ICAS response to the HMRC and HM Treasury consultation document
‘Patent Box: substantial activities’

3 December 2015
About ICAS

The Institute of Chartered Accountants of Scotland ("ICAS") is the oldest professional body of accountants. We represent around 20,000 members who advise and lead businesses. Around half our members are based in Scotland, the other half work in the rest of the UK and in almost 100 countries around the world. Nearly two thirds of our members work in business, whilst a third work in accountancy practices. ICAS members play leading roles in around 80% of FTSE 100 companies. ICAS is also a public interest body.

General Comments

ICAS welcomes the opportunity to comment on the HMRC and HM Treasury consultation document ‘Patent Box: substantial activities’.

ICAS recognises that the proposals attempt to incorporate the OECD requirements without unnecessary complexity. However we are concerned that some small companies are already deterred by the complexity of the existing rules, particularly the aspects involving notional royalties and the use of transfer pricing principles. This is likely to be aggravated by the proposed changes which increase complexity in a number of areas.

The new regime will require data to be collected and retained at the level of the individual patent, product or product family. This will create a significant compliance burden for companies as the current regime allows profits to be calculated using either a proportional split or streaming. This will effectively mandate the way in which companies collect financial data if they want to claim tax relief. The need for such detailed information is likely to act as a barrier for those companies who are not already multi-national enterprises with significant resources. Most modern accounting and management information reporting systems are unable to generate this level of detail in reporting income, so companies which want to claim patent box tax relief will need either bespoke add-ons to their accounting systems to capture this information or additional staff time to analyse data from the system and then substantiate their claims. Both options will add considerably to compliance costs. The experience with R&D tax relief suggests that this hurdle will be most difficult for SMEs. It is fast-growing, innovative companies outside the traditional pool of multi-nationals where the economic benefit of the relief would be the most valuable to the UK economy.

To assist small companies we suggest that HMRC should extend the Advance Assurance scheme for R&D claims to cover Patent Box to try to ensure that innovative small companies are not excluded from using it. In this context it is worth noting that over 15,000 SMEs claimed R&D Relief in 2013/14 whereas the consultation notes that only 639 companies in total have so far taken advantage of Patent Box (and many of these will be large companies).

We are also concerned that even larger companies which already use Patent Box may have difficulties dealing with the transitional rules as currently proposed, particularly where they have a product which incorporates both old regime and new regime patents.

We have suggested some specific simplification possibilities in our responses to the questions.

We also note that the take up of Patent Box to date has been below the original predictions: the consultation document states that 639 companies have received benefits totalling £335 million. The revised 2012 TIIN2 predicted £350m for 2013/14, £720m for 2014/15 and £820m for 2015/16. The post-BEPS regime is likely to reduce the benefits of patent box for many companies. We therefore see scope for improvements and extensions to the regime to maintain and enhance the attractiveness of the UK Patent Box. These are discussed in our response to Question 1 below.

---

1 Making R&D Easier HMRC’s plan for small business R&D tax relief, October 2015

2 Overview of Tax Legislation and Rates, March 2012
Specific questions

Question 1 - The Government would be grateful for any wider comments, beyond responses to the specific questions below.

As noted in our general comments above we see scope for improvements and extensions to the Patent Box regime. We therefore suggest that the Patent Box should be extended to cover copyrighted software, as permitted within the OECD rules. We also suggest that it should be extended to cover US Patents which are currently excluded.

As noted in the consultation document the current patent box is being phased in so that companies will only fully benefit from the 10% rate from 2017/18. Given the lower-than-predicted costs of the regime to date we suggest that phasing in could be ended now so that companies can obtain the full benefit of the 10% rate earlier.

We also believe that consideration should be given to allowing companies to opt into Patent Box on a patent by patent basis rather than on a company basis.

Question 2 - The Government would be grateful for views on whether the current approach to defining profits should be retained, including any evidence supporting the retention of a small claims election.

