PATENT BOX – HOW TO REDUCE UK CORPORATION TAX

From 1 April 2013 a company subject to UK Corporation Tax can pay a lower rate of tax on profits arising from patented inventions, by using the Patent Box. This includes UK subsidiaries of overseas groups.

In order to benefit, you must be liable for UK Corporation Tax on profits from innovations protected with a UK patent or one granted by the European Patent Office (EPO). The benefit also extends to profits from certain other industry-specific intellectual property rights and from licensed inventions in certain defined circumstances.

A company can put qualifying profits into the imaginary “box” and enjoy a lower rate of tax on a proportion of those profits. You will need corporate tax advice on applying the rules and calculating your reductions, which can be as high as 50% of the tax liability.

You may wish to review your patenting strategy both to benefit from the Patent Box and to achieve your wider commercial aims. Below is a link to a Briefing dealing with some of the pertinent issues.

Patent Box – Patent Strategy Considerations

Please let us know if you have any questions about the legislation or would like help in devising a suitable patent strategy, perhaps liaising with your accountants/tax advisors to ensure maximum benefit.

Below is a link to an overview of the Patent Box. The flow chart below contains links to explanations of the more important parts of the legislation.

ARE YOU A *QUALIFYING* COMPANY?

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DO YOU HOLD *QUALIFYING* IP RIGHTS?

↓

WHAT IS *RELEVANT* IP INCOME?

↓

WHEN SHOULD YOU *ELECT IN* TO THE PATENT BOX?

↓

HOW TO CALCULATE THE PATENT BOX BENEFIT

PATENT BOX – Patent Strategy Considerations

Summary

The Patent Box makes the existence of a patent more attractive, whatever the breadth of the patent's claim, so long as it covers the product (or process or service). A company may wish to adapt its strategies both for filing and prosecuting patent applications and for patent and patent application abandonments.

Introduction

The general aim of conventional patent strategy is to provide sufficiently broad protection to prevent competitors from making modifications to a product or process that negate the protection afforded by the patent. For a patent to deliver Patent Box benefits to a company there is no need to achieve broad protection; all that is important is that the patent covers part or all of a product or service, even a small part of a complex product.

Patents directed to features which might be easy for competitors to design around or to omit altogether may now become valuable if they shift profits into the Patent Box. It may now be worthwhile to pursue a patent application for the sole purpose of placing a product's profits in the Patent Box without ever having the intention or expectation of enforcing the patent against a competitor.

A UK patent is relatively inexpensive and quick to obtain, with the inventive step criterion sometimes being easier to meet than at some other patent offices. So a UK patent is ideally suited to bringing profits into the Patent Box.

Filing Strategy

Your existing patent strategy may mean that all of your products are/will be automatically protected by patents or other *qualifying IP rights* and that few, if any, steps need to be taken for you to take advantage of the Patent Box, other than claiming the relief. You may however benefit from a change in strategy in prosecuting applications to grant (see below).

If you are a manufacturer, you may not previously have applied for patents for all of your products, including products that are well-established. Without patent protection you cannot put profits relating to the products into the Patent Box. You might consider making changes to the products, not necessarily in a radical way, so that you can apply for a patent to cover part or all of the product and bring it into the Patent Box regime. This includes products that you already have on the market.

It may be worthwhile discussing with designers and developers whether changes could be made to existing and/or new products so that a UK patent could be applied for, for the sole purpose of being able to put profits relating to that product into the Patent Box and pay a lower rate of UK Corporation Tax.

Drafting and Prosecuting Patent Applications

For a new product that requires patent protection to support a company's IP strategy, your patent attorney will probably draft the patent application in substantially the same way as they would have done if the Patent Box did not exist, but possibly incorporate more details about the actual product to be marketed in order to ensure that Patent Box relief is realised. The main change here may be to adapt the way patent application(s) are prosecuted to grant (see below).

In the case of a new product for which patent protection would not previously have been sought to meet a company's IP strategy, it may be worthwhile to incorporate some patentable feature in the product and seek a patent merely to take advantage of the Patent Box regime. The patentable feature may not necessarily improve the functionality of the product or its method of manufacture.

One approach may be to apply for a narrow, but quickly-obtained, patent protecting the specific features of a particular product. This would be done to secure Patent Box relief for profits relating to that product swiftly and with minimal risk of the application failing. This would not preclude the possibility of a separate broader patent being pursued, where appropriate, with the more conventional aim of excluding competitors. A possible approach might be to pursue narrow claims in a UK Patent Application (primarily for Patent Box relief) and claims with a greater scope on a broader international basis through the PCT route (to progress the company's broad IP strategy).

As the Patent Box benefit is likely to be greater for products than methods or processes, companies should check their future and pending patent applications to see if an attempt should be made, where appropriate, to insert a product claim where presently only method or process claims are on file, or alternatively consider filing a divisional application to introduce a product claim.

For similar reasons, companies pursuing Patent Box relief may wish to ensure that their pending and future patent applications include claims related to downstream products. This would make it unnecessary to consider the provisions relating to items incorporating a *qualifying item* including the anti-avoidance provision relating to incorporated items.

Licence Agreements

Companies may wish to review agreements relating to the right to a design, trade mark or other non-qualifying IP right. If any such agreement can be incorporated into an agreement granting a right in respect of a *qualifying IP right*, this may be beneficial as all the income from such an agreement will be classed as *relevant IP income*.

