The Chartered Institute of Taxation

Application and Professional Skills

Taxation of Larger Companies and Groups

November 2023

Suggested solution

REPORT TO EASTTEACO PLC

COLLABORATION PROJECTS

Introduction

This report has been prepared for the Board of EastTeaCo plc to consider the UK tax consequences of two projects with M20 Projects Ltd. It should not be relied on for any other purposes or by any other persons.

It is based on information provided in your email of 1 November 2023 with two attachments and is based on legislation in force on today's date. If there is a delay in implementing our recommendations, a significant fiscal event (such as a Budget), or a change in circumstances, confirmation should be sought as to whether this affects the conclusions and recommendations in this report.

Lambert Maskell LLP
2 November 2023

Executive summary

The EastTeaCo group is looking to collaborate on two related projects with M20 Projects Ltd. The collaboration, if successful, will result in royalty income for the group, as well as cost savings for EastTeaCo UK Ltd. We have been asked to recommend which of two potential structures is the most appropriate. The first structure is a joint venture between EastTeaCo UK Ltd and M20 Projects Ltd under which EastTeaCo UK Ltd would own 70%, and M20 Projects would own the other 30%, of the patent rights created. The second structure is to incorporate a new company (Newco) with EastTeaCo UK Ltd holding 70%, and M20 Projects Ltd holding the other 30% of the shares of Newco. EastTeaCo UK Ltd intends to enter into an option agreement to buy out M20 Projects Ltd's patent rights/shares in Newco after four years, in July 2028.

This report sets out the tax consequences of each structure over the first four years, and then the tax consequences of the exit strategy. The key points are:

Joint venture option

- The trading expenditure and receipts from the projects will be amalgamated with the other transactions undertaken by EastTeaCo UK Ltd. The overall results of the company will depend on other activities, but the projects will generate an excess of expenditure over income of approximately £30 million in the years ended 30 June 2025 and 2026. If there is an overall loss in the company, the loss may be surrendered to other group companies should there be available profits.
- In each of the years ended 30 June 2027 and 2028, the projects will generate a surplus of income of £17.9 million. Under the patent box regime, the profits will be subject to a Corporation Tax rate of 12%.
- There are no transfer pricing consequences under this structure because EastTeaCo UK Ltd and M20 Projects Ltd are not connected parties.
- Research and development expenditure credit (RDEC) of £9.1million in total would be available to EastTeaCo UK Ltd.

Newco option

- The total quantum of the losses which would be available to the EastTeaCo group as consortium relief is very similar to the joint venture option.

- Profits of Newco would be chargeable at a Corporation Tax rate of 12% under the patent box regime. There would be some transactions between Newco and EastTeaCo UK Ltd which would be subject to the UK transfer pricing rules, therefore all transactions between must be at an arm's length price for tax purposes.
- RDEC of £20 million would be available to Newco. This is similar in economic terms to the R&D benefit under the joint venture option since EastTeaCo UK Ltd would be a 70% shareholder (£20 million x 70% = £14 million).

Exit Strategy

- Under the option agreement, it is likely to cost £77.3 million to acquire the patent rights under the JV structure compared to £69.5 million to purchase the Newco shares from M20 Projects Ltd. These are the net amounts after all reliefs.
- In addition, if the Newco shares are purchased by EastTeaCo UK Ltd, stamp duty of £347,500 (0.5% x £69.5 million consideration) would be payable.

Recommendations

Over the first four years, the two structures have similar results in terms of the creation of losses and the availability of R&D tax relief for the EastTeaCo group. However, there may be more flexibility in how losses are used across the group under the Newco structure. Under either structure, Patent Box profits will begin to be generated in the year ended 30 June 2027, and an election for those profits to be in the regime should be made before 30 June 2029.

Based on the financials for M20 Projects Ltd, however, this company is unlikely to have profits from other activities (which break-even) to make use of its share of consortium losses under the Newco structure. Thus, the joint venture structure utilises losses in the most effective manner for this company through the R&D scheme for small and medium enterprises (SME), and therefore is likely to be the preferred structure for M20 Projects Ltd. Ignoring the exit strategy calculations, we would recommend the joint venture structure.