ICAS broadly supports the retention of the current approach to defining profits in order to minimise disruption for those already claiming Patent Box who will be familiar with the existing rules. As noted above in our response to Question 1 we are concerned about the effect of the complexity of the new regime on claims by smaller companies. We therefore also support the retention of a small claims election.

We wonder however if the government could go further in simplifying computations for smaller companies. One area of difficulty for these companies is the notional royalty provisions which have to be applied where a company uses a patented invention in a way which does not give rise to relevant IP income, for example, to create non-patented products or to provide services. The notional royalties must be calculated in accordance with transfer pricing principles which is already likely to deter small companies from using Patent Box. Coupled with mandatory streaming (which we consider below in our response to Question 4) the deterrent effect is likely to be greater under the new regime. We therefore suggest that this aspect of the rules should be reviewed to see whether smaller companies could be given the option of a simpler method of calculation linked to the actual income.

Question 3 - The Government would be grateful for views on requiring streaming in all cases.

We recognise that the OECD approach makes it difficult to retain the proportional split approach to calculating profit for the Patent Box. However proportional split is simpler to operate than streaming. As noted in our response to Question 3 above we would like consideration to be given to making simpler options available to smaller companies under the new regime.

Paragraph 3.10 of the consultation document describes a possible exception to streaming where a company has only incurred qualifying expenditure (plus, perhaps, very small amounts of non-qualifying expenditure, which would be covered by the uplift) so that the nexus fraction equals 1. If a company met this ‘gateway’ test it could use proportional split.

We note the reasons given for rejecting this approach but these make the assumption that the company’s approach to its IP development will change in future, so we suggest that this should be reconsidered. Any companies (not just smaller ones) with relatively straightforward arrangements for developing their own IP might be able to use proportional split indefinitely if their circumstances did not change. Clearly there would need to be provisions to cover the situation where a company which had used proportional split changed its approach, so that it could no longer do so. These would no doubt be complex but we are not convinced that this is a sufficient reason for rejecting the suggested simplification without further consideration.
Question 4 - The Government would be grateful for views on the suggested approach to the rebuttable presumption, especially on what circumstances should be considered exceptional and justify its use, and what examples should be included in guidance.

ICAS agrees that the flexible approach set out in paragraph 3.14 (i) would be preferable to the exhaustive list option described in 3.14(ii). As noted in paragraph 3.15 an exhaustive list would be likely to lead to unfair exclusions. We agree therefore that the legislative approach should be flexible and should allow companies to provide evidence of exceptional circumstances to support their claim to an adjusted fraction. It would be useful to have examples of what would or would not be considered acceptable in HMRC guidance.

Question 5 - The Government would be grateful for comments on the suggested approach to co-development.

We welcome the Government’s agreement that co-development arrangements should not be disadvantaged.

We do, however, disagree with the proposal that funding or other non-R&D contributions should automatically be treated as acquisition or related party subcontracting costs. In our experience, it is inevitable that the parties to any co-development agreement are required to true-up their R&D contributions each period, which means that one or more parties will be obliged to provide non-R&D (typically cash) contributions to the others. This is best illustrated by a simple example.

Two otherwise unrelated companies, A and B, come to an agreement whereby each is contractually obliged to provide 50% of the R&D effort to a co-development agreement. At the end of year one, it transpires that Company A actually provided 125 of R&D and Company B actually provided 75 of R&D. In that scenario, Company A has over-provided R&D, and is due cash funding of 25 from Company B.

Company A’s nexus fraction would seem to be 125/125. We do not believe that 25 of cash funding from Company B would alter Company A’s nexus fraction, but even if it were taken into account then the alternative would be a nexus fraction of 100/100 – the same result.

Company B’s nexus fraction would be 75/100 (ignoring the 30% uplift) – if its cash funding into the co-development agreement is deemed to be related party outsourcing or acquisition expenditure, despite the fact that all of its R&D efforts would qualify in full if it had undertaken its part of the R&D alone.

