A clear picture

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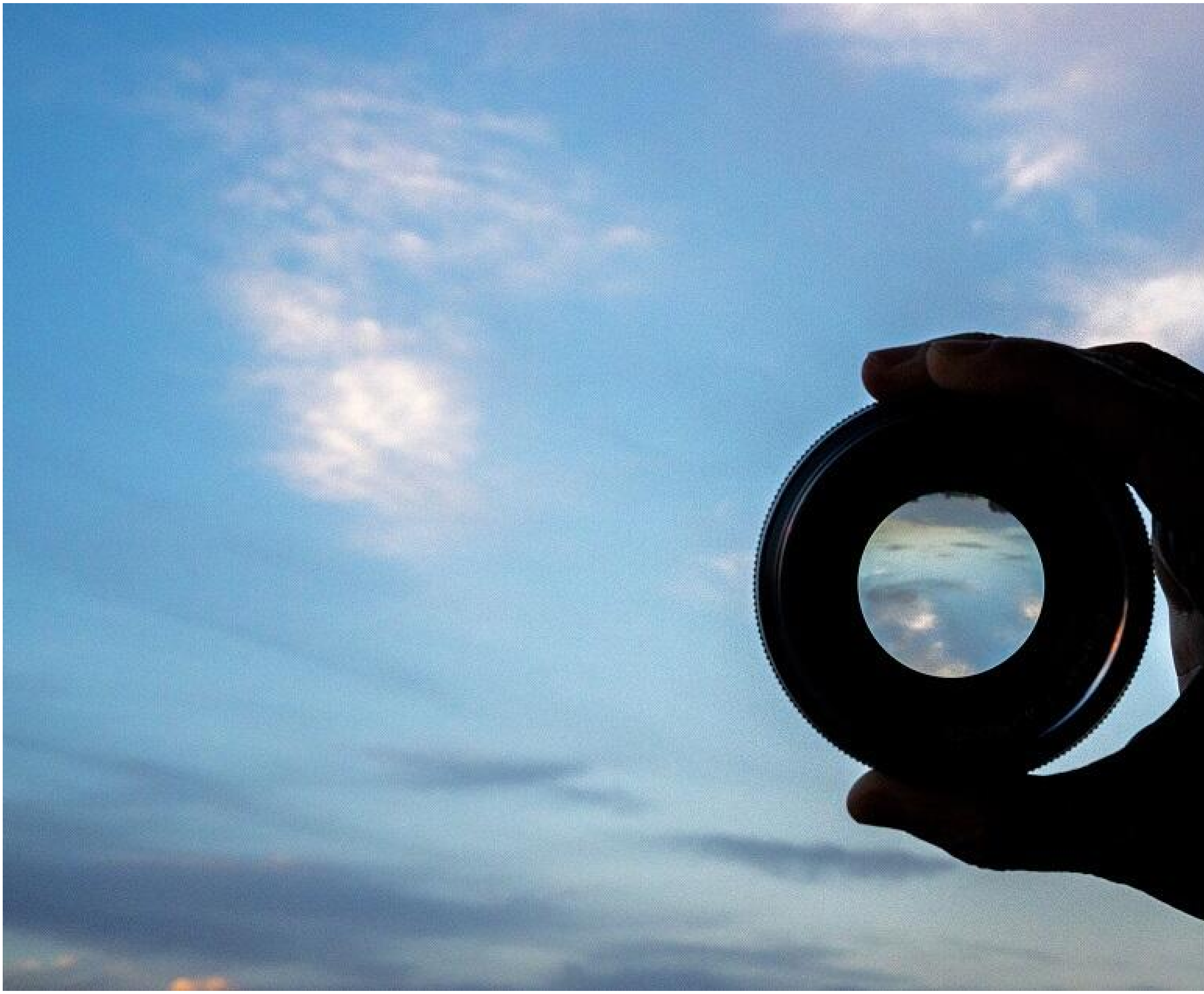

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Caroline Walton, Nigel Holmes and Raj Ghose look at the misconceptions around the Patent Box, and provide clarity on the benefits

Key Points

What is the issue?