Sale of Qualifying IP Rights

Companies may wish to ensure that they have *elected in* to the Patent Box for an accounting period in which ownership of a *qualifying IP right* is transferred. This is necessary in order to obtain Patent Box relief on profits derived from income relating to the sale if that income is received in a subsequent accounting period.

PATENT BOX - Overview

Summary

As of the financial year starting 1 April 2013 a company subject to UK Corporation Tax can opt into the Patent Box regime and pay a lower rate of Corporation Tax (potentially as low as 10%) on profits resulting from certain intellectual property rights.

The Patent Box is relevant to all companies paying UK Corporation Tax, including UK subsidiaries of overseas groups. For overseas groups in particular, consideration will need to be given to ownership, development and/or management of IP rights to ensure that they are classified as *relevant IP rights* and so capable of being included in the Patent Box.

The initial Patent Box rules introduced in 2013 (the pre- 1 July 2016 Patent Box rules) were criticised by the Organisation for Economic Cooperation and Development for being unjustifiably generous in allowing companies to benefit from the UK Patent Box where there is little or no economic activity in the UK. As a result, post- 1 July 2016 Patent Box rules have been introduced which use R&D expenditure as a proxy for substantial economic activity and thereby link the benefits of the Patent Box to a requirement to have undertaken R&D expenditure to develop the IP rights. This is referred to as the nexus approach.

We give here an overview of the pre- and post- 1 July 2016 Patent Box legislation. Separate Briefings are directed to the main themes:

- **Patent Strategy Considerations**
- **Are you a *Qualifying Company*?**
- **Do you hold *Qualifying IP Rights*?**
- **What is *Relevant IP Income*?**
- **When should you *Elect In* to the Patent Box?**
- **How to Calculate the Patent Box Benefit**

Introduction

The pre- and post- 1 July 2016 Patent Box rules have many similarities. The main difference is the introduction of the nexus approach. For some companies this new approach will change the potential benefit achieved through the UK Patent Box, possibly eliminating the benefits altogether. For all companies there are likely to be advantages to electing into the Patent Box regime under the pre- 1 July 2016 Patent Box rules, which can then be the relevant rules for that company until 30 June 2021.

For qualifying IP rights which were applied for (but not granted) before 1 July 2016, it is possible to elect into the Patent Box regime after this date within the normal time limits and benefit from the pre- 1 July 2016 Patent Box rules (until 30 June 2021) provided the conditions for election into the Patent Box regime are met prior to 1 July 2016. The Briefing "Patent Box - When should you *Elect In* to the Patent Box?" high-lights some of the considerations in deciding whether to elect in to the pre- or post- 1 July 2016 Patent Box rules and how your patenting strategy might change depending on which Patent Box rules apply. Briefly the change for a company which conducts its own R&D and generates its own IP under the post- 1 July 2016 Patent Box rules compared to the pre- 1 July 2016 Patent Box rules is a greater accounting burden. For a company which acquires much of its qualifying IP and/or sub-contracts R&D to a connected company e.g. in the same group of companies, the post- 1 July 2016 Patent Box rules will reduce the tax saving available. Such companies may benefit from seeking advice from their accountants regarding the possibility of restructuring the group structure to maximise the tax benefit available through the UK Patent Box.

Both sets of Patent Box rules permit a claim to be made by a *qualifying company* liable to pay Corporation Tax in the UK to reduce the effective rate of Corporation Tax on profits arising from IP. The Briefing "Patent Box - Are you a *Qualifying Company*?" deals with the requirements of a *qualifying company*.

A *qualifying company* must hold or be an exclusive licensee of a *relevant IP right*. But merely owning a patent will not be enough to qualify the patent as a *relevant IP right*. A development condition and, in certain circumstances, a separate active ownership condition must be met. The most common form of *relevant IP right* is a patent. Trade marks, designs and copyright are not *relevant IP rights*. The Briefing "Patent Box - Do you Hold *Qualifying IP Rights?*" deals with the conditions that must be met for an IP right to qualify for the Patent Box.

To calculate the deduction in UK Corporation Tax, *relevant IP income* needs to be calculated. *Relevant IP income* is income from activity associated with *qualifying IP rights*. Only profits arising from *relevant IP income* can be included in the Patent Box calculation to reduce the Corporation Tax payable. The worldwide income associated with the *qualifying IP rights* is deemed as *relevant IP income* and so the low rate of Corporation Tax can be claimed for that income, even if all or part of the income is generated without the benefit of IP protection (e.g. in a country in which no patent protecting the product exists). The Briefing "Patent Box - What is *Relevant IP Income*?" deals with what income streams can be classified as *relevant IP income* and therefore taken into account in calculating a Patent Box benefit.

In order to benefit from a reduction in UK Corporation Tax the *qualifying company* must have *elected in* to the Patent Box in the relevant accounting period. The Briefing "Patent Box - When should you *Elect In* to the Patent Box?" deals with this issue.

The legislation defines how to calculate a *Patent Box deduction* which is subtracted from the total profits of trade to arrive at a figure on which UK Corporation Tax is payable at the normal rate. The *Patent Box deduction* will ultimately be effective to reduce the UK Corporation Tax payable on *relevant IP profit* to 10%, after deductions have been made to account for a *routine return* and marketing and in the case of a claim under the post- 1 July 2016 Patent Box rules, reduced by the nexus fraction. The Briefing "Patent Box – How to calculate the Patent Box Benefit" explains the calculation and gives a simple example using both sets of rules.

