Tolley's Tax Digest

The Patent Box Rules

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Practical, expert guidance including:

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- history and aims of the Patent Box;
- who can claim, and qualifying companies;
- the development condition;
- the mechanics of the 10% rate;
- structuring for SMEs;
- Patent Box losses;
- elections under Patent Box;
- tax avoidance;
- and much more.

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The Francis Clark Innovation and Technology Tax Group (ITTG) is made up of experienced corporation tax specialist partners, directors and consultants. The Group was set up in early 2012, recruiting in professionals from around the practice with years of experience in R&D tax relief, to ensure that the opportunities presented by the new Patent Box legislation were fully understood by the tax practice, the Francis Clark corporate teams and by clients. The ITTG has linked with local patent attorneys and intellectual property lawyers to provide an holistic approach to intellectual property planning for its client base and the South West corporate market. The Group also has responsibility for the education, marketing and delivery of Francis Clark's services in respect of R&D tax relief and the new creative industry relief.

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1 Introduction

FA 2012 Sch 2 inserted Part 8A (ss 357A–357GE) into CTA 2010. 'Profits arising from the exploitation of patents etc…', colloquially known as the 'Patent Box' (though it applies to more than patents), applies for accounting periods ending on or after 1 April 2013.

Whilst there is a large amount of detailed legislation, the new provisions broadly provide for a reduced rate of corporation tax of just 10% for profits attributable to income from qualifying IP rights. The rate is being phased in over a four year period. From April 2013 60% of the benefit will be available, rising by 10% each year until the full benefit is available in April 2017.

This *Tax Digest* has been written with the general tax practitioner in mind who probably deals with SMEs and who will not be an expert on Patent Box. This has therefore been designed to provide practical guidance on the areas that those advising an SME claimant will commonly encounter, though it covers all of the tax aspects of the Patent Box. In addition, one section deals with structuring as applicable to the SME.

By its nature Patent Box has some aspects which go beyond the remit of the tax adviser. In particular, in deciding whether some rights other than patents are qualifying intellectual property or when considering whether an item process is patentable, the advice of a suitably qualified professional such as a patent attorney should be sought. These aspects are beyond the scope of this *Tax Digest*.

Included in this *Tax Digest* as **Appendices 3** and **4** are two tools which the general practitioner may find helpful. **Appendix 3** is a flowchart which can be used to assess whether a company is a qualifying company for the purposes of the Patent Box. This summarises the legislation in CTA 2010 Pt 8A Ch 2 in diagrammatic form. **Appendix 4** is a checklist which works through the calculation of the Patent Box deduction set out in CTA 2010 Pt 8A Ch 3 in a logical way. This is necessarily simplified and does make some assumptions, these being that the company is not a member of the Patent Box group and only has one trade. When using **Appendix 4** it is strongly recommended that this is read in conjunction with the explanation of the calculation in the text. It also deals with the standard calculation though it could be adapted to deal with streaming.

Integrated within this *Tax Digest* are relevant references to the HMRC manual that covers Patent Box, the Corporate Intangibles Research and Development Manual (CIRD). This developed from the technical guidance which was originally issued with the draft legislation. Also included within the text, where relevant, are examples given by HMRC to illustrate particular points.

Included at the end of this *Tax Digest* is an extended worked example of the calculation using the checklist at **Appendix 4**. This should be read in conjunction with the main text explaining the calculation to illustrate the various components of this.

2 History and aims

The Patent Box was first proposed by the Labour government in 2009. The legislation underwent three rounds of consultation, beginning in November 2010.

The aim of the Patent Box is to reward companies for innovation, to retain companies in the UK tax net and to attract companies into the UK tax net. In the global environment the UK is competing with jurisdictions which already have established Patent Box regimes. It is hoped that the UK Patent Box will stop the drift of companies to lower tax jurisdictions.

The relief will be available in respect of qualifying IP rights regardless of when they were granted. It was originally proposed that Patent Box would only apply to rights granted after the legislation came into force. However in its final incarnation it applies to all rights whenever granted the quid pro quo being that the benefit will now be phased in.

It is apparent that the Patent Box legislation has been developed in conjunction with very large companies. It does however apply to all sizes of company and because of this the SME may have particular issues in using the regime arising from their structure and accounting processes.

Patent Box can be thought of as a tax break which kicks in when the benefit of R&D tax credits ends, thus providing support for innovative companies.

3 Who can claim the benefit of Patent Box?

3.1 Companies

Only companies can benefit from Patent Box. It is a corporation tax relief. There are no restrictions on the size of company that can qualify, so the smallest company with one patent can qualify in the same way as the large pharmaceutical companies.

3.2 Corporate partners in a partnership

Corporate partners in a partnership can also elect into the regime. CTA 2010 s 357GB provides that where a qualifying IP right has been developed on a collaborative basis using a partnership arrangement and the partnership meets both the development and active ownership requirements in respect of the qualifying IP rights then a corporate partner in that partnership can benefit from the Patent Box regime.

A partnership meets the development condition if it has carried out qualifying development or if a corporate

partner who is entitled to at least 40% of profits or losses has done so.

Corporate partners can elect to be taxed as if the partnership itself had elected into the Patent Box regime. The profit allocated to the partner will then be reduced through the Patent Box calculation so the profit is taxed at 10%.

As the election is made by each company individually, some corporate partners might elect into the regime whilst others might not. The time limits apply in the normal way.

If the corporate partner's return is economically equivalent to interest then it is treated as if no election had been made.

3.3 Cost sharing arrangements

Cost sharing arrangements are commonly encountered and allow businesses to share their skills and resources to pursue a common aim. The 'partners' will contribute to the activities and costs in agreed proportions.

A cost sharing arrangement might establish a separate legal entity or be a contractual arrangement. A separate legal entity will have Patent Box applied to it in the normal way. A contractual arrangement will be dealt with under CTA 2010 s 357GC.

The company is treated as if it held the qualifying IP (and is therefore eligible for Patent Box) where:

- one of the parties holds qualifying IP or an exclusive licence;
- each party is required to contribute to the costs or perform activities for the purpose of creating or developing the invention or any item or process incorporating the invention;
- it is entitled to a share of any income attributable to the right or licence or has one or more rights in respect of the invention; and
- the amount of any income received by each of the parties is proportionate to its participation in the arrangement.

It will however not apply if the CSA gives the company a return that is economically equivalent to interest.

4 Qualifying companies

The benefits of the Patent Box are only available to qualifying companies. A qualifying company can elect to benefit from the Patent Box (under CTA 2010 s 357A) if it is liable to UK corporation tax, it makes a profit from exploiting qualifying IP, it owns or exclusively licences qualifying IP and has undertaken qualifying development in relation to the qualifying IP.

Where a company is a member of a group, it may be a qualifying company if another company in the group has carried out the qualifying development.

There are plenty of definitions to run through to establish whether a company can elect in to Patent Box.

4.1 Qualifying company

The definition of a qualifying company requires companies to either:

- hold qualifying IP rights or hold an exclusive licence over qualifying IP at any time during an accounting period (Condition A); or
- receive income in a later accounting period in respect of qualifying IP rights that were held in a previous accounting period where a Patent Box election was in place (Condition B).

It is likely that in most circumstances, Condition A will be relevant but Condition B recognises that there may be situations where the IP rights have expired (say on the expiry of the 20 year term on the patent or where patent rights have not been renewed) and yet income is received in respect of those rights.

HMRC manuals provide an example where a company has taken legal proceedings against the infringement of its patent but the income cannot be recognised until the successful conclusion of the legal process, by which time the patent may have expired. Provided that the company was a qualifying company at the time of the infringement, then the income recognised in the later period will be available for the Patent Box tax rate prevailing at the time of recognition.

Where a company is a member of a group, it must also satisfy the active ownership test (Condition C) (see below).

A company will also be treated as a qualifying company by electing into the scheme whilst its application for a patent is being considered (patent pending). In so doing, where profits are made from the exploitation of the IP during the patent pending period, once the patent is granted, the Patent Box benefits can be applied to those profits in the later accounting period in which the patent is granted. This is so even if the IP has been sold between the period of electing in to that in which patent is granted (CTA 2010 s 357CQ). Further detail on this point is provided later on.

4.2 Qualifying IP rights

There are conditions for intellectual property to be a qualifying IP right (CTA 2010 s 357B(4)):

- it is a right to which the legislation applies. CTA 2010 s 357BB lists those rights to which Patent Box will apply; and
- the company meets the development condition in respect of that right.

The list at CTA 2010 s 357BB provides that the following are qualifying IP rights (subject to the development condition):

- patents granted under the Patents Act 1977 by the UK Intellectual Property Office (IPO);
- where a patent is not granted by the UK IPO under provisions regarding national security or public safety and the applicant has been notified that the application otherwise complies with the Patents Act 1977;
- patents granted under the European Patent Convention by the European Patent Office (EPO);
- patents (or their legal equivalents) granted under the law of specified EEA states (these states are Austria, Bulgaria, The Czech Republic, Denmark, Estonia, Finland, Germany, Hungary, Poland, Portugal, Romania, Slovakia, Sweden);
- supplementary protection certificates (which extend the monopoly protection offered by patents beyond their normal time period and are granted in certain sectors where the duration of the authorisation period is lengthy e.g. human or veterinary medicines and plant protection products) issued under either Regulation (EC) 469/2009 or Regulation (EC) 1610/96;
- plant breeders' rights granted in accordance with Part 1 of the Plant Varieties Act 1997 (rights very similar to patents);
- community plant variety rights granted under Council Regulation (EC) No 2100/94 (rights similar to patents); and
- where marketing authorisation in respect of a product is granted in accordance with any EU legislation and the product benefits from marketing or data protection as a result. There are some further detailed rules on exactly what qualifies.

4.3 Exclusive licence

If the company does not own the IP, Patent Box may still be available as the company can qualify if it holds an exclusive licence on a product.

A person holding an IP right may choose to licence another person to exploit the IP right rather than doing so themselves. The licence to exploit may be limited to applying the IP right in certain fields or territories, enabling the IP right holder to exploit the IP right in the remaining fields or territories or able to grant further licences to other persons.

An exclusive licence may have many terms as to the fields and territories that it applies to, the duration of the licence, how royalties are to be calculated. For the purposes of the Patent Box legislation, however, an exclusive licence is one which must meet specific requirements as set out in the legislation (CTA 2010 s 357BA).

- It is granted by a person who either:
  - holds the qualifying IP right (as described above); or
  - holds themselves an exclusive license to those qualifying IP rights; and
- gives the licensee certain rights over the qualifying IP rights, namely:
  - rights to the exclusion of all others (including the person that has granted the licence) in one or more than one country (territorial rights must extend to cover at least one national territory); and
  - the right to bring proceedings (without the consent of the person who granted the licence or any other person) for infringement of the rights; or
  - the right to receive the whole (or the majority) of any damages awarded following proceedings for infringement.

An exclusive licence should be distinguished from a sole licence where the IP right holder would still have reserved the rights to also exploit the idea in competition with the licensee. In the case of an exclusive licence, the licensee is the *only* person legally entitled to make use of the IP right in the fields and / or territories detailed in the licence agreement.

Exclusivity in a licence must be real and commercially justifiable. Where a licence is made exclusive for the main purpose of obtaining the benefits of the Patent Box, the Patent Box relief will not be available (CTA 2010 s 357F). This is not to say that licences cannot be re-negotiated to make an existing licence exclusive, providing that the new terms genuinely confer the exclusive rights, as defined below, and genuinely reflects the way in which the IP right holder and the licensee intend to operate. Where exclusivity is already implicit in an agreement, it is recommended that time is taken to document this fact.

Non-commercial or unnecessary terms can be ignored for the Patent Box. HMRC manuals provide an example of a manufacturer of a piece of patented kit granting an exclusive worldwide licence to a car manufacturer to install into that car manufacturer's own vehicles. The exclusivity in the contract is commercially redundant as only the car manufacturer has the right to decide what it should or should not install in its cars. If the car manufacturer then chose to claim Patent Box relief on the profits from the sale of the cars (as it believes that a component in the car carries a qualifying IP right) then the Patent Box relief would be denied.

The fact that an exclusive licence is granted to a company in one national territory does not necessarily exclude other persons with exclusive licences of the same IP right in other national territories from importing their product containing the IP right into the first territory. This does not mean that the company does not have an exclusive licence

and HMRC will not prevent the company from being a qualifying company if this is the case.

Often in group situations, one company may hold the qualifying IP right but another company may exploit those rights. It is recognised that licensing arrangements within groups may not be as legally robust as agreements with third parties. Where one group company confers all its rights to another group company, that second company will be treated as holding an exclusive licence over that IP right. It will not be necessary for the company that is the actual holder of the IP right to also confer the rights to enforce, assign or grant a licence to the other group company, allowing the holder of the IP right to continue to manage the IP right itself. For the definition of a group, see below.

5 Development condition

In addition to the company owning or holding an exclusive licence over one or more of the IP rights as listed in CTA 2010 s 357BB, the company must also meet the development condition in respect of that right. The purpose of including the development condition is to reward only those companies that are innovating in some way and to stop companies from acquiring numerous IP rights for profitable exploitation and securing the advantageous tax rate without having carried out or with any future intention of carrying out any further development.

