TAXREP 10/01

TAXATION OF INTELLECTUAL PROPERTY, GOODWILL AND OTHER INTANGIBLE ASSETS: THE NEW REGIME.

Text of a memorandum submitted in May 2001 to the Inland Revenue in response to a Technical Note issued in March 2001

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GENERAL COMMENTS

1 We welcome the opportunity to comment further on this consultation exercise in relation to intellectual property (IP) etc. We are also pleased to see that most of the points which we (and we suspect other representative bodies) have made in the previous rounds of consultation have been accepted.

2 We welcome the publication of illustrative clauses. We are concerned, however, that this proposed reform is taking a long time to come to fruition. Whilst we appreciate the problems involved, we hope that the next step will be the publication of draft clauses for inclusion in the Finance Bill and that the new rules will be implemented in the Finance Bill 2002 at the latest.

3 We also welcome the proposal to introduce a form of reinvestment relief and also the proposal to extend reinvestment relief to an acquisition of shares in a company which has intellectual property assets.

4 It is also important that there is detailed co-ordination with the team responsible for the consultation on deferral relief for substantial shareholdings. We understand that the proposed reform of IP and the proposed deferral relief have always been regarded as parts of a package. The proposed reinvestment relief into shares makes it vital that these two reforms are co-ordinated.

SPECIFIC COMMENTS ON THE TECHNICAL NOTE

Paragraph 2.8

5 We agree with the proposed exclusions.

Paragraph 2.12

6 We understand that the intention is that negative goodwill would be taxed only to the extent that it is attributable to assets which are themselves within the new intangibles regime. Obviously it would not be appropriate to tax the whole of the negative goodwill arising on acquisition of a business just because some of the assets fall within the new regime while others do not. Presumably the amount attributable to the intangibles would be computed as the difference between the fair value of those assets, as determined for the purposes of FRS 7, and their actual cost ascertained by just apportionment of the net price paid for all the assets acquired in the same transaction.

Paragraph 2.14

7 The difficulty with this proposal is that this moves away from an accounts based system back towards a capital allowances system. We wonder whether the suggestion is a recognition that most 'long-life' assets would currently have been dealt with under

the capital gains tax rules whereas under this proposed reform any gains will now be subject to income tax with no relief.

8 However, there may be circumstances where it is appropriate, indeed necessary, to offer tax relief for the cost of non-depreciating intangibles. For example, it may be necessary in order to ensure that the UK's tax system remains internationally competitive.

9 Our suggestion is that companies owning assets of this sort should be able to elect that such assets are subject to the old (i.e. capital gains tax) regime so long as no depreciation (or other tax relief on the cost, if such is in fact permitted) is actually claimed.

Paragraph 3.6

10 If the purpose of a rollover relief is to allow the company to reinvest disposal proceeds in a new asset of the same value, without having the proceeds depleted by a tax charge and therefore partly unavailable for reinvestment, it should be possible to roll over the whole of the gain which emerges on disposal of the old asset regardless of whether it represents recapture of amortisation allowed previously or a surplus over the original cost. This would also avoid the need for a calculation such as is illustrated by example 3.3 in the Technical Note. This calculation will get extremely complicated when there has been a series of rollovers into successive assets and will require records of what has happened at each stage to be kept indefinitely.

Paragraph 3.12

11 We refer to an earlier note (a copy of which is set out in the Annex) to you from the chairman of our Business Tax Sub-Committee arguing for an accounts-based test to determine when a transaction is to be treated as a (part-) disposal so as to qualify for rollover relief.

12 If the approach outlined in the above note is not accepted, an alternative suggestion is to incorporate into the rules the strict legal meaning of 'disposal'. For example, the creation of a licence does not involve any legal disposal, even though it may be treated for accounting and/or capital gains tax (CGT) purposes as though it did (in the case of CGT by reason of deeming provisions in sections 21(2)(b) and 22, TCGA 1992).

13 It would be unfair to deny rollover treatment for licensing transactions altogether, because for some types of IP the grant of a long, exclusive licence may be the only practical way of effecting what is in substance a complete disposal.

14 However, a suitable compromise would be to allow rollover relief for gains arising on either (a) a disposal, in the strict sense, of the whole or part of an asset or (b) any other transaction, treated for accounting purposes as a disposal, after which the book value of the retained asset is less than (say) 25% of what it was before.

Paragraph 3.18

15 We welcome the proposal to allow rollover relief against new assets acquired indirectly, provided that it can be implemented without undue complexity. The consultation document also considers briefly whether the UK should go further and

introduce the equivalent of section 338 of the US Code. In principle, a provision along the lines of section 338 would be desirable, but there are many ramifications that need to be addressed. We suggest that any such proposal is subject to a further consultation.

16 The IP proposals should not be delayed whilst the Government considers the possible introduction of a section 338-type provision. Rather the specific proposal on reinvestment relief should be introduced as it stands pending the possible introduction of a section 338-type exemption.