Patent Box is a very generous but underclaimed corporation tax relief.

What does it mean to me?

A better understanding of Patent Box and why the number of claims are low.

What can I take away?

An understanding of the misconceptions and a better understanding of the benefits of the relief.

Background to the regime

The UK Patent Box became effective from 1 April 2013 with legislation governing the regime contained within CTA 2010 ss 357A-357GE Part 8A.

The Patent Box was introduced to incentivise companies to continue to carry out innovative activity within the UK by taxing profits resulting from specific categories of intellectual property (IP) arising from R&D activity, at a preferential rate.

The Patent Box is intended to operate in harmony with the R&D SME and RDEC regimes which also reward companies carrying out innovative activity.

Whereas the R&D SME and RDEC regimes work by providing extra relief for expenditure incurred on R&D projects, the Patent Box operates differently by taxing the profits of qualifying IP at 10% as opposed to the main rate of corporation tax payable; currently 19%.
To arrive at the preferential 10% corporation tax rate, it is necessary to carry out a multi-step calculation which results in a patent box deduction. This is deducted from the company's taxable profits charged to corporation tax. The deduction gives an effective tax rate on qualifying IP profits of 10%. There is no actual 10% rate of tax.

The full Patent Box tax benefit has been phased in with 60% of the benefit available from 1 April 2013 and increasing by 10% annually until 1 April 2017 when 100% of the benefit has been available to claimant companies.

Success of the UK Patent Box to date

HMRC statistics show that in 2015 /16, 1,160 companies claimed relief under the Patent Box with a total value of £754.3 million. In 2016 /17, 1,025 companies claimed relief under the Patent Box with a total value of £942.5 million. Although the number of companies claiming relief in 2016 /17 appears to have decreased, the statistics are based on partial data and are expected to be revised upwards when a complete set of data becomes available in Autumn 2019.

HMRC advise that the total value of the relief claimed has increased year on year since 2013 /14 as the benefit of the Patent Box was phased in. Although positive, it is clear that the number of Patent Box claimants is very low when compared with the number of companies claiming under the R&D SME and RDEC regimes for the same period (around 40,000 claims in 2016 /17 so far).

Whilst the UK Patent Box is a new tax relief regime and will have undoubtedly suffered in terms of the numbers of claimants due to the phasing in of the benefits, it is disappointing that the relief is not being more widely claimed. Are there reasons for the low uptake? Are there any barriers within the Patent Box regime and if so, how might they be overcome?

UK Patent Box eligibility requirements

To qualify for Patent Box, a claimant company must:

- be a UK registered company liable to corporation tax. The Patent Box is not applicable to sole traders, partnerships or unincorporated entities;
- be a qualifying company, i.e. a company which either holds any qualifying IP right, holds an exclusive licence for any qualifying IP right or has held a qualifying IP right in the past (or held a licence), has since disposed of the right but received income from the same which falls to be taxed in a relevant accounting period;
- have carried out qualifying development on the qualifying IP right, i.e. have created or significantly contributed towards the development of the invention or alternatively, have performed a significant amount of activity to develop the invention if acquired by the claiming company post creation;
- have carried out active ownership on the qualifying IP right in the case of a group company claimant, i.e. be able to demonstrate that it has performed a significant amount of management activity in relation to the IP rights held.

Whilst the name implies that only patents qualify, the benefits actually apply to:

- patents granted by the UK Intellectual Property Office (IPO), European Patent Office (‘EPO’) or by the National IPO of Austria, Bulgaria, Czech Republic, Denmark, Estonia, Finland, Germany, Hungary, Poland, Portugal, Romania, Slovakia or Sweden;
- a supplementary protection certificate relating to medicinal or plant protection products granted by the UK IPO or EPO;
- an application for a patent which would have been granted by the UK IPO but for issues involving National Security;
- plant variety rights and/or community plant variety rights;
- medicinal and veterinary products with marketing authorisations and marketing or data protection.

