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Patent Box

The Patent Box encourages companies to keep and commercialise intellectual property in the UK.

It allows a company to pay a lower rate of Corporation Tax - 10% - on profits earned from its patented inventions.

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Background

Who can benefit?

You can use the Patent Box if your company:

- is liable to Corporation Tax
- makes a profit from exploiting patented inventions
- owns or has exclusively licenced-in the patents (the ownership requirement)
- has undertaken qualifying development on the patents (the development requirement)

What patents are eligible?

To benefit from the Patent Box the company must own or exclusively licence-in patents granted by:

- the UK Intellectual Property Office;
- the European Patent Office; or
- certain countries in the European Economic Area.

Your company (or another group company) must also have undertaken qualifying development for the patent. It must have made a significant contribution to either:

- the creation or development of the patented invention
- a product incorporating the patented invention

An 'exclusive licence' is a licence that:

- is granted by the person who holds either the qualifying intellectual property rights, or holds an exclusive licence to those rights; and
- gives the licensee (alone or with others authorised by the licensee) specific rights over the qualifying intellectual property rights.

These specific rights are:

- rights over the qualifying intellectual property to the commercial exclusion of all others, including the grantor, in a commercially distinct area of business in at least one country; and either the right to bring proceedings for infringement of the rights without consent of the grantor or any other person; or
- the right to receive the whole (or greater part) of any damages awarded in respect of any infringement.

Eligibility requirements

The ownership requirement

The company must meet either the current or the prior ownership conditions.

Current and prior ownership

A company will meet the current ownership condition for a particular accounting period where, during that accounting period, it either:

- owns qualifying intellectual property rights; or
- has an exclusive licence in respect of qualifying intellectual property rights

The prior ownership condition will be met where it has income derived from an event that occurred when the company owned or had an exclusive licence to the intellectual property and had elected into the Patent Box regime.

Active ownership (group companies only)

This condition must be met in addition to either the current ownership condition or the prior ownership condition but applies to group companies only: it is intended to ensure that the company owning the intellectual property is not simply a passive holding company within the group.

In order to fulfil the condition for an accounting period, all, or almost all, of the qualifying intellectual property held by the company must be intellectual property for which the company either:

- carries out a significant amount of management activity; or
- carries out the development itself (ie the development condition is not met by attribution of another group company's activity).

"Management activity" means formulating plans and making decisions in relation to the development or exploitation of the rights. "Significant" is not defined; whether the level of activity is "significant" will depend on all the relevant circumstances, including the resources and responsibilities of the company within the group. "Almost all" is also not defined; however, in practice is it likely that this will mean at least 90% of the qualifying intellectual property will need to be actively managed or have been developed by the group company owning it.

The development requirement

The company must have either:

- created, or significantly contributed to the creation of, the intellectual property; or
- performed a significant amount of activity for the purposes of developing the intellectual property or any item or process incorporating the intellectual property.

‘Significant’ is, again, not defined but – as for the active ownership condition – all relevant circumstances need to be taken into account. Merely applying for a patent in respect of acquired rights or acquiring the rights to and marketing a fully developed patent or invention, or product incorporating the invention, will not constitute ‘significant’ activity.

How it works - calculating the profit

Broadly, there are three stages to calculate the profit that can benefit from Patent Box:

1. Identify the profits attributable to income arising from exploiting patented inventions (known as relevant IP income).
2. Remove a routine profit - this reflects the fact that a business would be expected to earn a profit even if it had no access to patented technology or intellectual property.
3. Remove the profit associated with intangible assets, such as brand or other marketing assets.

Under the new rules, the calculation must be done on the streaming basis, and a separate calculation is required for each patent.

Worked example

Goldfinger's Lasers Ltd is a manufacturing company with trading turnover of £10m, of which £6m has been generated from the sale of items that have a patent. Goldfinger's Lasers Ltd has one patent. It has tax deductible expenses of £7.5m including £1.5m for R&D, however for ease of the calculation no claim has been made under the SME or RDEC schemes.