17 The mechanics would require the amount paid for the shares to be apportioned between the underlying assets on a just basis: for that purpose the fair value calculations used in preparing the consolidated accounts should be accepted unless there is clear evidence of manipulation. The amount allocated to the target company's intangible assets would then be treated as a qualifying reinvestment. However, since the book value of the intangibles would not itself be being written up (or down) to fair value, the amount treated as reinvested would have to be limited to that book value (as computed for tax purposes, taking into account any previous rollover), otherwise the rollover could reduce the book value to a negative figure.

Paragraph 4.6

18 Presumably the reference to impairment relates to the treatment in the group accounts, not in the accounts of the acquiring company as the example suggests. If the asset has been bought and sold for a particular price there is no reason for the stand-alone accounts of each company to treat the transaction any other way.

19 The rule will need to cater for the case of a foreign-based group which does not prepare consolidated accounts subject to FRS 11.

20 Presumably it is in fact intended that the rule as described in this paragraph would apply to any transfer for a price which is different from book value, whether or not the transfer price represents, or is intended to represent, market value. Presumably, also, for this purpose 'book value' means the actual book value, rather than the tax book value if different. Intra-group transfers would normally be made at actual book value, and the 'stand in shoes' treatment should apply if they are - albeit the effect of that treatment will be that the transferee inherits the transferor's (possibly lower) tax book value.

Paragraph 4.15

21 In principle we do not object to the proposal that the charge should be triggered in the disposing group rather than in the company which leaves it. We also welcome the statement that it would qualify for reinvestment relief.

22 However, we think it would be extremely undesirable, both in terms of complexity and the possibilities for arbitrage, to have different 'company leaving a group' regimes for intangibles and for capital gains. Therefore if the intangibles rule does take the form suggested in the document, we think that there should be a parallel change to the mechanism of section 179, TCGA 1992. However, we are concerned that any such fundamental change to section 179 would require further consultation and might delay the introduction of the new IP regime.

23 We therefore suggest that a simpler solution would be for section 179 to be left as it is, and a similar system introduced for intangibles, but that the company which leaves the group should be allowed by joint election to transfer the liability, and the ability to claim reinvestment relief, to any UK-resident company or companies in the vendor group.

Paragraph 5.2

24 It appears to be accepted that goodwill can be assumed to come into existence at the time of commencement of the trade in question (or, presumably, a part-trade). However we think there should need a statutory rule to that effect: we are not convinced that goodwill can be said to exist unless it actually has a value.

Paragraph 5.3

25 The proposal is that gains on 'grandfathered' assets would be computed under the CGT rules but that any claim for rollover relief would have to be under the new regime, and therefore could only be made in respect of replacement assets which are within the new regime. Since the objective is to respect the expectations of taxpayers in relation to existing assets, we consider that in such a case the taxpayer should have the option to roll over the gain under the old rules against a new asset (other than goodwill) within the classes of assets set out in section 155, TCGA 1992.

26 We appreciate that there should not be a general right to claim rollover relief under either the old rules or the new, on the grounds that this would allow gains which ought to be taxed as income under the new system to leak back into the CGT regime. However, we do not think that this objection can be made against a proposal to allow the option for grandfathered assets only, since the gain on those is actually treated in all other respects as arising under the old regime.

27 One other question is how you deal with a claim for rollover relief on a disposal of goodwill if the disposal of the old asset occurs before commencement of the new regime but the acquisition of the new asset occurs after commencement.

28 In such a case it should be uncontroversial that the taxpayer is entitled to roll over his gain into a replacement asset other than goodwill entirely under the old rules, regardless of when the new asset is acquired. More difficult is what should happen if the new asset is goodwill. We accept that in this case the rollover should be under the new rules, therefore reducing the depreciable cost of the new asset, even though that does arguably mean giving the new regime some element of retrospective effect.

29 One also has to consider the converse case of a gain arising on a disposal of goodwill within the first 12 months of the new regime, which is to be rolled over into a 'new' asset acquired before commencement. Under the proposal as it stands a post-commencement gain on goodwill can only be rolled over under the new regime, against an acquisition of an intangible.

30 We can see no practical way of extending this new-style rollover to a replacement asset which is not actually within the new regime because it was acquired before commencement.

31 We propose that the normal 12-month rule should apply, and if a claim is made in respect of a ‘new’ asset which was acquired before commencement that claim should take effect under the old regime. In theory this does allow some leakage of gains from the new regime back into the old but that should not be regarded as too objectionable, considering that the situation will rarely arise in practice. If it does, the overwhelming probability is that the old asset will be goodwill which was owned on commencement day and had accrued most of its gain before that time.