The chart below sets out the steps for determining whether a company will be able to take advantage of the Patent Box regime and the extent to which they will be able to benefit from it.

ARE YOU A *QUALIFYING COMPANY*?

↓

DO YOU HOLD *QUALIFYING IP RIGHTS*?

↓

WHAT IS *RELEVANT IP INCOME*?

↓

WHEN SHOULD YOU *ELECT IN* TO THE PATENT BOX?

↓

HOW TO CALCULATE THE PATENT BOX BENEFIT

PATENT BOX – Are you a *Qualifying Company*?

Summary

In order to benefit from the Patent Box, the beneficiary must be a *qualifying company* as defined in the legislation. We discuss here the requirements of a *qualifying company*.

Qualifying Company

The Patent Box is relevant to UK companies who pay or will in the future pay UK Corporation Tax.

A *qualifying company* must hold or have held, during the relevant accounting period, either *qualifying IP rights* or an exclusive licence to *qualifying IP rights*. The separate Briefing "Patent Box – Do you hold *Qualifying IP Rights*?" explains what is meant by *qualifying IP rights* under the Patent Box. In order to benefit from the Patent Box, the company must have generated income from commercial activity relating to the *qualifying IP rights*, including income from sale or licensing of a *qualifying IP right*.

For those companies who are currently unable to take advantage of the Patent Box but are looking in the future to dispose of intellectual property rights they hold, the Patent Box is still relevant. If it is possible to dispose of the intellectual property in a way which enables the recipient to claim the benefit of the Patent Box, this will increase the value of the intellectual property.

The Meaning of Exclusive Licence

For a licence to be considered as exclusive under the Patent Box legislation, it must be exclusive for at least one country or territory. The licence may cover only part of the scope of the *qualifying IP rights,* but the scope must be sufficient that the licence is effectively exclusive. For example, if the sector to which the licence grants exclusivity is too narrow, or licensed activity would not constitute infringement of the licensed patent, the licence may be deemed not to be exclusive for the purposes of the Patent Box. The licence must give either the right to bring proceedings for infringement without the consent of the right holder or any other party, or the right to receive the greater part of any damages for infringement.

A licence which grants exclusive rights in part of the world and non-exclusive rights in another part of the world will be treated as if it were two separate licences and therefore could fulfil the exclusivity requirement.

Considerations for Individual Inventors

Only UK companies that pay UK Corporation Tax are eligible for the Patent Box. Individuals may not make use of the Patent Box. This may have implications for individual inventors who hold IP rights in their own name rather than in the name of a company subject to UK Corporation Tax. Such individuals will need to consider whether to transfer IP rights to a *qualifying company* in order to benefit from the Patent Box.

Identifying *Qualifying IP Rights* and Matching IP to Income

For the Patent Box it is necessary to establish which parts of income are covered by which *qualifying IP right*. For some companies this will be a relatively simple matter. For others this may require more effort. For example, a company which has two products may know that only one of those products is covered by a *qualifying IP right* which they hold or for which they have an exclusive licence and that the other product is not covered by any *qualifying IP rights*. For such a company, it may be relatively easy to identify which part of their income relates to the *qualifying IP rights* they hold and which parts of their income do not relate to the *qualifying IP rights* they hold, as is necessary for taking advantage of the Patent Box. Other companies may have a more extensive product line-up and information about which products are covered by which *qualifying IP rights* may be harder to establish. Such companies may wish to start matching their *qualifying IP rights* to their products now so that they are in a position to provide this information to their corporate tax advisers when required.

For companies with licences to *qualifying IP rights,* it may be worthwhile to perform an audit of any IP licences to ensure that they will be regarded by HMRC as exclusive licences.

PATENT BOX – Do You Hold *Qualifying IP Rights*?

Summary

In order to benefit from the Patent Box, a company must hold or have an exclusive license to a *qualifying IP right*. Here we discuss the definition of a *qualifying IP right*.

Qualifying IP Right

In order to be regarded as a *qualifying company*, one of the conditions a company must meet is that it holds or has an exclusive license to a *qualifying IP right*.

Qualifying IP rights can be patents granted by the UK and European Patent Offices (irrespective of the countries in which they are validated) and patents granted by at least some other EEA Member States (currently Austria, Bulgaria, Czech Republic, Denmark, Estonia, Finland, Germany, Hungary, Poland, Portugal, Romania, Slovakia and Sweden). Patents granted by the US Patent and Trademark Office or the Japanese Patent Office are excluded. *Qualifying IP rights* can also include rights applicable to human and veterinary medicines and plants, namely Regulatory Data Protection, Supplementary Protection Certificates and Plant Variety Rights. However, trade marks, designs and copyright are not listed as *qualifying IP rights*.

It does not appear necessary for the *qualifying IP rights* to relate to the territory in which the profits are generated.

In order for the IP rights to be *qualifying IP right*s, the company must also meet a development condition and an active ownership condition.