The development conditions are laid out in CTA 2010 s 357BC, listed as Conditions A, B, C or D and the company must meet one of these. These conditions use the term 'qualifying development' which is defined in CTA 2010 s 357BD, so it may be useful to understand this definition first.

5.1 Qualifying development – CTA 2010 s 357BD

Qualifying development in respect of an IP right is considered to be where a company has created, or *significantly* contributed to the creation of, the invention or it has performed a significant amount of activity to develop the invention (including developing new ways for the invention to be used) or any item or process that incorporates the invention. In order to satisfy the development condition required to qualify the IP right for Patent Box it is unimportant whether the qualifying development takes place before or after the company (or any member of the company's group, where relevant) became the owner of the IP right or holder of an exclusive licence over that IP right.

Where ownership requirements are satisfied by an exclusive licence, it is the company holding the licence (the licensee) or a member of the licensee's group that must have carried out the qualifying development.

Where a company has created the invention itself and then secured intellectual property protection there is no question that there has been qualifying development. However where this is not the case, but the company has made some contribution or performed some activity towards the development of the item then it is necessary to ascertain the extent of that contribution or activity.

The legislation uses the term 'significant' in respect of contributions made towards qualifying development. As you would expect, there is no further definition of what significant might be. HMRC manuals at CIRD 210190 comment that 'whether activity is significant will be determined in the light of all the relevant circumstances'.

A contribution may be considered significant under a number of measures, i.e. by cost, time or effort or even by the impact or value that the contribution creates (e.g. coming up with the breakthrough idea). If a company's only development activity is how to commercialise the product then this will not be considered significant.

Back to the development conditions A, B, C or D, only one of which needs to be met.

5.1.1 Condition A

The company must have carried out the qualifying development and since doing so has not ceased to be, or become, a controlled member of a group.

5.1.2 Condition B

The company must have carried out the qualifying development and since doing so has ceased to be, or become, a controlled member of a group. Since it ceased to be, or became, a member of a group it has for a further 12 months from that time carried out the same type of activities that previously constituted qualifying development activities.

This condition enables another company to acquire a company with qualifying IP rights and for the acquired company to obtain Patent Box relief provided that it continues with qualifying development activities for at least 12 months after its acquisition.

The condition is designed to prevent companies acquiring other companies with fully developed patents in a cash cow stage to access Patent Box relief.

5.1.3 Condition C

The company is a member of a group and another company that is, or has been, a member of the group has carried out qualifying development of the IP right and that second company carried out the qualifying development at a time when it was a member of the group.

This allows typical group arrangements where one group company holds all of the IP rights and another group company carries out all of the R&D work.

Note that the company holding the IP right need not have been a member of the group at the same time as the qualifying development was carried out. The qualifying development must simply have been carried out in the group of which the claimant company is now a member.

5.1.4 Condition D

This condition is an extension of Condition B above. This allows a group which acquires a company which developed the IP right to transfer the right to another group company. The qualifying development activities that took place prior to joining the group will satisfy the development condition if the acquired company, or another company in the group, carries on with the same type of qualifying development for 12 months following the acquisition.

6 Active ownership condition

Where a company is a member of a group, a further condition, Condition C, must be met. Where a company is a member of a group, it must also meet the active ownership test.

Firstly, the definition of a group for the purpose of Patent Box needs to be considered as it is a wider definition than would normally be expected.

A group in respect of a company includes that company and each company associated with it. Companies will be associated with each other at the 'relevant time' if any of the following conditions are met:

- If the financial results of each company meet the consolidation condition, i.e. the results are required to be fully consolidated in group accounts or would be so included if not for an exemption or the results are in fact fully consolidated in group accounts. Group accounts are accounts prepared under the Companies Act 2006 or any equivalent rules in other territories.
- The two companies are connected for the accounting period of each company in which the relevant time falls. Connection is as defined in CTA 2009 ss 466–471, i.e. that one company controls the other or both are under common control, control being determined by the holding of shares, votes or other powers conferred by the company's articles or other regulating document. This means that parallel stand-alone companies with common ownership will be considered a group for Patent Box purposes.
- One company holds a major interest in another. Major interest is defined (CTA 2009 ss 473–474) generally as being where the company and one other person taken together have control of another company and the first company and that other person each have interests, rights and powers of at least 40% in the subject company.
- Where two companies meet the consolidation condition and at the relevant time, another company has a major interest in one of the first two companies, then all three companies are within the same group for Patent Box purposes
- Two companies are connected during an accounting period in which the relevant time falls and at the relevant time, one of these companies holds a major interest in a third company, then all three are within the same group for Patent Box purposes.

Now we know which companies are a part of a Patent Box group, the active ownership condition can be considered. The qualifying company definition requires that where a company is a member of a group, the company should have either developed its qualifying IP rights portfolio itself or be actively managing it.

The active management condition more specifically states that all or 'almost all' (undefined) of the qualifying IP rights are rights where either:

- during the accounting period the company has performed a 'significant' amount of management in respect of those rights; or
- the company itself meets the development condition in respect of the rights under Condition A or Condition B in CTA 2010 s 357BC.

So whilst a company can meet the development condition by virtue of the development activity of another group company, the first company must still show that it has an active role in managing the qualifying IP rights it holds in order to make a claim for Patent Box relief. Management activity is defined in CTA 2010 s 357BE as 'formulating plans and making decisions in relation to the development or exploitation of the rights'.

HMRC Manuals at CIRD 210210 cite the following as management activity:

- deciding whether to maintain legal protection in particular territories;
- granting licences over IP rights;
- researching alternative applications for the innovation or licensing others so to do; and
- deciding on which products that incorporate the innovation go to market and features the product will have and on the distribution to and location of markets in which the product will be sold.

As for qualifying development, the management activity must be 'significant' and once again this term remains undefined. HMRC guidance states that the significance of management activity will be 'determined in the light of all relevant circumstances' and that it will usually be quite clear whether a company's activity is significant.

The significance of the management activity will be measured taking account of the resources of the company, the extent of its responsibilities over the IP rights, the nature of the IP rights and the management they require and the impact of the decisions it makes in relation to the IP rights when compared with other group companies.

It is useful that HMRC have recognised that from a commercial perspective some IP rights will need little in the way of management once established and so there may not even be management activity in every accounting period for every IP right.

It is also recognised that some decisions may be made elsewhere in the group, for instance at a parent company level. This does not preclude the IP rights holding company from making a Patent Box claim provided that it is actively involved in whatever activity is necessary in making those plans and decisions that may actually be ratified elsewhere.

Further, some groups may have a central parent company Board which manages the IP rights, even though the IP rights are held in another group company. Provided that directors of the IP rights holding companies are represented on this central Board and participate in the decision-making in relation to the development and exploitation of the IP rights then the active ownership condition is likely to be met.

7 Some further thoughts on groups

The definition of group for Patent Box purposes as set out at CTA 2010 s 357GD is discussed in detail above. It is worth noting that this is a much wider definition of group than we are used to for most corporation tax purposes. It will encompass worldwide companies as well as joint ventures.

There are two other places where whether a company is a member of a group for Patent Box purposes or not is relevant in addition to the active ownership condition, development condition and exclusive licences considered above.

These are in respect of calculating a deduction for a 'routine return' and for the purposes of set-off where losses are involved. Both of these are discussed further below.

This wide definition has positives and negatives. On the one hand it ensures that companies can more easily meet conditions by considering issues on the group-wide basis. However it can cause complications when calculating the routine return and in respect of set-off amounts. These complications will mostly come from the fact that companies will need to identify relevant group members and then the relevant expenses, profits or losses within them. This may also give some surprising results where companies which are loosely connected will need to set off Patent Box losses between them. See further below.

8 Structuring for SMEs

The Patent Box regime has created new structuring issues to be considered when advising SMEs. These are very different to the issues for large companies. One of the key features when advising SMEs with intellectual property is the fact that it is quite usual to discover that the IP is owned personally or often it is the case that it is unclear as to who owns the intellectual property. Often such new companies do not have the necessary professional advisers involved in order to give appropriate advice. Therefore it is very easy for 'untidy' situations to arise.

This presents problems when considering the structuring of the SME business. If a 10% corporation tax rate can be achieved then a client would certainly expect that to have been identified as an opportunity and achieved if possible by the company's tax advisers. However in the course of achieving that objective other tax issues may be flagged up.

8.1 Nature of the intellectual property

It is not necessary to have existing patent rights in order to qualify for the Patent Box regime and all that is required is patentable intellectual property. Therefore there will be companies that can potentially qualify for the regime which have not to date applied for a patent. The starting point for the professional adviser is therefore to consider the nature of the intellectual property in existence.

8.2 Tax consequences of personal ownership – disposal – income or capital?

In attempting to transfer the IP to the company to maximise the Patent Box claim, tax charges may accrue, and these may not be as expected and the usual reliefs may not be available.

It is often thought that intellectual property is a capital asset which is subject to the capital gains tax (CGT) regime if it is owned personally. However, there are specific income tax provisions in ITTOIA 2005 Pt 5 Ch 2 entitled 'Receipts from intellectual property'. This longstanding legislation which is post re-write in ITTOIA 2005 ss 578-607 provides for income tax to apply to income or proceeds received from intellectual property, know-how, patent rights and similar income. However, whilst the income tax legislation in ITTOIA 2005 is very wide ranging, it does not apply to all intellectual property and some categories are still within the capital gains tax regime (such as goodwill).

Therefore because income tax takes precedence over capital gains tax (TCGA 1992 s 37) there are only a very limited range of assets to which the CGT rules apply which are best described as 'goodwill'.

The boundary between income taxation and capital gains taxation for intellectual property disposals is not very clear and HMRC's Capital Gains Manual at CG68000 states that 'because of developments in technology and the way in

which intellectual property is dealt with in commercial transactions, it is an area where our views are developing. Any cases of doubt or difficulty should be referred to the CG technical group'.

However, it is clear that where patents are involved then the CGT legislation does not apply and instead patents owned personally are subject to income tax (see **Example 1**). Other than a specific relief to spread income over a six year period, proceeds from patent rights do not benefit from specific tax reliefs that would apply to capital assets subject to the capital gains tax regime. As a result various reliefs extending from holdover relief, incorporation relief, rollover relief to the spouse exemption have no bearing on disposals of patent rights.

Example 1

Len has invented a product which he has successfully patented. He receives an offer to sell the patent rights but instead sets up a company to further develop and exploit the new product. He transfers the rights on 1 June 2013 when the market value of the rights is agreed to be £120,000.

Len is assessable on £20,000 (1/6 x £20,000) in 2013/14 and on £20,000 in each of the following five tax years. Alternatively, Len could elect to be assessed in full on £120,000 in 2013/14.

8.3 Transactions with connected parties

The transfer of an intangible asset either from, or to, a company is treated as taking place at market value if it was a chargeable intangible asset either before or after the transfer (CTA 2009 s 845). A chargeable intangible asset is one which would be within the corporate intangibles regime and so if the patent was regarded as having been created after 1 April 2002 then it will be within the chargeable intangible assets regime.

The transfer is deemed to take place at market value for all tax purposes and not only as far as the corporate intangible asset regime is concerned. This does have the advantage that if a company is deemed to have acquired a patent at market value from a related party individual then the company would be entitled to amortisation deductions for corporation tax purposes in respect of the patent. However if the Patent Box regime applies then in turn these amortisation deductions are only being relieved at an effective tax rate at 10%.

If it is not tax efficient to transfer the patent to the company then consideration should be given to an exclusive licence.

8.4 Exclusive licence for Patent Box purposes

It is possible to have a patent owned outside of the company qualifying for the Patent Box regime as long as the company has an exclusive licence. Therefore the patent could be held by an individual who is a shareholder/director and owns the patent personally. However ITTOIA 2005 s 597 states that the granting of a licence in respect of a patent is equivalent to a sale on acquisition of patent rights. Therefore, if an exclusive licence is put in place, even for no consideration, then an income tax liability will arise. This will not therefore solve the problem

8.5 Early transfer of patent rights

It is therefore apparent that where the benefit of the Patent Box is sought by the company without the problem of tax charges accruing on transfer of the rights or a licence to the rights that an early transfer of patent rights is desirable.

This may however be limited by commercial factors. Whilst equity investors may want to have the patent rights within a company before they invest, owners of that intellectual property may want to try and retain it personally in order to better protect their position should the company fail and they want to try and use the intellectual property in a new venture.

8.6 Valuation

A further complicating factor here is the uncertainty of the valuation of the patent rights. Valuation is key to any aspect of planning as if a transfer is made or an exclusive licence is put in place at an early stage then the patent rights are hopefully still of a very modest value such that any income tax charge is bearable. However if matters are delayed whilst the business is being established then it is likely that the patent rights will increase in value considerably. This is a difficult position for the tax adviser to be in, but a likely one where SMEs are involved.

