

TAXREP 04/02

TAXATION OF INTELLECTUAL PROPERTY, GOODWILL AND OTHER INTANGIBLE ASSETS: DRAFT LEGISLATION

*Text of a memorandum submitted in January 2002 to the Inland Revenue in
response to a Technical Note issued in November 2001*

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INTRODUCTION

- 1 We welcome the opportunity to comment on the Technical Note published on 27 November 2001.
- 2 We also appreciated the opportunity to discuss the issues raised by this Note, both in the related working party and in a separate meeting. We welcome the positive and open approach adopted by the Revenue to this consultation and we believe that the result has been a success.

GENERAL COMMENTS

- 3 We welcome the decision to draft this legislation in the style of the Tax Law Rewrite Project. This has generally been successful, although there are some exceptions to which we refer in more detail below.
- 4 It would be helpful to have rather more signposting in the operative paragraphs to indicate when a phrase is being used in a special sense which is defined elsewhere, for example 'generally accepted accounting practice' in paragraph A6 and 'other assets' in paragraph I4(4). The reference to 'other assets' as a defined phrase in paragraph O9 is not only a long way away from paragraph I4, it incorrectly implies that the phrase is used only in Part G.
- 5 Similarly, more signposting would be helpful where provisions are subject to significant exceptions. In particular, Part A should say that the definitions are subject to major exceptions in Part J.
- 6 The phrase 'subject to any adjustment required for tax purposes', which is used repeatedly, is particularly unhelpful. It implies that there are exceptions, but gives no indication of what they might be. It tells one no more than (taking paragraph B5(4) as an example) 'The cost of the asset recognised for tax purposes is x, unless it is something else'. As is made clear from reading paragraph 296 of the commentary, the relevant exceptions are not even confined to other provisions in the Schedule itself. They could be anywhere in the tax code, and even deciding whether any particular provision in a different Act does or does not operate to override the intangible assets legislation is not necessarily straightforward.
- 7 Any such overriding provisions should be explicitly identified. They should not be too difficult to identify as we assume that the Revenue must already have worked out which they are, in order to decide what needed to be included in Part M.

KEY POINTS

Paragraph I2 - Transfers within a group not at book value

Underlying policy

- 8 We can see no strong policy reason for the rules set out in this paragraph, which will give rise to a further divergence between tax and the accounts in cases where it is not satisfied. Although, overall, the condition seems likely to operate in favour of the taxpayer, we are not in favour of departing any further than is absolutely necessary from the original objective of aligning tax with the accounting treatment.
- 9 We also believe that there is scope for too much difficulty and disagreement in the application of the rules set out in the paragraph. This is because they require the taxpayer to hypothesise what might have been done in the accounts in circumstances which did not in fact occur. For both these reasons, we would therefore prefer that all transfers within a group at other than book value be treated for tax in the same way as they will be in the individual companies' accounts, that is as realisations for the consideration actually paid.

Drafting points

- 10 The drafting of this paragraph is not wholly satisfactory. The paragraph does not explicitly include the condition, mentioned in paragraph 17 of Chapter 2 of the Technical Note, that the circumstances must be such that the increase or decrease over book value would have been recognised in the accounts if the transfer had not taken place. We understand that sub-paragraph (4) is intended to have this effect, but the way it is expressed is not clear. If this condition is to be included, it should be expressly stated.
- 11 Presumably 'corresponding' in sub-paragraphs (2)(b) and (3)(b) means corresponding in the sense defined by paragraphs B3 and C3, but an explicit cross-reference would be more helpful.

Paragraph L1 - Transfer between company and related party treated as being at market value

- 12 Similar comments apply here as in our comments on paragraph I2 in paragraph 8 above. Since Schedule 28AA ICTA 1988 applies to transactions involving intangibles, we do not see any need for this additional market value rule. At best it is an unnecessary complication. At worst, it appears to provide the Revenue with another opportunity to attack a transaction which is already subject to Schedule 28AA. Schedule 28AA represents a balanced package and the main function of paragraph L1 seems to be to override such elements of the package as provide a measure of protection for the taxpayer.
- 13 In particular, paragraph 5(2) of Schedule 28AA provides, broadly, that no adjustment is to be made if both parties are within the charge to UK tax, but in that event paragraph L1 would operate to impose market value anyway. We would accept that, in relation to intangibles, paragraph 5(2) may require an additional condition to exclude the case where the disadvantaged party is the purchaser of an intangible asset,

in view of the timing advantage which could be gained by underpricing such a transaction. However, we do not think that any further adjustments are required.

