**Polycon Journey Summary of Issues**

The Polycon journey, used to illustrate the issues involved in structuring the development of international companies, was the basis of the IBSA annual conference. The issues raised were so varied and interesting and epitomise the problems and opportunities when helping particularly medium sized companies develop their businesses internationally.

The Polycon journey analyses the transformation of Polycon Lens Company into the Eyemax Group, over a generation of 25 years. The business started with a fictitious inventor–entrepreneur, Stephen Holmes, developing the first progressive power acrylic lenses for spectacles and manufacturing them for wholesalers prior to selling them as white label designer glasses. The business progressed into the research and subsequent manufacture and sale of high quality optical lenses for telescopes, then to lenses for digital cameras and subsequently for mobile phones. Polycon Lens Company was rebranded as the Eyemax Group. As Eyemax, it eventually harnessed Stephen’s creative brain to develop the solar lens bowl for capturing solar energy and converting it to electricity in a joint venture with a utility company.

The following summarises the issues which the IBSA team of experts presented during just one day!

***Intellectual property***

The types of intellectual property relevant to Polycon are the patents for the various lenses, the confidential information and know-how of the processes of manufacture, Polycon’s and ultimately Eyemax’s trade mark rights and the copyright in the story of Polycon’s journey used in professional journals. If its employees work on products, then protection is afforded through employment law, but this does not extend to work done by consultants and sub-contractors unless intellectual property such as copyright is specifically assigned to Polycon.

Since the acrylic lenses are innovative, Polycon should apply for patent protection but must ensure the relevant material and creation are not in the public domain. This means that Stephen Holmes should have entered into non-disclosure agreements (NDAs) when speaking to wholesalers and financiers prior to applying for patent protection.

The trade marks should be registered to provide monopoly protection, although unregistered protection through legislation of ‘passing off’ is always available. Polycon’s name as well as its logos, corporate signatures, photos of its products, as well as any associated scents and colours can be protected through trade mark legislation! Polycon can also apply for design protection.

***Research and Development grants***

Having spent a considerable amount of money on the development of the acrylic lenses, Stephen Holmes wonders what his options are for recovering some money against his taxable income from the tax administration. For SMEs like Polycon, the UK allows up to 26% of qualifying R & D costs as tax relief, and Polycon could even get a cash refund if it makes losses of up to 33.35% of qualifying R & D costs.

Qualifying activities require current scientific or technological uncertainty and the requirement to advance in this area, so an extension of knowledge or capability, creation of a process, material, device, product or service which improves existing material, would qualify. Moreover, Polycon can make a claim for the past two years so it is not only current year costs that can qualify. And Stephen Holmes learns that many other European countries permit similar claims.

The costs Polycon identifies relating to its acrylic lenses are the initial feasibility studies, all of its research costs, the creation of prototype lenses, their testing and independent evaluation, several pilot trials with wholesalers, as well as certain management costs, provided all of these are written off to its P & L account as opposed to being capitalised as fixed assets.

***Patent box regimes***

Stephen Holmes has been advised that there are certain tax jurisdictions which offer preferential rates of tax for income associated with intellectual property, but under Action 5 of BEPS it is generally required that substantial activity takes place in the particular regime for privileges to be granted.

The so-called modified nexus approach according to Action 5 is limited to patents owned by resident companies where expenditure has been incurred by these companies directly connected with the IP assets. However, although the theory of Action 5 has been agreed within OECD countries, all 16 countries currently with patent box regimes are deemed inconsistent with the nexus approach, amongst them the UK, Belgium, Luxembourg and Netherlands.

From 2021, the UK is to have a 10% tax rate on profits emanating from selling or licensing intellectual property rights related to patents (but not software copyright), and in Spain a similar rate applies for patents plus designs and know-how but again not software copyright. The Netherlands offers a 5% tax rate on relevant (patent box) income which may include software copyright, and in Ireland the rate is 6.25% for relevant income from patents and software copyright. Luxembourg has abolished its preferential regime but is considering a replacement, whilst Cyprus and Malta have specific regimes which are more widely drawn in respect of the types of income covered.

***VAT***

VAT issues are always being considered by the advisers to Polycon. Distant selling limits need to be observed before requiring VAT registration, and although Polycon plans to arrange consignment sales agreements with wholesalers to avoid creating taxable income where its products are subsequently returned, the absence of a VAT return is not always the case. And Polycon’s e-commerce transactions are now subject to varying rates of VAT in the countries where its customers are located, rather than where the e-commerce subsidiary is located.

***Branding Polycon as Eyemax***

As Polycon grows, its marketing director realises that companies cannot any longer ‘sell’ their product through advertising techniques, but instead need to create an environment where customers want to buy their products and services. This is why companies like Netflix are more successful than main-line TV channels, where consumers are not interrupted continuously by advertisements. In this case, Polycon advised to tell a story about its lenses. As a result, it decides to rebrand its spectacles, recently acquired digital cameras and mobile phone subsidiaries, and even the solar lens bowl concept, into the Eyemax Group of companies.

