EC views parts of UK patent box scheme as 'harmful tax competition'

The European Council’s Code of Conduct Group on Business Taxation will discuss next Tuesday two aspects of the UK’s patent box legislation it regards as harmful. These are: the lack of a specific provision requiring activities to be located in the UK which constitute 'real economic activity'; and the lower rate of tax allowing a statutory deduction equal to 50% of final profits, which is not in line with internationally agreed principles.

The patent box regime is being phased in from 1 April 2013 with 60% of the relief available in 2013-14, 70% in 2014-15, 80% in 2015-16, 90% in 2016-17, with the full relief becoming available in financial year 2017-18. Profits attributable to qualifying intellectual property (IP) will be subject to an effective tax rate of 10% (current UK corporation tax rate 23% reducing to 20% by 2015). Although this rate is neither nil or nominal it is significantly lower than the rate generally applying. The measure is therefore
potentially harmful within the meaning of paragraph A of the Code.

Criterion 1:

"whether advantages are accorded only to non-residents or in respect of transactions carried out with non-residents"

Criterion 1 contains two elements. The first element is whether the measure is exclusively available to non-residents or transactions with non-residents (criterion 1a). The second element is whether it is only or mainly used by non-residents or for transactions with non-residents (criterion 1b).

1a) Criterion 1a concerns the de jure application of the measure. The patent box does not have general application; taxpayers have to opt into its provisions. However any company within the scope of UK corporation tax is eligible to do so. This includes companies resident in the UK or companies trading in the UK through a permanent establishment. We have therefore proposed a cross ("X") for this criteria.

1b) Criterion 1b is used to complement the assessment under criterion 1a which only looks at the literal interpretation of the measure. It takes account of the de facto effect of the measure. Where the majority of taxpayers (or counterparties to transactions) benefiting from the measure are in fact non-residents the measure will fall foul of criterion 1b. The UK has to date identified 35 groups that anticipate electing into the patent box and which are forecast to receive tax benefits totalling £175m (EUR 206m) from this measure. 63% of these are UK headed groups and forecast to receive £135m (EUR 159m or 77%) of the benefits; 37% are non-UK headed groups which are forecast to receive £40m (EUR 47m or 23%) of the benefits. On the basis of this information we have therefore proposed a cross ("X") for this criterion.

Criterion 2:

"whether advantages are ring-fenced from the domestic market, so they do not affect the national tax base"

As regards criterion 2 the division between criteria 2a and 2b is done in the same way as in the case of criterion 1 (i.e. de jure interpretation and de facto analysis). In general, a measure is caught by criterion 2 if the advantages are ring-fenced from the domestic market so that they do not affect the national tax base. In most cases, the evaluation against criterion 2 follows closely that of criterion 1.

2a) What has been written under criterion 1 a applies to analogously to criterion 2a. There are no rules preventing domestic taxpayers from benefiting from the regime or to exclude domestic transactions. We have therefore proposed a cross ("X") for this criteria.

2b) On the basis of the explanations provided above and the marking under criterion 1b, the evaluation of criterion 2b fol-
low the same reasoning. As the result of its impact assessment the
UK government will account for a cost of around £760m (EUR 898m)
each year once the regime is fully in force in 2018. The UK has to
date identified 35 groups that anticipate electing into the patent
box and which are forecast to receive tax benefits totalling £175m
(EUR 206m) from this measure. 63% of these are UK headed groups
and forecast to receive £135m (EUR 159m or 77%) of the benefits;
37% are non-UK headed groups which are forecast to receive
£40m (EUR 47m or 23%) of the benefits. On the basis of this in-
formation we have therefore proposed a cross ("X") for this cri-
terion.

Criterion 3:
"whether advantages are granted even without any real economic activity and substantial economic presence within the Member State offering such tax advantages"

According to the standard practice for the evaluation of a measure against criterion 3, a measure is found harmful under this cri-
terion if there are no specific requirements with regard to real economic activities or employment obligations. The relevant ele-
ments of this measure are the development condition and the active ownership or management condition. The development condition must be met by either the company claiming the tax benefits or another company in the same group. The development condition requires the performance of a significant amount of development activity in relation to the IP. In most cases fulfilment of the development condition will require real economic activity and a substantial economic presence. However there is no provision requiring such activ-
ities to be located in the UK.

If the company claiming the benefits does not itself satisfy the development condition (e.g. it is satisfied by another company in the group) it can still claim the benefits if it fulfils the active ownership or management requirement. This states that the company must perform a significant amount of management activity in relation to the IP. However a company’s decision making processes do not necessarily require real economic activity and a substantial economic presence in the UK. This might be the case where, for example, a management decision to research alternative applications for the IP does not result in such activities being carried on in the UK or where the exploitation of the IP in question does not re-
quire substantial management input.

Although the fulfilment of both the development condition and the active ownership or management requirement may involve real economic activities and a substantial economic presence in the UK, this does not always have to be the case. Tax advantages may be granted even in their absence. We would therefore suggest a tick ("V") for criterion 3.

Criterion 4:
"whether the rules for profit determination in respect of
activities within a multinational group of companies departs from internationally accepted principles, notably the rules agreed upon within the OECD."

The profits from qualifying IP, including embedded royalties, which are subject to the lower level of tax are calculated using a three stage process. The first stage determines what proportion of a company's tax profits (calculated in accordance with internationally agreed principles) are relevant to the patent box. These are identified using the ratio between the company's qualifying income (e.g. royalties, income from products incorporating patents) and its non-qualifying income calculated according to accountancy principles. Where the result of this comparison is distorted by a mismatch between accounting and taxation principles (e.g. where a transfer pricing adjustment has been made) a special rule applies to counter any advantage accruing to the company.

Qualifying income includes not only licence and royalty income but also income from the sale of products incorporating a patented invention (embedded royalties), the sale of patents and damages for infringement and other compensation. There is no minimum proportion of income related to a patent to classify the whole of the income from such product sales as qualifying income. In the second stage the profits relevant to the patent box are reduced by profits attributable to routine activities (i.e. part of the non-qualifying element). These routine profits are calculated using a fixed 10% margin on certain specific costs. In the third stage the patent box profits are again reduced, this time by any profits attributable to a marketing asset such as a brand (i.e. the remaining non-qualifying element) which are calculated using OECD principles. An exception to this is made where the profits after the deduction of the routine return are less than £3m (EUR 3.5m) in which case the profit attributable to the marketing intangible is identified using a statutory formula.

All three stages in calculating the profits subject to the lower level of tax involve a statutory formula rather than internationally agreed principles. However the impact of this is reduced because in the first stage potential distortions are dealt with by special rules and in the third stage it is only in cases where the profits are less than £3m that a formula rather than OECD principles are used.

We note also that once the measure has been fully phased in the lower rate of tax will be applied by allowing a deduction equal to 50% of the final profits. This deduction is also not in line with internationally agreed principles.

We would therefore propose a tick ("V") for this criterion.

**Criterion 5:**

"whether the tax measures lack transparency, including where legal provisions are relaxed at administrative level in a non-transparent way"
| All preconditions necessary for the granting of a tax benefit should be clearly laid down in publicly available laws, decrees, regulations etc. before a measure can be considered transparent. Since this is the case with respect to this measure we have proposed a cross ("X") for criterion 5. |