The Development Condition

In order for the IP rights to be *qualifying IP right*s, the company must meet a development condition by fulfilling one or more of the following criteria:

- the company creates the invention
- the company significantly contributes to the creation of the invention (including developing ways in which the invention may be used or applied)
- the company performs a significant amount of activity to develop the invention or any item or process incorporating it

The situation may arise where a company, after meeting the development condition, becomes a member of a group of companies (the definition of a “group” is quite broad), ceases to be a member of a group of companies, or cedes a major shareholding to another company. After such an event, in order to continue to qualify for Patent Box relief, it may be necessary for the company to meet the development condition again within a maximum period of 12 months, or to fulfil an active ownership condition as described below.

For a company which is a member of a group of companies, it may be acceptable for another company in the group to meet the development condition. However, in such a case it will be necessary to show that the company claiming the benefit of the Patent Box is actively involved in the ongoing active management of the *qualifying IP rights* as described below in relation to the active ownership condition.
It is possible for group companies jointly to fulfil the development condition. However, for the purposes of calculating *relevant IP income*, any Patent Box loss must be offset against any Patent Box profits in the same group of companies and vice versa.

The Active Ownership Condition

The active ownership condition requires the company either to have carried out the development activity itself or to be actively involved in the ongoing active management of the *qualifying IP rights*.

If the company has not met the development condition itself, but a different company in the same group has met it, the company claiming the Patent Box benefit must itself be deemed to be actively involved in the ongoing management of the *qualifying IP rights*. In order to meet this condition the company must be involved in the planning and decision-making activities associated with developing or exploiting substantially all of its qualifying IP portfolio. Activities such as deciding whether to maintain protection in particular jurisdictions, grant licences, research alternative applications for the innovation or license others to do so count as management activity. Similarly, where the rights are being exploited by incorporating the item sold into larger products, activities such as deciding which products will go to market, what features those products will have and how and where they will be sold will also count as management activity.

Whether what is done is a significant amount of management activity is to be determined in the light of all relevant circumstances, given the resources the company employs, the breadth of its responsibilities for the IP and the significance and impact of the decisions and plans that this particular company, as opposed to other group companies, makes in relation to that IP.

HRMC are of the opinion that the active ownership requirement is unlikely to be particularly onerous in most cases.

Relevance of Development and Active Ownership Conditions to Buying and Selling IP

The development and active ownership conditions were intended to prevent a company from simply buying IP in order to benefit from the Patent Box without contributing in any way to its development or on going management. The nexus fraction introduced in the post- 1 July 2016 Patent Box rules which links any Patent Box benefit with the amount of R&D expenditure by the company further reduces the scope of obtaining benefit from the Patent Box by buying IP without continuity to its development. Therefore, when buying (or indeed selling) IP, consideration should be given to the structure of any agreement to take into account the potential to benefit from the Patent Box after the transaction has been completed, as well as the requirement to meet the development condition and the active ownership condition and how, using post- 1 July 2016 Patent Box rules, the requirement to calculate a nexus fraction might effect the Patent Box benefit available.

PATENT BOX – What is *Relevant IP Income*?

Summary

We discuss here issues relating to which income streams can qualify for the Patent Box. The Patent Box legislation defines what income streams count as *relevant IP income*. The calculation of *relevant IP income* is used in determining an amount deductable from the profits of the trade for the calculation of UK Corporation Tax liability. Determining the amount deductable from the profits of the trade will ultimately lead to the amount of UK Corporation Tax due being equivalent to paying a rate of 10% on the *relevant IP income (*following certain deductions as explained in our separate Briefing "Patent Box – How to calculate the Patent Box Benefit").

Relevant IP Income

Relevant IP income is defined in the legislation under five main categories, each of which is dealt with below.

1 *Income by sale of item protected by a qualifying IP right*

Relevant IP income includes worldwide income from the sale by a *qualifying company* of:

a) items in respect of which a *qualifying IP right* held by the company has been granted ("*qualifying items*")

b) items incorporating one or more *qualifying items* and

c) items that are wholly or mainly designed to be incorporated into such items

Thus, a single *qualifying IP right* (for example a UK patent) brings all worldwide profits relating to sales of a *qualifying item* into the Patent Box. This includes profits relating to sales in any territory (even a major market such as the USA) in which there is no equivalent IP right.

For Patent Box purposes, an item is not considered to be protected by a *qualifying IP right* by virtue of being made by a method protected by the *qualifying IP right*. Therefore, if the invention relates to a method, it is important, if at all possible, to obtain a claim relating to the product itself, for example using a "product by process" claim format. It is often problematic to obtain such "product by process" claims. If a "product by process" claim cannot be obtained, this may be a disadvantage in terms of Corporation Tax saving because it will then only be possible to claim as *relevant IP income* a notional royalty (discussed below) for use of the *qualifying IP right*.

It is significant that income relating to the sale of items incorporating one or more qualifying items is also counted as *relevant IP income*. This means, for example, that the whole income from the sale of a car may be considered as *relevant IP income* for the sole reason that the engine management system is covered by *qualifying IP right*s. HMRC is expected to interpret the term “incorporating” as referring to an item that is physically part of a larger item and intended to be so for its operating life. For a printer and a printer cartridge sold together, the income from the sale of the printer and cartridge is *relevant IP income* even if only the cartridge is protected by *qualifying IP right*s (under heads a) and b) above). If the company has *qualifying IP right*s only in respect of the printer, sale of the cartridge on its own qualifies as *relevant IP income* under head c) as an item wholly or mainly designed to be incorporated into the printer.