This does not seem to be an equitable result. Where the parties to a co-development agreement are not, as a matter of fact, related parties then we take the view that it would be better for true-up cash funding to be treated as third party outsourcing. If this were the case, then Company B’s nexus fraction would be 100/100.

Question 6 - Do respondents agree that

- the same definition of R&D should be used for nexus as for R&D tax credits?
- expenditure for the nexus fraction should be relevant R&D of the company?
- the definitions of and rules for calculating direct and subcontracted expenditure should be aligned with the R&D tax credits, as set out above?

We agree that it is sensible to align the definitions as closely as possible with those used for R&D tax credits. Existing users of R&D tax credits will be familiar with these definitions so this will provide some certainty.

It would be useful to have some clarification from HMRC of how they will interpret the requirement that expenditure for the nexus fraction should be relevant R&D of the company, in the context of a group.
Question 7 - Do respondents agree with the suggested approach to the timing of expenditure for the nexus fraction?

As noted in our response to Question 6 we support alignment with the R&D rules where this is feasible. We therefore agree that following the timing of expenditure rules used for R&D tax credits (including the provisions of s1308 CTA 2009 in respect of capitalised expenditure) is a sensible approach.

We also agree that the existing Patent Box anti-avoidance rules in s357FB CTA 2010 should be used to counter attempts to manipulate the nexus fraction. We believe that this would be preferable to introducing new anti-avoidance rules, for example, based on the film tax provisions.

Question 8 - The Government would be grateful for

- views on the merits of the suggested approach to tracking and tracing, in contrast to defining “product” and “product family” more precisely; and,
- suggestions as to what factors might be relevant in judging the conditions set out in paragraph 4.03.

This will clearly be a difficult process for many companies, with a strong subjective element in determining the most appropriate level for tracking and tracing and producing the evidence to demonstrate this to HMRC. We do not have any detailed comments as we believe this is a matter for the companies which will have to implement the proposals in practice.

However as noted elsewhere we are concerned about the impact of the complex requirements of the new regime on smaller companies. Large companies will be able to discuss their approach with their CRMs and relevant specialists. Small companies do not have this option so tracking and tracing is another area which may deter them from electing to use Patent Box unless they have access to some assistance. This could be provided through an extension of the R&D Advance Assurance Scheme to Patent Box as we suggested in our general comments above.

Question 9 - The Government would be grateful for views on the alternative approaches suggested for dealing with pre-merger costs, including, under option (i), how long this treatment ought to last. The Government would also welcome suggestions for any alternative options which respondents feel may better address the issue raised at 4.09.

We agree that if two companies merge, each owning IP with an established spending history, it would be right to recognise this as ‘own spending’ when calculating future nexus ratios. We note the government’s concerns about possible ‘contrived’ mergers. Of the three options proposed to address this we think the first proposal, a form of loss streaming, would be feasible although, as with other aspects of the new regime, it is likely to create complexity. We understand that HMRC is considering a possible time limit on the streaming requirement; this would be helpful as the separate records required for streaming would only have to be maintained for a finite period.

If the second option (purpose test) were to be adopted we consider that there should be a formal clearance procedure to provide certainty of treatment. Whilst not being the main purpose of a transaction, the treatment of IP might be a factor in a merger, and the tax treatment would certainly have to be considered, so without a clearance procedure commercial transactions might be hindered by lack of certainty about whether the anti-avoidance rules would apply.

We do not support the introduction of rules to mirror the restrictions on loss buying.

Question 10 - The Government would also welcome information about any other circumstances in which a company may come to own IP and which may not be clearly addressed by the proposed rules.

We have no evidence on which to comment.
Question 11 - The Government would be grateful for views on the suggested approach to retiring expenditure from the nexus fraction, including other suggestions for addressing the issue without introducing undue complexity.

We support the proposal for a simple approach. We have no comments on whether the 15 years suggested is an appropriate period; this should be determined by input from affected companies.

