PATENT BOX

OVERVIEW

Summary

A company subject to UK Corporation Tax can opt into the Patent Box regime and pay a lower rate of Corporation Tax (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.

We give here an overview of the Patent Box legislation. Separate sections 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 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 Patent Box legislation permits 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 section "Patent Box - Are you a Qualifying Company?" deals with the requirements of a *qualifying company*.

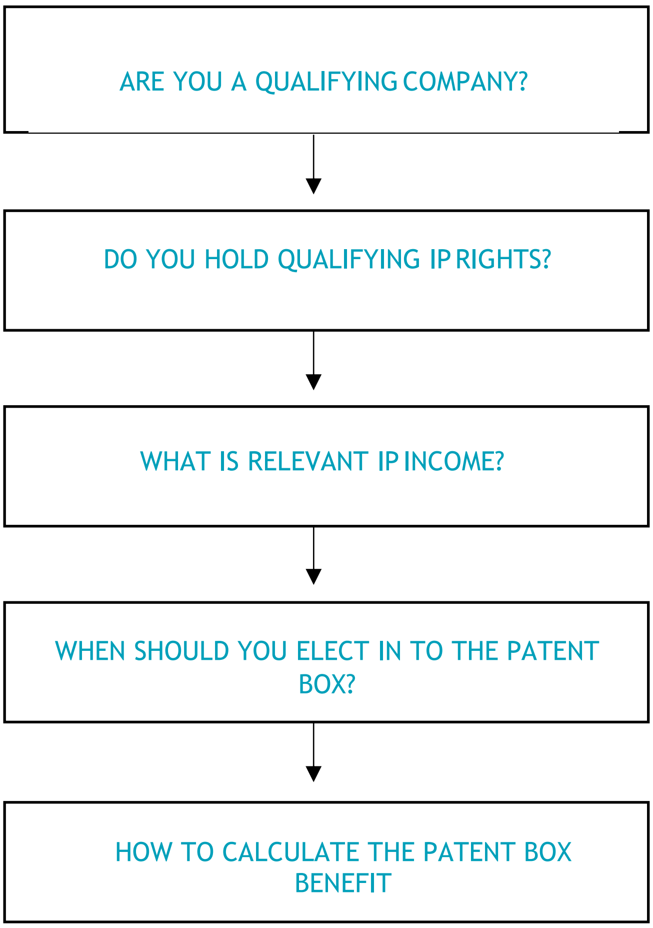
A *qualifying company* must hold or be an exclusive licensee of a *relevant IP right*. But merely owning a patent will not be enough to qualify the patent as a *relevant IP right*. A development condition and, in certain circumstances, a separate active ownership condition must be met. The most common form of *relevant IP right* is a patent. Trade marks, designs and copyright are not *relevant IP rights*. The section "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 section "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 section "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* is 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 asset return* and after an *R&D fraction* has been applied. The section "Patent Box – How to calculate the Patent Box Benefit" explains the calculation and gives a simple example.

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



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 optimise its strategies both for filing and prosecuting patent applications and for patent and patent application abandonments bearing in mind the tax savings available through the Patent Box.

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 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 routinely apply 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.

In the case of a new product for which patent protection would not be worthwhile in terms of preventing competitors from doing something because available scope of protection is very narrow, 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 draft their applications accordingly.

For similar reasons, companies pursuing Patent Box relief may wish to ensure that their patent applications include claims related to downstream products. This makes 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 consider Patent Box benefits when drafting 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.

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 Section "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.

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 is 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, subject to future subsidiary legislation, 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.

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

The development and active ownership conditions are 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. 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.

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 leads 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 section "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*. 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.

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 section 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 section "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).

Electing In - Considerations

As it is possible to make a Patent Box loss, it is important to consider carefully 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.

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.

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.

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 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 relevant profit*. The *qualifying relevant 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*. Under the nexus rules, *relevant IP profits* have a *relevant R&D fraction* applied that reflects the proportion of relevant R&D expenditure by the company. In effect the Patent Box allows companies to pay a lower rate of UK Corporation Tax on the calculated *relevant IP profits* for which they contributed in R&D expenditure.

The chart below sets out the seven steps of the calculation to arrive at the proportion of *relevant IP profits* attributable to IP from which the UK Corporation Tax deduction available under the Patent Box can be calculated.

STEP 1
IDENTIFY *RELEVANT IP INCOME* STREAM AND STANDARD INCOME STREAM

↓

STEP 2
ALLOCATE *RELEVANT IP INCOME* TO SUB STREAMS

↓

STEP 3
ALLOCATE DEDUCTIONS TO SUB STREAMS

↓

STEP 4
MAKE DEDUCTIONS INCLUDING *ROUTINE RETURN DEDUCTION* FOR EACH SUB STREAM

↓

STEP 5
MAKE A *MARKETING ASSETS RETURN DEDUCTION* TO ARRIVE AT *RELEVANT IP PROFITS*

↓

STEP 6
APPLY THE *R&D FRACTION* TO EACH SUB STREAM

↓

STEP 7
COMBINE THE SUB STREAMS

Steps 1 to 7

In the calculation, Step 1 requires *relevant IP income* and standard income to be determined and divided into a *relevant IP income* stream and a standard income stream. The total of these should be the total company income. This involves considering all income streams and apportioning them either as *relevant IP income* or as non-relevant IP (standard) income.

In Step 2, the *relevant IP income* stream is allocated to sub streams. It is required that IP right level streaming is chosen where income is apportioned against each *Relevant IP Right,* if possible. However, product or process level streaming or product family streaming are possible. These sub streams allow appropriate deductions and an R&D fraction to be applied in cases where there are multiple IP rights and/or multiple products or processes contributing to the IP income. The sub stream level will depend on how the IP rights correlate to the products or processes. A global stream may be used for small claims.

