TAXREP 19/99

REFORM OF THE TAXATION OF INTELLECTUAL PROPERTY

A representation submitted by the Tax Faculty to the Inland Revenue in response to a request for comments in a Technical Note issued on 10 March 1999.

	Paragraph
INTRODUCTION	**1**
GENERAL COMMENTS	**2 – 3**
RESPONSES TO QUESTIONS	
Question 1	**4 – 6**
Question 2	**7 – 8**
Question 3	**9 – 10**
Question 4	**11 – 12**
Question 5	**13 – 24**
Question 6	**25**
Question 7	**26 – 27**
Question 8	**28 – 30**
Question 9	**31 – 36**
Question 10	**37**
Question 11	**38 – 42**
Question 12	**43 – 44**
CONCLUSION	**45 – 46**

REFORM OF THE TAXATION OF INTELLECTUAL PROPERTY

INTRODUCTION

1 We refer to the above consultation document issued on 10 March 1999. We welcome the opportunity to comment on this document. This consultation, of course, follows up one aspect of the consultation document issued last year, *Innovating for the future, Investing in R & D.* We commented on that earlier document in our representation TAX 20/98, a copy of which is attached as Annex A. Our comments on this consultation document build upon the comments which we made in that earlier representation concerning the proposed reform of the taxation of intellectual property.

GENERAL COMMENTS

2 We think that the consultation on the proposed reform of intellectual property to date has been successful. The consultation document is a helpful summary of the issues and problems, and sets out the matters for consideration in a constructive way. We are in broad agreement with the thrust of the document and the conclusions reached. We are confident that the taxation of intellectual property can be reformed in a revenue neutral way. We think that the reformed rules should be a significant improvement over the current, highly complicated, system and we would hope that a more straightforward set of rules would help in a modest way to encourage a climate of innovation in the UK.

3 We set out below our comments on the twelve questions raised in the document, which are summarised in Chapter 10 of the document.

RESPONSES TO QUESTIONS

Question 1

We would welcome comments on what should be included in the definition of intellectual property and on how this might best be converted into a clear statutory definition (paragraph 66)?

4 We note the various options outlined in Chapter 3. We are in favour of adopting the definition as found in the OECD model royalty article, as set out in paragraphs 40 and 41. We appreciate that this might require some modification, but this should be kept to a minimum.

5 The reason why we are in favour of the OECD definition is that many of the difficulties concerning the taxation of intellectual property that arise in practice relate to cross-border transactions. In order to reduce the potential for such difficulties, we think it must be sensible to apply the established OECD definition, because this is internationally accepted, reasonably well-understood and in line with many of the royalty articles in the UK's double taxation agreements. In addition, as mentioned in paragraph 41, the OECD

definition appears to encompass all of the types of intellectual property under consideration.

6 In principle we consider that any new system should be extended to include goodwill. The cost of purchased goodwill (assuming it depreciates) is a cost of earning the taxable profits and it should qualify for relief as much as any other depreciating asset. However we appreciate that the present consultation is confined to intellectual property, and that the cost of extending relief to goodwill would probably be considerable.

Question 2
Should the reform be based on a conventional capital allowances approach or on the accounts (paragraph 98)?

7 We commented in the previous consultation (paragraph 15 of TAX 20/98) that we prefer to adopt a tax treatment that is based upon the treatment in the accounts, provided that the accounting treatment is in accordance with generally accepted accounting principles. We are still firmly of this view. We see no reason in principle why the taxation of intellectual property transactions should not follow the accounting treatment.

8 As a general comment, we are in favour of aligning the accounting and taxation treatment of transactions wherever possible. We think that closer alignment of accounts and tax will help to ensure that the tax system is straightforward to understand and that the tax rules are applied correctly by taxpayers. It is of course vital under such a system that UK Accounting Standards are applied correctly by taxpayers.

Question 3
Would the capital allowances option be preferable if the rate was (say) 20%, 15% or 10%? If you think that there should be different rates for different types of intellectual property, please say so and why (paragraph 99)?

9 We said in answer to question 2 that we do not favour a capital allowances method. Consequently, we do not think that such a method is appropriate whatever is the rate of the allowance. However, if it is decided to use a capital allowances system rather than a system based upon the accounts, we think that there should be one standard rate rather than a multiplicity of rates.