- 14 Moreover, in relation to cross-border transactions with a counterparty resident in a treaty country, paragraph L1 is contrary to the UK's treaty obligations. The arm's length price determined according to OECD principles is not necessarily the same as the objectively determined market value specified by paragraph L1(4). There is therefore the possibility that there may be no adjustment under Schedule 28AA because an arm's length price has actually been used but paragraph L1 nevertheless applies, or is argued by the Revenue to apply, to impose an open market value. We would in any case welcome assurances that this provision will not be applied to a transaction which is already subject in principle to Schedule 28AA, even if no adjustment is required under that Schedule.
- 15 We agree that there is a need, not currently met by Schedule 28AA, for a symmetrical adjustment in the case where the disadvantaged party is chargeable to capital gains tax, which the commentary implies is the purpose of paragraph L1. However, this should be provided for within the framework of Schedule 28AA itself. Paragraph L1 would in any case be largely ineffective for the purpose, since it only applies in cases where there is no adjustment under Schedule 28AA.

Paragraph M13 - Controlled foreign companies

- 16 We understand that, since intangibles are being brought into an income regime, the intention is that the controlled foreign companies (CFC) rules should apply to them in exactly the same way as to any other type of income. The Revenue's view is, therefore, that few adjustments are required to the CFC legislation.
- 17 However the intangibles legislation contains a number of features which are not present in the existing regime for taxation of income, and it is necessary to ensure that these are appropriately dealt with in the computation of chargeable profits for CFC purposes. One such feature is the rollover relief for intangibles, which is one of the points covered by paragraph M13. However, there are several others which are not, notably the tax-neutral treatment of intra-group transfers, the market-value rule in paragraph L1, and the various provisions for reconstructions in Part K.
- 18 We accept that transfers of intangibles within a non-resident group cannot be treated as tax-neutral in circumstances where this would allow an accrued profit to be moved out of the CFC net. However such transfers should be treated as tax-neutral if the transferee is itself within the CFC regime. Paragraph 20(2) of Schedule 24 to ICTA 1988 provides a broadly similar rule for transfer pricing purposes and could be used as a model. We note that if the 'group' were defined for this purpose to include just CFCs and UK-resident companies, the degrouping rule in paragraph I5 would operate if the transferee subsequently ceased to be a CFC. This would prevent any unrealised gain from escaping the CFC net in those circumstances.
- 19 Similarly paragraph L1, if it is to be retained at all (see our comments above), should not impose a market value on a transfer of intangibles between two CFCs.

- 20 Since the rules in Part K are subject to a motive test, there is no reason why they should not be extended to apply for CFC purposes to reconstructions involving the CFC and another non-resident company. The reliefs in paragraphs K1 and K3, at least, are potentially important and should be available to CFCs. Those in paragraphs K2 and K4 are probably of less practical importance in relation to CFCs, but since they are derived from the EC Mergers Directive consideration should be given as to whether EC law requires them too to be implemented in this context.
- 21 The amendments which we think are required to apply paragraphs K1 and K3 are relatively minor. In paragraph K1, as applied for CFC purposes, it will be necessary to deem the intangibles to be chargeable intangible assets in the hands of the transferee, even though it is non-UK resident. Paragraph K3 seems to need no substantive adaptation, since it assumes a non-resident transferee in any case. Both paragraphs would however require machinery to allow the reliefs to be notionally claimed, and Revenue clearance given, for transactions which are not directly subject to UK tax.
- 22 These rules also need to ensure that they cater for more recent developments in EU law, in particular the new EU company Statute, which will provide a new structure for reorganisations and mergers across EU borders.

Paragraph J10 - Research and development

23 Subparagraph (3) seems to have the effect that the whole of the proceeds of any disposal of a research and development (R&D) asset will be brought into account as a credit under paragraph D4 or D5, producing a double charge to the extent of any balancing charge under the Capital Allowances Act 1992. We understand that the intention is that the balancing charge would in fact be excluded by the general rule against double charging in paragraph A1(3). However, it is strange to find the original expenditure being relieved under the capital allowances code but disposal proceeds charged under the new system. If this is really what is intended, the legislation should at least make it more explicit.

OTHER POINTS

Paragraph A2 - Definition of intangible assets

- 24 We agree that 'intangible assets' should be defined primarily by reference to accountancy practice. We are not aware of any other types of intangible assets which need to be specifically mentioned.
- 25 'Fixed asset' is also an accountancy concept, so we believe that if a definition of this phrase is needed, that too should be by reference to the meaning of the words for accounting purposes rather than a free-standing definition as in the draft paragraph A3(1) - which is of course based on accounting practice in any event. In fact, since for accounting purposes an 'intangible asset' is defined as being necessarily a fixed asset (see FRS 10 paragraph 2) the definition, and the references throughout the Schedule to 'intangible *fixed* assets', appear to be unnecessary, though there may be

some merit in retaining them for the avoidance of doubt. On the other hand, if the definition in paragraph A2 is intended for any reason to include intangibles which are *not* held as fixed assets, the definition needs to be amended.