The rationale for including IP rights other than patents is that these additional types of IP involve similarly rigorous procedures and it is considered that the profit resulting ought to benefit from similarly preferential tax treatment.

The scheme does not apply to IP such as trademarks, copyright and design rights.

What income qualifies for Patent Box tax relief?

There are five specific heads of IP income in Patent Box:

- Sales income:

  i Sales of items in respect of which a *qualifying IP right* has been granted
  ii Sales of items incorporating one or items in respect of which a *qualifying IP right* has been granted
  iii Sales of items, the main or principle purpose of which is to be incorporated into an item in respect of

which a *qualifying IP right* has been granted or which incorporates an item in respect of which a *qualifying IP right* has been granted

- Licence and royalty income
- Income arising from the sale or other disposal of a *qualifying IP right* or an exclusive licence in respect of such a right
- Damages received by the 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
- Damages received by the company, proceeds of insurance or other compensation which does not amount to damages for an infringement or alleged infringement of a qualifying IP right but which is paid in respect of sales income and represents a loss of income which would have been relevant IP income.

In addition, the Patent Box recognises that there may be additional types of income which do not fall within the five specific heads outlined above but which arise from the exploitation of a qualifying IP right and ought to be able to take advantage of the tax relief.

A claimant company can 'elect' to treat an appropriate percentage of its income that arises from exploitation of a qualifying IP right as IP derived income for Patent Box. The term given to income arising from exploitation of an IP right is 'the notional royalty'.

The amount of income which a claimant company can elect to include as the notional royalty is the amount that the claimant company would have had to pay a third party for the right to exploit the qualifying IP in the accounting period in question.

Examples of where a notional royalty might be relevant include the example of a company owning a manufacturing process patent who can evidence an increase in revenue from the introduction of the manufacturing process into its modus operandi or the example of a company owning a patented tool which is used as part of its internal manufacturing process and who can evidence an increase in revenue from the use of the tool when compared to revenue generated preceding the tool.

Election into the UK Patent Box

It is mandatory for a claimant company to notify HMRC in writing if it wishes to take advantage of the UK Patent Box. This is known as '*electing in*'. The election must be made within two years after the end of an accounting period in which the relevant profits and income arose.

Once elected in, the claimant company will remain in the Patent Box until such time that it decides to opt out. If a company opts out, it will not be permitted to elect back in for five years.

The pre-grant relief provisions allow a company to elect into the Patent Box to claim tax relief on any profits which are generated in relation to the patent in the period between filing the patent application and the patent grant, up to a maximum of six years. Whilst the benefit from electing in early will not be realised until a Patent Box claim is made, once the patent has been granted, it is possible to roll up the profits generated in the accounting periods for which a company has chosen to elect in and to claim the relief in the first year that a Patent Box claim is submitted to HMRC.

Why the low take-up?

According to the UK's Intellectual Property Office, 6,311 patents were granted in 2017 and 41,635 in total over the last seven years. Of course, not every patent granted will be to a company, and Patent Box is only available to companies.

Why are the number of Patent Box claims much lower? We suggest there are several possible reasons, listed below.

Costs and timescales

Some don't apply for a patent but could do so. Where cost and/or timescale is a factor, it's worth noting that the corporation tax saving will usually repay the legal and administration costs many times over. Furthermore, the pre-grant relief mentioned above provides rolled up relief during the patent pending period.

Complexity and the phase-in

The calculations required for Patent Box are complex and potentially difficult to explain to business owners. This can be off putting to many, in particular to smaller SMEs. The phase-in period has now come to an end, which helps, and the full relief is now available from 31 March 2017.

Loss-making companies

As Patent Box is a tax relief to reduce taxable profits, the relief is of no use to loss making companies. Many start-up companies will make losses in their earlier years – but this should not be viewed as a 'one-size fits all' decision.

