Patent nexuses

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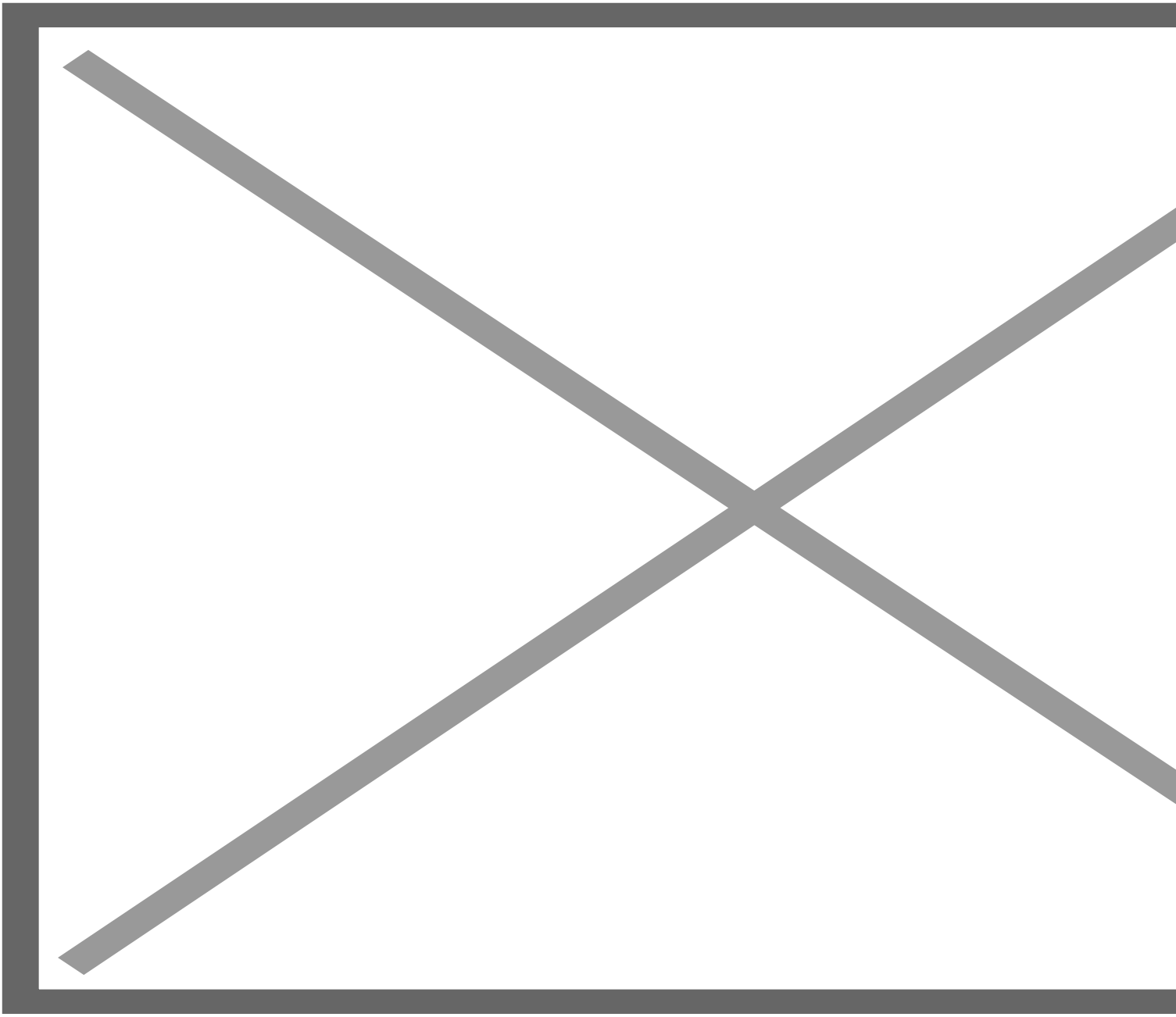

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Nigel Dolman considers what the future holds for patent boxes

Key Points

What is the issue?

The OECD's BEPS project, as well as scrutiny at a European level, has turned the spotlight on intellectual property tax regimes, including the UK's patent box. As a result, changes are being phased in to all such regimes

What does it mean for me?

The changes could mean increased tax rates on certain IP-related income streams. In particular, businesses that outsource R&D activity will need to consider how they will be affected

What can I take away?

Businesses need to prepare for the phasing out of existing IP tax regimes and the introduction of new ones. As well as the tax impact, the cost of setting up systems to track and trace IP expenditure will need to be taken into account

Intellectual property tax regimes (including the UK's patent box) are changing. A new international approach has been agreed and patent boxes must comply in order not to be regarded as harmful tax practices. Decisions on the details of these changes still need to be made, however.

Background: BEPS

One of the key actions in the OECD's project to tackle base erosion and profit shifting (BEPS) is Action 5, which aims to counter harmful tax practices more effectively, taking account of transparency and substance. The focus of Action 5 has been on substantial activity, in the context of regimes that provide preferential tax treatment for certain income arising from qualifying intellectual property (IP) regimes.

The OECD proposed a 'nexus approach', under which there would be a direct nexus between the income receiving benefits (in the form of lower tax rates) and the activity contributing to that income. It would mean that benefits could only apply to the income arising from IP where the actual R&D activity is undertaken by the business itself. The income arising from capital contribution to or expenditure on substantial R&D activity by an entity other than the company claiming the benefit would not qualify for reduced tax rates. A review of the existing regimes in OECD member countries was also proposed.

This nexus approach is stricter than the conditions that currently apply to some IP tax regimes. For example, a company can benefit from the UK patent box if it is a member of a group in which another group company has carried out a qualifying development, provided that the UK company that is claiming the benefit has played a significant role in managing the portfolio of patent rights, or of products that incorporate the patent rights. This formulation would be unlikely to satisfy the nexus test.

