[April 2011]

[6.4.1] Patent Royalties and Related Distributions – Applications for a determination under Section 141 Taxes Consolidation Act 1997

[See also Tax Instruction 7.3.6 Patent Royalties and Related Distributions (Section 234 and 141 TCA 1997)]

Note: The exemptions provided for in sections 141 and 234 TCA 1997 were abolished in Finance Act 2011 – see below.

Introduction

Section 234 TCA 1997 provides that certain income derived from patent royalties is exempt from tax and is not, subject to an annual limit, to be taken into account for any purposes of the Tax Acts. Section 141 TCA 1997 deals with the tax exemption which applies to distributions paid by companies out of exempt income derived from such royalties.

In the case of royalty payments received by a company from a third party and qualifying for exemption under Section 234 TCA, dividends paid out of such patent royalty income are exempt from tax by virtue of the provisions of section 141 TCA 1997.

In the case of royalty payments received by a company from a connected person where the royalties are paid for the purposes of manufacturing activities eligible for the 10% corporation tax rate, relief is also available subject to certain conditions, as follows.

Firstly, only so much of the royalties as would be paid between two parties acting at arm’s length will be exempt from tax under the provisions of section 234 TCA. Secondly, a company that incurs expenditure on research and development can, for an accounting period, make tax-exempt distributions out of income derived from royalties received from a connected company up to a certain measure of expenditure under the provisions of Section 141 TCA. That measure is the research and development expenditure incurred by the company, its group companies and companies under common ownership in that accounting period and the previous two accounting periods. Alternatively, a company receiving royalties in respect of a patent can apply to the Revenue Commissioners for a determination that the Revenue Commissioners are satisfied that the patented invention involved radical innovation and was patented for bona fide commercial reasons and not primarily for the purpose of avoiding liability to tax. If such a determination is made, the restriction limiting the amount of tax-exempt distributions to 3 years research and development expenditure will not apply.

Applications for a determination under Section 141 Taxes Consolidation Act, 1997.

Companies in receipt of patent royalty income from a connected person can apply, in writing, to the Revenue Commissioners for a determination that the patent invention
(a) involved radical innovation and
(b) was patented for bona fide commercial reasons and not primarily for the purpose of avoiding liability to tax.

All applications for such a determination will be dealt with by Direct Taxes, RLS Division. Applications received by districts should be forwarded to Business Income Tax 2, Income & Capital Taxes Division, New Stamping Building, Dublin Castle and the taxpayer so advised.

Finance Act 2006

Section 55 of the Finance Act 2006 introduced a number of anti-avoidance measures to prevent certain abuses of the scheme of relief for distributions made out of income from patent royalties which are tax-free in certain circumstances.

The first change relates to distributions made by a company out of exempt patent royalties received from a connected person and paid for the purposes of a manufacturing trade. The quantum of such patent dividends to be treated as exempt was already limited by reference to the research and development expenditure incurred by the company, and its group companies, over a three-year period. This quantum limit does not apply where the patent involves “radical innovation” and the patent was registered for bona fide commercial purposes and not primarily for the purposes of avoiding liability to taxation. Where the quantum limit does apply, the “bona fide” test does not apply. This omission is rectified by section 55 which ensures that, where the quantum limit on the amount of distributions to be treated as tax-free does apply, a company will be required to show that the patent was patented for bona-fide commercial reasons and not primarily for the purpose of tax avoidance before any distributions made by the company out of exempt patent royalties would themselves qualify for exemption from tax.

Secondly, it provided for a further restriction on the amount of exempt income that can be regarded as exempt in the hands of shareholders when distributed. This applies in relation to an arrangement that dresses up franchising, licensing or other similar fees between unconnected parties as patent royalty payments. Exemption for distributions in the hands of shareholders out of such income will now be limited by reference to research and development expenditure incurred by the company, and its group companies, over a three-year period. This limited exemption then applies provided that the patent was patented for bona-fide commercial reasons and not primarily for the purpose of avoiding liability to tax.

These changes apply for distributions made on or after 2 February 2006.