8.7 Splitting the rights?

As a matter of law, it would appear to be very difficult to split up patent rights such that some value is retained by the existing owner and only a certain amount transferred to a company. There is potentially scope to split up patent rights on a geographical basis as between different countries or larger regions but this is likely to be expensive from a legal and patent registration perspective and is unlikely to have much benefit from a tax perspective unless the patents in those new geographical regions subsequently produce significant value.

In this context it is worth noting that CTA 2009 s 845 only applies to companies subject to UK corporation tax, and so it is conceivable that an overseas company could be involved, but in order for such a planning strategy to work it would be necessary to avoid a tax charge under the transfer of assets abroad legislation in ITA 2007. This is likely to be difficult to achieve for UK-based individuals.

8.8 Holding the IP in a company – profit extraction

There are also income tax advantages to holding patent rights within a corporate structure as far as the extraction

of profits is concerned (see **Table 1**), however commercial factors mean that the owners of the patent rights and the shareholders in the company may not be identical.

Where Patent Box applies, and assuming an effective rate of corporation tax for the company of 10%, then it favours dividend income as opposed to royalty income as a method of extracting profit from a company.

Table 1 – Tax rates on profit extraction

Type of taxpayer	Royalty %	Dividend %
Basic rate	20%	10.0%
Higher rate	40%	32.5%
Additional rate	45%	37.5%

8.9 A comparison of holding structures

However it is not only income tax that needs to be considered as the ownership of patent rights within a trading company does also bring a number of other tax advantages (see **Table 2** below). On a sale the shares are likely to qualify for entrepreneurs' relief or alternatively on death or other succession planning then holdover relief should be available and business property relief would apply for inheritance tax purposes. None of these advantages are available to patent rights owned personally or in a standalone company which is not undertaking any other activity.

Whilst the tax issues for individuals in respect of patent rights have not been changed by the creation of the Patent Box regime, the potential attractiveness of a 10% corporation tax rate will cause many more companies to try and access the Patent Box regime and in turn will give rise to these personal income tax issues in respect of patent rights that very probably would not otherwise have been encountered.

9 Clients' patent policy

Many SMEs have not patented items or processes in the past. This could be because they did not understand the patent process, had decided it was too costly, or more usually that they did not want to disclose commercially sensitive information.

Table 2 – Comparison of tax issues on ownership structures

	Patent owned by Tradeco	**Patent owned by Holdco**	**Patent owned personally by an individual**
Patent Box regime available to user of patent	Potentially yes	Potentially yes	Potentially yes
Patent Box regime also available on income derived by owner of patent	N/A	Potentially yes	No
Patent income subject to: or	N/A	Corporation tax – potentially at 10%	Income tax at 20%, 40% 45%
Taxation on sale	CGT on shares – potentially 10% if entrepreneurs' relief applies	CGT on shares – potentially 10% if entrepreneurs' relief applies	Income tax at 20%, 40% or 45% (with spreading)
Taxation on death	Nil if BPR available on shares	Nil if BPR available on shares	IHT at 40%
Taxation on gift:			
To a spouse	No gain/no loss	No gain/no loss	No income tax or CGT should arise
Not to a spouse	Holdover relief potentially available	Holdover relief potentially available	CGT at 28% (18%)

Previously patents would be drafted as widely as possible to ensure that the fullest possible protection was gained from the patent. There may be a change of strategy now that we have Patent Box. This is because the legislation requires income to be derived from a patent. It will be easier and quicker to get a patent granted on a narrower area and, for the purposes of Patent Box, this may be sufficient.

It may also be the case that as time goes on further developments may mean that a company moves away from the core features covered in the patent such that the protection of the patent is no longer valid. This may be discovered subsequently if an action is taken.

Where a patent is subsequently found not to be valid then there is no mechanism to clawback any tax relief already granted.

10 How HMRC will deal with Patent Box claims

Where a company has a customer relationship manager or customer coordinator they should approach them in the first instance with any specific queries on Patent Box. Companies which do not have either of these contacts should contact the Maidstone R&D unit who will be dealing with Patent Box claims. Their contact details are Medvale House, Mote Road, Maidstone, Kent ME15 6AF. Tel: 01622 760405.

Though HMRC are not able to provide any advance clearance in respect of Patent Box claims it seems that they will be adopting a helpful and collaborative approach to making a claim.

11 Tax avoidance

CTA 2010 s 356FB deals with the situation where a company, entitled to a deduction under the Patent Box rules, is or has at any time been party to a scheme and the main purpose or one of the main purposes of the company (or any member of the group where relevant) is to obtain 'a relevant tax advantage'. 'A relevant tax advantage' is where an increased deduction is available under the Patent Box rules and this arises from:

- the avoidance of the operation of any of the Patent Box rules;
- artificially inflating the amount of relevant IP income in calculating the profits of the trade; or
- a mismatch between the expenses of acquiring or developing a qualifying IP right or licence and the income arising from it.

The scheme includes any scheme, arrangement or understanding of any kind whatsoever, whether or not it is legally enforceable and whether it involves a single transaction or two or more transactions.

At CIRD250130 HMRC provides guidance on when the anti-avoidance provisions would be invoked. These are worth quoting in full.

> 'When these powers should not be used
>
> Undertaking practical and commercially appropriate transactions will not be taken to be tax advantage schemes even if they have the effect of creating or enhancing Patent Box benefits.
>
> For instance, the following transactions will not be tax advantage schemes:
>
> - making an election under 357A (CIRD201020);
> - delaying an election under 357A until such time as the company begins to make relevant IP profits rather than relevant IP losses;
> - electing out of the regime once relevant IP profits become relevant IP losses (though of course no further S357A election will be possible within 5 years (CIRD260110));
> - creating IP holding companies to crystallise income from qualifying IP in the form of royalties;
> - separating trades with profitable qualifying IP income streams and those with non profitable income streams into different companies to allow decisions about whether or not to elect in to the regime to be made more easily;
> - inbound businesses creating separate IP development companies for overseas tax reasons and transferring the successfully developed IP within the UK group in order to manage their overseas CFC position; or
> - bringing qualifying IP into the UK.
>
> Companies may wish to make changes to their commercial arrangements in order to take advantage of the Patent Box. In general, where the resulting arrangements would not have been taken to be tax advantage schemes if they had been in place from scratch, then reasonable and commercially appropriate steps taken to restructure group arrangements to maximise benefits from the Patent Box will not be taken to be a tax avoidance scheme to which S357F to S357FB will apply.'

12 The election

To take advantage of the 10% Patent Box rate an election must be made under CTA 2010 s 357A. CTA 2010 s 357G provides that the election is made by giving notice to an officer of HMRC. The notice must specify the first

accounting period of the company for which the election is to have effect. The time limit for making the election is two years from the end of the accounting period.

The election will apply to all trades that are carried on by the company. The election will have effect for that accounting period and all subsequent accounting periods unless or until the election is revoked.

The company may revoke the election by giving notice to an officer of HMRC. This must specify the first accounting period of the company for which the revocation is to have effect. The time limit is two years from the end of the accounting period for which the election is to be revoked. Revocation has effect in relation to the specified accounting period and subsequent accounting periods. The company cannot then elect back into Patent Box until six years have elapsed.

13 The mechanics of the 10% rate

Unfortunately, the headline of 'a 10% tax rate on patents' undersells the complexity of the calculation necessary to take advantage of the regime. Added to this is the fact that the full benefit of the rate will not be available until April 2017 due to the phasing in.

The 10% rate of tax is effected by taking a deduction in the corporation tax computation for an amount calculated as follows:

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; and
- IPR is the special IP rate of corporation tax (ie currently 10%).

The calculation of RP is set out in chapter three and is an extensive calculation. The phased in benefit of the Patent Box is effected by FA 2012 Sch 2 Para 8(1) and treats RP as meaning the following:

In financial year:

2013 60% of RP;
2014 70% of RP;
2015 80% of RP; and
2016 90% of RP.

For the short period of time for which we will continue to have a small companies rate of corporation tax, the mathematics of the computation means that small companies have a lower rate than that which applies to large companies. In conjunction with the phase-in there are a range of tax rates on Patent Box profits depending on the financial year and the size of the company. These rates are shown below.

	Phasing in %	Main rate –tax rate %	Small companies rate–tax rate %
Apr 2013–Apr 2014	60%	15.20%	13.22%
Apr 2014–Apr 2015	70%	13.30%	12.67%
Apr 2015–Apr 2016	80%	12%	12%
Apr 2016–Apr 2017	90%	11%	11%
Apr 2017–Apr 2018	100%	10%	10%

Where an accounting period straddles a financial year then the profits will need to be apportioned across financial years and the relevant phasing in percentage applied to the relevant profits as necessary.

14 Calculating relevant IP profits

There are two ways to calculate relevant IP profits. Ch 3 sets out the standard calculation. Ch 4 sets out an alternative method known as streaming. We will look at each in turn.

In the rare case where the company has more than one trade the calculation will need to be made for each trade.

14.1 The standard calculation

Ch 3 sets out a seven step calculation to compute the relevant IP profits. Although the calculation appears complex at first, it can be broken down into several components which, when taken individually, appear more straightforward. However each element is arrived at through several detailed steps.

The calculation can be simplified as shown in **Equation 1**.

For those who are not mathematically minded, this may appear to be a cumbersome and incomprehensible formula. The diagram at **Appendix 1** may help. This illustrates how the total profits are whittled down to find relevant profits, which are effectively taxed at 10%.

The seven steps are the maximum number of steps in the calculation and not all will need to be considered with each claim. This is the 'standard' calculation. There is an alternative streaming calculation that can be used instead either through choice or if the compulsory conditions are met.

If the calculation gives a positive number this is your relevant IP profits of the trade; if the amount is negative

Equation 1

$$\frac{\text{Income from qualifying items}}{\text{Turnover}} \times \text{Profits of the trade} - (10\% \times \text{routine return} \times \frac{\text{Income from qualifying items}}{\text{Turnover}}) - \text{marketing royalty} + \text{profits during patent pending period}$$

then this is the relevant IP loss of the trade for the accounting period.

14.1.1 Step 1 – calculating the total gross income of the trade for the accounting period (TI) – CTA 2010 ss 357CA and 357CB

Total gross income of the trade is:

- any amounts which in accordance with generally accepted accounting practice (GAAP) are recognised as revenue in the company's profit and loss account or income statement for the accounting period and which are brought into account as credits in calculating the profits of the trade for the accounting period.

  If the company does not draw up accounts for an accounting period in accordance with GAAP then the amount to be included is any amount which would be so recognised if the company had drawn up such accounts;
- plus any of the following in so far as they are not already included in the above:
  - any amount of damages, proceeds of insurance or compensation which are brought into account as credits in calculating profits of the trade;
  - any receipts brought into account under CTA 2009 s 181 in calculating the profits of the trade. This is adjustment income arising on a change of basis;
  - any credits brought into account in respect of the realisation of intangible fixed assets in calculating the profits of the trade for the accounting period; and
  - any profits from the sale by the company of the whole or part of any pre-2002 patent rights held for the purposes of the trade and taxed under CTA 2009 s 912.

HMRC make it clear at CIRD220120 that amounts that do not fall under any of these headings such as transfer pricing adjustments and reversals of provisions are not taken into account in calculating the total gross income of the trade unless they are reflected in turnover.

Total gross income of the trade for the accounting period excludes any finance income such as credits in respect of loan relationships or derivative contracts as well as any amount recognised as arising from a financial asset in accordance with GAAP and any return which is economically equivalent to interest. Examples include any interest received or exchange gains on money debts.

14.1.2 Step 2a – calculating relevant IP income (RIPI) – CTA 2010 ss 357CC–357F

Relevant IP income is the sum of the following amounts.

Sales income

Income arising from the sale by the company of any of the following:

- Items in respect of which a qualifying IP right held by the company has been granted. This is known as a qualifying item.

  No claim can therefore be made on income arising before a qualifying IP right is held or after a qualifying IP right has lapsed or been disposed of.

  Though a patent may be granted in one jurisdiction only, for instance the UK, income from the worldwide sales of that item will still be included as sales under this heading.
- Items incorporating one or more qualifying items

  This is a generous heading as it includes income from the sale of items that incorporate the qualifying item. To qualify as incorporated the qualifying item must be physically part of the larger item and intended to be so for its operating life. The larger item is known as the 'parent item'. If the parent item and the qualifying item are sold together as a single unit or as part of single unit at a single price then both the qualifying item and the parent item will qualify as sales income.

  This was made clear at the committee stage of the passage of Finance Bill 2012. David Gauke (Exchequer Secretary to the Treasury) made clear in a response to a question about the sale of a car incorporating a patented braking system that whole of the income from the sale of the car would be included.
- Items that are wholly or mainly designed to be incorporated into either of the above

  This heading covers bespoke spare parts. HMRC guidance states that the spare parts will qualify as

long as the company holds a qualifying IP right for the item for which the spare parts are designed at the time that it was the spare parts.

HMRC give five helpful examples of incorporated items and packaging at CIRD220190 and these are reproduced below.

'Example 1

A patented printer cartridge is designed to be inserted in a printer and once installed not to be removed until empty, at which point it will be replaced. The printer cartridge will be incorporated in the printer. Income from the sale of a printer including the printer cartridge (whether the cartridge is installed or included separately in the box with the printer as part of a single package) can therefore qualify as relevant IP income, even if there were no patent over the printer itself.

