

AN ALERT FROM THE BDO INTERNATIONAL TAX PRACTICE

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SUBJECT

UNITED KINGDOM TAX AUTHORITY ISSUES A CONSULTATION DOCUMENT SETTING OUT THE PREFERRED APPROACH OF THE UNITED KINGDOM GOVERNMENT FOR AMENDMENTS TO THE UK PATENT BOX REGIME

SUMMARY

On October 22, 2015, the United Kingdom tax authority, Her Majesty's Revenue & Customs ("HMRC"), issued the consultation document "Patent Box: substantial activities." This document sets out the UK Government's preferred approach to changes in the design of the UK patent box rules so that they comply with the new international framework for preferential tax regimes for intellectual property ("IP") set out by the Organisation for Economic Co-operation and Development ("OECD").

The intent of the proposed changes to the UK patent box regime is to ensure that businesses can only benefit from the preferential tax rate where they have conducted the substantial activities that generated the income benefitting from the regime. The agreed approach uses research & development (R&D) expenditure as a proxy for substantial activity and links benefits to the requirement to have undertaken the R&D expenditure incurred to develop the IP.

BACKGROUND

The UK Government is committed to creating the most competitive tax system in the G20. As part of that commitment corporate tax rates have been cut to 20 percent and will drop to 18 percent by April 1, 2020. The UK patent box, which provides for a 10-percent corporate tax rate on profits arising from qualifying IP, is a key part of this initiative.

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In order to comply with the OECD's Base Erosion and Profit Shifting ("BEPS") project, in particular to ensure that preferential tax regimes such as the patent box have sufficient economic substance such that they cannot be used for profit shifting, the UK patent box rules require amending.

DETAILS

The UK patent box was introduced on April 1, 2013, and provides for a reduced rate of corporation tax (10 percent) on profits arising from qualifying IP. While the current patent box rules require that certain conditions be met with respect to ownership and active development of the IP qualifying for the patent box, the rules do not align with the now mandatory "nexus" approach, which requires that benefits under the regime must be linked to the level of R&D expenditure incurred to develop the IP as a proxy for substantial activity in relation to that development.

The consultation document sets out the UK Government's proposals that, in the future, IP profits be required to be tracked and traced to the level of the IP (the patent) itself, a product or a product family. It will then be necessary to apply a "nexus fraction" to each IP profit parcel to ensure that companies can only benefit from the patent box in proportion to the activity they have performed on that IP.

The nexus fraction ("N") uses R&D expenditure as a proxy for substantial activities and is calculated as:

$$N = \frac{D + S + U}{D + S + A + R}$$

Where:

- ▶ D is in-house direct R&D spend
- ▶ S is expenditure on R&D subcontracted to third parties
- ▶ A is expenditure on acquiring IP
- ▶ R is expenditure on R&D subcontracted to related parties

U is an allowed uplift to qualifying R&D expenditure, (making UK rules an allowable "modified nexus approach"), which is calculated as the lesser of A + R and 30 percent of (D + S).

The nexus fraction is a rebuttable presumption, i.e., in exceptional circumstances a company may be allowed to challenge the outcome of the nexus fraction where it does not align with the underlying principle of nexus to link the patent box benefit with substantial activity.

The new rules will operate beginning July 1, 2016. Companies that are already elected into the current UK patent box regime, or elect in prior to June 30, 2016, will continue to benefit from the existing patent box rules until June 30, 2021, but only in respect of IP that exists at June 30, 2016, after which they will switch to the new regime.

The consultation document asks for comments on various issues including: whether streaming should be required in all circumstances; how R&D should be defined; how joint development should be dealt with; the timing in relation to expenditure included in the nexus fraction; and what circumstances should be regarded as exceptional to allow companies to challenge the nexus fraction.

The consultation period will take place from October 22, 2015, to December 4, 2015, with draft legislation expected in December 2015. A response to the consultation should be published during spring 2016, at which time, any amendments to the draft legislation will also be published, including those arising from changes required in response to comments received in the consultation period.

BDO INSIGHTS

The UK patent box should continue to provide benefits for companies with qualifying patent income. For groups not already elected into the regime, consideration should be given to ensuring that relevant patents are registered and the election made prior to June 30, 2016, to allow for qualification under the old regime through June 30, 2021.

For companies coming into the new proposed regime, consideration should be given to whether R&D can be incurred in the UK to maximize the nexus fraction and hence associated patent box benefit. However, companies should also be prepared for a significant increase in the compliance burden associated with the new patent box regime.

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