Finance Act 2007
The Finance Act 2007 introduced a cap on the amount of income from patent royalties that can be disregarded for Income Tax and Corporation Tax purposes. With effect from 1 January 2008 the amount of disregarded income cannot exceed €5m in a relevant period. Therefore a company making distributions out of income derived from royalties received from a connected company can only make these distributions free of tax out of the first €5m of patent royalty income even where the company has a “radical innovation” determination from Revenue. The Finance Act 2007 also changed one of the qualifying conditions for the patent royalty tax exemption. Prior to this amendment, all research, planning, processing, experimenting, testing, devising, designing, developing or similar activity leading to the invention, which is the subject of the patent had to take place in the State. This has now been extended to include all inventions where such research and development activities are carried out in an EEA state. The new treatment applies in respect of cases where such work is carried out on or after 1 January 2008.

Finance Act 2011

Section 26 of the Finance Act abolished the tax exemption provided for in section 234 of the TCA for royalty and other income arising to an Irish resident individual or company in respect of a qualifying patent. The abolition of the exemption applies to income from a qualifying patent which is paid to a person on or after 24 November 2010. The section also abolished the tax exemption provided for in section 141 of the TCA in respect of certain distributions made out of patent income where such income is exempted from income tax. The abolition of the exemption applies to distributions made out of exempt patent income on or after 24 November 2010.

Reference Material

Extract from Tax Briefing Issue 38 (December 1999)

1. Income derived from Patent Royalties

In response to requests from practitioners we include this article on patent royalties. The article deals with income derived from patent royalties and the treatment of distributions paid out of income from patent royalties.

1.1 Introduction

Section 234 TCA 1997 provides that certain income derived from patent royalties is exempt from tax and is not to be taken into account for any purposes of the Tax Acts.

1.2 Exemption

An Irish resident individual or company on making a claim is entitled to have any income accruing from a qualifying patent disregarded for the purposes of the Income Tax Acts or Corporation Tax Acts, as appropriate. Applicants claiming exemption must, however, make the appropriate tax returns.

An individual in receipt of income from a qualifying patent is not entitled to have that income treated as exempt income unless the individual carried out, either solely or
jointly with another person, the research, planning, processing, experimenting, testing, devising, development or other similar activity leading to the invention which is the subject of the qualifying patent.

Revenue may, in determining the amount of income to be disregarded, make such apportionment of receipts and expenses as may be necessary.

Persons in receipt of disregarded income are obliged to show the amount of such income in their tax returns.
1.3 Qualifying Patent

A qualifying patent is a patent where the work which gives rise to the invention which is patented is carried out in the State. Where difficulties arise in establishing whether the work concerned was wholly carried out in the State (for example, study and research may have to be carried out in libraries abroad into works of reference not available here or tests may have to be made abroad in particular climatic or other circumstances) a reasonable attitude will be adopted where Revenue are satisfied that the spirit of the section is fulfilled (that is, that the exemption provided arises out of genuine inventions researched and developed in Ireland).

1.4 Income from a qualifying patent

Income from a qualifying patent is any royalty or other sum paid in respect of the user of the invention to which the qualifying patent relates and includes any sum paid for the grant of a licence to exercise rights under the patent. The royalty or other sum must be paid for the purposes of activities which:

- Are regarded as activities within the 10 per cent scheme of corporation tax, other than international financial services carried on from the International Financial Services Centre and Shannon Zone services activities (it is to be noted, that the repair or maintenance of aircraft in the Shannon Zone are not excluded)

  or

- Would be eligible manufacturing activities even though they are carried on by an enterprise or are carried on unincorporated outside the State. However, as respects royalties or other sums paid after 23 April 1996, only so much of a royalty or other sum paid to the holder of a patent by a connected manufacturing company as does not exceed an amount which would be paid between persons acting at arm’s length is treated as income from a qualifying patent.

Also treated as income from a qualifying patent are royalties or other sums paid:

- For the purpose of a non-manufacturing activities where the payer is not connected (“connected” here means connected for the purposes of the Capital Gains Tax Acts as defined in Section 10 TCA 1997) with the beneficial recipient of the royalty or other sum

  and

- Where no arrangements exist which have as a main purpose the satisfying of the condition that the royalty or other sum must be received from an unconnected person. In other words if third parties are brought into the payment stream to achieve exemption of royalties, the royalties or other sums are not exempt.
1.5 **Resident of the State**

Resident of the State is any person resident in the State for tax purposes and not resident elsewhere. A company is regarded as a resident of the State if it is managed and controlled in the State.

2. **Distributions out of Income from Patent Royalties Section 141 TCA 1997**

2.1 **Introduction**

Certain distributions made out of income from certain patents which have been disregarded for income tax or corporation tax purposes under Section 234 TCA 1997 are themselves disregarded for the purposes of income tax and corporation tax. Such distributions do not attract a tax credit.