Question 12 - The Government would be grateful for views on the suggested rules for calculating the nexus fraction, including the lengths of the time periods to be used (with evidence if possible showing why these are appropriate).

We have no detailed comments on most of these proposals which seem broadly sensible. However we are concerned about the scenario outlined in paragraphs 4.25 and 4.26 which relate to a product which contains both old and new IP. The proposed requirement to split the income stream from a single product between the old and the new IP seems to add unnecessary complexity to an already difficult regime. We recommend that alternatives to this approach should be considered to cover the period from 1/7/16 to the end of the grandfathered regime at 30/06/21, when the entire product would become subject to the new regime. For example, where the majority of the IP is within the old regime could the post 30/06/16 element simply be ignored so that the grandfathered approach applied to the whole product until 2021? The test could adopt a ‘gateway’ approach, possibly using a broad percentage basis, to eliminate the need for the difficult valuations which would be required to split the income.

Question 13 - The Government would be grateful for evidence about the length of time likely to be needed for companies to adapt systems, reorganise their affairs, and begin collecting the information they will need to calculate the nexus fraction to inform the length of the grandfathering period.

We expect that most companies would want the grandfathering period to extend as far as possible ie to 30/06/21 but we have no detailed comments and we believe the length of the period should be decided in the light of input from companies using the current Patent Box.

Question 14 - The Government would be grateful for views on the suggested transitional rules.

We note that the consultation document does not make specific reference to the safeguards set out at paragraph 66 to the Action 5 Final Report. Paragraph 66 permits jurisdictions to implement rules that permit IP assets to benefit from existing regimes for the full grandfathering period “unless they are acquired directly or indirectly from related parties after 1 January 2016 and they do not qualify for benefits at the time of such acquisition under an existing “backend” IP regime”, in which case they only benefit from existing regimes until 31 December 2016.

As the nexus approach requires both historic R&D expenditure and future IP income to reside in the same claimant entity, virtually all UK claimants will be required to restructure their UK operations to align R&D and commercialisation in the same entity. (In our experience it is rare for commercialisation, legal ownership and R&D activities to take place in the same entity at present. Companies typically wish legal title to be held at the parent company level, as that confers greater protection if a claim for IP infringement is required. Equally, the skills required of a sales force commercialising IP differ markedly from the skills required of an R&D team, and it is common practice for each to be managed in separate legal entities to reflect this.)

Well-advised claimants are already taking the steps necessary to align R&D activities, income generation activities and legal ownership of their patents. We fear that un-advised businesses, particularly small and medium sized enterprises with less resource available to divert to restructuring projects may not be able to meet the 1 January 2016 deadline to restructure (or may not be aware that the deadline exists).

We suggest that where restructurings take place wholly within the UK then it should be possible for them to complete after 1 January 2016 (but before 1 July 2016) and still fall within
the existing regime. We cannot see that UK-UK restructurings could give rise to base erosion or profit shifting concerns, given that they take place within one jurisdiction.

Question 15 - The Government would be grateful for views from business as to the likely impact on amounts of relief they may claim under the new rules.

We have no comment on this.

Question 16 - The Government would be grateful for views from business as to the likely impacts on administration and compliance costs, and how these can be kept to a minimum.

The new regime will inevitably increase the compliance burden for companies and we have made some suggestions above for possible measures to mitigate this. In particular, as noted in our responses to questions 2 and 3 we would like to see consideration being given to possible simplified options for smaller companies and companies where the imposition of streaming would involve considerable work but would have little effect on the outcome.

As noted in our response to Question 1 some companies might also find it helpful to have the option to opt into Patent Box on a patent by patent basis rather than on a company basis.

Question 17 - The Government would welcome views on other possible impacts arising from these changes, including the equalities impact, impacts on additional administrative burdens and compliance costs and on small businesses.

As noted in our general comments above we suggest that for small companies HMRC should extend the Advance Assurance scheme for R&D claims to cover Patent Box, to try to ensure that innovative small companies are not excluded from using it.