Example 2

Conversely, if the printer includes a patented invention and the printer cartridge does not, then sales of the cartridges on their own (by the company holding the relevant patents) will qualify as items wholly or mainly designed to be incorporated into the printer provided that they are bespoke to that printer.

Example 3

In contrast, a patented DVD may be designed to work with a wide variety of DVD players and after each use is intended to be removed. So it is not incorporated in the DVD player, or designed to be incorporated.

So unless the DVD player is patented or includes a patented invention, including a patented DVD with it in a sale will not qualify the income from the player as relevant IP income (it is unlikely that the non-qualifying income would be trivial in this). Similarly, if the DVD player is patented and DVDs are not, sales of the DVDs will not produce relevant IP income.

Example 4

A company sells patented razor blades along with a non-patented handle, as a single item and for a single price. The handle is designed to incorporate the blade. As a result, the item is treated under S357CC(5) as a single item incorporating a patented item, and all income is relevant IP income.

[…]

Example 7

A company holds a patent over a system that consists of a number of individual items. Although the items are not all physically incorporated together they are functionally incorporated by virtue of a wireless/ infra-red connection. The company sells the system as a single unit for a single price. The item is the entire system and the income from the sale of the system would fall under Head 1.'

CTA 2010 s 357FA is an anti-avoidance section which deals with the incorporation of a qualifying item where the main purpose or one of the main purposes of incorporating the qualifying item is to turn the income into qualifying income. For example, where a patented chip is incorporated into a machine but the chip does not perform a function, then the income from the machine will not be qualifying income. HMRC has provided some clarification of how this section will work at CIRD250120. They state that 'this is intended to apply where a choice is made for tax purposes when there is no, or insignificant, commercial rationale. It is not intended to affect any reasonable commercial choice'.

Packaging

CTA 2010 s 357CC(3) deals with packaging. An item and its packaging are not to be treated as a single item unless the packaging performs a function essential for the use of the item for the purposes for which it is intended to be used.

So what is a 'function essential for the use'? HMRC guidance states that this means a function other than the normal function of packaging. Packaging is defined as any form of container or other packaging used the containment, protection, handling, delivery or presentation of the item, including by way of attaching the item to or winding the item around, some other article.

In exceptional cases the packaging may perform a function other than as packaging and therefore be an integral part of the product.

HMRC give two examples of packaging at CIRD220190. These are reproduced below.

'Example 5

A non-refillable medical inhaler may include a sleeve, a canister and the active ingredient plus gas and other contents inside the canister to ensure an effective and measured dose of the active ingredient is administered. It may be that each of these items the sleeve, the canister and the contents of the canister are patented.

But even if this is not the case, income from sale of the sleeve, canister and contents together will be within head 1 if any one of the components is patented. The packaging rule will not exclude either the sleeve or the canister, because they fulfil an essential function in the proper administration of the drug and therefore do not need to be considered as separate items.

Example 6

A company sells sandwiches in patented packaging that significantly extends their life on the supermarket shelves. The purpose for which the sandwich is intended to be used is human consumption. HMRC would not accept that extending the shelf-life of the sandwich is essential for that use. The income attributable to the packaging only, computed on a just and reasonable basis, would qualify.'

There are four possibilities when looking at an item and its packaging where the packaging does not perform an essential function. These are as follows.

- Non-patented contents and non-patented packaging

  This combination causes the fewest problems, as Patent Box will not apply to the income attributable to either item.

- Patented contents and patented packaging

  Similarly, where both the contents and packaging are patented then the whole of the sales income will qualify for Patent Box.

- Patented contents and non-patented packaging

  This would probably be the most common scenario, and is dealt with by HMRC's guidance at CIRD220180. The mixed income rule at CTA 2010 s 357CF will apply. This is considered further below. However for these purposes, it is sufficient to note that where a patented and non-patented item are sold together, a just and reasonable apportionment of the income is required. This is subject to CTA 2010 s 357CF(6) which does not require an apportionment in respect of packaging where the apportioned amount is a trivial proportion of the income. Therefore the income attributable to the packaging will also qualify for Patent Box where the attributable amount would be trivial.

  Trivial is not defined in the legislation, though HMRC guidance at CIRD220290 explains that 'figures in excess of 5% are unlikely to be trivial and figures below 5% will in most circumstances be likely to be trivial'.

- Non-patented contents and patented packaging

  Again, the mixed income rule at CTA 2010 s 357CF will apply to mean that the income justly and reasonably apportioned to the packaging will qualify for Patent Box.

Licence fees

This heading covers any licence fees and royalties which the company receives under an agreement granting another person rights over any qualifying IP rights held by the company or any other right in respect of a qualifying item or process. A qualifying process is a process in respect of which a qualifying IP right is held by the company.

In addition, any licence fees and royalties from other intellectual property rights granted under an agreement granting one of the above. The HMRC guidance at CIRD220210 makes clear that this will cover things such as designs, trademarks, know-how and technical information which are licensed at the same time to enable the licensee to manufacture and sell the items.

Proceeds of sale

This heading covers any income arising from the sale or disposal of a qualifying IP right or exclusive licence in respect of such a right. Where this relates to a post-2002 right, the 'income' will be the taxable credit which will be the excess of the proceeds of realisation over the amortised value in the accounts. For disposals of pre-2002 assets the 'income' will be the amount brought into charge to tax in that year.

Damages for infringement and other compensation

This covers any amount received by the company in respect of an infringement or alleged infringement of a qualifying IP right. The right must have been held by the company at the time of the infringement or alleged infringement.

It also covers any amount of damages, presses of insurance or other compensation which is paid in respect of any items covered by 'sales income' at the time of the event or is an amount in respect of lost income which had it been received would have represented relevant IP income.

To qualify under this heading the company must have been a qualifying company which was elected into Patent Box at the time of the event. It does not matter that the company is not a qualifying company when the income is received as under CTA 2010 s 357B(3) it is deemed to be a qualifying company.

Where the amount received relates partly to a time where either the company or the right was qualifying and partly to a time when either the company or the right were not qualifying then a just and reasonable apportionment needs to be carried out.

Notional royalties – CTA 2010 s 357CD

Where a patent is held over a process or tool used in the production process rather than over a product then the income from the sales of the product will not be relevant IP income. Instead, a notional royalty may be calculated to reflect the income attributable to the process. Subsection (3) provides that the notional royalty is treated as relevant IP income if the company so elects.

The notional royalty rules apply only to patents, i.e. those which fall within CTA 2010 s 357BB(1)(*a*)-(c), or an exclusive

licence in respect of these where the right are relevant qualifying IP rights.

A relevant qualifying IP right is where the total gross income of the trade of the company for the accounting period includes any income arising from things done by the company that involve the exploitation by the company of the right where the income is not relevant IP income or excluded income.

The effect of this section is to provide the benefits of Patent Box to companies which use patented processes or tools but which do not produce a patented product.

HMRC provide two examples at CIRD220250 of where a notional royalty may be calculated.

> 'Example 1
>
> Company X manufactures widgets. It holds a patent over the machine that makes the widget but the patent does not cover the widget itself. The sale of the widgets does not fall within head 1. The income from sale of the widgets for the purposes of the notional royalty provision will be "IP-derived income", to the extent that it is reflected in the company's total gross income.
>
> Example 2
>
> An airline company develops a flight simulator using one or more patented components. The simulator is used both to train its own pilots, and also generates income by providing a training facility to pilots of other airlines. The airline's own ticket sales and the direct income from the training facility provision are both non-relevant IP income that for the purposes of the notional royalty provision will be "IP- derived income".'

The notional royalty is the 'appropriate percentage' of the IP derived income for the accounting period. The 'appropriate percentage' is the proportion of any IP derived income which the company would pay another person for the right to exploit the relevant qualifying IP rights in that accounting period if the company were not otherwise able to exploit them.

In calculating the 'appropriate percentage' various assumptions are made. These are that:

- the parties are dealing at arm's-length;
- the company will have the right to exploit the relevant qualifying IP rights to the exclusion of any other person;
- the company will have the same rights in relation to the relevant qualifying IP rights as it actually has;
- the relevant IP rights are granted at the beginning of the accounting period or, if during the accounting period, on the day that they are granted;
- the appropriate percentage is determined at the beginning of the accounting period;
- appropriate percentage reply to each succeeding accounting period for which the company has the right to exploit relevant qualifying IP rights; and
- no other income will rise from the exploitation of the relevant qualifying IP rights.

In determining the 'appropriate percentage' the company must act in accordance with Article 9 of the OECD model tax convention and the OECD transfer pricing guidelines. HMRC have stated in their guidance that any enquiries by them into the computation of the notional royalty will be subject to the transfer pricing governance process as set out in the International Tax Manual at INTM480000 et seq.

Excluded income

Some sources of income are specifically excluded from being relevant IP income under CTA 2010 s 357CE. This includes any income arising from oil extraction activities or oil rights and any income which is justly and reasonably apportioned as attributable to a non-exclusive licence. HMRC provide an example of this at CIRD220280.

> 'Example 1
>
> A company has a licence to manufacture and sell products using a process patented in the UK, Germany and China.
>
> If the licence is exclusive in all three territories, then as the company holds an exclusive licence over a qualifying IP right (S357BA) and S357CE is not applicable. Chinese, German and UK income can all be relevant IP income.
>
> If the licence is exclusive in the UK and Germany and non-exclusive in China then S357CE(4) requires an apportionment of income to two notional licences; an exclusive licence covering UK and Germany and a non-exclusive licence covering China. The former income is relevant IP income but the latter is not, under S357CE(3).
>
> If the licence is exclusive in UK and China but not in Germany then S357CE(4) treats the German rights as a separate non-exclusive licence. S357CE(3) excludes this from relevant IP income, while the UK and Chinese licence income can qualify as relevant IP income.'

Mixed sources of income CTA 2010 s 357CF

This section covers two distinct scenarios.

- Where there is 'mixed income' – being the income from the sale of an item which qualifies under the

'sales income' heading together with an item which does not qualify where the items are sold together as part of a single unit for single price.

- Income paid under a 'mixed agreement' – being an agreement which generates relevant IP income as sales income, licence fees and royalties or income arising from the sale or disposal of qualifying IP rights or exclusive licence in respect of such, along with income which would not qualify as relevant IP income. This would include the sale of any other item, the grant of any other rights, any of the sale or disposal and the provision of any services.

Income arising in either of these circumstances as mixed income or income paid under a mixed agreement must be apportioned between qualifying non-qualifying amounts on a just and reasonable basis. Where any non qualifying element is a 'trivial proportion' of the income then all of the income will be relevant IP income. The meaning of trivial is discussed above under 'Packaging'.

14.1.3 Step 2b – calculating X%

Once we have calculated amounts for TI and RIPI, we need to calculate a percentage 'X%' as follows:

(RIPI/TI) x 100 = X%

14.1.4 Step 3a – calculating the profits of the trade CTA 2010 ss 357CG and 357CH

CTA 2010 ss 357CG and 357CH detail how to calculate the profits of the trade for Patent Box purposes. 'The profits of the trade' would at first glance appear to be one of the more straightforward elements of the calculation, however, an adjustment needs to be made for any 'shortfall in R&D expenditure'. This is considered further below.

Adjustments to taxable profit

Starting with the taxable profits of the trade, the following adjustments must be made.

- Additions to profit – any debits treated as expenses of the trade which are debits in respect of loan relationships or derivative contracts and the enhanced element of any R&D claim.
- Deductions from profit – any finance income treated as income of the trade. This is as defined in CTA 2010 s 357CB and is discussed above under step 1 (**14.1.1**).

Therefore for a typical SME the first stage of the calculation can be simplified as follows:

Taxable profits of the trade	+
Loan relationship debits	+
Enhanced element of R&D tax relief	

R&D shortfall adjustment

However, the first stage calculation set out in CTA 2010 s 357CG is subject to any adjustment calculated under CTA 2010 s 357CH. This requires an adjustment for any 'shortfall in R&D expenditure'.

It helps to step back at this point and consider what the calculation is trying to achieve. Steps 1, 2 and 3 of the calculation are trying to estimate the profits derived from the patented items.

HMRC's Corporate Intangibles Research and Development manual (CIRD) at 220410 explains the reason for the adjustment as follows:

> 'The key aim of 357CH is for companies newly entered into the Patent Box to provide a mechanism for attributing prior year R&D costs to current year profits. This is necessary only if current year R&D costs have significantly declined since the company's patent portfolio started to produce income; in other cases, current year ongoing R&D spend will be an adequate proxy for historic spend that gave rise to current income.'

HMRC's technical note which accompanied the Finance Bill clauses published in March 2012 adds the following.

> '3.88 This is to ensure that the Patent Box in these early years broadly applies to net income after all relevant annualised expenses have been taken into account, including pre-commercialisation R&D expenses.'

Therefore in arriving at the 'profits of the trade' for the purposes of the Patent Box calculation the profits of the trade are to be adjusted to reduce the profits where there has been a substantial reduction in R&D costs, as the current higher profits do not reflect the R&D expenses which have gone into producing the patent.