Paragraph B3 - Amortisation or impairment loss

- 26 We would prefer charges for amortisation etc. in the accounts to be referred to as 'accounting debits' rather than 'accounting losses' as the former is closer to normal usage. However, if the latter expression has to be used, the word 'debit' at its second occurrence in the first line of paragraph B3(4), should for consistency be replaced by 'loss'.
- 27 The formula in sub-paragraph (6) will give an indeterminate result for any period in which the asset has been fully amortised, so that 'accounting loss' and 'book value' are both zero. With the possible exception mentioned in paragraph 37 below, in relation to paragraph I5, it appears that the debit for tax purposes in such cases should always be zero, but the legislation still needs to cover the case. The same applies in paragraph C3(3).

Paragraph D2 - Meaning of realisation

- 28 The definition in sub-paragraph (1) needs to be extended to cover the case of a total loss of the asset. The total loss of an asset is not a 'transaction' in the normal sense of the word; nor is it an event giving rise to a gain.
- 29 The effect of sub-paragraph (2) is not at all clear. It needs to be expanded to explain, as in paragraph 81 of the commentary, that one has to apply sub-paragraph (1) by reference to what would have been done in the accounts if the asset had had a balance sheet value. It appears also that the existence of a balance sheet value is to be assumed only for the purposes of indent (a) in subparagraph (1). If applied to indent (b), or to the extended definition of 'transaction', the assumption of a non-zero carrying value might result in the transaction being deemed to realise a loss when there is in fact a gain. This is not what is intended.

Paragraph F6 - Claim to set non-trading loss against total profits

- 30 There is some inconsistency as to whether a non-trading loss carried forward is treated as a loss or as a debit in the subsequent period. The draft legislation actually says it is a debit, but paragraph 120 of the commentary refers to it as a loss. The new section 403ZD(6), ICTA 1988 seems to assume that it is a debit, and so just forms part of the loss for the later period, but the new section 768E is at least more easily construed if it is a loss in its own right. There is some practical difference, since a claim would have to be made within two years to use a brought-forward loss against profits of the later period, whereas a debit would be taken into account automatically in computing the overall non-trading profit or loss from intangibles in that period.

Paragraph F8 - Change in ownership of company with unused trading loss

- 31 New section 768C(13) begins 'In the application of this section to [an intangible fixed asset] ...', which implies a need for an amendment to section 768C(1) to say that the

section actually does apply in relation to such assets. A new paragraph (e) could be inserted to new section 768C(13) to cover the case.

- 32 Paragraph 7(1)(b) of Schedule 28A to ICTA 1988 (amounts apportioned wholly to the first part of the accounting period) needs to include a reference to the new sub-paragraph (df) in paragraph 6, and similarly paragraph 16(1)(b) needs to refer to new sub-paragraph 13(e).f).

Paragraph G2 - Conditions to be met in relation to the old asset and its realisation

- 33 The words 'the time *and extent* to which ... ' in sub-paragraph (2) allow for the possibility that an asset might only partly qualify as a chargeable intangible asset. If this probably very rare situation is to be covered it seems to require some expansion of indent (b) of sub-paragraph (2), to include the alternative possibilities that the asset is only partly a chargeable intangible asset, and/or that it is a chargeable intangible asset for only part of the time.

Paragraph I3 - Roll-over relief on reinvestment: application to group member

- 34 We are not convinced that subparagraph (2) is necessary. The corresponding provision in section 175(1), TCGA 1992 is needed because the basic rules for capital gains rollover require the old and the new assets to be used in the same trade, or in trades carried on by the same person. However the new relief in Part G is differently constructed, and seems only to require (*via* paragraph J6) that each of the assets should be used for *some* business or commercial purpose of 'the company' - presumably meaning the company which owns the asset in question. Some element of redundancy in the legislation may do no harm, but we are concerned in case the apparent redundancy in this case may indicate that we have misunderstood the requirements of Part G and we would welcome clarification.

Paragraph I4- Roll-over relief on reinvestment: acquisition of company becoming member of group

- 35 We are not convinced that the reference in sub-paragraph (4) to 'the gain' is correct. What needs to be apportioned is the amount available for relief.