10 We think it is sensible to set the rate at the same amount as that for writing down allowances on plant and machinery, i.e. a 25% writing down allowance on the reducing balance basis. This system has the advantage that it is well understood and easy to operate. It strikes a reasonable compromise between forms of intellectual property which have a very short life due to technological obsolescence and others, such as trademarks, which may have quite long lives. We appreciate that if this system is adopted, some taxpayers will gain and some taxpayers will lose but, on balance, we think that the benefit of a single standard rate of allowance outweighs the likely disadvantage of unfairness.

Question 4
Is the Exchequer at risk from overly prudent accounting policies under the accounts option (paragraph 100)?

11 We appreciate the concern, but do not think that in practice there will be a significant risk. Firstly, if UK Accounting Standards are applied correctly, then there should be no significant risk to the Exchequer. . The adoption of an overly prudent accounting policy would not be in accordance with generally accepted accounting policies and UK Accounting Standards. Secondly, in the listed company sector, any pressure to push assumed asset lives to the limit is likely to be in the direction of enhancing reported earnings by adopting policies which are arguably insufficiently prudent. It is true that private companies are not subject to the same market discipline, and some may be tempted to adopt over-prudent policies, but the same is true in relation to accounts provisions generally, and we are not aware that major revenue leakage has occurred in this area following the Gallagher v Jones line of cases.

12 On balance, therefore, we do not think that there should be a significant risk. However, we appreciate the concern of the Revenue and suggest that the issue should be kept under regular review.

Question 5
We would welcome comments on each of the special situations described in this chapter (paragraph 154)?.

13 Our comments on some of the special situations are set out below. Where we have not made any comments on the particular situation, we are in agreement with the comments made in the consultation document.

Revenue approach to accounts (paragraphs 113 to 116)
14 We are concerned as to what treatment should be adopted in cases where the taxpayer may be a foreign company that may not be subject to UK Accounting Standards. In these circumstances, it may be necessary to make adjustments so as to arrive at the tax position on the assumption that UK Accounting Standards had applied. This should at least ensure equity of treatment as between the Exchequer and taxpayers and also as between taxpayers. It should also assist in the prevention of possible abuse.

15 However, it is unlikely to be a very satisfactory solution in practice: we are aware that there is a precedent for this approach in the legislation on finance leasing, but that is legislation which is not expected to apply in practice with any regularity. A routine requirement for overseas companies to prepare parallel accounts in accordance with UK Accounting Standards is likely to prove a considerable administrative burden. We would be happy to explore with you possible solutions to this problem.

Ensuring all the fruits are taxed (paragraph 128)
16 We find it difficult to envisage the circumstances where the problem mentioned might arise. However, we accept that the principle appears reasonable.

'Charges' deduction rules for royalties would go (paragraphs 129 and 130).

17 The comments and proposals appear to us to be reasonable. In respect of the comment made in paragraph 130, we accept that such a provision may be necessary, but it should be limited to the narrow circumstances that apply in the existing rules on loan relationships.

Intra group and connected party sales (paragraphs 138 and 139)

18 We accept that the rules may need to prevent the claiming of excessive relief, as suggested in paragraph 139, but in general limiting the amount which qualifies for tax relief to an arm's length price should be sufficient to achieve this purpose. In the case of transactions which are uncommercial and/or entered into for the purpose of obtaining tax relief it may be reasonable to limit relief to the lower of actual price or cost.

19 However, if intellectual property is purchased from a connected company in a commercial transaction at an arm's length price we do not see any reason why the tax relief should be limited to original cost, any more than in a third-party transaction. In any event, we think that any limitation should not apply to transactions between UK resident taxpayers.

Exit charge (paragraph 140)

20 We agree that it may be reasonable for the rules to provide some further protection to the Revenue in the event that dealings take place on uncommercial terms. An exit charge should however only apply in situations where the transaction is uncommercial.

21 We also request clarification as to how a proposed 'exit charge' for intellectual property transactions would interact with the existing exit charge for capital gains tax for companies. We would also welcome clarification of the treatment of goodwill in these circumstances.

Finance Leasing (paragraphs 144 to 150))

22 We agree with the comments made and accept the conclusion set out in paragraph 150.

Income spreading rules (paragraphs 151 to 153)

23 We note the desire of the Revenue to abolish these reliefs. Whilst we have some sympathy with the proposed abolition, we are not in favour of this suggestion. The spreading reliefs are targeted at taxpayers whose earnings can vary greatly, and the relief is a help to authors, painters and similar artists whose earnings are irregular and frequently low. We agree that the benefit is reduced when compared to earlier years, but we do not agree that the rationale has largely gone. The reliefs help those most in need, and we are therefore in favour of retaining them.