There is an anti-avoidance provision which states that income arising from the sale of any item that incorporates a *qualifying item* is not *relevant IP income* if the main purpose, or one of the main purposes, of incorporating the *qualifying item* is to secure income arising from any such sale as *relevant IP income*. It is to be seen how HMRC interprets this provision. An example which would fall foul of the provision is a case where a company produces speakers which include no patented part but the company decides to incorporate a patented computer chip into the speakers, even though the chip performs no useful function and is not connected to the internal electrics of the speaker itself. If in practice a novel and inventive component is to be sold incorporated into a larger product it would be sound patent practice to include where possible a patent claim to the commercial product incorporating the component (a downstream claim). In patent terms the downstream claim can be said to protect the commercial product as such and it should not therefore be necessary to consider the provisions relating to items incorporating a qualifying items including this anti-avoidance provision.

For the purposes of determining *relevant IP income*, packaging is not considered to be part of an item unless the packaging performs a function that is essential for the use of the item for the purposes for which it is intended to be used (e.g. an inhaler).

It may be the case that two or more items are sold together, but none of the items can be regarded as being incorporated in any of the other items, yet at least one of the items is protected by a *qualifying IP right* and at least one of the items is not protected. In such a situation it will be necessary to attribute the income on the basis of a “just and reasonable apportionment” between *relevant IP income* and non-relevant IP income, unless the proportion of income not attributable to non-relevant IP income is trivial.

2 *Income from a Licence of a Relevant IP Right*

Relevant IP income includes any licence fee or royalty which the company receives under an agreement granting to another person a right in respect of any *qualifying IP right* held by the company.

Significantly, the *relevant IP income* also includes any licence fee or royalty for any other right in respect of a *qualifying item* or process, if the right is granted in the same agreement as a *qualifying IP right* and for the same purpose. Thus, if the right to a design or trade mark (which is not a *qualifying IP right)* is included in an agreement which grants the right to a *qualifying IP right* such as a patent, the income from the agreement related to the right to the design or trade mark also counts as *relevant IP income*.

3 *Income by Sale of a Relevant IP Right*

Income arising from a sale or other disposal of a *qualifying IP right* or an exclusive licence of such a right is also deemed *relevant IP income.*

In the case of a company selling *qualifying IP rights* and receiving income in an accounting period different from the period in which the ownership of the *qualifying IP right* transferred, it is necessary to have *elected in* to the Patent Box for the period when the sale was made, not just for the period when income is received.

4 *Income as Damages for Infringement*

Any amount of damages received by a company in respect of an infringement, or alleged infringement, of a *qualifying IP right* held by the company at the time of the infringement or alleged infringement counts as *relevant IP income*.

5 *Other Income in Respect of Use of a Relevant IP Right*

A company may elect to treat as *relevant IP income* a notional royalty in respect of use of a *qualifying IP right* to bring in otherwise non-qualifying parts of the company's gross income. Therefore it is possible to make use of the Patent Box even if the company only holds a *qualifying IP right* relating (a) to a method and not to an item or (b) to items used only in providing a service. However calculating *relevant IP income* on the basis of a notional royalty rather than on the basis of sale of a whole product is likely to be less beneficial to a company. Therefore all efforts should be made to obtain *qualifying IP right*s related to the item to be sold.

PATENT BOX – When should you *Elect In* to the Patent Box?

Summary

A company must *elect in* to the Patent Box regime in order to take advantage of the reduction in payable UK Corporation Tax. For some companies there may be advantages in delaying entry into the Patent Box. This Briefing looks at this issue.

Electing In

A company may *elect in* to the Patent Box regime for profits earned in a particular accounting period within two years of the end of that period. If a company *elects in* to the regime all of its trade will be subject to the Patent Box. It is possible for a company to elect out of the Patent Box regime. It will then be barred from re-entering the Patent Box regime for five years.

As can be seen from the sample calculations in the Briefing "Patent Box – How to Calculate the Patent Box Benefit", it is possible to make a Patent Box loss on a particular product, for example a product with a low profit margin. A Patent Box loss occurs when the calculation of *relevant IP profits* (which models the profit which is due to the *qualifying IP right* in a specific way which is defined by the legislation) is a negative number. Any Patent Box loss made in previous accounting periods in which the company has *elected in* will need to be set off against Patent Box profits made in subsequent periods.

Although it is not possible to claim a Patent Box benefit until after a *qualifying IP right* – typically a patent – has been granted, relief can then be claimed for profits made up to six years prior to grant (so long as the company has *elected in* for the accounting period in which those profits were made).

For qualifying IP rights which were applied for (but not granted) before 1 July 2016, it is possible to elect into the Patent Box regime after this date within the normal time limits and benefit from the pre- 1 July 2016 Patent Box rules (until 30 June 2021), provided the conditions for election into the Patent Box regime are met prior to 1 July 2016.

***Electing In* - Considerations**

As it is possible to make a Patent Box loss, it is important carefully to consider whether to *elect in* to the Patent Box at all, and to plan the timing of any such election.

It is not uncommon for profits to be low or non-existent during the early exploitation of a patent. It may therefore be appropriate to *elect in* to the Patent Box at a point in the business life cycle when a Patent Box profit is available on the product(s) covered by a company's patents. Any Patent Box loss will need to be set off against the Patent Box profit, so the Patent Box benefit may be greatly reduced or even eliminated as a consequence of having *elected in* to the regime too early.