2.2 **Distributions**

A distribution made partly out of disregarded income and partly out of other profits is treated as if it consisted of two distributions, one made out of disregarded income and the other made out of other profits.

Distributions out of **disregarded income** made to a person are disregarded for income tax purposes:

- Where the distribution is made in respect of **eligible shares**

  or

- Where the distribution is made out of disregarded income, being income derived from a qualifying patent where the person to whom it is paid was involved in the carrying out of the research, etc which gave rise to the invention the subject of the patent (referred to as “relevant income”)

A distribution made partly out of disregarded income which is relevant income and partly out of other disregarded income is treated as if it were two separate distributions, one made out of relevant income and the other out of the other disregarded income.

Distributions out of disregarded income made to a company are, where the distributions are made in respect of eligible shares, treated as disregarded income of the recipient company.
2.3 Disregarded income

Disregarded income is income derived from:

• A qualifying patent which has been disregarded for income tax purposes under Section 234(2) TCA 1997 and

A qualifying patent which is disregarded for corporation tax purposes under Section 234.

However, such income accruing to a company on or after 28 March 1996, does not include income from a qualifying patent paid by a connected manufacturing or deemed manufacturing company (such income is referred to as “specified income”).

2.4 Eligible shares

Eligible shares are shares forming part of the ordinary share capital of the company which:

• Are fully paid-up

• Carry no present or future preferential right to dividends or to assets on the company’s winding up

• Carry no present or future right to be redeemed

and

• Are not subject to any different treatment from other shares of the same class, in particular different treatment as to dividends payable, repayment, restrictions, or offers of substituted or additional shares, securities or any other rights in respect of the shares.

2.5 Other profits

Other profits includes dividends and distributions, but excludes a distribution made to a company out of disregarded income where that distribution is in respect of eligible shares.

2.6 Distributions out of Specified Income

Where a company makes a distribution out of specified income (see definition of disregarded income above) which accrued to the company on or after 28 March 1996, the distribution is treated as a distribution out of disregarded income to the extent that the distribution does not exceed the aggregate expenditure on research and development incurred by the company for the accounting period in which the distribution is made.

Alternatively, where a person in receipt of specified income shows to the satisfaction of Revenue that the specified income derived from a qualifying patent for an invention
involving radical innovation which was not patented primarily for tax avoidance purposes, Revenue may determine that all distributions made out of the specified income derived from the patent are to be treated as made out of disregarded income. In making their determination Revenue may consult appropriate experts. A person aggrieved by such a determination of Revenue has a right to appeal the determination to the Appeal Commissioners and subsequently to the courts.

2.7 Research and development activities

Research and development activities have the meaning set out in Section 766 (deduction for certain expenditure on research and development).

2.8 Amount of the expenditure on research and development

The amount of the expenditure on research and development is expenditure on emoluments, materials, goods, and payments to third parties made in relation to research and development activities. Research and development expenditure incurred by companies which are members of a group may on a joint written election be treated as such expenditure by one member of the group. For this purpose, in addition to the usual requirement that one company is a 75 per cent subsidiary of another company or that the two companies are 75 per cent subsidiaries of a third company, two companies are in a group if both are owned to the extent of 75 per cent by the same individual or individuals.

The amount of aggregate expenditure on research and development incurred by a company in relation to an accounting period is the amount of expenditure on research and development activities incurred in the State by a company in an accounting period and each of the two preceding accounting periods. Where 75 per cent or more of all expenditure on research and development is incurred in the State then all such expenditure is to be taken into account in determining this aggregate.

2.9 Dividend warrants

The statements required to accompany dividends and other distributions must show, where appropriate, that distributions are made out of disregarded income.

The amount of a supplementary distribution must be shown on the dividend warrant.

2.10 Attribution to accounting periods

A distribution for an accounting period is regarded as being made, as far as is possible, out of the distributable income of that period, any excess of the distribution over that income is treated as having been made out of the income of the most recent preceding accounting period in priority to earlier ones.

Subsections (6) and (7) of Section 145 apply to distributions out of disregarded income. These provisions provide, respectively, for the apportionment of distributions where the period for which a company makes up accounts is partly within and partly outside an accounting period for corporation tax purposes, and for regarding a distribution which is not for any specified period as having being made for the accounting period in which it is made.