A majority of countries accepted the nexus proposal, but it was rejected by the UK, the Netherlands, Luxembourg and Spain. In November 2014, the UK and Germany tabled a plan to resolve the disagreement.

Modified nexus approach

The modified nexus approach put forward by the UK and Germany maintains the need for a link between the income eligible for tax benefits and the activity generating that income. However, it recognises that IP companies which choose to outsource their R&D activity to other group companies are unlikely to be able to benefit from reduced tax rates on the resulting income. Such outsourcing is particularly common in the pharmaceutical and biotech industries.

The approach allows related party outsourced expenditure (and any IP acquisition costs) to be taken into account. However, the underlying theme is that the proportion of income that can benefit from an IP tax regime is the same proportion that qualifying expenditure bears to overall expenditure. In order to reflect that principle, a 30% cap will apply to otherwise qualifying R&D expenditure. The OECD has given some explanation on how this calculation, termed the 'uplift', would work in ***Example 1***.

Example 1

In each case, parent company qualifying expenses are 100, so the maximum uplift amount is 100 x 30% = 30.

a)
Parent company acquisition costs = 10
Subsidiary R&D expenses = 40
Overall qualifying expenses = 130

b)
Parent company acquisition costs = 5
Subsidiary R&D expenses = 20
Overall qualifying expenses = 125

Some businesses are unhappy with this approach, however, on the grounds that it favours non-EU countries. The OECD proposed in its September 2014 Deliverable on Action 5 to allow non-EU member states to vary the limitation on the uplift (to the lower of all non-qualifying expenditure or 30% of qualifying expenditure), giving them a competitive advantage over EU member states. Also, the extent to which member states could adopt different definitions of qualifying expenditure is not clear at this stage. Variations would lead to uncertainty and might even result in a breach of the fundamental freedoms under European law.

Agreement and timetable

All OECD and G20 member countries have now endorsed the proposals put forward by the UK and Germany. This means:

- in 2015, countries must begin the process of changing their laws for existing IP regimes;
- by 30 June 2016:
    - new regimes, including the modified nexus approach, must take effect, and
    - existing regimes must be closed to new entrants (countries can specify an earlier cut-off date if they wish); and
- by 30 June 2021, no more tax benefits can be given under non-nexus compliant regimes (countries can choose an earlier date if they wish).

Practicalities and guidance

Coinciding with the announcement of the agreed modified nexus approach, the OECD published a short guidance note on it. This has generated a flurry of comments from businesses on potential practical problems, as well as on the scope of what is proposed.

The only IP assets that could qualify for benefits, under OECD proposals, are patents and functionally equivalent IP assets that are legally protected and subject to approval and registration processes where relevant. This is not final, however. The OECD is still considering the definition of qualifying IP assets, looking in particular at copyrighted software and at innovations from technical developments or scientific research that are not patented. The existing UK patent box applies only to income from qualifying patents, but regimes in other countries are broader. Under the OECD's new definition, marketing related IP assets, such as trademarks, are explicitly excluded.

Businesses will need to track and trace IP income and R&D expenditure on an asset by asset basis in order to demonstrate the necessary nexus. Countries will have the freedom to develop their own procedures, but this is not going to be straightforward. Some businesses have already pointed out that separating R&D expenditure in this way is unrealistic, since the R&D in question could relate to several innovative products or developments.

There is likely to be particular difficulty where IP is transferred from existing regimes (that do not require tracking) to new regimes. In order to avoid imposing significant compliance costs on business, approved methods are needed that will fit in with existing accounting processes and systems, as long as these record income and expenditure in such a way as to be able to establish the link between them.

Anti-avoidance

The long grandfathering period for existing regimes has prompted concerns that businesses will pile into them before the closing date in order to maximise the benefits. The OECD is considering increased transparency (eg exchange of information on businesses benefiting from a grandfathered regime), monitoring of new entrants and possible restrictions.

European Commission perspective

A welcome development was the announcement that the EU Code of Conduct Group for business taxation had dropped its review of IP tax regimes across Europe. In 2013, the European Commission gave an opinion that the UK's patent box regime was a potentially harmful tax practice and that it was to be reviewed. The focus was subsequently broadened to include other European regimes. That review has, to an extent, been overtaken by events on an international level; and it was recently confirmed that it would be discontinued, on the grounds that in 2008 the Commission had approved a patent box regime in Spain and that approval gave 'legitimate expectations' that such regimes are legal.

However, the question of patent box and similar regimes is still on the Commission's agenda. We can expect to see its action plan on corporate taxation on 18 June, setting out how the outcomes of the BEPS project can be implemented into European law. According to an official, the Commission might develop its own rules on specific issues, such as permanent establishments and patent boxes, which might go further than the OECD's recommendations.

Interestingly, the Commission admitted in its *Tax Transparency Package*, published on 18 March, that the Code of Conduct has become a less effective tool for tackling harmful tax regimes. This is partly because its criteria were inadequate to assess certain modern and complex tax regimes; and partly because the Code of Conduct

Group lacked a strong enough mandate to act decisively against such regimes. The Commission will therefore try to improve the code and make the group more effective.

Next steps: UK

The UK government will be introducing legislation to change the existing patent box rules and to introduce a new regime that complies with the modified nexus approach. This will include transitional provisions and possible anti-avoidance rules, and is likely to appear later this year.

Businesses need to plan for potential reductions in tax benefits once the current regime comes to an end, consider the impact of the uplift and plan for the new regime. The cost of introducing appropriate systems to track and trace expenditure will also need to be factored into the equation.