Paragraph I5 - Company ceasing to be member of group

- 36 Sub-paragraph (1)(c)(ii) has the effect of imposing a degrouping charge in cases where the transferee was not a member of the group at the time when the asset was transferred to it. We do not think that there should be a charge in such circumstances, since in such a case the asset could not have been transferred on a tax-neutral basis, and the mischief at which the charge is aimed would not exist. The degrouping charge should only operate in cases where there has been a tax-neutral intra-group transfer (which is what paragraph 178 of the commentary suggests is the intention).
- 37 Paragraphs 180 to 182 of the commentary imply that the adjustment for additional depreciation after a degrouping charge is to be calculated by notionally rewriting the accounts, applying the company's depreciation policy to the deemed reacquisition

cost, rather than using the pro rata method of paragraph B3. If that is the intention, the legislation needs to say so. On the other hand, if the pro rata method is to be used it will need some adaptation to cater for the possibility that the asset may have been fully depreciated by the time when the company leaves the group, so that its book value in all subsequent periods is zero and the formula in paragraph B3(6) cannot be used.

- 38 Sub-paragraph (3) provides that the adjustments consequent on a company ceasing to be a member of a group are to be brought into account in the accounting period in which, or at the end of which, the company leaves the group. Section 179(4), TCGA 1992 is more specific, providing in most cases that the chargeable gain or allowable loss is deemed to accrue immediately after the beginning of that accounting period.
- 39 Section 179(4) was drafted in that way mainly in order that, if the accounting period had to be divided for group relief purposes, any section 179 gain would be allocated to the first part of the period and so would qualify for relief against losses of the old group. Group relief may be less of an issue under the new legislation, because it appears that much the same result can be achieved by reallocating the degrouping charge to the company which has the losses.
- 40 However, the legislation still needs to define whether group relief is or is not available in such a case, and it may also be important for other purposes to know when in the accounting period the charge is deemed to accrue: for example in order to determine whether it can be set against losses or debits brought forward in a case to which section 768, ICTA 1988 applies. We think therefore that paragraph I5(3) should also deem the adjustments to arise immediately after the beginning of the accounting period, with a corresponding provision in paragraph 7 of Schedule 28A to ICTA 1988.
- 41 Sub-paragraph (3) may also not deal adequately with the case where the asset has been transferred to an associated company of the original transferee some time before they both leave the group, so that adjustments are needed in both companies, particularly if they have different accounting periods.

Paragraph I6 - Degrouping: associated companies leaving group at the same time

- 42 We are disappointed that at subparagraph I6(3), it has been thought appropriate to reproduce sub-section 179(2B), TCGA 1992 as we think that this sub-section is far from easy to understand. However, we believe that as a matter of construction, 'that paragraph' in section 179(2B)(c)(ii) must mean paragraph (b) rather than, as it has been rendered in the new version, paragraph (a).

Paragraph I12 - Reallocation of degrouping charge within group

- 43 It would be helpful to state, if only for the avoidance of doubt, that a reallocation claim does not alter either the fact that it is company X which is deemed to reacquire the asset, or the incidence of any consequential adjustments under paragraph I5(3).

Paragraph I13 - Application of roll-over relief in relation to reallocated degrouping charge

- 44 This paragraph clearly provides for a reallocated gain to be rolled over under Part G. On the face of it, much the same result could be achieved without the need for a reallocation claim by applying paragraph I3 to the deemed realisation, but we are a little puzzled by the contrast with the draft legislation on section 179, TCGA 1992 where there is provision for group rollover under section 175 but nothing explicit about rollover of a reallocated gain. We would be grateful for confirmation of which routes are intended to be available in each case.

Paragraph J5: Assets entirely excluded: rights in companies, trusts, etc

- 45 We assume that sub-paragraphs (2) and (3) are intended to cover the case where a trust or partnership is treated for accounts purposes as being transparent, so that although in law what the company owns is an interest in the trust or partnership, its accounts treat it as owning a share in any underlying intangibles. However, neither the draft legislation nor the commentary is particularly clear on this. They could be read as referring to a case where the company records its interest in the trust or partnership as a single asset, but classifies it as an intangible.
- 46 We are in any case concerned that there is a possibility of double counting in the case of a trust, which is taxed as an entity in its own right, if the investor is also treated as itself being within the new regime in respect of its interest, either in the trust as such or in the underlying assets. Even in the case of a partnership, although the partnership is not actually a taxable entity it is required to make a return of its own profits, which normally then flow through to the partners' self-assessment returns in the appropriate proportions without further adjustment. It is not entirely clear that the machinery exists to prevent a double charge in the case of a corporate partner which is accounting for its interest in the partnership as transparent.