As the benefit of the Patent Box is being introduced over time and the Corporation Tax deduction rate applicable is that of the year of grant of the *qualifying IP right*, it may be beneficial to delay grant of a patent (where possible) perhaps until the 2017/2018 tax year, to benefit from a higher deduction rate for a greater part of the period for which relief is being claimed. For example for calculated *relevant IP profits (relevant IP income* minus certain deductions, see the Briefing "Patent Box - How to Calculate the Patent Box Benefit") of GBP 100k in the tax year 2013/14, the saving in UK Corporation Tax if the *qualifying IP right* granted in 2012 is GBP 6k (at an assumed UK Corporation Tax rate of 20%). If the *qualifying IP right* grants in the tax year 2014/15, the saving in UK Corporation Tax is GBP 7k. If grant of the *qualifying IP right* is delayed until the tax year 2017/18, the saving in UK Corporation Tax is GBP 10k. Of course the benefit of the larger saving in UK Corporation Tax must be offset against the disadvantages of receiving the saving in UK Corporation Tax at a later date.

For companies or groups where a proportion of any R&D relating to *Relevant IP Income* is carried out by another company in the same group, or who have acquired their *Qualifying IP Rights,* there will likely be a benefit in electing in to the pre- 1 July 2016 Patent Box rules. This is because no nexus fraction reduction as required under the post- 1 July 2016 Patent Box rules will need to be applied which might reduce any Patent Box saving under these circumstances.

PATENT BOX – How to Calculate the Patent Box Benefit

Summary

We outline here the accounting steps which are necessary to calculate the Patent Box benefit.

We also present a simplified example calculation which may help you to estimate the amount of saving in UK Corporation Tax you might expect to make if you were to *elect in* to the Patent Box regime under either the pre- or post- 1 July 2016 Patent Box rules.

A fully reasoned Patent Box calculation might place a large accounting burden on a SME. The original legislation therefore provided the option of using a simplified formulaic way of calculating the Patent Box benefit which places a smaller accounting burden on SMEs. However, for Patent Box claims under the post- 1 July 2016 Patent Box rules, a streamed calculation in which income and outgoings need to be accounted for on a by income stream (e.g. by product) basis is mandatory, rather than optional.

You will need to seek the advice of your corporate tax advisor for an accurate estimate of savings you might achieve and the best accounting approach to make the biggest saving and for advice regarding transitional rules where an income stream may benefit from protection of IP rights filed before and after 1 July 2016.

Calculating the Reduction in Corporation Tax

The tax calculation required by the Patent Box legislation is complicated and specialist tax advice is required. We set out below the basic approach to assist with a preliminary assessment of the likely benefit to a company from the Patent Box.

In order to determine the available deduction from UK Corporation Tax, the original legislation provided for a formulaic calculation in which profits of the trade are apportioned pro rata on the basis of the ratio of *relevant IP income* to total gross income. This was intended to make the calculation less onerous for smaller businesses. Under the pre- 1 July 2016 Patent Box rules companies may elect to perform a more detailed calculation (a so-called streamed calculation) which will benefit many larger entities. HMRC may insist on a streamed calculation for larger companies and for companies whose profits attributable to IP will otherwise be grossly over-estimated by applying the formulaic approach. For Patent Box claims under the post- 1 July 2016 Patent Box rules, a streamed calculation is mandatory.

In the calculation, it is not necessary to estimate the proportion of profit attributable to each *qualifying IP right*. Instead, the legislation requires the calculation of a *routine return* and a *marketing deduction* to be made. The *routine return* is defined in the legislation as 10% of the deductions on the balance sheet (excluding R & D expenses and capital expenditure). The *routine return* is subtracted from a profit attributed to the *relevant IP income* to give a *qualifying residual profit*. The *qualifying residual profit* is then reduced by the marketing deduction to take account of marketing costs in order to arrive at the *relevant IP profits*. The *relevant IP profits* are essentially the profits HMRC attributes to the existence of the *qualifying IP right*. In effect under pre- 1 July 2016 Patent Box rules the Patent Box allows companies to pay a lower rate of UK Corporation Tax on the calculated *relevant IP profits*.

Under post- 1 July 2016 rules the *relevant IP profits* are limited by the nexus fraction for each income stream which is the lower of 1 and:

$$\frac{(D + S1)\ \times\ 1.3}{D + S1 + S2 + A}$$

Where

D = qualifying expenditure on in-house R&D relevant to the income stream

S1 = 65% of qualifying expenditure on 3rd party sub-contracted R&D relevant to the income stream

S2 = 65% of qualifying expenditure on connected party (i.e. a company in the same group) sub-contracted R&D

A = expenditure on acquisition of qualifying IP rights

The chart below sets out the five steps of the pre-July 2016 formulaic calculation to arrive at the *relevant IP profits* attributable to IP from which the UK Corporation Tax deduction available under the Patent Box can be calculated.

