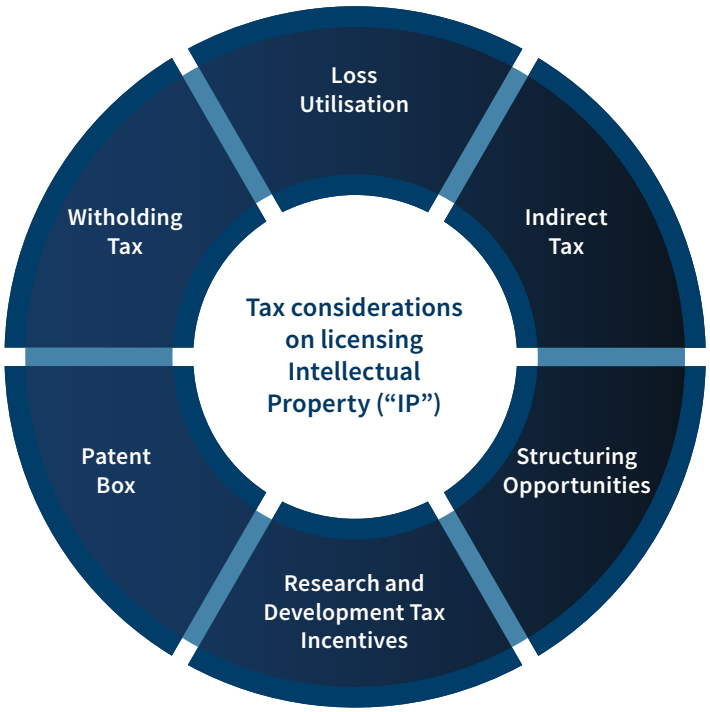
Life Sciences Insights 1:

Tax Implications of Licensing and Collaborations

Licence and collaboration agreements play a pivotal role in the life sciences industry, often involving significant transfers of value across borders and enabling companies to monetise and leverage their discoveries while minimising their risks.

Unintended tax consequences can arise but identifying these early in the heads of terms allows them to be resolved before an agreement is reached and while negotiations are still flexible.

There are six principal tax areas to consider:



Withholding Tax

Withholding tax ("WHT") is a tax deducted at the source, by the payer of royalties (the licensee) before payment is made to the recipient (the licensor) in a different jurisdiction.

Essentially, it is a tax liability of the licensor and although it can, in certain circumstances, be offset against the licensor's own domestic tax liability, it can be a real cost to companies operating at a loss that do not have any domestic tax to offset against.

Aspects to consider include:

— Is WHT likely to be a cost, and can it be quantified? Different countries have different rates, and some countries may apply WHT to upfront and milestone payments, as well as to royalties.

— Are there any double tax treaties that could be taken advantage of to reduce the rate? Often, this will require co-operation from both parties to undertake the compliance requirements, so clauses should be included in the agreement to facilitate this.

— Does the licensee have the right to assign the contract? This may change the WHT profile, so it is important to ensure that there is suitable control over rights of assignment.

Loss Utilisation

If a large milestone receipt is likely to be received under a licensing agreement, it is important to consider how this can be offset by tax losses to minimise any tax liability.

Under current rules, any milestone receipts can be offset against current-year losses first. Brought-forward losses can normally then be used, but are limited to offset against the first £5 million of profit and then 50 percent of the remaining profit.

Things to consider are:

— When would the milestone be recognised as revenue for accounting purposes? The tax treatment will normally follow the accounting treatment.

— What is the nature of the brought-forward tax losses? If the tax losses originated before April 2017, there may be some restrictions on use.

Indirect Tax

Template licensing agreements are often unclear with regard to indirect tax, so clauses should be reviewed to determine whether they are appropriate and provide clarity. For example:

- Do prices include or exclude value-added tax ("VAT")? If VAT or other indirect taxes are chargeable, they may not be recoverable by the licensor.
- Are the definitions of sales and other thresholds explicit with regard to the inclusion or exclusion of indirect tax?
- Are materials being transferred cross-border, and if so, how are the valuation and compliance being addressed for import duty purposes? Will a VAT registration requirement arise in any jurisdiction?
- Is the agreement with a territory that has more complex sales tax rules (e.g. a Latin American country), which may require local assistance?

Patent Box

The patent box is a valuable UK incentive that can provide a reduced rate of UK corporation tax of 10 percent for profits attributable to patents.

Both the licensor and licensee may want to take advantage of the UK patent box, but the terms of the agreement may influence whether a company can benefit and the extent to which it does so. The implications are different for the licensor and licensee.

Points for consideration include:

- Is there sufficient evidence available to demonstrate that the licensee has qualifying IP rights (including UK or EU patents)?
- If patents are not granted at the time of the agreement, is there a mechanism requiring the licensor to notify the licensee following grant?
- Is the income eligible for the patent box?
- Has qualification for the patent box been confirmed and the benefit quantified? Is there any advantage to spinning out the licensor to maximise the benefit?

Research and Development Incentives

Under the new merged research and development ("R&D") rules (applicable for accounting periods starting on or after 1 April 2024), there is no longer a restriction on the inclusion of subsidised costs (e.g. where costs are reimbursed in a collaboration agreement) in a company's R&D tax credit claim.

However, it is still important to consider whether the nature and terms of the agreement could impact a company's ability to claim R&D tax credits. For example:

- Who retains any newly created IP?
- Will any R&D services be subcontracted to the licensor?
- Will receipts under the agreement impact surrenderable losses?

Structuring Opportunities

When a company out-licenses a programme, any milestone or sales receipts and royalties will be taxable at the company level. Then there is likely to be a further tax point when the profits are passed back to investors.

It is therefore worth thinking ahead to future divestment and exit scenarios to determine whether there are any structuring opportunities to avoid this double tax charge.

For example, it could be possible to transfer the IP into a subsidiary company at no gain no loss. Then, providing certain conditions are met, the sale of the subsidiary company could be exempt from tax under the substantial shareholding exemption.

There are wide-ranging requirements and conditions for both the company and shareholders, so it is important that the position is reviewed in detail before embarking on any structuring.

How can we help:

— Review key components of your proposed transaction in heads of terms to identify and address key areas of tax sensitivity.

— Review draft licensing agreements for an analysis of material tax matters and suggested alternative drafting where appropriate.

— Advise on structuring to mitigate tax exposures on future divestment and exit.

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