If the company chose not to elect into the Patent Box scheme, the Corporation Tax would be calculated as follows:

1. Trading turnover £10m
2. Tax deductible trading expenses £7.5m
3. Taxable trading profit £2.5m
4. Corporation Tax payable (assuming 25%) without the Patent Box £625k

Step 1 – Identify the streams of income – the taxable income of the trade (as above) is apportioned between IP and non-income streams. The IP stream is then divided into "relevant IP income sub streams" so that each sub-stream consists of income attributable to a particular qualifying IP right.

Worked example

IP related income is therefore £6m and non-IP related income is £4m. There is no need to further separate the IP income as there is only one patent in force.

Step 2 – Allocate expenses between the income streams – this should be done on a just and reasonable basis, which will depend on the particular circumstances.

Worked example

In this example, the expected IP related costs are £4.5m and non-IP related costs are £3m.

Step 3 – Calculate the relevant IP profit – deduct Step 2 from Step 1.

Worked example

Deducting Step 2 from Step 1, the IP profit is therefore £1.5m and non-IP related costs are £1m.

Step 4 – Deduct the routine return – the routine return is 10% of the routine expenses which are included in the relevant IP income sub-stream. The routine return represents the profit a company might have made if it didn't have access to a unique IP, and it looks at costs in six areas from the final accounts:

- capital allowances deducted in calculating taxable profits;
- premises costs (rent, rates, repair, water, fuel, power, etc);
- staff costs (costs of employing directors and employees, and costs of externally-provided workers);
- plant and machinery costs (other than capital allowances: includes leasing costs, construction and modification costs, maintenance, services, operations, etc);
- professional services (consultancy, professional fees, administration and management);
- other services (software, telecoms, post, transport, waste, legal, accountancy, etc).

Where some or all of these expenses are incurred by another group company on behalf of the company claiming the patent box, the expenses are included in the calculation as if they had been incurred by the patent box claimant.

Worked example

Let's say that of our IP allocated costs of £4.5m, £3m fall into the routine return categories. Therefore, our routine return deduction would be £300,000.

Then the Quantifying Residual Profit is calculated as the amount of step 3 minus the routine return: (£1.5m – £300k) = £1.2m

Step 5 or 6 – Exclude profits relating to trademarks

Step 5 is a formula calculation that takes no account of the actual contribution of brand and marketing intangibles. In practice, Step 5 can substantially reduce the benefit of the patent box claim.

Step 5 – Small claims election

A company can elect to use the small claims treatment with regards to the Marketing Assets Return (MAR) if applicable. The MAR is the difference between:

- the notional marketing royalty of the company; and
- any actual marketing royalty paid by the company.

The reason for the MAR is to remove the profit associated with marketing assets from the relevant IP profits. This focuses the benefit derived from the Patent Box on the technology covered by the IP rights.

The nature of the business will indicate whether the marketing activities are likely to make a significant contribution to the generation of profit and of course may believe that they do not in reality exploit any marketing assets.

If the company can demonstrate that this is so, it may choose not to elect for small claims treatment and make no deduction for MAR at all.

In practice, this formula will usually substantially reduce the value of the patent box to a company; it will usually be more appropriate to consider using the provisions of Step 6 instead.

Step 6 – Marketing assets return

Where a company does not qualify or elect to use Step 5, the company must calculate a MAR amount to deduct from QRP to establish the relevant IP profits (RIPP) of the trade.

However, the marketing assets return is deemed to be nil where the difference is:

- negative (ie the actual marketing royalty exceeds the notional marketing royalty); or
- less than 10% of the QRP for the accounting period.

The notional marketing royalty is the percentage of relevant intellectual property income for the accounting period (as calculated at Step 2 of the standard calculation) that the company would pay to a third party on an arm's length basis in order to be able to use the brand/marketing intangibles if the company did not already own those intangibles.

