Response to *Patent Box: substantial activities*, published on 22 October 2015

Introduction

I am grateful for the opportunity to comment on the proposed changes to the UK's Patent Box regime in order to make it compliant with the OECD's nexus requirements.

I look forward to seeing the draft legislation in due course.

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

As an initial comment, I think that the decision to amend the existing regime – as opposed to winding it up and legislating for a completely new scheme – is to be applauded. I believe that this will provide the best opportunity for businesses to transition from the old to the new with the minimum of disruption.

That said, my overriding concern is that the new scheme is still going to be so complicated and difficult to comply with that most smaller businesses (if not most businesses) are going to be put off utilising the regime at all. I think this will be a real shame and may call into question the viability of the regime as a whole in the UK. It will be difficult to justify a relief that actually benefits only the largest companies with the resources to comply with its requirements.

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.

I believe that retaining the current approach to defining profits is a good decision. Businesses already utilising the patent box - and those who have been considering its use – will already be familiar with these rules.

I think the question with regard to the small claims election is possibly framed incorrectly. I believe the question should be, is there any real reason not to retain it? This election was introduced in the first place to minimise complexity for smaller businesses and, given the inevitable added complexity that these changes will bring, anything that can be done to help smaller businesses is positive. I believe that the small claims election should be retained.

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

This would appear to be a quite logical step to take. Those businesses that find they will need to track and trace R&D expenditure and income to patents, products and/or product classes will have to stream anyway. For those businesses with a simple model of, say, just a single patent the issue is almost moot.

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.

Given your two stated options, I agree that this is the preferred option.

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

The approach is welcomed, although clarity will be required in the distinction between 'R&D contributions' and 'funding provided under a co-development agreement'.

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?**

Yes, it makes a lot of sense to utilise the same definition in both reliefs. The requirement that the R&D expenditure in the nexus fraction be 'relevant R&D' is reasonable – indeed, it seems almost too obvious to mention!

Applying the principles of the SME subcontracting rules to all subcontracting, irrespective of the company size is a sensible way to overcome the potential problems for large companies.

Question 7. Do respondents agree with the suggested approach to the timing of expenditure for the nexus fraction?

I'm not completely convinced that your thinking correctly follows the OECD recommendation. It is clear that their intention is that expenditure should be fully included in the year it is incurred, irrespective of the accounting treatment. At the end of Paragraph 39 on page 27 they say:

> "Qualifying expenditures will be included in the nexus calculation at the time they are incurred, regardless of their treatment for accounting or other tax purposes. In other words, expenditures that are not fully deductible in the year in which they were incurred because they are capitalised will still be included in full in the nexus ratio starting in the year in which they were incurred."

The problem with following the rules for R&D tax relief is that there would be a difference between expenditure included within a tangible asset and that included within an intangible asset. R&D expenditure included within a tangible asset on the balance sheet would not be included until it is amortised through the P&L. This is clearly in contradiction to the OECD recommendation.

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.**

I think that, if the Government is not prepared to define "product" and "product family" – which would seem to be relatively straightforward to do – then HMRC will pretty much have to accept whatever companies come up with. In principle, of course, this should not really matter since companies will always have to demonstrate that whatever category they are tracking to be the lowest practical level.

The factors set out in paragraph 4.03 are, in themselves, quite sensible but they are subjective. Ultimately, this is going to come down to the company's opinion versus HMRC's opinion. I would hope that there would be a sensible approach to this in practice. A significant practical difficulty with the proposed approach is likely to be that by the time HMRC has challenged the company's self assessment it may be too difficult for the company to go back and redo the tracking. I assume that HMRC are not going to be prepared to

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.

Whilst I can (sort of) understand the concerns about this relief encouraging companies to acquire the company rather than the target IP, there is another side to this issue. A great many small companies will see acquisition by a larger company as a viable growth strategy. Any rules introduced here should recognise that and not create any unreasonable barriers.

I think the first of your options at paragraph 4.10 is probably the most reasonable. Option (iii) would possibly work but I suspect that it would be unnecessarily complicated. Option (ii), however, would almost certainly be unworkable in practice, as it appears to rely almost totally on a subjective opinion.

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.

Nil response

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.

In principle, the idea of having a simple fixed rule for retiring expenditure is attractive for its simplicity. I think that you have summed up the problem, however, in paragraph 4.13 of the consultation document where you acknowledge that protection may well be extended. Where patent protection is extended, it is likely that the company will anticipate significant future benefit from that added protection. Removing the earlier expenditure would be unreasonable.

Is it possible to define a rule whereby the expenditure is removed after (say) 15 years unless the company can demonstrate that the expenditure is still generating benefit?

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).

Case 1. No comment.

Case 2. If I have read this correctly, I believe you are saying that the "global data" will be used on a three year rolling basis, with the earliest year dropping out as each new year of tracked data comes into play. Thus, the global data will have dropped out of the nexus fraction completely after three years. From that point, only tracked data would be included in the nexus fraction. The OECD document contains an example (at Annex A); is this consistent with the way you envisage this working in the UK?

In general on this issue, the OECD recommendations require countries to implement anti-avoidance measures to prevent manipulation. The consultation does not appear to consider this point.

Case 3. Will companies be permitted to move straight into the new regime id they wish?

Case 4. In practice, this is likely to get quite complicated and it may be that companies will choose to move the old IP straight into the new regime along with the new IP. One could envisage a scenario where a company has a product containing a single qualifying IP asset that is within the existing regime. Under the existing regime it includes all of the relevant income from that product (subject to adjustments for routine return and marketing assets etc.) If, post 1/7/16, it launches a new version of the product that also contains a new qualifying IP asset, the company will need to consider whether it can track income to that individual patent. If so, the company will end up tracking income to the product for the grandfathered asset and to the new IP asset for the new regime. Clearly, the company will need to ensure there is no double counting but there is also the complexity of fairly splitting the income between the assets. Alternatively, the ne legislation might allow tracking to the product level (as this will be more convenient) whilst there is also a grandfathered IP asset present.

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.

As an adviser I am not best placed to provide such evidence. However, I am extremely concerned that smaller companies will balk at the complexity of this regime and the changes needed for them to be able to comply. In many cases I suspect that they will simply not bother. These concerns are founded on discussions I have already had with companies looking at the existing regime, even before the extra requirements are imposed.

I realise and fully accept that the Government has no real option but to make these changes if it wishes to have a patent box regime. However, I do very much believe that it needs to be recognised that the complexities may mean that the benefits of the regime are effectively out of reach of smaller companies.

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

Broadly, I think that the proposals are quite reasonable. I would suggest, however, that any company with 'grandfathered' IP should have the option of moving straight into the new regime. Whilst it may seem unlikely, at first glance, that any company would choose this option, I believe that the added complexity of managing two different sets of requirements may make this attractive. In particular, in a scenario outlined in paragraphs 5.07 and 5.08, the ability to avoid the need to apportion profits and R&D expenditure could be quite beneficial.

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.

N/A

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.

N/A

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.

I think that the biggest impact on business is going to be to make the patent box regime far more complex. For the biggest companies, this is likely to be little more than in inconvenience that they will address and deal with. The risk, however, is that other companies – especially smaller businesses with less resources available – will simply decide that the regime is too complex and will forego the benefits.

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