Paragraph J6 - Assets entirely excluded: non-commercial purposes etc

- 47 Since these assets are excluded to the extent that they are held for non-business purposes, it seems that they would be better classified as 'assets excluded to the extent specified' rather than 'assets entirely excluded'. More importantly, we think that there is a need for rules to deal with cases where an asset begins or ceases to be used for business purposes, other than on a change of ownership, or where the proportion of business use changes.

Paragraph L4 - Delayed payment of royalty payable by company to related party

- 48 This rule should be confined, like paragraph 2 of Schedule 9 to FA 1996, to cases where the recipient of the royalty does not bring it into account for UK tax purposes on an accruals basis. Otherwise there will be an unsymmetrical adjustment in the most usual case, where both parties are within the charge to UK tax and account for the royalty in accordance with accepted accounting practice but the payer is for some reason unable to pay on time.

- 49 We do not understand the expression 'accrue due', in the last line of this paragraph. When a royalty accrues is one thing, and when it falls due is quite another. It would appear that what is meant is simply 'accrue', as in paragraph 2 of Schedule 9. This issue also arises where the same expression is used in paragraphs M10(2) and M11(2).

Paragraph N4 – Treatment of fungible assets

- 50 The commentary on paragraph M4 suggests that the only practical approach to fungible assets is to treat pre- and post-commencement assets of the same kind as forming separate pools. We agree in principle, though we are not sure what kinds of intangible property would in practice be fungible assets and we would welcome clarification.
- 51 A much more common situation is likely to be that the post-commencement expenditure is treated as enhancing the value of an existing pre-commencement asset, rather than giving rise to a new asset (albeit of the identical sort) in the hands of the purchaser. For example if a substantial existing business acquires a new branch, the sum paid for the goodwill of the branch might be regarded by the purchaser as merely enhancing the overall goodwill of its existing business. In order to cover this situation the references in paragraph N4 to 'acquisition or creation' need to be extended to include 'enhancement', but that seems to be all that is required.

Paragraph N5 - Internally generated goodwill: whether created before or after commencement

- 52 We think that a definition is needed for the expression 'internally-generated'. We would have supposed that it would mean 'created by the company itself'. However it is unclear whether it also extends to an asset created by another company in the same group, and we are not even sure whether our understanding is correct, since on that basis the reference in paragraph N7 to expenditure on the creation of an asset seems to be otiose. Paragraph N7 can apparently never apply to internally-generated assets, since they would always be within paragraph N5, N6 or N9, but if we have understood the expression correctly 'creation' would only be relevant to internally-generated assets.

Paragraph N7 – When expenditure treated as incurred: general rule

- 53 We do not think that a rule based on accountancy practice is suitable for defining when expenditure is incurred, although we recognise that this default rule may in practice be needed very rarely. For most companies the commencement date will fall in the middle of an accounting period, so it will not be directly apparent from the accounts when exactly the expenditure in question was treated as incurred. We have already expressed our reservations in paragraph 9 about the use for tax purposes of tests based on hypothetical accounts, and certainly in this case accountancy standards do not provide any sufficiently specific rules to allow one to say with reasonable certainty when the expenditure would have been treated as incurred.

Paragraph N12 - Roll-over relief: application in relation to realisation of existing asset after commencement

- 54 So far as we are aware the expression 'acquisition cost', in paragraph (1)(d), is not used in the TCGA 1992. In any event, what is needed here, in order to preserve the effect of the existing rollover relief for existing assets, is a wider expression covering all costs which are deductible under section 38, TCGA 1992 in computing a chargeable gain.

CONCLUSIONS

- 55 We welcome the draft legislation. It is by and large well drafted and appears to implement successfully the proposed reform of the rules governing intellectual property. Our key comments on the draft rules are that:
- although we think that the drafting is generally successful, we would welcome more signposting within the rules, particularly in respect of definitions which may be found elsewhere;
 - the rules should only diverge from accounting rules where it is absolutely necessary. We therefore do not think that it is necessary to override the accounting rules for transfers within a group or to a related party;
 - the rules for computing profits under the controlled foreign companies rules need to be amended to cater for the new rules set out in this draft legislation as well as developments in EU law; and
 - the rules should clarify the interaction with research and development expenditure so that no double charges arise.
- 56 We would be happy to discuss these points further, if that would be helpful. We would also welcome any feedback from the responses to this consultation. In particular, we would be grateful for feedback on the items we have highlighted above that require clarification.

14-45-36
FJH
31 January 2002