercialise their intellectual property.

George Osborne, the UK Chancellor, said the compromise was a 'great deal for Britain--we protect our vital scientific research while making sure there are international rules that stop aggressive tax avoidance'.

Wolfgang Schäuble, the German finance minister, said:

'We have reached an important agreement on patent boxes. Preferential tax treatment of intellectual property must be dependent on substantial economic activity.'

Why is the UK patent box important?

The patent box was welcomed widely by British businesses when it was introduced at the 2011 Budget. It was viewed as an innovative measure to incentivise value-added commercialisation of IP in the UK. It was also seen as a logical counterpoint to the changes in the controlled foreign company regime which made it harder for companies to take their profits offshore. By rewarding those companies who bring their IP profits into the UK, the Chancellor took the sting out of the tightening of the rules for overseas profits.

The pharmaceuticals giant GlaxoSmithKline was one of the first companies to demonstrate that the new regime would incentivise it to change its commercialisation behaviour, and would change its view of the UK as a place to do business. GlaxoSmithKline not only announced within days of the launch of the patent box proposals that it would shift hundreds of research jobs back to Britain, but it also announced that it was committing to building its first new UK site for 40 years.

What triggered the Anglo-German dispute?

The core of the argument was twofold:

- o whether these schemes facilitate genuine economic growth and innovation or whether they simply facilitate tax avoidance, and
- o whether equal and fair treatment can be applied to these schemes across all countries

Germany argued that the patent box effectively gave unfair preferential tax treatment to intellectual property, adding that 'just because something is legal, does not mean it is fair in tax terms'.

The Treasury, in response, argued that the patent box did encourage bona fide innovation because it focused on patents--which are innovative by definition--and also argued that the patent box did not breach the EU's code of conduct covering harmful tax competition and was legal within the context of the UK's jurisdiction over its domestic tax affairs.

Germany also has various direct criticisms. For instance, they considered it unfair that current profits made from patents granted before the regime's start date of 1 April 2013 are eligible for tax relief. They believed this gives relief without necessarily encouraging any further innovation. Germany was also concerned that relief was allowable for profits arising from products that contain a qualifying patent, rather than the direct profits from the patent itself.

The German perception is that the patent box is a tax scheme to help companies avoid tax. The reality is that it is a tax incentive to encourage companies to commercialise their IP. The proposed reforms will ensure reality triumphs over perception.

What is the difference between a 'nexus' approach and 'transfer pricing' approach?

The UK patent box is based on transfer pricing principles which define a substantial activity test and either the IP commercialisation activity passes the test or it does not, and all IP income thus either qualifies, or is disqualified, for the patent box.

In contrast, the nexus approach focuses on the location of activity. It uses the underlying R&D expenditure incurred in creating the IP as a proxy for the extent of activity, and this then defines the proportion of qualifying income generated from the IP that is eligible for tax relief. In essence, the nexus approach means that substantial activity must be undertaken in the jurisdiction offering the relief. It would restrict the UK patent box relief to profits generated from IP that was initially developed in the UK. This is a far greater constraint than existing patent box rules. It also means multi-nationals would have to move their R&D facilities to the UK, and not just their IP profits.

Is the Anglo-German accord a desirable development and is it likely to achieve its objectives?

The proposals will give certainty for the (ground-breaking) UK patent box, and for UK and multi-national companies investing in R&D in the UK and generating IP in the UK. It gives further stability to the UK

technology tax framework which encourages companies to invest in UK people, and UK skills, and UK R&D. It is this investment process that generates UK innovation, UK profits, and UK jobs and prosperity, rather than simply allowing companies to bring their patents into the UK and benefit from UK tax rules on the surface without investing in this country.

Basing the rules on the nexus approach also directly links R&D tax relief to the patent box. It gives a direct link between eligible R&D expenditure and patent box benefit--if eligible R&D expenditure has not been incurred in developing the IP, then the IP profits will not qualify for the patent box. This is the core of the 'nexus approach'. So tracking eligible R&D activity and expenditure will now have a direct and tangible impact on future tax incentives, not just current year tax incentives.

What will the impact be for UK companies and overseas companies operating out of the UK?

The Anglo-German accord will initiate significant reform of the current regime. This will create uncertainty--in the development of the legislation--but also stability in a clearer strategic path for companies to follow in their R&D investment and IP commercialisation.

Conversely, it also gives a competitive advantage for UK businesses which have already elected into the patent box, or are preparing to elect into the patent box. The scheme will close to new entrants in June 2016. Firms that have elected in before the cut-off will continue to receive the tax relief until June 2021, while other firms would be blocked from taking it up until the new proposals come into play which is not likely to be for several years.

These potential changes will also impact numerous different types of IP commercialisation activity currently covered under the UK patent box, for instance:

- o UK companies that develop and acquire patent rights
- o UK companies that use overseas group companies to undertake research and development, and
- o overseas-based multinationals that license IP rights to UK companies

What is the timetable for any likely change?

We will find out more in next week's Autumn Statement when it is likely that a timetable for reform of the patent box legislation will be laid out by the Chancellor.

