UK and Germany agree to joint proposal on preferential intellectual property regimes

Executive summary

On 11 November 2014, the UK and German Governments published their joint proposal\(^1\) to advance the negotiations on new rules for preferential intellectual property (IP) regimes within the G20 and Organisation for Economic Co-operation and Development (OECD) Base Erosion and Profit Shifting (BEPS) project. The proposal will be taken forward in OECD discussions.

The recommendations are not specific to the UK regime. They are intended to move forward the discussions regarding acceptable parameters for preferential IP regimes in general. The proposal seeks to achieve a balance between maintaining countries’ ability to offer tax benefits for the development of intellectual property and preventing the misuse of such benefits. The proposal takes forward the “nexus” approach outlined in the OECD’s interim report on BEPS Action 5 so as to ensure substantial activity is undertaken in the jurisdiction offering the preferential IP regime, but seeks to reflect the commercial realities of research and development (R&D) investment by business.\(^2\)

The proposal includes transitional arrangements between existing and new rules, so that existing regimes would be open to new and existing IP until June 2016 and would then remain in place until June 2021 for that IP. A fundamental part of the proposal is that further work needs to be undertaken in the next six months to develop practical ways of implementing the proposed modified nexus approach.

For the UK, the agreement means that the UK Patent Box regime is likely to remain attractive to many groups and it enables them to model the position through to 2021 with greater confidence. Given that the negotiations had created uncertainty, this announcement also provides comfort about the form of the new regime and that the existing rules will apply for several years for IP that is already within the Patent Box by 2016, reinforcing the commitment of the UK to have the most competitive tax regime in the G20.
For Germany, there is no imminent proposal to establish a German Patent Box system. The German and UK initiative is rather driven by the motivation of Germany to seek and support a compromise between the different positions of OECD and G20 members thereby ensuring successful finalization of the BEPS project by the end of 2015.

**Detailed discussion**

**Background**

On 16 September 2014, the OECD released an interim report on countering harmful tax practices in connection with BEPS Action 5. In that report the OECD’s Forum on Harmful Tax Practices (FHTP) considered three approaches in relation to regimes providing preferential tax treatment for income arising from qualifying intellectual property. Of those three approaches, it suggested that a nexus approach that links the benefits of the regime with the R&D expenses incurred by the taxpayer was the most appropriate.

The UK and Germany proposal is based on the nexus approach proposed by the OECD but amends the approach to address concerns expressed by some countries. In particular it seeks to build a platform for addressing outstanding issues in relation to qualification of expenditures, grandfathering and tracking qualifying research and development expenditure.

**Main points of the proposal**

Under the proposed transitional arrangements, existing rules would apply to IP already within a regime until June 2016 and continue for IP within the regime at that date until June 2021. It is expected that countries, including the UK, would seek to implement revised OECD compliant regimes in June 2016 to cover IP that is not grandfathered. Transitional rules are a key area identified in the joint announcement as requiring further work.

It is expected that revised regimes will need to restrict the benefits by reference to the R&D undertaken by the entity, or outsourced to third parties, relative to its overall spend on global R&D. To compensate for the fact that under the nexus approach related-party outsourcing and acquisition costs would not constitute qualifying expenditure, a company would be able to uplift its qualifying expenditure by a set amount. The proposal suggests that this would be the lower of 30% of its qualifying expenditure and the actual expenditure on outsourcing and acquisition costs. The effect appears to be that, for example, a company would be able to outsource 30/130 of its R&D expenditure to related parties and still effectively obtain the full benefits of the relevant IP regime. Expenditure outsourced to related parties above this proportion could lead to a restriction in the benefits that would otherwise be available under the regime.

The proposal notes that the OECD Forum on Harmful Tax Practices (FHTP) should work to reach agreement by June 2015 on a practical and proportionate tracking and tracing approach that can be implemented by companies and tax authorities, which includes transitional mechanisms for IP from existing into new regimes and special rules for previous expenditure. The UK’s acceptance of the proposal is conditional on this agreement being reached.

**Next steps**

The UK and Germany will present their joint proposal to the FHTP during its meeting on 17-19 November with the hope that the other G20 and OECD countries will agree that these proposals will form the basis for future negotiations and eventual agreement on this aspect of Action 5.

In the interim, the full benefits of the UK Patent Box and other preferential regimes should continue to be available and this proposal may provide sufficient clarity, so as to enable groups to plan their approach, particularly with regard to gaining access to the proposed grandfathering provisions.
Endnotes


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