However, when considering M20 Projects Ltd's exit strategy, the Newco structure would result in a lower cost (by £7.8million less the stamp duty payable) for EastTeaCo UK Ltd, and therefore overall, we would recommend the Newco structure.

Joint venture structure consequences

An income or cost-sharing arrangement, without profit-sharing, is a possibility in appropriate commercial circumstances. No separate legal entity is set up, the rights and duties of the parties are governed by the contract between them, and the arrangement merely involves the pooling of resources.

The joint venture agreement should deal with the intellectual property created. The terms of the agreement should stipulate that EastTeaCo UK Ltd will make payments to M20 Projects Ltd for its own use of any patented process.

EastTeaCo UK Ltd and M20 Projects Ltd will incur its own costs and earn its own income, in accordance with their agreement as to how they will collaborate. The advantage of this structure is the integration of the joint venture trading results into the accounts and tax computations for each party.

Potential use of losses resulting from collaboration agreement

Under the joint venture structure, the results of EastTeaCo UK Ltd will be reduced by the £30 million development costs in the year ended 30 June 2025 and a net £30.4 million in the year ended 30 June 2026 (see Table 1). As these projects would only form part of the overall results of the company, they may (after restriction for the RDEC – see Table 2) reduce a taxable profit, turn a profit into a loss, or increase a loss within the company. Where an overall loss is incurred, it may be surrendered to other companies in the EastTeaCo group or carried forward against other company/group profits.

Table 1 - Joint venture structure - Net Income or cost to EastTeaCo Ltd

Year ended 30 June	Development costs borne by EastTeaCo UK Ltd	Payments to M20 Projects Ltd for own use	Royalty income (70%)	Net income or (expenditure)
	£million	£million	£million	£million
2025	(30)	-	-	(30.0)
2026	(40)	(3.0)	12.6	(30.4)
2027	-	(4.5)	22.4	17.9
2028	-	(4.5)	22.4	17.9
Total	(70)	(12.0)	57.4	(24.6)

Table 2 - Joint venture structure - Tax losses after adjusting for RDEC (see Table 3 below for RDEC calculation)

Year ended 30 June	Loss before RDEC	RDEC @ 13%	Loss
	£million	£million	£million
2025	(30.0)	3.9	26.1
2026	(30.4)	5.2	25.2

From 1 July 2026 onwards, there should be net income because of the payment of third-party royalties (the full costs of the projects having been fully incurred by then).

Taxation of royalty income/payments

A patent is the right to use a process or product. The payment of a patent royalty, such as the payments that EastTeaCo UK Ltd will make to M20 Projects Ltd, is an allowable cost for corporation tax purposes (being expenditure incurred wholly and exclusively for the purposes of its trade). The receipt of patent royalty income is taxable, but this could be at a lower than usual rate if the patent box regime applies.

Patent box regime

A company is a qualifying company if it holds qualifying intellectual property (IP) rights during the accounting period. The patents that would be created by the projects would be qualifying IP, and therefore under the joint venture structure, EastTeaCo UK Ltd would be a qualifying company. EastTeaCo UK Ltd would have met the development condition for accessing the patent box regime as it has collaborated in producing the new patented process.

The company would have the option of electing for relevant IP profits (RIPPs) to be taxed within the patent box regime. The election should be made in writing within two years of the end of the accounting period to which the profits relate. The election will only be required once patent box profits are being generated, that is, the year ended 30 June 2027.

The notes of the 30 October 2023 meeting state that the RIPPs arising from these projects would be taxed at a Corporation Tax rate of 12%. Due to the requirement to 'stream', adequate records should be kept to identify the RIPPs from the profits/losses arising from other activities carried out by EastTeaCo UK Ltd.

Transfer pricing considerations

EastTeaCo UK Ltd is not connected to M20 Projects Ltd since these companies are not controlled by the same person, and therefore the transfer pricing rules will not apply to transactions between them (for example, to quantify payments by EastTeaCo UK Ltd for its own use of the patented process).