32 Different considerations apply if one or both of the assets is an intangible other than goodwill. In that case rollover would not have been available at all under the old regime, so the question of preserving expectations does not arise. In these cases we think it is reasonable that the 12-month backward time limit should be capped, so that a post-commencement gain cannot be rolled over into a new asset acquired before commencement.

Paragraph 6.6

33 Finance leases of intangibles are probably rare at present but the new system will have to cover them eventually if, as we expect, the same accounting treatment is extended to all leases (including IP licences). However, we think it is best to leave them outside the new tax regime for the time being, rather than try to deal piecemeal with just this one aspect of the probable change in accountancy practice.

Paragraph 6.11

34 We agree that in practice the case is likely to arise very infrequently, but in view of their existing CGT exemption it seems right in principle that these vehicles should not be subject to the new regime.

Paragraph 6.13

35 The suggested approach appears reasonable.

Paragraph 6.16

36 We agree with the comments. Although the need to prepare two computations is in theory a complication, we are not aware that in the FOREX context it has caused any serious difficulty.

OTHER POINTS

Controlled Foreign Companies (CFCs)

37 One effect of the new regime will be that some items, both receipts and deductions, which were not previously within the CFC regime will come within it.

38 One specific problem which arises is that intra-group transfers and reconstructions which are to be treated as tax-neutral in the domestic context will potentially give rise to chargeable profits under the CFC regime unless the relevant reliefs are extended. The obvious solution to this problem would be to allow 'stand in shoes' treatment for the purpose of the CFC calculations regardless of the residence of the companies concerned. We think that this approach is reasonable, given that the transferee company would itself necessarily be either another CFC, or UK-resident, or not subject to a lower level of taxation.

CONCLUSIONS

39 Once again, we believe this consultation exercise has been successful. We welcome the proposed reforms along the lines set out in the document. As mentioned in paragraph 2, we are concerned that this proposed reform is taking a long time to come to fruition. We hope that the next step will be the publication of draft clauses for inclusion in the Finance Bill and that the new rules will be implemented in the Finance Bill 2002 at the latest.

40 We would be happy to meet to discuss these points further, if that would be helpful and we would welcome any feedback from the responses to this consultation.

14-45-36
FJH
31 May 2001

Annex

Reform of intellectual property: proposed reinvestment relief

Note dated 13 April 2001 from Colin Campbell, Chairman of Business Tax sub-committee, to Jon Sherman of Business Profits Division

I commented then that the suggestion that rollover should only be available if more than 75% of the asset is disposed of would raise extremely difficult boundary issues, as to whether the disposal is actually of the whole of a separate asset or part of a larger one. It is in any case unjustifiable as a matter of principle, since there is no fundamental reason why disposal of (say) half of a large asset should be any less deserving of relief than disposal of the whole of a small one. No such distinction is drawn for capital gains rollover.

I understand the Revenue's desire to avoid giving rollover relief for transactions which in reality are only generating ordinary income, but to avoid any explicit reintroduction of the revenue/capital divide into the new regime. For all that, I think that restricting rollover to disposals on capital account would be preferable to the proposal in the Technical Note. The revenue/capital distinction is at least reasonably well understood, and is likely to give rise to fewer serious boundary questions than the whole asset/part of asset distinction. Retention of the revenue/capital distinction for limited purposes within an income-based regime is not unprecedented (see paragraph 14 of Schedule 9 FA 1996), and cannot really be said to undermine the whole principle of the new scheme.

However it still seems to me that your concerns could be met by reliance on the accounts, without needing to invoke the volumes of caselaw on income versus capital. It should be sufficient to say that rollover relief is available only for transactions which are treated, in accordance with normal accountancy practice, as disposal of all or part of an asset.

Suppose for example that IP rights relating to a particular product are purchased for £1,000. Subsequently part of the rights are disposed of for £500 - for simplicity assume within the same accounting period so there has not yet been any depreciation. In the accounts, £400 of the cost is set against the disposal proceeds and a gain of £100 is recorded.

The accounting is not helpful in resolving the question posed by the proposal in the Technical Note. The accountant has evidently taken the view that 40% of the rights originally acquired have been disposed of, but he will never have needed even to ask himself whether what was disposed of was 40% of a single asset, or one or more separate assets amounting to 40% of an original bundle.

However, in deciding to set part of the cost of the rights against the amount subsequently received, the accountant has taken the view that the transaction involves a significant change in the company's access to benefits and exposure to risks: see paragraphs 22-25 and 70-75 of FRS 5. Although expressed in the language of accountancy this seems to me to meet the Revenue's requirement to exclude revenue transactions. Treatment in the accounts as disposal (or part disposal) of a fixed asset should therefore be sufficient to qualify the transaction for IP rollover relief. It will also, conveniently, tell you how much of the original cost is to be allocated to the asset (or part) disposed of, subject to a proportionate adjustment if book cost differs from tax cost due to an earlier rollover claim.