STEP 1
CALCULATE TOTAL GROSS INCOME AND *RELEVANT IP INCOME*

↓

STEP 2
CALCULATE RATIO OF *RELEVANT IP INCOME* TO TOTAL GROSS INCOME

↓

STEP 3
DETERMINE TAXABLE TRADING PROFIT AND MULTIPLY BY RATIO FROM STEP 2

↓

STEP 4
CALCULATE A *ROUTINE RETURN* AND SUBTRACT THIS FROM THE AMOUNT GIVEN IN STEP 3 TO ARRIVE AT A *QUALIFYING RESIDUAL PROFIT*

↓

STEP 5
MAKE A *MARKETING DEDUCTION* FROM THE *QUALIFYING RESIDUAL PROFIT* TO ARRIVE AT *RELEVANT IP PROFITS (and for post- 1 July 2016 Patent Box rules, multiplying by the nexus fraction)*

↓

CALCULATING THE *PATENT BOX DEDUCTION FROM CORPORATION TAX*
RELEVANT IP PROFITS x (MAIN RATE OF CORPORATION TAX – PATENT BOX RATE)/MAIN RATE OF CORPORATION TAX

Steps 1 to 5

In the formulaic calculation allowed under pre- 1 July 2016 Patent Box rules, Step 1 requires *relevant IP income* and gross total income to be determined. This involves considering all income streams and apportioning them either as *relevant IP income* or as non-relevant IP income. For post- 1 July 2016 Patent Box rule claims this first step and all subsequent steps will need to be calculated on a streamed basis.

In Step 2 the ratio of *relevant IP income* to gross total income is determined.

In Step 3 the taxable trading profit is adjusted, for example by adding back in any R&D tax credits claimed and any R&D expenditure to determine an adjusted trading profit. The adjusted trading profit is then multiplied by the ratio determined in Step 2 to arrive at a pro rata trading profit. (Step 3 may also be performed in a streamed calculation under pre- 1 July 2016 Patent Box rules in which *relevant IP profits* is calculated on a reasoned basis and not on a pro rata basis.)

In Step 4 routine deductions (costs) to the business (excluding R&D costs) are calculated. A *routine return* is calculated by multiplying the routine deductions by 10% (a routine mark-up rate fixed by the legislation in both the pre- and post- 1 July 2016 Patent Box rules) and multiplying that by the ratio derived from Step 2. A *qualifying residual profit* is then determined by subtracting the calculated *routine return* from the *amount calculated in Step 3*. (Step 4 may also be performed in a streamed calculation under pre- 1 July 2016 Patent Box rules in which the routine costs resulting in the *relevant IP income* are calculated on a reasoned basis and multiplied by the fixed 10% to arrive at the *qualifying residual profit.)*

If in Step 4 the *qualifying residual profit* is a negative number this is a *Patent Box loss* and Step 5 is not performed.

From the *qualifying residual profit* it is necessary to make a *marketing deduction* to account for profits generated by established brands. This is done in Step 5. A small claims *marketing deduction* may be calculated under pre- 1 July 2016 Patent Box rules if the *qualifying residual profit* is less than GBP 1 million. The small claims calculation involves multiplying the *qualifying residual profit* by 75% (i.e. assuming 25% marketing). This leads to the *relevant IP profits* which are used directly to calculate the *Patent Box Deduction* under pre- 1 July 2016 Patent Box rules. Step 5 may also be performed in a streamed way under pre- 1 July 2016 Patent Box rules (or that may be insisted on by HMRC for example if the *qualifying residual profit* is in excess of GBP 3 million).

For Patent Box claims under the post- 1 July 2016 Patent Box rules (which may not need to be applied for Patent Box claims made on the basis of IP filed before 1 July 2016), the relevant IP profits are multiplied by the nexus fraction prior to the calculation of the *Patent Box reduction*.

Careful consideration should be given to whether or not the calculation under pre- 1 July 2016 Patent Box rules is performed in the standard (formulaic) way or in the streamed way as it will have an impact in subsequent accounting periods. Switching between the streamed and the non-streamed basis of calculation cannot be done freely from one accounting period to the next.

Calculating the *Patent Box Deduction*

The effect of the Patent Box legislation is to reduce the profit on which UK Corporation Tax is payable. The calculated *relevant IP profits* (RP) from Step 5 are multiplied by the relevant main rate of Corporation Tax (MR) minus the special IP rate of Corporation Tax (IPR, ultimately 10%) divided by the main rate of Corporation Tax. i.e.:

$$RP \times \left(\frac{MR - IPR}{MR}\right)$$

This leads to a *Patent Box deduction* which is subtracted from the taxable profits before the amount of UK Corporation Tax is calculated at the relevant main rate.

During the first six years of the legislation the special IP rate of Corporation Tax will be phased in gradually. Only a percentage of relevant IP profits will be included when calculating the Patent Box deduction. In the 2015 financial year, 80% of the relevant IP profits can be included in the calculation, increasing by 10% each year until 2017.

Example Calculation

Below is a simplified example calculation using the fully streamed approach.

Company A has trading turnover of GBP 1,000, of which GBP 700 (70%) is from the sale of items covered by a *qualifying IP right*. It has tax deductible expenses of GBP 750 including GBP 50 for R&D, all of which qualify for R&D tax credits.

Without the Patent Box, the Corporation Tax computation would be as follows:

- Trading income **GBP 1,000**
- Tax deductible trading expenses: **GBP 750**
  - R&D (GBP 50)
  - R&D tax credit additional deduction (GBP 50)
  - Other costs (GBP 650)
- Taxable trading profit **GBP 250**
- Corporation Tax payable (assuming 20%) without the Patent Box is (GBP 250 x 20%) = **GBP 50**.