The calculations require income streams to be created for each patent and then there is a 'catch all' non-patent stream. If the calculations result in a loss-making company having a profitable patent stream or streams, then making a Patent Box claim will reduce the taxable profits in the patent stream, thus preserving tax losses. Some loss-making companies will find Patent Box is worthwhile.

The actual patent

One of the most common problems encountered, especially for smaller businesses, is that the patent has been applied for in the name of the inventor, even though the patent is being exploited by the company.

Patent Box requires that the company has to have legal rights to exploit the patent. If the patent is to be assigned or licensed to the company, tax and legal advice on the assignment or licence should be sought.

Lack of awareness

There is a lack of awareness as to the availability of Patent Box and what can be achieved from it by making a successful claim – as well as an R&D tax credit claim.

The calculation

To illustrate how the calculation works, consider a Company P claiming a Patent Box deduction for its accounting period ended 31/03/17. P had elected in Patent Box for 2015 and pre-grant profits (elected individually for each patent/right) can be included in its 2017 claim.

Step 1: relevant IP income:

The company's income (excluding finance income) is separated into two streams – the 'relevant IP income (RIPI) stream' and the 'standard income stream'.

Step 2: relevant IP income sub-streams

Divide the RIPI stream into RIPI sub-streams, consisting of income attributable to a particular qualifying IP right, or a particular kind of IP item, or a particular kind of IP process.

Step 3: allocate costs

Costs brought into account in calculating the profits of the trade must be allocated on a just and reasonable basis, excluding those relating to loan relationships, derivative contracts and (importantly) additional deductions obtained in respect of R&D tax relief.

Step 4: routine return

Once the costs have been allocated at Step 3, they must be deducted at Step 4. The routine return figure for the sub-stream must also be deducted, representing the profit a business might have made if it did not have access to unique IP and other intangible assets. This deduction is simply calculated by taking 10% of certain costs prescribed by the legislation, such as capital allowances, premises costs (excluding mortgage interest) and personnel costs.

This step will arrive at the amount of that profit that is attributable to the intellectual property (both Patent-related IP and other IP, such as marketing assets), a figure described as the qualifying residual profit (QRP).

Step 5: marketing assets return

This is the difference between a notional marketing royalty and an actual marketing royalty (the difference is ignored when the actual is greater than the notional or the difference is less than 10% of the profit calculated so far). The notional marketing royalty is the amount the company would pay to a third party on an arm's length basis for the right to exploit the marketing asset such as trademarks and customer information. The actual marketing royalty is the amount the company pays for licensed or acquired marketing assets.

Step 6: R&D fraction

The calculation of the R&D fraction relates the benefit derived from Patent Box to the qualifying development performed by the company.
It is based on the amount of qualifying in-house R&D expenditure incurred by the company on that particular patent plus third party sub-contracted R&D, relative to overall R&D expenditure and any relevant IP acquisition costs. A separate fraction will have to be calculated for each stream of qualifying Patent Box profits, based on R&D expenditure incurred on the specific patent to which the income stream relates.

The figures for the fraction are calculated on a cumulative basis over the life of the relevant IP asset, for which records will need to be maintained for up to 20 years.

Step 7: combine the sub-streams

Add together the amounts of the RIPI sub-streams, following the application of the R&D fraction at Step 6.

Step 8: profits arising before the grant of patent rights

The company has made an election which provides for profits arising before the grant of a right to be treated as relevant IP profits. The additional amount thus treated is added to the result found at Step 7.

Calculating the Patent Box deduction

A deduction is taken when calculating the period's tax-adjusted trading profits, with the effect that the Patent Box relief is given by way of a lower effective rate of corporation tax on Patent Box profits.

The way in which the deduction is calculated is set out in CTA 2010, s 357A(3) as follows:

(90% x RP) x (MR-IPR)/MR

Where:

- RP is the relevant IP profits of the trade of the company
- MR is the main rate of corporation tax
- IPR is the special IP rate of corporation tax

Conclusion

The Patent Box can be complex. Yet the savings made can be substantial and relevant to large and small companies. There is no reason why many more companies should not be applying for patents and electing to claim Patent Box relief.