In Step 3, debits to be deducted in arriving at taxable trading profit are allocated to each *relevant IP income* sub stream. These include R&D expenditure or R&D tax credits.

In Step 4, after making the deductions from Step 3, a *routine return* is calculated and then further deducted to arrive at a *qualifying relevant profit (QRP)*. In legislation, the *routine return* is set at 10% of routine expenditure. Routine expenditure does not include R&D expenditure.

In Step 5 appropriate marketing assets are determined as a *marketing assets return* and deducted. This step takes into account income that is derived from goodwill or branding, which is not eligible for Patent Box, as opposed to income from IP activities.

In Step 6 an *R&D fraction* is calculated and applied to each sub steam to arrive at a *relevant profits (RP)*. In the calculation, the sum of direct R&D expenditure (D) and third party subcontracted R&D expenditure (S1), with a 30% "good R&D" uplift, is divided by the total expenditure, which consists of the "good R&D" expenditure (D + S1), plus connected party subcontracted R&D expenditure (S2) and IP acquisition cost (A). The R&D fraction is (D + S1) x 1.3/ (D + S1 + A + S2). However, the fraction is capped at 1.

In Step 7 the *relevant profits* with *R&D fraction* applied, for each stream, are added together to determine the *total relevant profit* attributable to the Patent Box.

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 *total relevant profits* (RP) from Step 7 are multiplied by the relevant main rate of Corporation Tax (MR) minus the special IP rate of Corporation Tax (IPR, 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 main rate.

Example Calculation

Company A has trading turnover of GBP 1,000k, of which GBP 700k is from the sale of items covered by a two *qualifying IP rights* - GBP 500k for IPR1 and GBP 200k for IPR2. For IPR2, 20% of the profit is attributed to branding, as opposed to exploitation of IPR2.

Company A has tax deductible expenses of GBP 750k including GBP 50k for R&D. Total deductions for items relating to IPR1 and IPR2 are GBP 100k each. All the R&D for IPR1 was conducted in-house in a previous year. IPR2 was acquired for GBP 40k in a previous year with a further GBP 50k spent on R&D this year.

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

- Trading income **GBP 1,000k**
- Tax deductible trading expenses: **GBP 750k**
- Taxable trading profit **GBP 250k**
- Corporation Tax payable (assuming 19%) without the Patent Box is (GBP 250 x 19%) = **GBP 48k**

The Patent Box calculation is as follows:

Step 1 - Establish a standard income stream and a *relevant IP income* stream:

Standard income stream = **GBP 300k**

Relevant IP income stream = **GBP 700k**

Step 2 – Income for the two sub streams relating to the two IP rights, IRP1 and IPR2, is allocated:

Relevant IP income for IPR1 sub stream = **GBP 500k**

Relevant IP income for IPR2 sub stream = **GBP 200k**

Step 3 – Allocate debits to be deducted in arriving at taxable trading profit:

Deductions for IPR1 sub stream = **GBP 100k** non-R&D costs

Deductions for IPR2 sub stream = **GBP 50k** R&D costs, **GBP 50k** non-R&D costs

Step 4 – Net profit is reduced by the *routine return* to arrive at *qualifying relevant profit (QRP)*. None of the deductions allocated in Step 3 to the IPR1 sub stream relate to R&D, so all are included in the *routine return* calculation:

IPR1 sub stream *QRP* = (500k – 100k) – (100k x 10%) = **GBP 390k**

Only GBP 50k of the deductions allocated in Step 3 to the IPR2 sub stream relate to non-R&D costs, so only these are included in the *routine return* calculation:

IPR2 sub stream *QRP* = (200k – 100k) – (50k x 10%) = **GBP 95k**

Step 5 – Deduct *marketing assets return*. All the profit for the IPR1 sub stream arises from exploitation of the IP, whereas 20% of profit for the IPR2 sub stream is attributable to branding:

IPR1 sub stream *QRP* with marketing deduction = 390k – 0 = **GBP 390k**

IPR2 sub stream *QRP* with marketing deduction = 95k – 19k = **GBP 76k**

Step 6 – Calculating and applying *R&D fraction* to arrive at *relevant profits*. IPR1 was developed completely in-house, so the *R&D fraction* for that sub stream is 1. On the other hand, the company spent 50k on in-house R&D and GBP 40k acquiring IPR2, so the *R&D fraction* = (50k x 1.3)/(50k + 40k) = 0.72

IPR1 sub stream RP = 390k x 1 = **GBP 390k**

IPR2 sub stream RP = 76k x 0.72 = **GBP 55k**

Step 7 – Combine the *relevant profits*, with *R&D fraction* applied, for each stream to arrive at *total relevant profits*:

Total relevant profits = 390k + 55k = **GBP 445k**

Finally the *patent box deduction* can be calculated. In this case, assuming 10% Patent Box rate and Corporation Tax rate of 19%: (445k x ((19-10)/19)) = **GBP 211k**

So the full rate of Corporation Tax is payable on the taxable trading profit (GBP 250k) minus the *patent box deduction* (GBP 211k) = **GBP 39**.

At a Corporation Tax rate of 19%, Corporation Tax of **GBP 7k** (GBP 57k x 19%) would be payable with the Patent Box, compared to **GBP 48k** without the Patent Box.

The Calculation - Considerations

The calculation to arrive at the *patent box deduction*, 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. Further, companies will need historic data regarding relevant R&D expenditure. Companies may therefore need to address this information deficit before they are able to determine likely Patent Box benefit. A detailed understanding of income and costs and how they are attributable between various income streams will be required.

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