Green light for new approach to patent boxes

The recent agreement by OECD and G20 member countries on a modified nexus approach means that existing IP tax regimes (including the UK's patent box) must be changed to be compliant. Shortly before the agreement was announced, the European Commission dropped its investigation into patent box regimes across the EU.

**Background**

In November 2014, the UK and Germany tabled a plan to resolve disagreement over the OECD’s proposals to counter harmful tax competition as part of the BEPS Project. The area of focus was IP tax regimes and the nexus approach that requires substantial economic activities to be undertaken in the country offering the favourable tax regime (e.g. the UK in the case of the UK patent box) and linking tax benefits directly to R&D expenditure.

**Agreement and timetable**

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

- In 2015: countries must begin the process to change their laws for existing IP regimes.
- By 30 June 2016: (1) new regimes including the modified nexus approach must take effect; (2) existing regimes closed to new entrants (countries can specify an earlier cut-off date if they wish).
- By 30 June 2021: no more tax benefits under non-nexus compliant regimes (countries can choose an earlier date if they wish).

**Modified nexus approach**

The nexus approach is based on a substantial activity requirement. Essentially, there must be a direct nexus between the income receiving benefits and the activity contributing to that income. This means that benefits (in the form of reduced tax rates) can only
apply to income arising from IP where the actual R&D activity is undertaken by the business itself. Capital contribution or expenditure on substantial R&D activity by someone other than the business will mean that income arising from that activity will not qualify for benefits.

This test 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 the company claiming the benefit has played a significant role in managing the portfolio of patent rights or portfolio of products that incorporate the patent rights. This formulation would be unlikely to satisfy the nexus test.

The modified nexus approach recognises that IP companies who choose to outsource R&D activity to other group companies are unlikely to be able to benefit from reduced tax rates on the resulting income, so it will allow related party outsource expenditure (and any IP acquisition costs) to be taken into account. However, the underlying approach 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, so in order to reflect that principle, a 30% cap applies to otherwise qualifying R&D expenditure. The OECD has given some basic examples of how this calculation (termed the "uplift") would work:

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.

**Practicalities and guidance**

Businesses will need to track and trace R&D expenditure. This is not going to be straightforward, in particular where IP is transferred from existing regimes (that do not require tracking) to new regimes. The OECD is working on methods to identify qualifying expenditure (including for past years). There will be new guidance on the definition of qualifying IP assets. The existing UK patent box applies only to income from qualifying patents, but regimes in other countries are broader. Under the new definition, marketing-related IP assets such as trademarks are explicitly excluded.

**Anti-avoidance**

The long grandfathering period has prompted concern that businesses will pile into existing regimes before the closure date in order to get the benefits. The OECD is considering increased transparency (e.g. exchange of information on businesses
benefitting from a grandfathered regime), monitoring of new entrants and possible restrictions.

**European Commission Investigation**

In 2013, the European Commission gave an opinion that the UK's patent box regime was a potentially harmful tax practice. The review by the EU's Code of Conduct Group was subsequently broadened to include all IP tax regimes across Europe. With the modified nexus approach now agreed upon at OECD and G20 levels, the European-level review has to an extent been overtaken by events, but it was recently announced that the review would be dropped, on the grounds that the Commission had approved, in 2008, a patent box regime in Spain and that approval gave "legitimate expectations" that such regimes are legal.

**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.