This means that companies with a consistently high R&D spend will not have a reduction in the profits, even where the current R&D is not relevant to the patented items that the income is derived from.

This adjustment is only ever a reduction in profits, never an increase.

An R&D shortfall adjustment can only ever arise in the first four years in which a company is elected into Patent Box (where the accounting periods are 12 months long).

To calculate the R&D shortfall, the company must calculate the average of its R&D spend in the four years before electing into the Patent Box. Where the company has not traded for four years before electing into the regime the average is calculated over the period from the commencement of trade.

The R&D expenditure taken into account for these purposes is defined by CTA 2010 s 357CG(6) as 'expenditure on research and development in relation to the trade.' HMRC's CIRD manual at 220410 clarifies that R&D expenditure for these purposes is 'the expenditure recognised in the company's statutory accounts under generally accepted accounting practice […]'. This is therefore actual expenditure on research and development per the accounts.

It has been confirmed with HMRC that this does not limit R&D to expenditure specifically described in the statutory accounts as R&D. The particular issue for SMEs is that often expenditure which could be validly described as R&D will not be disclosed as such in the statutory accounts, though the accounts will still comply with GAAP. This either means that SMEs will need to interrogate their records for the four years prior to the election into Patent Box to ensure they hold the relevant data or otherwise face an R&D shortfall adjustment despite having incurred sufficient R&D expenditure.

Mechanics of the adjustment

Firstly, the average amount of R&D expenditure must be calculated. To calculate the average amount the formula is:

(E/N) x 365

Where:

E is the amount of R&D expenditure that has been incurred by the company for the four years prior to the start of the first accounting period where they are elected into Patent Box. If they have been trading for fewer than four years then this period is the period from the date that they began to trade.

N is the number of days in that period.

Where an accounting period is less than 12 months the average amount of R&D expenditure is proportionately reduced.

Because of the way the averaging calculation is set out, the average can be a surprising result. Consider a company where the R&D spend for each of the four years is £1,000. The average using the formula above is £999.

The company must then calculate 75% of its average R&D expenditure. These numbers are fixed at the first calculation and are not re-calculated on a rolling basis.

The company must then compare its annual R&D spend with these two figures. If the annual R&D expenditure is in excess of the average, then no adjustment is necessary. The company will receive credit in the form of an 'additional amount' to carry forward to the extent that its annual R&D exceeds the average R&D.

If the R&D exceeds 75% of the average then no adjustment is necessary and no 'additional amount' is accrued or utilised.

If the R&D is less than 75% of the average R&D then the company must add any 'additional amount' brought forwards to the actual R&D and any remaining difference is an R&D shortfall to be deducted from the profits of the trade for the purposes of step 3. If there is no remaining difference then the additional amount carried forwards is reduced by the amount added to the average R&D amount.

A simple example may make this clearer.

Kwazii Limited has the following results:

Average R&D = £10,000. Therefore 75% = £7,500.

Accounting period	**1**	**2**	**3**	**4**
R&D	12,000	9,000	6,000	5,000
Additional amount b/f		2,000	2,000	500
Accrued / utilised	2,000	–	(1,500)	(500)
Additional amount c/f	2,000	2,000	500	–
R&D shortfall adjustment	–	–	–	2,000

14.1.5 Step 3b – multiply the profits of the trade by X%

If there are no profits, then calculate x% of the loss of the trade.

14.1.6 Step 4 – Deduct the routine return to calculate qualifying residual profit (QRP)

Next we have to deduct a routine profit element. This is to represent the profit that would have been made without access to the 'Patent Box' assets, based on a 'cost plus' method. HMRC state that 10% is used because 'a 10% return on certain specified costs as a representative routine return which it is reasonable to apply in respect of businesses across all sectors'. (CIRD220430.)

The calculation is set out in CTA 2010 ss 357CI–357CK and is calculated as follows:

Aggregate of routine deductions x 0.1 x X% (from step 2b, above).

The legislation stipulates what constitutes routine deductions. These must be deductions taken in calculating the company's trade profits for the purposes of corporation tax. These are as follows (but are subject to the list at CTA 2010 s 357CJ, below).

- Any capital allowances under the Capital Allowances Act (CAA) 2001.
- Costs of premises – any deductions made by the company in respect of any premises occupied by the company, including rent, rates, repairs and maintenance. 'Premises' includes any land.
- Personnel costs – any deductions made by the company in respect of any director or employee of the company or any externally provided workers. This includes employer's National Insurance contributions, both secondary Class 1 and Class 1A. It also includes share scheme and pension deductions.

  It will not include payments to self-employed consultants (though they may fall under miscellaneous services below).

  'Externally provided worker' has the same meaning as in CTA 2009 Pt 13 (ie for R&D relief purposes). It will not include any services provided by workers on activities that have been contracted out.
- Plant and machinery costs – any deductions made by the company in respect of any plant and machinery used by the company. This would include costs such as the costs of leasing, constructing, modifying, maintaining, servicing and operating.
- Professional services – any deductions made by the company in respect of legal services (other than IP-related services), financial services such as accounting, audit, insurance services, and valuation or actuarial services, services provided in connection with the administration or management of the company's directors and employees and any other consultancy services.

  'IP-related services' means services provided in connection with any application for a right to which the Patent Box rules apply or any proceedings relating to the enforcement of any such right.
- Miscellaneous services – any deductions made by the company in respect of the supply of water, fuel or power, telecommunications services, computing services (including computer software), postal services, the transportation of any items, and the collection, removal and disposal of refuse.

  Practically, this means that transport costs will need to be split from cost of sales and be included in the calculation of routine return.

  'Telecommunications service' means any service that consists in the provision of access to, and of facilities for making use of, any telecommunication system (whether or not one provided by the person providing the service).

Deductions which are not routine deductions are set out at CTA 2010 s 357CK. These are:

- any debits which are treated as expenses of the trade in respect of loan relationships or derivative contracts. This will include mortgage interest;
- any R&D expenditure on which an R&D claim is made (including the super-deduction element);
- any capital allowances on R&D under CAA 2001 Pt 6 or patents under CAA 2001 Pt 8;
- any relief for employee share acquisitions where the employees are engaged in R&D.

HMRC think that it would normally be clear whether an item was or was not a routine deduction. The CIRD at 220440 states

> 'Where there is doubt as to whether an expense is a routine one, HMRC would have regard to materiality of the sum in terms of its overall effect on the Patent Box claim in deciding the best way of allocating the amount. A routine deduction includes any exceptional item falling [under s357CJ].'

HMRCs view in respect of exceptional items is also set out in the same section:

> 'Routine expenses may include exceptional items that significantly affect the amount of profit that qualifies for the beneficial CT rate. There is no special rule for such expenses. This may be to the benefit of the company if the expense falls in a period for which no election into the regime has been made, or to its disadvantage if the expense has to be marked up in a period for which an election is in force.'

HMRC provides a useful table at CIRD220460 setting out some typical company expenses and showing whether these are routine deductions. This is reproduced below. Note that reference to the expense needing to be 'marked up' means that it is a routine deduction.

Expenses	Routine deductions?
Audit fees	Yes
Bank overdraft interest	No
Charitable donations	No
Client entertaining	No
Companies House fees	No
Contractors	Contractors will not have to be marked up provided they are provided through a service provider who supervises and

Expenses (cont'd)	Routine deductions? (cont'd)
	takes responsibility for their activities. Nor will they have to be marked up if they are self-employed workers operating on their own account and not under the terms of a contract between the contractor and a staff provider.
Credit check charges	The cost of obtaining credit rating reports represents the purchase of a financial service falling within Head 5 and will therefore need to be marked up.
Depreciation	No
Exchange losses	No
Group recharges	Group recharges will need to be marked up if the amounts are incurred on behalf of the claimant and they relate to expenses that would have been marked up if incurred by the company directly.
Human resources	Yes
Legal fees	Provided that the legal fees relate to the defence of qualifying IP rights they will not be routine deductions.
Marketing costs	If there is no element of consultancy they will not need to be marked up.
Mortgage interest	No
National Insurance	Yes
Raw materials	No
R&D costs	Provided that the R&D costs qualify for the R&D additional deduction (CIRD220400) they will not need to be marked up. The additional amount for which a CT deduction is given will also not be marked up.
Rent and rates	Yes
Repairs	Yes
Safety supplies	Yes
Salaries and pensions	Yes, pension contributions relating to both existing and past employees are routine deductions.
Scrap	No
Security guards	If the security guards are employees of the company they will need to be marked up. Otherwise, the same considerations that are relevant to contractors will apply.
Staff entertaining	Yes
Exceptional item	Exceptional items will be marked up if they fall into one of the heads in S357CJ and are not excluded under S357CK. It would be necessary to establish what the expense relates to.
Subscriptions	No
Water, light & fuel	Yes
VAT penalties	No

Where a company is a member of a group and another group company incurred expenses on their behalf, and if the expense had been incurred by the company it would have been a deduction in calculating the profits of the trade for the accounting period and the deduction would have been a routine deduction, then the company is treated for the purposes of the routine return calculation as having incurred the expense. This provision is aimed at stopping elements being removed from the routine return calculation by routing them through other group companies.

HMRC provide some clarification at CIRD220430 where one group company is performing a function for another in connection with its trade. In this case as long as the company is charging an arm's-length price that reflects the fact that it has taken on the economic risks and rewards of that function then no adjustment will need to be made.

If QRP is negative, then go to step 7 (if relevant).

14.1.7 The next step – removing the profit relating to branding and marketing

There are two methods for removing an element of profit which relates to the return on branding and marketing.

This adjustment attempts to reduce the amount of QRP by amount representing a royalty paid to a theoretical third party owner of the brand.

Either step five or step six will be completed to remove this element of profit. Step five is known as the 'small claims treatment' which can be used by election as long as the company meets the qualifying conditions. It is a formulaic method which is simpler to apply. Otherwise, companies must progress to step six.

14.1.8 Step 5 – small claims treatment – CTA 2010 ss 357CL and 357CM

Who can use the election?

A company may elect to use the small claims treatment if it meets either condition A or condition B for the accounting period.

- condition A is that the aggregate amount of QRP of each trade of the company for the accounting period does not exceed £1 million; or
- condition B is that the aggregate amounts of the QRP for each trade of the company for the accounting period does not exceed £3 million; and
- the company has not used step six to calculate their relevant IP profits in any previous accounting period beginning within the previous four years.

The £3 million limit is divided by the number of associated companies plus one which are also elected into Patent Box for the accounting period. It is also proportionately reduced for accounting periods of less than 12 months.

The definition of an associated company is as set out in CTA 2010 s 25 et seq.

Where any QRP for a trade is less than zero, this is disregarded in the above calculations.

This therefore gives the following results (ignoring associated companies):

- where QRP is less than £1 million a company can always elect for small claims treatment;
- where QRP is more than £3 million the company cannot elect for small claims treatment; and
- where QRP is between £1 million and £3 million the company can elect for small claims treatment if it has not used step six in the previous four years.

Calculating the small claims amount

The small claims amount in relation to each trade of the company for the accounting period is the lower of:

- the aggregate of QRP for all of the trades of the company multiplied by 75%; or
- £1 million (known as the 'small claims threshold') divided by the number of trades of the company.

The small claims threshold must be divided by the number of associated companies elected into the Patent Box plus one. Where any QRP for a trade is less than zero, this is disregarded in the above calculation.

The small claims threshold is proportionately reduced for accounting periods of less than 12 months.

The definition of an associated company is as set out in CTA 2010 s 25 et seq.

14.1.9 Step six – calculating the marketing assets return – CTA 2010 ss 357CN–357CP

If a company does not elect into small claims treatment then it must calculate the marketing assets return figure.

This is calculated as follows:

NMR – AMR

Where:

- NMR is the notional marketing royalty in respect of the accounting period; and
- AMR is the actual marketing royalty in respect of the accounting period.

If the difference between NMR and AMR is less than 10% of the QRP then it is not necessary to make any adjustment whatsoever and the marketing asset return is deemed to be nil. Similarly, where AMR is greater than NMR no adjustment needs to made.

Marketing assets are defined as:

- anything in respect of which proceedings for passing off could be brought including a registered trademark and anything which would be recognised as such under the law of the different country or territory;
- any sign or indication which designates the geographical region of goods or services; and
- any information which relates to customers or potential customers of the company (or another group member) and is intended to be used for marketing purposes.

The notional marketing royalty is the 'appropriate percentage' of the relevant IP income for the accounting period. The 'appropriate percentage' is the proportion of any relevant IP income which the company would

pay another person for the right to exploit the relevant marketing assets in that accounting period if the company were not otherwise able to exploit them.

In calculating the 'appropriate percentage' various assumptions are made. These are that:

- the parties are dealing at arm's-length;
- the company will have the right to exploit the relevant marketing assets to the exclusion of any other person;
- the company will have the same rights in relation to the relevant marketing assets as it actually has;
- the right to exploit the relevant marketing assets is granted at the beginning of the accounting period or, if during the accounting period, on the day that they are granted;
- the appropriate percentage is determined at the beginning of the accounting period;
- appropriate percentage reply to each succeeding accounting period for which the company has the right to exploit relevant marketing assets; and
- no other income will rise from the exploitation of the relevant marketing assets.