Availability of R&D tax relief

For a project to benefit from UK R&D tax relief, the activities involved must fall within the definition of R&D. These are activities that fall to be treated as research and development in accordance with generally accepted accounting practice (GAAP), subject to the R&D Regulations giving effect to the definition of qualifying R&D activities set out by the relevant government department. These include projects whose aims are to extend overall knowledge or capability in a field of science or technology or to make an appreciable improvement to an existing process, material, device, product or service through scientific or technological changes. Even if the advance in science or technology sought by a project is not achieved or not fully realised, R&D can still be considered to have taken place. Both of the proposed projects would constitute qualifying R&D.

R&D tax relief is provided through two different routes:

a) Small or medium-sized enterprise research and development (SME R&D); or
b) Research and development expenditure credit (RDEC) for large companies.

The thresholds for SME R&D are as follows:

- no more than 500 employees; and either
- annual turnover of no more than €100 million; or
- an annual balance sheet figure of no more than €86 million.

A large company is one that is not a SME company.

Under the joint venture structure, EastTeaCo UK Ltd will be able to claim under the RDEC regime.

Qualifying expenditure includes in-house direct R&D. The RDEC rate is currently 13% but this rate could change so we recommend that you seek further advice before making a RDEC claim. A RDEC claim must be made in the company's tax return up to the first anniversary of the filing date for the company's tax return.

Table 3: R&D relief available to EastTeaCo Ltd

Year ended 30 June	Qualifying expenditure	RDEC at 13%
	£million	£million
2025	30	3.9
2026	40	5.2
Total	70	9.1

Overall, there will be an increase in taxable profits (or decrease in allowable losses) of the total amount of £9.1 million. However, that amount would be available to set off against the tax liabilities of the EastTeaCo group or to be paid in cash as a tax credit to EastTeaCo UK Ltd. There are a series of steps to determine how this may be utilised and we would be happy to advise on that when the results of the company are available for those years.

Newco structure consequences

Under this proposal, EastTeaCo UK Ltd would own 70% of Newco, and therefore control that company.

Initially, given that the projected development costs are greater than the royalty income, Newco would make losses. When it subsequently moves into profit, as royalties are earned and minimal costs are incurred, those profits can be distributed in their entirety by way of dividend to the shareholders, EastTeaCo UK Ltd and M20 Projects Ltd, in the same proportion as the shareholdings.

Potential use of losses

Table 4 below sets out the workings for Newco's profit/(loss) with EastTeaCo UK Ltd's net income position shown in table 6 below.

Table 4 – Newco structure – Financial results

Year ended 30 June	Development costs	Payments from EastTeaCo UK Ltd for use of patents	Royalty income	Profit or (loss) of Newco	EastTeaCo UK Ltd (70%)	M20 Projects Ltd (30%)
	£million	£million	£million	£million	£million	£million
2025	(43)	-	-	(43)	(30.1)	(12.9)
2026	(57)	10	18	(29)	(20.3)	(8.7)
2027	-	15	32	47	32.9	14.1
2028		15	32	47	32.9	14.1
Total	(100)	40	82	22	15.4	6.6

Table 5 – Newco structure – Tax losses after adjusting for RDEC (see Table 7 below for RDEC calculation)

Year ended 30 June	Loss before RDEC	RDEC 13%	Loss	EastTeaCo UK Ltd (70%)	M20 Projects Ltd (30%)
	£million	£million	£million	£million	£million
2025	(43)	5.6	(37.4)	(26.2)	(11.2)
2026	(29)	7.4	(21.6)	(15.1)	(6.5)

Table 6 – Newco structure - EastTeaCo UK Ltd's position

Year ended 30 June	Payments to Newco for own use of patents	Share of Newco's profit/(loss)	Total
	£million	£million	£million
2025	-	(30.1)	(30.1)
2026	(10)	(20.3)	(30.3)
2027	(15)	32.9	17.9
2028	(15)	32.9	17.9
Total	(40)	15.4	(24.6)