24 It would aid, however, our consideration of this issue if the Revenue could provide some evidence of the number of taxpayers who take advantage of these reliefs, and the average benefit, as compared to the number of artists for whom the reliefs offer no advantages.

Question 6

Are there any other special situations we ought to consider and what do you think should be done about them (paragraph 155)?

25 Consideration should be given to the provisions of section 531, Income and Corporation

Taxes Act 1988 and how this fits in with the proposed reforms. This section deals with, inter alia, the tax treatment arising from a disposal of know-how. Section 531(2) provides that where there is a disposal of a trade or part of a trade together with any know-how used in the trade, any consideration received for the know-how is treated as a payment for goodwill. This treatment applies to both the vendor and the purchaser, but is subject to the parties' ability to elect by a notice given jointly within two years of the disposal that this treatment should not apply to them.

Question 7
Do you think it is worth bringing any of the special reliefs into the wider solution and, if so, which ones and when (paragraph 168)?

26 There are good reasons as to why, for example, Scientific Research Allowances ('SRAs') have their own separate code. In any event, the Government is of the view that research and innovation in the UK must be encouraged further, and we have commented already on the further proposals in respect of the role of SRAs in encouraging research and development (TAX 6/99), attached as Annex B. We see no reason to bring in SRAs to the wider solution.

27 In addition, we see no compelling reason to incorporate into the wider solution the special reliefs for films. These too were introduced as an incentive for that particular industry, and so should remain outside the present review.

Question 8
Should the reform be extended to non-traders and if so how (paragraph 177)?

28 In principle we do not see why there should be different rules for non-traders as compared to traders. We are therefore in favour of extending the reform to non-traders. We agree with the principle set out in paragraph 172, namely that it makes sense to have a common system for computing the amount of income.

29 We recognise that it may be necessary to preserve the distinction between trading and professional income on the one hand and investment income on the other hand, as adopted in the recent reform of the taxation of income from property. We also recognise that there may need to be rules to protect the UK Revenue, for example where payments are made to tax havens. However we do not understand the problems hinted at in paragraph 173. The person making the payment will in general be subject to UK Accounting Standards, even if the recipient is in a tax haven, and the problem of excessive payments possibly being made between connected parties seems no different for traders and non-traders, and in either case can be dealt with by transfer pricing provisions. We would be happy to discuss these aspects further.

30 There seems to be no real difficulty for an individual investor in preparing figures for tax purposes based on correct accounting principles. The same issue arises for property investment, and seems to have caused no serious difficulty. In any event, it would be manifestly unfair to tax receipts as income while not allowing relief for expenditure, as suggested in paragraph 176.

Question 9
What is the best way to deal with the transition (paragraph 190)?

31 We agree that this is likely to be complicated. We note the various options presented to move to the new system. We note that the approach (set out in paragraph 182) to continue with the existing basis for existing intellectual property and move to the new basis for new expenditure is rejected for two reasons. These are that intellectual property has a very long or indefinite life (the example given in paragraph 183 is trademarks) and the inconvenience of continuing two parallel systems far into the future.

32 However, we do not accept these reasons and our conclusion is that the approach adopted should be as set out in paragraph 182. Firstly, we appreciate that this may lead to quite a long transitional period, but this is inevitable and the number of 'old' assets will reduce in time. We suspect that in practice the number of cases where there will be a long transitional relief will be quite small. This approach has invariably been adopted in respect of similar tax reforms in the past, for example the reform of mines and oil wells allowances and its replacement by mineral extraction allowances. We do not think that a different approach should be adopted in this case.

33 Secondly, we do not think running two parallel systems will be that inconvenient, because the taxpayer will simply continue with the old treatment for the old expenditure assets and adopt the new treatment for the new expenditure. The only problem we foresee is that any deprecation charged on old and new assets will need to be identified, but this should not be that difficult provided that the accounting records are able to identify the old and the new expenditure.

34 Thirdly, if we move to a new system for both past and future expenditure, we suspect that complicated transitional rules will be required so as to ensure that neither taxpayers nor the Revenue are disadvantaged.

35 The commentary in Chapter Eight sets out many of the potential problems if a move is made entirely to a new system, and serves to confirm our view that the approach suggested in paragraph 182 is the right solution.