In the meantime, the UK and Germany submitted their proposal to the OECD Forum on Harmful Tax Practices during its meeting on 17-19 November, and they have also committed to seek formal approval from the OECD and G20 at the January 2015 meeting of the OECD's Committee on Fiscal Affairs.

The prospect is complex from a UK legislative context. The reform will involve new thinking and new rules, probably with a full public consultation, as the changes will affect all the current rules--for instance, it may affect qualifying patent jurisdictions, and it will definitely affect the transfer pricing ethos which underpins the existing patent box principles.

All of these issues will require time and expertise to craft effective legislation.

What are the implications for advisors and their clients? What should they do next?

Advisors should be speaking with their clients immediately to plan for a potential election into the patent box before the deadline date of June 2016 when the existing scheme will be closed to new entrants.

Advisors should also work with the clients to inform and guide submissions into any public consultation process launched by the government as a result of the new proposals.

Has the UK simply caved in to Germany?

A Euro-sceptic view might argue that this UK tax initiative is legal and that Germany has no right to influence or control UK fiscal policy, particularly since the UK is not within the Euro zone.

Wolfgang Schäuble, the German finance minister, did not dispute the legality of the UK patent box and argued that 'just because something is legal, does not mean it is fair in tax terms'.

However, in September it became clear that Britain faced international opposition, led by Germany, over its refusal to adopt new curbs on the patent box. Some 40 countries supported these curbs while the UK was joined only by Luxembourg, the Netherlands and Spain in opposing them. The UK patent box was treated as the lead example of several intellectual property incentive regimes that are the subject of ongoing scrutiny within the OECD Forum on Harmful Tax Practices and the EU Code of Conduct Group.

The issue was also a distraction from the UK government's efforts to lead the base erosion and profit shifting campaign (BEPS) within the G20 and OECD. The BEPS theme is prominent in G20 and OECD international tax discussions where countries want to ensure a level international tax playing field by discouraging rules which allow multinational companies to artificially shift their profits to countries with lower tax rates.

So, this is not just a UK-Germany issue. The main arguments have been led by the UK and Germany because the UK patent box was seen as the most far-reaching of all the various intellectual property incentive regimes within the EU, and because Germany have the strongest objection to date because they currently have no initiatives to incentivise the commercialisation of intellectual property.

Are there any patterns or trends emerging in this area? Do you have any predictions for future developments?

It will not be a surprise if Germany and other developed countries follow suit and develop their own intellectual property incentive tax regimes in the coming years. Now that the main principles for these types of regimes have been established, it will be open to any EU or OECD member state to establish their own scheme within this framework.

While no G7 country has increased corporation tax since 1997, the UK approach adopted by the Coalition government has been driven by George Osborne's oft-stated desire to give Britain the 'most competitive tax system in the G20'. The main rate of UK corporation tax rate has been cut since 2010 from 28% to 21%. Next year it will be 20%--the lowest rate ever in the UK, and the joint lowest rate in the G20.

In the UK, the long-term trend is clear--the government is moving away from taxes on profits, where profits are volatile and vulnerable to manipulation, and instead focusing on more visible, predictable and collectible taxes such as employment taxes, VAT, business rates etc.

Meanwhile, IP incentivisation remains a cornerstone macro-economic policy objective for many developed world economies. The developed world needs strategies to increase the skill base and technology base of their economies to counter the low-cost commoditised production capabilities of the developing world.

Are there any details yet about the proposed changes?

The Anglo-German proposal aims to resolve the concerns that countries have expressed about some features of the modified nexus approach. Concerns have been expressed about issues such as:

- o how to calculate qualifying R&D expenditure
- o transitional arrangements between regimes, and
- o the tracking and tracing methodology for R&D expenditure

The proposal seeks to address the concerns that have been raised, while reinforcing the nexus approach and providing safeguards against profit shifting. These also aim to ensure that the approach to implementing new rules is consistent with existing OECD rules on fair taxation.

The main points have been announced as follows and will be fleshed out in the consultations and legislation to come:

- o a 30% uplift will be allowed to increase the value of the eligible R&D expenditure proxy for outsourcing or acquisition costs
- o the existing UK regime will be closed to new entrants (for both products and patents) in June 2016--the existing scheme will be abolished in full by June 2021
- o IP within the existing regime will be able to retain the benefits of these until June 2021, to allow time for transition to the new nexus regime
- o a practical and proportionate tracking and tracing approach will be introduced that can be implemented by companies and tax authorities with practical methodologies that companies and tax authorities can adopt to map R&D expenditure to IP creation

Will these measures be successful and encourage technical innovation to remain in the UK?

The patent box is precisely what we should be doing to encourage UK industrial competitiveness on a global front, particularly to give UK plc the best opportunities to create high value, skilled jobs in pharmaceuticals, hi-tech, engineering etc.

These new proposals will link the benefits more closely to R&D investment.

The end result should be clearer benefits for corporate R&D and IP commercialisation efforts, and this should benefit UK PLC as a whole.

Peter Denison-Pender is an experienced professional with a track record of business creation, technology commercialisation and investment. Currently, Peter is the only individual on the government working groups for both R&D Tax Relief and Patent Box Tax Relief. He is a Fellow of the Association of Chartered Certified Accountants and a member of the Institute of Chartered Financial Analysts.

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