The Patent Box calculation is as follows:

Step 1 - Calculate the total gross income of the trade: **GBP 1,000**.

Step 2 - Establish the percentage of total gross income that is *relevant IP income*: (*relevant IP income* GBP 700 / Total Income GBP 1000) = **70%.**

Step 3 – Determine the total profits of trade and multiply by the ratio derived from Step 2: (take the taxable trading profit GBP 250 and add back the R&D additional deduction of GBP 50 to get total profit GBP 300, and adjust that profit of GBP 300 on a pro rata basis (GBP 300 × 70%)) = **GBP 210**.

Step 4 - Remove a *routine return* to determine a *qualifying residual profit*. First, the total routine deductions of GBP 650 (GBP 750 minus GBP 50 x 2 R&D) are multiplied by the legislated mark-up rate of 10% (=GBP 65). Then the *routine return* figure is calculated as total routine deductions (GBP 65) multiplied by ratio of Step 2: (GBP 65 x 70%) = GBP 46. Then the *qualifying residual profit* is calculated as the amount of Step 3 minus the *routine return*: (GBP 210 – GBP 46) = **GBP 164**.

Step 5 Pre- 1 July 2016 Patent Box rules - Make a *marketing deduction* associated with other intangibles from the *qualifying residual profit* to arrive at the *residual profit* (RP): (using the small claims treatment: assume marketing assets royalty of 25% to calculate *relevant IP profits* from the *qualifying residual profit* (GBP 164 × 75%)) = **GBP 123**.

Finally the *patent box deduction* can be calculated. In this case, assuming 10% patent box rate and Corporation Tax rate 20%: (GBP 123((20-10/20)) = **GBP 62.**

So the full rate of Corporation Tax is payable on the taxable trading profit (GBP 250) minus the *patent box deduction* (GBP 62) = **GBP 188.**

At a Corporation Tax rate of 20%, Corporation Tax of **GBP 37** (GBP 188 x 20%) would be payable with the Patent Box, compared to **GBP 50** without Patent Box.

Step 5 Post- 1 July 2016 Patent Box rules - Make a *marketing deduction* associated with other intangibles from the *qualifying residual profit* to arrive at the *residual profit* (RP): (using the small claims treatment: assume marketing assets royalty of 25% to calculate *relevant IP profits* from the *qualifying residual profit* (GBP 164 × 75%)) = **GBP 123**.

Assuming half of the relevant R&D expenditure of **GBP 200** incurred in the relevant period (up to 20 years) is for sub-contractor costs (20% 3rd party, 80% connected party) and **GBP 30** was spent on relevant IP acquisitions, the nexus fraction can be calculated as

$$\frac{(GBP\ 100 + (0.65\ \times\ GBP\ 20))\ \times\ 1.3}{GBP\ 100 + (0.65\ \times\ GBP\ 20) + (0.65\ \times\ GBP\ 80) + GBP\ 30} = \frac{146.9}{195} = 0.75$$

Finally the *patent box deduction* can be calculated. In this case, assuming 10% patent box rate and Corporation Tax rate 20%: (0.75 x GBP 123((20-10)/20)) = **GBP 47**.

So the full rate of Corporation Tax is payable on the taxable trading profit (GBP 250) minus the *patent box deduction* (GBP 47) = **GBP 203**.

At a Corporation Tax rate of 20%, Corporation Tax of **GBP 41** (GBP 203 x 20%) would be payable with the Patent Box, compared to **GBP 50** without Patent Box.

If all relevant R&D expenditure is on in-house R&D and/or on 3rd party sub-contracted R&D, or only a small fraction of the R&D expenditure is on connected party sub-contracted R&D, and there are no or low acquisition costs on qualifying IP rights, the nexus fraction will be at or near 1 so that the Corporation Tax saving would be the same under the pre- and post- 1 July 2016 Patent Box rules.

To Stream or Not to Stream

Under the pre- 1 July 2016 Patent Box rules, a company may either elect for the streamed basis of calculation of their own volition or be required to do so by HMRC. Typically such a requirement will arise where the formulaic approach is deemed to allow the company to claim a disproportionately large amount of *relevant IP profits*. A company which sells products which are not in the Patent Box but which licenses *qualifying IP rights* may benefit by selecting the streamed calculation. For companies with *relevant IP profits* greater than GBP 2 million or greater than 20% of gross income, a streaming calculation will be necessary.

For smaller companies it may be attractive to use the standard formulaic calculation as it is thought that the accountancy burden will be lower. However, it may be advantageous to perform a streamed calculation on some of the Steps, particularly Step 5 in which the marketing deduction is performed. Some companies may be able to claim that that all that is required is a very small *marketing deduction*, or none at all.

The Calculation - Considerations

The calculation to arrive at the *patent box deduction*, whether formulaic or streamed, requires the input of figures which some companies' existing accounting procedures may not readily provide. In particular, this is likely to be the case where companies have multiple sources of income, some of which will be *relevant IP income* and some of which will be non-relevant IP income. Companies may therefore wish to begin addressing this information deficit sooner rather than later. For example, companies may wish to audit their income streams to determine which ones can be classified as *relevant IP income* and undertake preliminary work to determine the *routine deduction* (costs) relevant to the calculation of the *routine return*. If a streaming calculation is to be made, a detailed understanding of income and costs and how they are attributable between various income streams will be required.

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