Where two or more companies own at least 75% of the ordinary share capital of another company and each of those two or more companies owns at least 5% of that share capital, those companies constitute the members of a consortium, and the company owned by them is a consortium company. Therefore, Newco, with EastTeaCo UK Ltd holding 70% of its shares, and M20 Projects Ltd owning the other 30% of its shares, would be a consortium company. In the years ended 30 June 2025 and 2026, EastTeaCo UK Ltd would be able to claim consortium relief of £26.2 million and £15.1 million, respectively, subject to the EastTeaCo group having sufficient profits to utilise that amount. Any surplus may be carried forward and set against future group profits.

The amount of relief is around £10 million less in the year ended 30 June 2026 under this structure than under the joint venture structure (i.e., £22.4m - £12.3m). However, the results of EastTeaCo UK Ltd will be reduced by the tax-deductible £10 million royalty payments to Newco.

Taxation of royalty income/payments

As with the joint venture structure, the profits arising from the projects would be taxed at a Corporation Tax rate of 12% because Newco would be a qualifying company under the patent box regime.

Transfer pricing considerations

UK transfer pricing legislation can apply to transactions such as services, including R&D activity, and royalty payments made intra-group.

Under this structure, Newco would be connected to the other companies in the EastTeaCo group because it would be under the control of both of them. If R&D activity is carried out by EastTeaCo UK Ltd and recharged to Newco, the recharges should be priced at arm's length, not just at cost.

The royalty payments made by EastTeaCo UK Ltd to Newco for EastTeaCo UK Ltd's own use of patents held by Newco should also be priced at arm's length. This could be determined by comparing the royalty payments with the third-party royalties receivable.

EastTeaCo UK Ltd should keep documentation to demonstrate that arm's length prices are charged in all these areas.

Availability of R&D tax relief

The thresholds for determining whether a company is large apply to the enterprise itself and linked enterprises. Linked enterprises are enterprises where one may exercise control, directly or indirectly, over another's affairs. Newco would be linked to the rest of the EastTeaCo group and therefore could only claim RDEC rather than the SME R&D.

Table 7: R&D relief

Year ended 30 June	Qualifying expenditure	RDEC 13%	EastTeaCo UK Ltd (70%)	M20 Projects Ltd (30%)
	£million	£million	£million	£million
2025	43	5.6	3.9	1.7
2026	57	7.4	5.2	2.2
Total	100	13.0	9.1	3.9

For EastTeaCo UK Ltd, the £9.1 million is approximately the same amount (in economic terms) as under the joint venture option.

The exit strategy

Joint venture structure

M20 Projects Ltd would be assigning its patent rights to EastTeaCo UK Ltd and disposing of its rights to future royalty income in return for a capital sum. Any profit on such a sale would not be treated as a chargeable gain but charged to Corporation Tax as income (under the IFA regime). The profit would be calculated as the proceeds less acquisition costs. But if the costs of creating the patent have been fully relieved by R&D tax relief, the acquisition costs would be considered to be £nil..

The table below sets out the calculation of the amount EastTeaCo UK Ltd would be required to pay M20 Projects Ltd upon exercise of the option, and shows that this amount would be £77.3 million.

Table 8: Amount payable by EastTeaCo UK Ltd under joint venture agreement

	Note	£'000	£'000	£'000	£'000
Royalty income from third parties	(a)				
Year ended 30 June 2026		5,400			
Year ended 30 June 2027		9,600			
Year ended 30 June 2028		9,600			
			24,600		
Additional royalty income from EastTeaCo UK Ltd	(b)				
Year ended 30 June 2026		3,000			
Year ended 30 June 2027		4,500			
Year ended 30 June 2028		4,500			
			12,000		
SME R&D tax credits (cash received)					
Year ended 30 June 2025	(c)	4,335			
Year ended 30 June 2026	(d)	4,451			
			8,786		
Total income				45,386	