In determining the 'appropriate percentage' the company must act in accordance with Article 9 of the OECD model tax convention and the OECD transfer pricing guidelines. CIRD2201510 develops this theme further, and leads into the transfer pricing sections of the International Manual.

The actual marketing royalty to be taken into account is X%(as calculated in step 2) of the aggregate amount paid by the company for the purposes of acquiring any of the marketing assets or rights to them and which were brought into account in calculating the profit of the trade for the accounting period.

The key issue here for claimants, particularly SMEs in the B2B space, is that it may be possible to argue that the notional marketing royalty should be less than 10% of QRP, and therefore leave QRP unadjusted.

Clearly even if the claimant company could obtain the small claims treatment, it may decide that it does not wish to do so where it believes that it can demonstrate a notional marketing royalty of less than 25% of QRP as it will be better off, much better off if it can demonstrate a royalty rate of less than 10% as it will suffer no marketing assets adjustment at all.

The HMRC guidance is helpful in setting out where a marketing asset return may be considered to be lower than 10%, in particular B2B arrangements where customers are more interested in technical and regulatory requirements than branding. In addition they point to cases where there is a low level of marketing expenditure generally, and / or the absence of significant market competition.

In addition, HMRC includes three examples in the Manuals at CIRD220520 in relation to the operation of the notional marketing royalty. Of particular interest is Example 1, which suggests that where the claimant company has no marketing assets of its own because it licences the product to another person to manufacture and distribute, there will be no adjustment.

Conversely, where the claimant company is selling direct to consumers this may indicate that brand is more important, as well as significant expenditure on marketing and other related areas.

It should therefore not be forgotten that where the company can qualify for the small claims treatment, and it determines it has a significant marketing asset, the 25% reduction may in actual fact be attractive.

Bizarrely therefore, even though the small claims treatment is presumably designed for SMEs to make the calculation more straightforward, it seems unlikely that the majority will utilise it and instead a more detailed review of the true marketing royalty will be appropriate for many smaller companies who will be able to demonstrate a lower marketing asset return than 25% of QRP.

Nevertheless, HMRC do also underline the need for a facts and circumstances approach and so it should not be assumed that the notional marketing royalty can be avoided simply because you have a B2B model. Claimant companies will need to clearly document their logical and supportable thoughts to demonstrate that they have considered the level of royalty properly and this might include some advice from a specialist intellectual property valuation expert, comprising a basic functional analysis and benchmarking study if appropriate, particularly where the Patent Box claim is for a material sum.

What is clear however is that rarely should a claimant company opt for the small claims treatment without considering calculating a more accurate notional marketing royalty as a comparison.

14.1.10 Step seven – profits arising before the grant of right – CTA 2010 s 357CQ

Patents can take considerable time to be granted. In the meantime the company will suffer the full rate of corporation tax on any profits generated. However when the patent is granted, a deduction may be taken by election under CTA 2010 s 357CQ to reflect the profit in the previous six years in relation to the patent.

It should be noted that relief under this section is only available in respect of a right to, or exclusive licence in respect of, a patent granted under the Patents Act 1977, a

patent granted under the European Patent Convention or a right which corresponds to either of those rights and is granted under the law of one of the specified EEA States. That is, a right within CTA 2010 s 357BB(1)(*a*)-(*c*) which excludes a supplementary protection certificates and plant breeders rights.

The relief can be due where the company holds the right or would have held the right except that they have disposed of it before the right was granted.

In the accounting period that the right is granted, the company can elect that an additional amount is added to the relevant IP profits of the trade.

To take advantage of step seven, a company must have been elected to the Patent Box regime in each of the years for which it would like to claim an additional deduction. The fact that the right had not yet been granted must be the only reason that the company does not qualify.

To take advantage of this relief the company must look back six years before the grant of the right and recalculate its relevant profits for each accounting period. Once on the basis of what the actual relevant profits were and once on the basis of what they would have been if the qualifying right had been granted. The RIPI in the year of grant can then be increased by the additional amount. The whole additional amount will be added in the year of grant, despite the fact that this may reflect several years' worth of expenditure.

There is no look back beyond April 2013 because it was not possible to have elected into Patent Box before that point.

14.2 Streaming – an alternative method to calculate relevant IP profits

In certain cases a straightforward apportionment of profit based on turnover may under- or over-allocate profits to RIPI. A streaming option is available for a company to consider and enter into, and is particularly attractive where the pro rata approach gives a lower RIPI than had the streaming approach been used instead.

In essence streaming requires a just and reasonable apportionment of a company's expenses rather than merely adopting the basic pro rata approach. The streaming option becomes mandatory in certain circumstances, including where a company receives substantial amounts of licensing income not qualifying as RIPI.

14.2.1 The election

The company will make the election to opt into streaming within the tax computation for that period. This will be evident by the way in which the calculation is assembled, however for completeness the computation should state that the streaming election under CTA 2010 s 357D(1) has been made.

The streaming election has effect for the accounting period for which it is made, and all other subsequent accounting periods, however the claimant may in effect opt back out of streaming if it can show that the pro rata approach is just and reasonable – see below.

14.2.2 Streaming steps

Once a streaming election has been made a number of steps should be followed to determine the streamed RIPI.

1. All amounts brought in as taxable credits of the trade in the accounting period, excluding transfer pricing adjustments and finance income, are divided into two streams of income – RIPI and non-RIPI.

   See above under step 2a for amounts which are and are not RIPI.

2. Debits deducted in arriving at taxable trading profit, excluding any loan relationship and derivative contact debits and any enhanced R&D deductions (but including any amount brought in by the R&D shortfall rules), are then allocated to the stream to which they relate on a just and reasonable basis.

3. The company deducts the debits allocated against the RIPI stream to carry forward to the routine return adjustment in the main calculation.

The only differences from the normal calculation after this point are in calculating the marketing assets return. Instead of multiplying by x% to calculate AMR, the amount allocated to the RIPI stream is treated as AMR.

14.2.3 'Just and reasonable'

This is a well-trodden concept for most tax practitioners which just means that the allocation must be commercially appropriate and justifiable.

It is important to note that the approach must be consistent year on year unless something happens that makes that previously used approach inappropriate. In such a case the company can select an alternative approach, or it may decide that the simple pro rata approach gives a more accurate outcome.

14.2.4 Mandatory streaming

There are three conditions, and where any of them are met streaming becomes mandatory for the claimant company.

- Amounts taken into account in calculating trading profits include substantial amounts that are not fully recognised as revenue in accordance with GAAP.
- The total gross income of the trade includes not only RIPI but also a substantial amount of licensing income that is not RIPI.
- The trade generates income that is not RIPI and the company receives a substantial amount of RIPI

from licences it grants, if that licensing income is attributable to rights that the company itself holds through exclusive licences.

This is intended to deal with conduit arrangements where what would be RIPI flows into the company, and then out of the company to a head licensor. In such cases the pro rata approach would not be appropriate as it would artificially inflate claims – hence streaming is required.

'Substantial' in this context means the lower of £2m or 20% of the total gross income of the trade for the accounting period in question. However, if the lower of these two amounts is £50,000 or less, then the mandatory streaming condition is not met (CIRD 230140).

Claimant companies will need to assess whether or not they need to consider streaming. For some this might be straightforward to determine, however for many it may not be so clear.

Whilst a simple pro-rata approach can be used to reduce the 'compliance burden', to ensure that maximum benefit is gained from the Patent Box the 'normal' calculation should be compared against a streamed outcome to determine which is the most beneficial for the claimant to take.

15 Patent Box losses

A company may derive income from qualifying IP rights, but may not return a profit on that income. This is particularly likely to be the case in the early stages of development. Alternatively the income may return a profit but that profit is less than the routine return on the costs of earning the income. In this case the calculation of relevant IP profits ('RP') will result in a negative figure which is referred to in the legislation as a relevant IP loss (CTA 2010 s 357C(3)), but commonly referred to as a 'Patent Box loss'.

Due to the nature of the calculation of RP, it is possible for a profitable company, possibly incurring significant corporation tax liabilities, to be in a Patent Box loss position. This is likely to be the case where the company also has significant income and profits generated otherwise than from qualifying IP rights, or where the margin achieved on the qualifying IP income is relatively low.

The implications of a Patent Box loss arising when the company is elected into the Patent Box regime, is a limitation upon the benefit of the Patent Box deduction for future RP as it is necessary to set off prior Patent Box losses before a Patent Box deduction is given. The set off rules are covered below.

15.1 First considerations

Before electing into the regime, companies should carry out some initial calculations of their potential RP in order to identify whether they will be in a Patent Box loss position. It should not be assumed that as the company is profitable for corporation tax purposes, it will be beneficial to elect into the regime, as this is not necessarily the case. The timing of the election can be important to maximising the benefits.

If a Patent Box loss will arise it will generally be beneficial for the company to delay electing into the regime in order to prevent the benefit of the Patent Box deduction from being eroded by accruing Patent Box losses which must then be set off.

A low margin on the qualifying IP income which causes a Patent Box loss may be temporary, for example due to the products being in the early stages of commercialisation and still incurring development costs or due to high overheads, or it may be a longer term position due to high royalty fees being payable if the qualifying IP in question is an exclusive licence. If the low margin is temporary then the potential RP should be monitored annually to identify the correct period in which to elect into the regime. If the low margin is more permanent, then the regime is unlikely to deliver any significant benefit to the company.

Conversely, it is not necessarily the case that a company which makes a loss for corporation tax purposes in a period will have a Patent Box loss, The company may have other activities which incur losses, whilst the qualifying IP income is profitable. If this is the case and the company has positive RP, then it is worthwhile making the Patent Box election as the deduction will further augment the losses carried forward for offset against future profits of the same trade.

15.2 A Patent Box loss is not a real loss

A Patent Box loss is not a real loss, but a fictional one within the Patent Box regime. It is therefore not to be confused with a normal corporation tax trading loss of the company. The company is able to deal with its actual trading loss as though it had not elected into the Patent Box regime. Therefore if a Patent Box loss arises in a period in which the company is elected into the regime, this does not prevent the company from relieving its actual loss against other profits within the company, surrendering it as group relief or carrying it back or forward against profits of the same trade.

The fictional Patent Box loss however will remain with the company to be set off against future RP (unless it is set off by another group company), even if the actual loss which this amount represents has been otherwise utilised.

15.3 The set off rules for Patent Box losses

If a Patent Box loss arises then this must be set off. The rules concerning set off are laid out in CTA 2010 ss 357E–357EF and guidance is given in the HMRC Manuals at CIRD240000 to CIRD240170.

The Patent Box loss must be set off in the following order:

1. If the company has another Patent Box trade and that trade has RP in the same period, then this must be reduced by setting off the Patent Box loss. The maximum set off will be to reduce the RP to nil.
2. If the company is a member of a group (and this has its wide Patent Box definition) and another company within that group is a 'relevant group member' (see below for definition) then that RP must be reduced by setting off the Patent Box loss. The maximum set off in any group member will be to reduce the RP to nil.
3. If after 1 and 2 above, a Patent Box loss remains for an accounting period, this must then be carried forward against any RP that would otherwise arise in the following accounting period for the same trade.
4. If the RP of the same trade in the next accounting period is insufficient to set off the brought forward Patent Box loss, then it must be set off as per 1 and 2 for that accounting period (i.e. against RP of another trade of the company and then against RP of relevant group members).
5. If the Patent Box loss has still not been set off in full, or has been augmented by further Patent Box losses, then this Patent Box loss carried forward to subsequent periods to be set off in the same manner.

15.4 Set off of Patent Box losses between relevant group members

A 'relevant group member' means another member of the group that has elected into the Patent Box regime and is a qualifying company for the relevant accounting period.

Where there is more than one relevant group member, the group members may jointly determine the order in which the set off is made. If no determination is made then the set off is automatically made against the group member trade with the highest RP, then the second highest etc. until the Patent Box loss is fully offset or the RP of all group members is reduced to nil.

Some benefit may be gained by making a joint determination if group members with RP are suffering corporation tax at different rates, in which case setting off the Patent Box loss against the group member suffering the lowest rate of corporation tax will preserve the Patent Box deduction in the company which will gain the greatest benefit.

A further consideration would also be whether a determination to set off against RP in a particular group member will enable any group member to avoid paying corporation tax by instalments for that accounting period.

15.5 Payments between group members for allocations to set off Patent Box losses

Tax free payments can be made between group companies to compensate for RP being reduced by Patent Box losses of other group companies being set off (CTA 2010 s 357EF).

The income for the recipient is not treated as taxable income (or an allowable deduction) for corporation tax purposes, nor is it treated as a distribution. The payment must not exceed the reduction in RP being set off, i.e. a maximum of £1 can be paid by the Patent Box loss company for each £1 of RP set off.

