

Taxation of IP reforms: how will this impact your business?

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On 29 November 2010, the Government published its "Road Map" for UK corporate tax reform, announcing its proposals for significant changes to the taxation of Intellectual Property (IP). These proposals will be the subject of consultation and engagement with business and other interested parties, as part of a 4-year timetable for implementing the reforms through legislation.

New Controlled Foreign Company (CFC) rules for IP

A CFC is an overseas company that is resident outside the UK but controlled by persons resident in the UK, and subject to a lower level of taxation in the territory in which it is resident. A UK company with an interest of 25% or more in a CFC will be subject to corporation tax at a rate of 28% on its proportionate share of the CFC's profits.

The Government recognises that the current rules for the taxation of CFCs "no longer reflect modern business practice... going beyond what is needed to protect the UK tax base". IP that was developed entirely outside of the UK, for example, can result in a CFC charge on profits that arise from that IP. The proposed changes are therefore intended to refocus the rules on targeting artificially diverted UK IP profits, while at the same time trying not to distort or inhibit the way that groups manage their commercial operations overseas by delivering a more territorial approach to the taxation of IP.

As a first step, foreign IP that has only a minimal connection with the UK is to be excluded from any potential UK CFC tax charge (for example, in relation to UK multinationals whose CFCs are involved in intra-group supplies of goods and services which do not involve the UK). This will form part of the interim improvements to be included in the Finance Bill for 2011.

The Government also wants to target high-risk areas where the current CFC rules are being exploited when:

- (a) IP that has been developed in the UK is transferred to a low tax jurisdiction;
- (b) IP held offshore is effectively managed in the UK; and
- (c) UK funds are used to invest in IP that is held offshore as an investment but the UK does not receive a return on that investment.

These changes will have implications for UK companies developing or managing intellectual property in the UK but holding it through a non-UK entity. The proposed new rules will also need to be taken into account when considering the transfer of UK-generated or UK-managed IP to other jurisdictions.

Patent Box

The Government plans to focus on scientific and high-tech IP by introducing a preferential corporate tax regime for profits arising from patents. This regime is referred to as the "Patent Box" and is intended to encourage Research and Development (R&D) and technical innovation.

The Patent Box regime is to be developed in partnership with business, and is to apply to relevant profits arising from 1 April 2013. The aim of the Patent Box is to reward "successful technical innovation".

A **10% corporation tax rate** (reduced from 28%) will apply to profits from patents that qualify under the regime, as an incentive to create and retain IP in the UK. The new regime will be optional, avoiding an additional compliance burden where the amounts of tax at stake do not justify opting into the rules.

Under the current proposals, all patents first "commercialised" after 29 November 2010 are to qualify for inclusion in the Patent Box. Draft legislation defining the "date of initial commercialisation" of a patent will be produced following consultation. HMRC are expected to publish more detailed requirements for qualification in the near future. It is anticipated that the Patent Box will apply to net income from patents, ie. income from royalties and/or from sales of patent-protected inventions, after deducting associated expenses, rather than to gross income.

In some cases, this 10% rate of corporation tax may reduce or remove the incentive to transfer intellectual property to an off-shore or other low tax jurisdiction. However, it will be important to consider the rules in detail before making any such decision. In particular, when more detailed proposals become available, we will be looking at the tax impact of disposing of qualifying IP in the UK and extent to which existing patents may benefit from the new regime.

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R&D

The UK's R&D tax credit schemes will continue as an incentive to encourage innovation by UK companies. The R&D tax credit scheme for small- and medium-sized companies affords relief from corporation tax to eligible companies at the rate of 175% of the qualifying revenue expenditure in the relevant accounting period. Companies that do not fulfil the small- and medium-sized company test but do have qualifying expenditure are entitled to a deduction of 130%.

Following a commitment to evaluate the R&D tax credit arrangements by the end of 2010, HMRC commissioned independent research into their impact on the decision-making processes of companies investing in R&D. The claimants surveyed broadly perceived that the schemes increase the overall amount of R&D they are able to undertake. HMRC conducted an additional internal economic analysis, concluding that the schemes have a positive impact on the levels of R&D expenditure incurred by regular claimants.

These proposals are the first steps in the Government's review of the UK corporate tax system. The Government has asked for any comments on their Corporate Tax Reform "Road Map" to be made by 22 February 2011. These will then be considered in the consultation process.

If you have any comments or questions about the proposals, or would like to contribute to the consultation, please contact us.



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