The brand/marketing intangibles that need to be considered are:

- trademarks and design rights (registered or unregistered; UK or foreign);
- signs or indications of geographic origin of goods or services; or
- customer information used for marketing purposes.

Worked example

This calculation is complex in its own right and each case should be considered on its own facts. For this example we have assumed that it would not be worthwhile to elect to use step 5 and we will assume that the MAR is 20% of the QRP.

(£1.2m × 20%) = £240,000

The relevant profit is therefore £960,000

Step 7 – Apply the R&D fraction

The R&D fraction links the beneficial rate on income from a qualifying IP right to the research and development expenditure incurred by the company. The fraction is created by dividing any relevant R&D expenditure directly undertaken by the company plus any relevant R&D expenditure subcontracted to an unconnected third party, for each sub-stream, by total relevant R&D expenditure for each sub-stream which includes the above plus relevant connected party R&D subcontracting expenditure and acquisition costs relating to the qualifying IP right(s) within the sub-stream from the relevant period.

The R&D fraction is:

$$\frac{(D+S) \times 1.3}{(D+S+A+R)}$$

where:
D = direct (in-house) R&D costs
S = costs of R&D subcontracted to third parties
A = IP acquisition/licensing costs
R = costs of R&D subcontracted to related parties

D, S, A and R are calculated on a cumulative basis, over the life of the relevant IP asset; it will be necessary to identify R&D expenditure, and acquisition costs, relating to an IP asset and maintain records of that expenditure for up to 20 years. The lower of the R&D fraction or 1 is then multiplied to the relevant IP profit.

In effect, Patent Box claims will effectively be limited where the company outsources a substantial amount of R&D to related parties – even if those related parties are in the UK.

Worked example

If we assume that £100k was spent on licencing costs and the relevant R&D expenditure of £1.5m is made up of: UK staff costs - £750k; 3rd party subcontractor £250k; and connected subcontractors (i.e via a group) £500k, then the calculation is as follows:

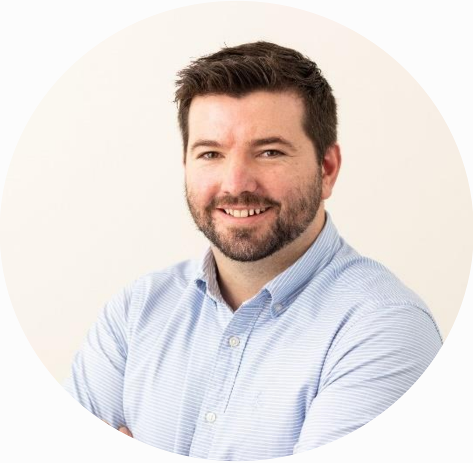
$$\frac{(750k + 250k) \times 1.3}{(750k + 250k + 100k + 500k)} = 0.8125$$

Using the previously calculated relevant profit of £960k, we apply the R&D fraction to give us £780k.

The deduction from taxable profits of £2.5m is calculated as (£780k*(25-10/25)) = £468k. At a Corporation tax rate of 25%, the Company's tax liability is now £508k compared to £625k – **a tax saving of £117k**.

Help and questions

If you have any queries regarding Patent Box, please contact us:



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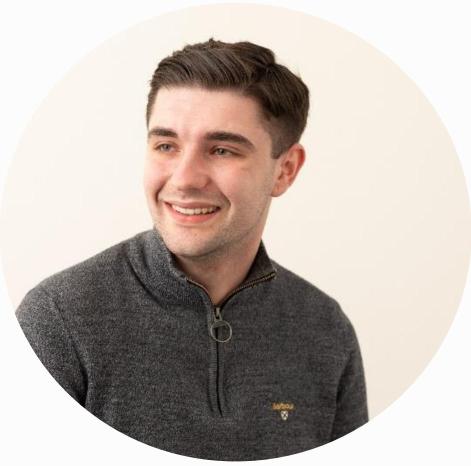

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