This works in the same way as payment for group relief surrenders. It is likely that as is the common practice for payments in respect of group relief claims, payments will tend to reflect the tax effect of the set off, rather than the gross adjustment (e.g. 20% of the amount set off for companies subject to the small company rate of corporation tax).

15.6 Company ceasing to trade

If a company has a Patent Box loss in relation to a trade and the company either:

- ceases to carry on the trade;
- ceases to be within the charge to corporation tax; or
- the Patent Box election made by the company ceases to have effect (i.e.it is withdrawn by the company),

the Patent Box loss must be transferred to be set off in the following order:

- against any RP of any other trade carried on by the company;
- against any other group member that is a qualifying company in the relevant accounting period (the accounting period immediately following the accounting period in which the company ceases to be within the charge to corporation tax in respect of that trade).

A group can decide which member with RP is to be allocated the Patent Box loss. If it does not, then like the general loss set off rules above, the set off goes in order to the companies with the largest RP for the relevant accounting period.

If all relevant group members also have Patent Box losses to be carried forward then the Patent Box loss in respect of the cessation is transferred to the company with the largest Patent Box loss.

15.7 Transfer of trade between group members

Where a group company with a Patent Box loss to be carried forward, transfers that trade to another group member, the Patent Box loss is also transferred. The transferred loss is treated as a Patent Box loss of the period in which the transferee begins to carry on the trade.

15.8 Additional planning considerations

If a company has more than one stream of qualifying IP income and one of these income streams produces a Patent

Box loss whilst the other incomes generate positive RP, it may be worthwhile considering separating these activities by transferring the qualifying IP and related activities of the income stream which creates a Patent Box loss into a separate company. If this transfer is to a group company then this can generally be achieved on a tax neutral basis. This will be particularly relevant for companies with qualifying IP which is fully commercialised and also have other qualifying IP which is still in development and therefore not generating losses.

Once the activities and qualifying IP are separated, the company with the commercialised products can elect into the regime and claim a maximised deduction due to a higher level of RP. The company with the loss generating qualifying IP should not elect into the regime until it generates positive RP.

There is no requirement to set off the Patent Box loss whilst no election into the regime has been made as the company will not be a relevant group member.

16 Elections under Patent Box

There are five different elections that can be made under the Patent Box rules. The diagram at **Appendix 2** summarises these.

The various permutations and considerations of the results with any or all of these will need to be considered by the adviser when advising the client whether or not to make any of the elections. This may well be a time-consuming exercise as calculations may need to be undertaken using various different assumptions.

One particular issue for the SME is the quality of accounting data and the ability and willingness of the client to get this extracted for the purposes of the calculations. This may affect whether a streaming calculation is possible and similarly whether a small claims election should be made where this is available rather than undertaking the calculation of a notional marketing royalty which will rely on extracted data.

17 An extended example

A comprehensive SME example will hopefully make the application of the Patent Box easier to understand. The company has no associated companies or companies which would be considered group companies under the Patent Box rules and only has one trade.

Jack in the Box Limited (JITB) is a company which has been designing and manufacturing specialised children's books for five years. The books have various buttons which, when pressed, make a range of noises, depending on the content of the book. The books contain a chip which JITB holds a UK patent over.

The books sell for £10 each. The costings for these are as follows. The income has been apportioned on a just and reasonable basis. 250,000 units were sold in the year.

	Cost	Profit	Income
Book	3.75	1.00	4.75
Chip	1.20	4.00	5.20
Packaging	0.05		0.05
	5.00	5.00	10.00

The packaging does not perform a function essential for the use of the book.

The company's R&D expenditure which qualified for tax purposes for the previous four years was:

Year ended 31 March 2010	120,000
Year ended 31 March 2011	250,000
Year ended 31 March 2012	275,000
Year ended 31 March 2013	220,000

Its profit and loss account for the years ended 31 March 2014 is as follows:

Income from products including chip	2,500,000	
Income from other products	4,000,000	
		6,500,000
Cost of sales		(2,500,000)
Rent	250,000	
Rates	30,000	
Repairs	3,000	
Depreciation	35,000	
Water	20,000	
Electricity	50,000	
Gas	10,000	
Phone and internet	60,000	
Insurance	25,000	
Wages and salaries	550,000	
Employer's NIC	60,000	
Pension contributions	50,000	
Plant hire	30,000	
Legal fees	2,500	
Accounts and audit	5,000	
Entertaining	5,000	
R&D	150,000	
Computer costs	125,000	
Postage and stationery	7,000	
		(1,467,500)
Rents receivable		5,000
Interest receivable		3,500

Bank interest payable		(60,000)
Profit before tax		**2,481,000**

Its taxable profits from the trade are as follows:

Profit per accounts		2,481,000
Add:	Depreciation	35,000
	Legal fees	2,500
	Entertaining	5,000
	Rental property expenses	1,500
Less:	Capital allowances	(50,000)
	Enhanced R&D deduction	(187,500)
	Rents receivable	(5,000)
	Interest receivable	(3,500)
Tax adjusted profits		2,279,000

The process for assessing the Patent Box claim for the year ended 31 March 2014 is shown on the following pages. This assumes that the standard calculation is used (and not streaming).

Step 1 – calculate the total gross income of the trade for the accounting period (TI)		
Any amounts recognised as revenue in the company's profit and loss account under GAAP and which are brought into account as credits in calculating the profits of the trade for the accounting period.	£6,500,000	
Any amount of damages, proceeds of insurance or compensation which are brought into account as credits in calculating profits of the trade.	–	
Any receipts brought into account under CTA 2009 s 181 in calculating the profits of the trade. This is adjustment income arising on a change of basis.	–	
Any credits brought into account in respect of the realisation of intangible fixed assets in calculating the profits of the trade for the accounting period.	–	
Any profits from the sale by the company of the whole or part of any pre-2002 patent rights held for the purposes of the trade and taxed under CTA 2009 s 912.	–	
Total of amounts under step 1 – This is TI		TI: £6,500,000
Step 2a – calculate relevant IP income (RIPI) and calculate X%		
Income from items in respect of which a qualifying IP right held by the company has been granted (a qualifying item).	Chip incorporated into another item	
Income from items incorporating one or more qualifying items.	Book incorporates a qualifying item – £9.95 per unit x 250,000 units = £2,487,500	
Income from items that are wholly or mainly designed to be incorporated into either of the above (bespoke spare parts)	–	
Licence fees and royalties	–	
Proceeds of sale	–	
Damages for infringement and other compensation	–	
Notional royalties calculated using transfer pricing principles	–	
Income from the sale of an item which qualifies under the 'sales income' heading together with an item which does not qualify where the items are sold together as part of a single unit for single price – qualifying amount	Packaging = 0.05% of income. Trivial therefore include. 0.05 x 250,000 units = £12,500	
Income paid under a 'mixed agreement' – being an agreement which generates relevant IP income along	–	

with income which would not qualify as relevant IP income – qualifying amount.		
Total of amounts under step 2a – This is RIPI	£2,487,500+£12,500	RIPI: £2,500,000
Step 2b – calculating X%		
(RIPI/TI) x 100 = X%	2,500,000/6,500,000 x 100 = 38.46%	X%: 38.46%
Step 3a – calculate the profits of the trade including any R&D shortfall adjustment		
Shortfall in R&D expenditure:		
R&D in four years before election = E	(120,000+250,000+275,000+220,000) = £865,000	
Number of days in the period = N	(365x3)+366 = 1461	
Average R&D in four years before election = E/N x 365	865,000/1,461 x 365 = £216,102	
75% of Average R&D	£216,102 x 75% = £162,076	
Actual R&D in the year	£150,000	
Then, either:		
Option 1 Annual R&D expenditure is in excess of the average. Calculate the 'additional amount' to carry forward to next year: Actual – Average = No shortfall adjustment is necessary	–	Additional amount to carry forward
Or option 2 R&D exceeds 75% of the average. No 'additional amount' is accrued or utilised. No shortfall adjustment is necessary	–	
Or option 3 R&D is less than 75% of the average R&D and there is an additional amount b/f and c/f. Add the 'additional amount' brought forwards to the actual R&D until the 75% threshold is reached. Reduce the additional amount by the amount added. Carry forward any remaining additional amount. No shortfall adjustment is necessary	–	Additional amount to carry forward
Or option 4 R&D is less than 75% of the average R&D. Add any 'additional amount' brought forwards to the actual R&D. Any remaining difference is an R&D shortfall amount Reduce the additional amount to zero.	Additional amount b/f = nil £162,000-£150,000 = £12,076	R&D shortfall amount to be deducted: £12,076
Additional amount memo		
Brought forwards	–	

Accrued	–	
Utilised	–	
Carried forwards	–	
1. Taxable profits of the trade	£2,279,000	
2. Add: Loan relationship and derivative contract debits	£60,000	
3. Add: Enhanced element of R&D tax relief	£187,500	
4. Less: Finance income treated as income of the trade	–	
5. Less: R&D shortfall (calculated above)	b/d £12,076	
Sum of 1–5	£2,279,000+£60,000+£187,500-£12,076 = £2,514,424	Profits of the trade: £2,514,424
Step 3b – multiply the profit or loss of the trade by X%		
Profit or loss of trade x X%	£2,514,424 x 38.46%	Total after step 3: £967,047
Step 4 – Deduct the routine return to calculate qualifying residual profit (QRP)		
Calculate routine deductions using legislation and HMRC list	Rent 250,000 Rates 30,000 Repairs 3,000 Less: Rental property expenses (£1,500) Water 20,000 Electricity 50,000 Gas 10,000 Phone and internet 60,000 Insurance 25,000 Wages and salaries 550,000 Employers NIC 60,000 Pension contributions 50,000 Plant hire 30,000 Legal fees 2,500 Less: Companies house filing fee (£13) Patent attorney fees (£500) Accounts and audit 5,000 Computer costs 125,000 Postage and stationery 7,000 Capital allowances £50,000 (Non-routine deductions = Depreciation, R&D, bank interest, rental property expenses, entertaining (client)) Total = £1,325,487	
		Routine deductions: £1,325,487

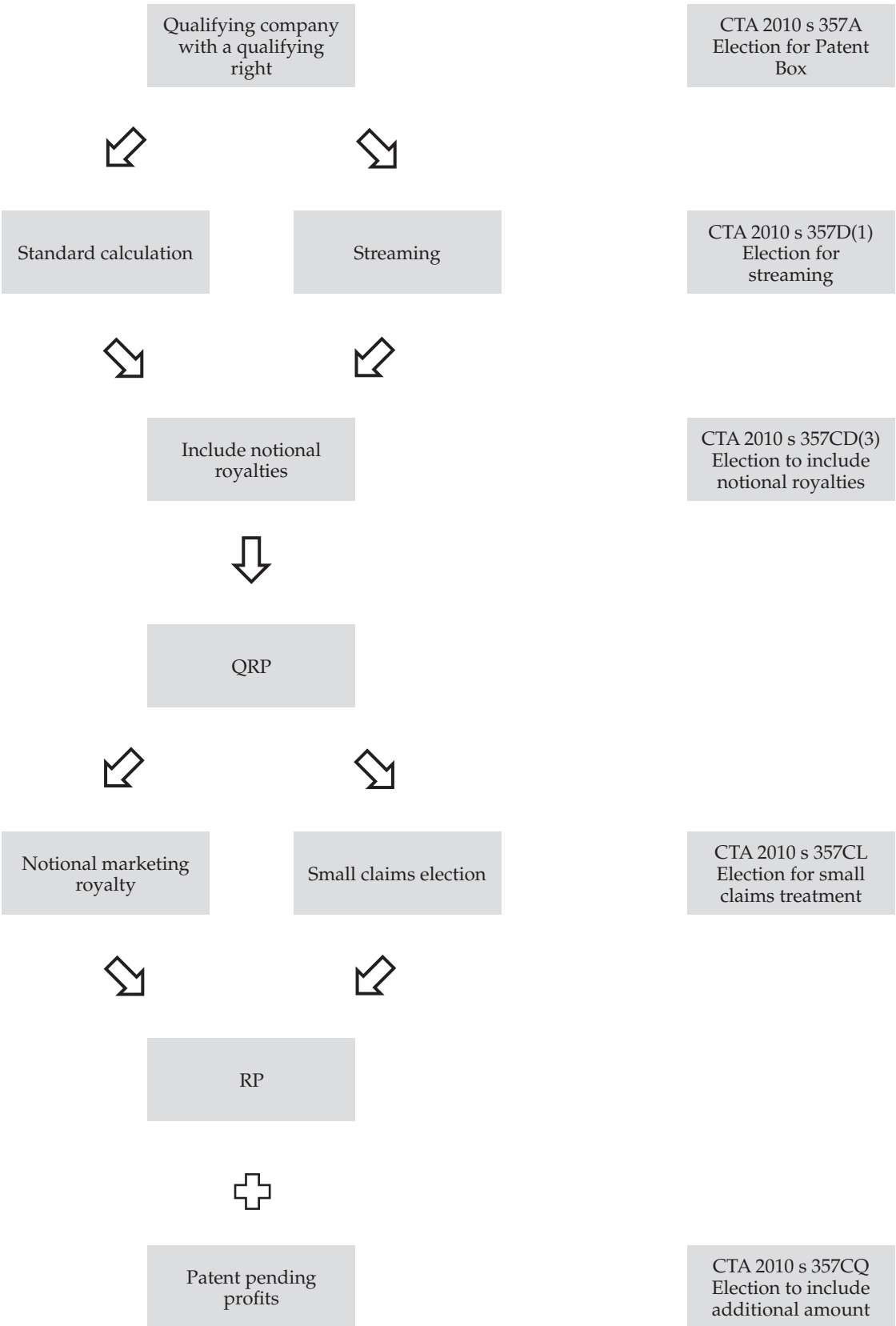
Routine return = aggregate of routine deductions x 0.1 x X%	£1,325,487 x 0.1 x 38.46% = £50,978	Routine return: £50,978
To calculate QRP, deduct routine return from total after step 3.	£967,047 - £50,978 = £916,069	QRP: £916,069
Step 5 and 6 – small claims treatment or notional marketing royalty Can only use small claims amount if condition A or B is met: check		
Condition A is that the aggregate amount of QRP of each trade of the company for the accounting period does not exceed £1 million or	✓ – the company has agreed to use this method as calculating a marketing royalty would be too time consuming.	
Condition B is that the aggregate amounts of the QRP for each trade of the company for the accounting period does not exceed £3 million and The company has not used step six to calculate their relevant IP profits in any previous accounting period beginning within the previous four years. Is condition A or B met? If so use step 5. If not, go to step 6.	n/a – meets condition A	
Either: Step 5 – small claims treatment		
Small claims amount is the lower of: the aggregate of QRP x 75%; or £1 million	£916,069 x 75% = £687,052 is lower than £1m, so this is the small claims amount.	Small claims amount: £687,052
Or Step 6 – notional marketing royalty		
Calculate the 'appropriate percentage' using transfer pricing principles	–	%
Multiply RIPI by the appropriate percentage to give NMR	–	NMR
Identify marketing royalties paid and multiply by X% from step 2 to give AMR	–	AMR
Deduct AMR from NMR. If the result is negative, or less than 10% of QRP (calculated above) no adjustment is needed.	–	MAR (if adj needed)
Deduct MAR from QRP if adjustment is needed	–	Total after step 6
Step 7 – Profits arising before the grant		
If a patent has been granted in the year recalculate profits for up to six previous years as if Patent Box applied.	–	Total to be added to RIPI
Then recalculate from step 2 onwards	–	Total after step 7