Expenditure on project	(e)				
Year ended 30 June 2025		13,000			
Year ended 30 June 2026		17,000			
				(30,000)	
Tax payable on royalty income					
Year ended 30 June 2026	(f)	nil			
Year ended 30 June 2027	(g)	1,692			
Year ended 30 June 2028	(g)	1,692			
				(3,384)	
Amounts reducing £80 million (post tax) due to M20 Projects Ltd					12,002
Post-tax amount required by M20 Projects Ltd					(80,000)
Total					**67,998**
Post-tax balance required (rounded)					68,000
Pre-tax balance required (rounded)	(h)				**77,300**

Notes

(a) This is 30% of the projected royalties receivable from third parties each year. Under the agreement, EastTeaCo UK Ltd would receive the full amounts and then make a payment of 30% to M20 Projects Ltd.

(b) Under the agreement, EastTeaCo UK Ltd would pay M20 Projects Ltd for its own use of the patented process.

(c) M20 Projects Ltd incurs most of its expenditure on R&D and is therefore a R&D intensive SME. The company would incur £13 million of qualifying expenditure in the year ended 30 June 2025, all of which could be surrendered for repayable tax credits. The repayment generated would be £13 million x 230% which would be £29.9 million. Since the SME R&D rate for a R&D intensive SME is 14.5%, this equates to a repayment of £4,335,500.

(d) M20 projects would incur £17 million of qualifying expenditure in the year ended 30 June 2026. This would be enhanced by a further 130% under the SME R&D scheme, increasing the expenditure to £39.1 million. As the company would have received income of £8.4 million in 2026, this would reduce the amount which could be surrendered for tax credits to £30.7 million. At the SME R&D rate of 14.5%, this would generate repayable credits of £4,451,500.

(e) Under the agreement, this would be the development costs to be borne by M20 Projects Ltd.

(f) There would be no tax payable in the year ended 30 June 2026 as M20 Projects Ltd would make a loss from the projects, which could be surrendered for tax credits. (Under the Newco structure, it is unlikely that M20 Projects Ltd could make such effective use of the loss generated from the projects.)

(g) The royalty income would be taxable at the patent box rate of 12%. The royalty income receivable by M20 Projects Ltd for each of the years ended 30 June 2027 and 2028 would be £9.6 million (30% x £32 million) from third parties and £4.5 million from EastTeaCo UK Ltd. £14.1 million x 12% is £1,692,000.

(h) The sale of patents rights would be taxable at the patent box rate of 12%. £77.3 million taxed at 12% results is approx. £9.3 million leaving an after-tax amount of the required £68 million.

Newco structure

The exit strategy would be for M20 Projects Ltd to sell its 30% shareholding of Newco to EastTeaCo UK Ltd. The amount required under this option is:

Table 9:

	£million
Agreed total consideration	80.0
Less:	
Dividends declared	(6.6)
RDEC credits	(3.9)
Total	69.5

By the end of July 2028, M20 Projects Ltd would have held the Newco shares for over three years. The gain on the disposal of shares should be covered by the substantial shareholding exemption (SSE) because the following conditions should be met:

- M20 Projects Ltd holds at least 10% of Newco,
- For a period of any twelve months within the six years prior to disposal, and
- Newco is a trading company for at least twelve months up to the date of disposal As there would be no Corporation Tax on Capital Gains chargeable, for M20 Projects Ltd to exit with £80 million cash, EastTeaCo UK Ltd would need to pay £67.4 million to M20 Projects Ltd upon exercise of its option. This will be the case cost to EastTeaCo UK Ltd of the shares acquired in Newco.

Stamp Duty

In addition, there would be a stamp duty cost of buying M20 Projects Ltd's shares in Newco. The stamp duty group relief exemption (which applies where shares pass between two companies in a group) would not apply because M20 Projects Ltd is not a 75% subsidiary of a company within the EastTeaCo group.

The amount payable is 0.5% of the consideration, which on £69.5 million is £347,500. This is a capital cost so there is no trading income relief.