36 We believe it is better to retain the existing rules and new rules side by side rather than introduce new rules for all assets. However, we agree that there will need to be rules to prevent exploitation between the old and the new rules by connected persons.

Question 10
Do you prefer an immediate switch to the new basis (paragraph 191)?

37 We said in question nine above that we are in favour of an immediate switch to the new basis, but only for expenditure arising on and from the date when the new system is introduced. Expenditure on intellectual property before this date should continue to be dealt with in accordance with the current rules.

Question 11
What kind of deduction of tax rule would be best (paragraph 255)?

38 We accept that some sort of deduction mechanism is necessary to protect the UK tax base, and we welcome the recognition that whatever new system is adopted should be simple and certain in its application. We agree that the 'pure income profit' concept is difficult to understand and apply. We think that this concept should be abolished in favour of the rule based upon the definition of royalties as set out in the OECD model royalty article. If this wording is adopted, then there will be consistency of treatment in respect of the deduction of tax as between domestic and treaty legislation Moreover, on the view which we have taken of Question 1, there would be consistency between the definitions used for the deduction system and for the new intellectual property regime itself.

39 We would however not necessarily accept that the new system should extend to film royalties, which are at present specifically excluded, presumably in recognition of the particular circumstances of that industry. We think that this aspect requires further consideration, in discussion with representatives of the industry, in the light of the policy reason for the present exclusion.

40 Paragraphs 221 and 222 raise the question of the territorial scope of the deduction charge. In this respect also we would like the system to be certain, relying on objective criteria rather than on the notoriously difficult tests which have come to be recognised as defining the geographical source of interest income. Once again the system also needs to fit in with the UK's treaty obligations. We would therefore favour applying the obligation to all royalty payments by a UK resident company or attributable to a UK permanent establishment of a non-resident company (subject to the above point about film royalties). We think this would generally have the effect that a tax deduction would only be available if the royalty comes within the deduction regime, but we would not wish this to be reintroduced as an explicit statutory limitation, if only because of the difficulty of applying it in the proposed system where relief is to be given on an accruals basis.

41 Paragraph 226 et seq. raise the problem of bundled rights. We do not think that there is any universal solution to this, given the diversity of the commercial agreements that exist in practice. We find it hard to see any better solution than the usual type of 'just and reasonable apportionment' provision. One possible approach might be to say that any composite payments which include a royalty element are to be treated as being wholly royalties, so in effect compelling the parties to unbundle their agreements themselves. However we do not favour this, since it would be a trap for the poorly-advised and would do little to address the problem of artificial allocation of the overall consideration between the various elements.

42 We think that consideration should be given to the abolition of the requirement to deduct tax (perhaps by way of a reduction in the rate to nil if this maintains the UK's ability to levy a withholding rate under a double tax treaty) where a royalty payment is paid between UK resident taxpayers. This would seem to be a reasonable quid pro quo for the extended scope of the obligation to deduct on cross-border royalties, and to involve no significant risk to the Revenue.

Question 12
How can the compliance costs of tax deduction be minimised (paragraph 256)?

43 In the light of the move to self assessment for corporation tax, and with a view to reducing the compliance burden, we think that consideration should be given to amending the deduction system from one based upon a prior clearance from the appropriate revenue authorities to one based upon self certification by the taxpayer. We appreciate that safeguards will need to built in to such a system to protect the Revenue and prevent possible abuse, though we would appreciate clarification of what safeguards the Revenue consider necessary over and above those which already apply when a payment is made without prior clearance.

44 Self-certification would be a mixed blessing for the payer, since the present system provides him with protection against the possibility that the recipient may, for example, not be resident where it says it is. It would however simplify matters for many intra-group royalty payments, where the recipient's entitlement to treaty relief is not really in doubt. We are therefore inclined to favour a system under which self-certification is optional. We agree however that no firm conclusion can be reached on this issue until the new regime for deduction from interest has been finalised: we would certainly not wish to have separate systems for royalties and interest, unless there is a very good reason.

CONCLUSION

45 We believe this consultation exercise has greatly assisted the debate over the reform of intellectual property and to date has been successful. The consultation document is a helpful and constructive summary of the issues and problems and we are in broad agreement with the conclusions reached. We are confident that the taxation of intellectual property can be reformed along the lines set out in the document and that the new rules will be a significant improvement over the current system.

46 We would be happy to meet to discuss these points further, if that would be helpful.

14-45-36
FJH
16 July 1999