Calculating the deduction		
Identify relevant profit. Depending on the number of steps this could be the small claims amount, total after step 6 or total after step 7.	Small claims amount = £687,052	Relevant profit: £687,052
Tax deduction = RP x ((MR– IPR)/MR) Remember to adjust RP for phase in % and MR for changes	(£687,052 x 60%) x ((23-10)/23) = £233,000	Tax deduction: £233,000

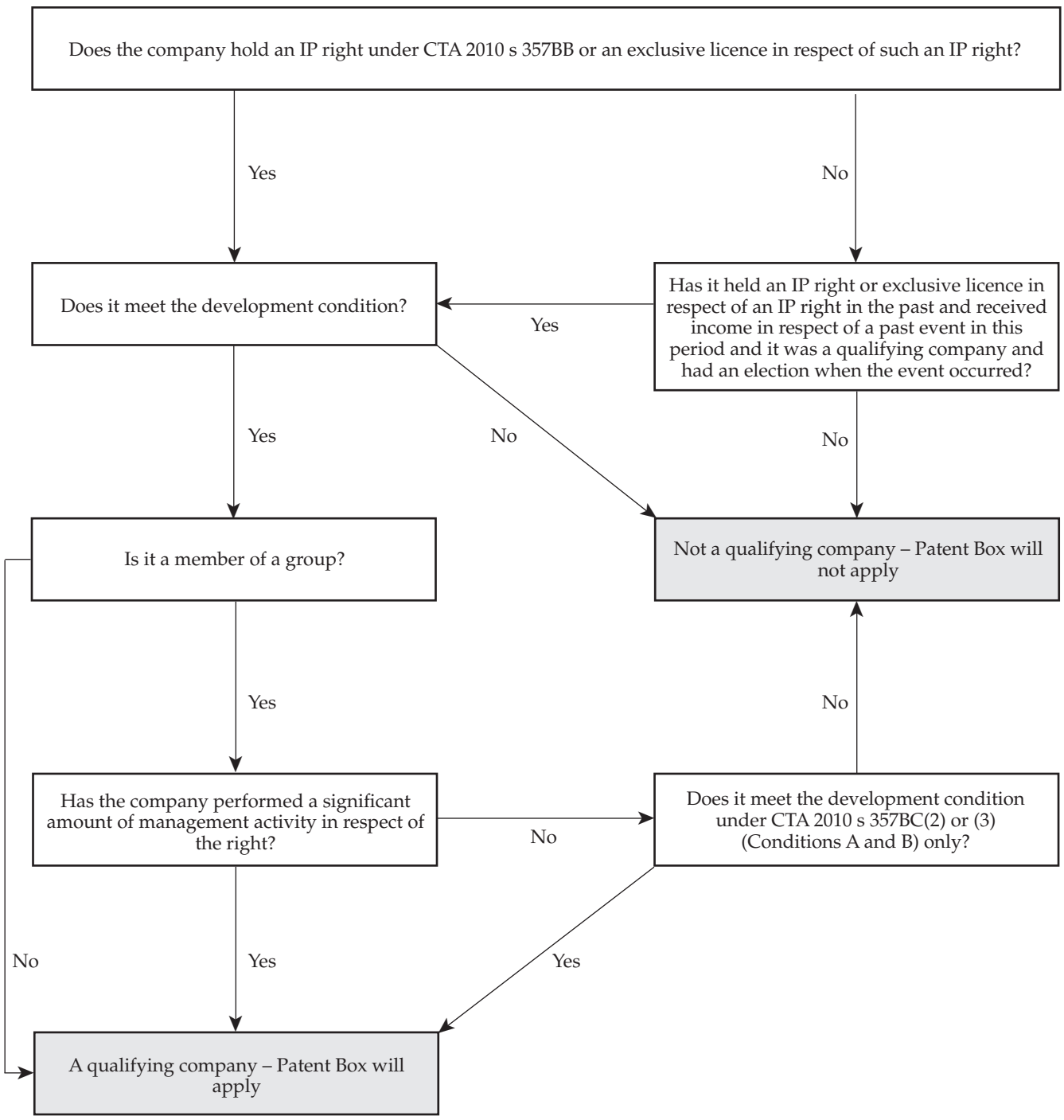
Appendix 1: Diagramatic representation of Patent Box

<table>
<tr><td colspan="6">Total profits</td></tr>
<tr><td colspan="5">Trade profits</td><td></td></tr>
<tr><td colspan="4">Profits attributable to patents = Patent income / total income x adjusted trade profits</td><td>Profits not attributable to patents</td><td>Capital gains, interest receivable, rent receivable</td></tr>
<tr><td colspan="3">Qualifying residual profits (QRP)</td><td>Routine return (routine deductions x 10% x patent income / total income)</td><td>Profits not attributable to patents</td><td>Capital gains, interest receivable, rent receivable</td></tr>
<tr><td colspan="2">Relevant profits (RP)</td><td>Marketing return = NMR-AMR or small claims (lower of £1m or 75% x QRP)</td><td>Routine return (routine deductions x 10% x patent income / total income)</td><td>Profits not attributable to patents</td><td>Capital gains, interest receivable, rent receivable</td></tr>
<tr><td>60% of RP in year 1 of phase in</td><td>Non-qualifying RP during phase in to 2017</td><td>Marketing return = NMR-AMR or small claims (lower of £1m or 75% x QRP)</td><td>Routine return (routine deductions x 10% x patent income / total income)</td><td>Profits not attributable to patents</td><td>Capital gains, interest receivable, rent receivable</td></tr>
</table>

Appendix 2: Elections available under Patent Box



Appendix 3: Is the company a qualifying company?



Appendix 4: Calculating the Patent Box deduction (standard calculation) – a blank pro forma

Step 1 – calculate the total gross income of the trade for the accounting period (TI)		
Any amounts recognised as revenue in the company's profit and loss account under GAAP and which are brought into account as credits in calculating the profits of the trade for the accounting period.		
Any amount of damages, proceeds of insurance or compensation which are brought into account as credits in calculating profits of the trade.		
Any receipts brought into account under CTA 2009 s 181 in calculating the profits of the trade. This is adjustment income arising on a change of basis.		
Any credits brought into account in respect of the realisation of intangible fixed assets in calculating the profits of the trade for the accounting period		
Any profits from the sale by the company of the whole or part of any pre-2002 patent rights held for the purposes of the trade and taxed under CTA 2009 s 912.		
Total of amounts under step 1 – this is TI		TI
Step 2a – calculate relevant IP income (RIPI) and calculate X%		
Income from items in respect of which a qualifying IP right held by the company has been granted (a qualifying item).		
Income from items incorporating one or more qualifying items.		
Income from items that are wholly or mainly designed to be incorporated into either of the above (bespoke spare parts).		
Licence fees and royalties		
Proceeds of sale		
Damages for infringement and other compensation		
Notional royalties calculated using transfer pricing principles		
Income from the sale of an item which qualifies under the 'sales income' heading together with an item which does not qualify where the items are sold together as part of a single unit for single price – qualifying amount		

Income paid under a 'mixed agreement' – being an agreement which generates relevant IP income along with income which would not qualify as relevant IP income – qualifying amount		
Total of amounts under step 2a – this is RIPI		RIPI
Step 2b – calculating X%		
(RIPI/TI) x 100 = X%		X%
Step 3a – calculate the profits of the trade including any R&D shortfall adjustment		
Shortfall in R&D expenditure:		
R&D in four years before election = E		
Number of days in the period = N		
Average R&D in four years before election = E/N x 365		
75% of average R&D		
Actual R&D in the year		
Then, either:		
Option 1 Annual R&D expenditure is in excess of the average. Calculate the 'additional amount' to carry forward to next year: Actual – Average = No shortfall adjustment is necessary		Additional amount to carry forward
Or option 2 R&D exceeds 75% of the average. No 'additional amount' is accrued or utilised. No shortfall adjustment is necessary		
Or option 3 R&D is less than 75% of the average R&D and there is an additional amount b/f and c/f. Add the 'additional amount' brought forwards to the actual R&D until the 75% threshold is reached. Reduce the additional amount by the amount added. Carry forward any remaining additional amount. No shortfall adjustment is necessary		Additional amount to carry forwards
Or option 4 R&D is less than 75% of the average R&D. Add any 'additional amount' brought forwards to the actual R&D. Any remaining difference is an R&D shortfall amount Reduce the additional amount to zero.		R&D shortfall amount to be deducted
Additional amount memo		

Brought forwards		
Accrued		
Utilised		
Carried forwards		
1. Taxable profits of the trade		
2. Add: Loan relationship and derivative contract debits		
3. Add: Enhanced element of R&D tax relief		
4. Less: Finance income treated as income of the trade		
5. Less: R&D shortfall (calculated above)		
Sum of 1–5		Profits of the trade
Step 3b – multiply the profits of the trade by X%		
Profit or loss of trade x X%		Total after step 3
Step 4 – Deduct the routine return to calculate qualifying residual profit (QRP)		
Calculate routine deductions using legislation and HMRC list		

		Routine deductions
Routine return = aggregate of routine deductions x 0.1 x X%		Routine return
To calculate QRP, deduct routine return from total after step 3		QRP
Step 5 and 6 – small claims treatment or notional marketing royalty Can only use small claims amount if condition A or B is met: check		
Condition A is that the aggregate amount of QRP of each trade of the company for the accounting period does not exceed £1 million; or		
Condition B is that the aggregate amounts of the QRP for each trade of the company for the accounting period does not exceed £3 million; and The company has not used step six to calculate their relevant IP profits in any previous accounting period beginning within the previous four years. Is condition A or B met? If so use step 5. If not, go to step 6.		
Either: Step 5 – small claims treatment		
Small claims amount is the lower of: the aggregate of QRP x 75%; or £1 million		Small claims amount
Or Step 6 – notional marketing royalty		
Calculate the 'appropriate percentage' using transfer pricing principles		%
Multiply RIPI by the appropriate percentage to give NMR		NMR
Identify marketing royalties paid and multiply by X% from step 2 to give AMR		AMR
Deduct AMR from NMR. If the result is negative, or less than 10% of QRP (calculated above) no adjustment is needed.		MAR (if adj needed)
Deduct MAR from QRP if adjustment is needed		Total after step 6
Step 7 – Profits arising before the grant		
If a patent has been granted in the year recalculate profits for up to six previous years as if Patent Box applied.		Total to be added to RIPI

Then recalculate from step 2 onwards		Total after step 7
Calculating the deduction		
Identify relevant profit. Depending on the number of steps this could be the small claims amount, total after step 6 or total after step 7.		Relevant profit
Tax deduction = RP x ((MR– IPR)/MR) Remember to adjust RP for phase in % and MR for changes		Tax deduction

Notes

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