***Corporate Finance issues***

As the Group grows, Eyemax considers an IPO to access capital, raise the profile of the company, use its shares for further acquisitions and incentivise its management and employees through stock ownership schemes. Eyemax realises that it will need to enhance its Board with reputable non-executive members, and create greater corporate governance which could inhibit the creative mind of Stephen Holmes to some degree. Raising equity could be through a full listing, with its associated costs, or often through a placement of its shares with selected institutions. As to which relevant stock exchange Eyemax may consider listing, the FTSE capitalisation is twice that of Euronext and nearly four times the German bourse.

Loan finance is an alternative proposition, and this may be from a single lender or a syndicated loan, with securities being loan stock, listed bonds or high yield retail bonds. Corporate mini-bonds are often issued to customers to raise the brand profile and engage customer loyalty, and Eyemax is considering this for its mobile phone customers.

Eyemax’s recently appointed CFO needs to consider hedging abilities where different currencies are relevant for income and expenditure, as well as considering the Group’s cash and liquidity management.

***Joint venture relationships***

As regards the solar lens bowl, Eyemax’s directors realise that it needs to enter into a joint venture arrangement, preferably with a substantial utility group. This would help with regard to combining the expertise of both groups, spreading the financial risk of developing the solar lens bowl and actually obtaining the relevant finance.

The JV agreement would need to cover management functions, minority share protection if relevant, deadlock and resolution, share transfers and termination, dividend and liquidation options, pre-emption rights, and drag along and tag along rights.

The relevant agreements would be the JV shareholders’ agreement, the Articles of Association of a specially created company, Service agreements of key personnel, plus related agency, licensing and intragroup agreements. The JV would usually start with Heads of Terms which would be reasonably comprehensive.

***International tax issues***

The international tax issues are both complex and extremely varied. Eyemax’s international tax advisers have focused on the issues which have changed in recent years as a result of the OECD’s initiatives to combat tax avoidance practices, specifically of large multi-national companies. However, these also impact on smaller companies like the Eyemax Group and have been identified specifically as follows.

The recommendations regarding the creation of specific tax provisions to the digital economy have been largely discarded, but the extension of the definition of a permanent establishment to create a fiscal presence in the relevant country has been approved. In Eyemax’s case, the warehousing operations for its lenses may simply be a storage and delivery option, which may not create a taxable presence, but if, like Amazon, the warehouse was fundamental to the business objective of Eyemax, then a fiscal presence could be established as a result.

Using beneficial tax regimes, for example for patent box benefits, requires substantive operations which actually develop the intellectual property rights concerned. Moreover, Action 6 attempts to deny treaty access for companies imposed whose principal purpose is to benefit from double tax treaty provisions.

Other provisions limit interest deductibility which previously has been dependent on the ratio of debt to equity (so called thin capitalisation provisions), but which now limit interest deductibility to between 10% and 30% of taxable profits as opposed to the company’s relevant capital. And one of the main provisions are BEPS Actions 8 to 10 relevant to transfer pricing, which primarily require a group to report its profits according to the functions and risks, and therefore relevant profits, that each operating company within a group should report.

The consequence of BEPS will undoubtedly be an increase in the number of international tax disputes between relevant countries. For example, the UK, French and Italian arbitrary assessments on Google will result in settlements being made which may have no bearing to reported profits (or the absence of them) reported in any particular country. How will the US give tax credits for such settlements, perhaps regarding them as fines or penalties rather than corporate tax credits?

The US has already stated that it will not sign up to a multi-lateral agreement, preferring to invoke its anti-avoidance provisions through bilateral and indeed unilateral provisions. To some extent, the US regards the OECD recommendations as being targeted against US companies (which is probably the case) and intends to create an environment in the US where tax avoidance is no longer relevant to US based companies.

Thus President-Elect Trump wishes to reduce personal income tax rates to bands of 12.5%, 25% and 33% for income above US$225,000, compared with current bands with a maximum of 39.6%. And he also advocates an abolition of Estate Tax, which is currently at 40% top rate over US$5.45 million. But of more relevance to Eyemax and similar companies, he wishes to create a single 15% corporate tax rate compared to the current 35% top rate, with the abolition of the complex Alternative Minimum Tax. By creating a more benign corporate tax environment, he hopes that the plethora of corporate inversions which have taken place in recent years will no longer be so attractive. And moreover, for companies like Apple who have retained profits overseas rather than repatriating them, he advocates a 10% single rate for repatriation of such foreign retained profits, which he hopes will bolster the US economy.

***Summary***

The metamorphosis of Polycon Lens Company into the Eyemax Group could not have been achieved without Stephen Holmes’ entrepreneurial skills and creative input. But equally, it required professional expertise in a variety of disciplines as explained above.

This then is the rationale behind my concept in creating the IBSA, the International Business Structuring Association. We have created a community of professional advisers who care sufficiently for their client’s financial wellbeing that they involve themselves in disciplines other than their own specialism. The Polycon journey undoubtedly shows how important it is to have a network of global multi-disciplinary advisors to work with and alongside, to understand and approach issues in which they become involved, to facilitate their clients more effectively.