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Life Sciences Structuring & Partnering

FTI Consulting

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Partnering

When a business out licenses IP rights it may result in a double charge at the corporate and shareholder level, although the corporate rate could be substantially reduced through Patent Box.

This memo presents some of the key tax considerations when partnering. The takeaway is that obtaining tax input at an early stage (e.g. Heads of Terms) regularly enhances the value of the deal. There are typically 5 aspects to consider: withholding tax, indirect tax, patent box, R&D incentives and access to tax losses. There may be options available to structure the transaction to remove any liability to tax at the company level.

Withholding Tax

Withholding tax ("WHT") is a tax deducted in the source jurisdiction and may be levied on royalties (and possibly up fronts and milestones) paid to a person outside that jurisdiction. It is essentially an allocation of taxing rights which can often be mitigated through a double tax treaty. Importantly it is the licensor's tax liability administered by the licensee.

To ensure that the right amount of WHT is paid and that, where possible, it can later be recovered, both licensor and licensee will need to exchange information. The obligation to cooperate should be reflected in the agreement. If WHT applies to any of the payments, assess what rate of withholding should be applied under the domestic law applicable to the licensee and then, if applicable, under the relevant double tax treaty.

WHT can be a real cost to loss-making companies or where full double tax relief is not available. Companies should first determine whether it is likely to be a cost, and if it is, consider potential solutions.

Companies should try to avoid having royalty flows from several licensees under the same agreement as this will increase the compliance requirements and risk of additional tax cost. It is also important to ensure that there is suitable control over rights of assignment such that, as a minimum, it requires written approval from the licensor.

Indirect tax

It is important to check whether prices include or exclude VAT. If VAT or other indirect taxes are chargeable, they may not be recoverable by the licensor. The anticipated VAT treatment of each component of the agreement will need to be determined. Consider whether the definition of sales and other thresholds are explicit with regard to the inclusion or exclusion of indirect tax.

If materials are being transferred cross-border, examine how the valuation and compliance is being addressed for import duty purposes. Potential duty rates should be determined and the agreement should specify which party should bear the cost.

Some territories have complex sales tax rules, e.g. Latin American countries. When dealing with such a territory, assistance may be required to understand the local rules.

Patent box

Both the licensor and licensee may want to take advantage of the UK patent box or a similar regime in another territory. The terms of the agreement may influence whether a company can benefit and the extent to which it does so. The notes below apply to the UK regime.

Qualification for Patent Box should be determined and the benefit quantified, including:

- Whether the Development Condition and/or Active Ownership tests are passed; and
- Whether any ancillary income streams under the agreement are eligible for inclusion as relevant IP income; and
- Whether the exclusivity criterion is satisfied; and
- Know the likely impact on the R&D fraction that might be applied to cut the overall benefit.

It is important to ensure that sufficient evidence is available to demonstrate the licensee has qualifying IP rights. If patents are not granted at the time of the agreement, ensure there is a mechanism requiring the Licensor to notify the Licensee following grant.

To value the benefit/cost of the license, the after-tax position can be calculated taking into account the Patent Box and R&D incentives. If either party has not elected into the regime, it may be helpful to consider whether the transaction now makes it worthwhile to elect in.

Loss Utilisation

It is not uncommon for companies to find that they have been unable to set tax losses against income streams under a license. It is important that this is considered carefully as an oversight can prove costly. The licensor can offset receipts under the agreement against tax losses provided the income and the loss are of the same nature for tax purposes.

It is important to consider reviewing the nature of the receipt (i.e. capital vs. revenue or trading vs. non-trading, originating from IP created pre/post April 2002).

Equally, companies should review the nature of the tax losses and consider whether there are any restrictions that could apply to their utilisation. In particular, consider the timing of when the revenue will be recognised for accounting purposes.

R&D Incentives

If the licensor is claiming R&D incentives, consider the impact of receipts under the agreement. If there is ongoing collaboration for development, any FTE reimbursement (or the equivalent) is likely to be regarded as subsidised R&D. As a consequence, the company receiving the payment may not be able to claim the SME incentive on the subsidised amount.

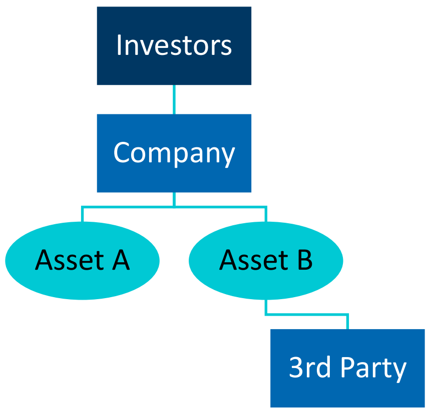
Milestones or other income could similarly be regarded as a deemed subsidy and might limit the ability to claim the UK SME relief. The terms of the agreement would be influential in deciding the treatment.

Structuring

Anticipating the basis on which different assets may be divested or partnered can lead to structuring considerations now that can significantly impact the tax position. Licensing rights can result in much greater patent box benefits over assignment but a transaction over the shares holding the rights can be exempt from tax. It is not uncommon for a company to hold one or more IP assets that may be of interest to different parties when the time comes to partner or divest. Maintaining these in single asset companies may mitigate the tax exposure but can also result in greater complexity, cost and limit access to R&D tax incentives and patent box benefit.

Base case

It is not uncommon for a company to hold one or more IP assets/programmes that will be of interest to different parties when the time comes to partner or divest. Maintaining these in a single company reduces; complexity, time and can make the tax position more robust both from an R&D incentive and Patent Box perspective.



Out license

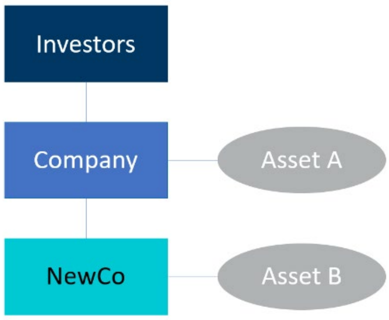
Rights to Asset B are out licensed to a third party. This will result in a double charge at corporate and shareholder level, although corporate rate could be substantially reduced through Patent Box if it applies.

Sale of assets

In a similar way to a licence, the sale of rights to Asset B will result in a double tax charge at the value of the asset at the time of sale reduced by any tax losses and, to some extent, the Patent Box, if available. The outright sale of patent rights is unlikely to generate the equivalent benefit under Patent Box as compared to license as it will only apply to the value of qualifying UK or EU patents. An equivalent licence would allow rights to all patents and associated IP to qualify.

Hive down – transfer of trade and assets (Option 1)

The transfer of trade and assets related to Asset B into NewCo should allow Asset B to be divested through the sale of shares in NewCo. This sale should be exempt under the Substantial Shareholding Exemption subject to fulfilling the qualifying criteria. There should be no tax on the transfer.



It is important to note that under the Substantial Shareholding Exemption the sale of shares in NewCo should be tax exempt (other conditions may apply) after 12 months following the transfer of asset B.

Liquidation demergers and capital reduction demergers, on the other hand, do not offer any protection against degrouping charges.

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