

# Innovation Matters

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## PATENT BOX – WHERE ARE WE NOW?

The UK Patent Box provides for a reduced rate of Corporation Tax (10%) on profits derived from patents.

As many people are aware, the current Patent Box scheme is due to undergo some changes from 1 July this year. Following the recent completion of a consultation exercise by HM Treasury, the latest position is presented in the Finance Bill which was released in March 2016. This sets out changes designed to bring the UK Patent Box legislation into line with the Base Erosion and Profit Shifting (BEPS) review conducted by the Organisation for Economic Co-operation and Development (OECD).

In broad terms, the changes to the Patent Box increase its complexity, will limit its benefit in some cases, and will impose a more onerous record-keeping requirement. All companies that have elected into the Patent Box, or are considering doing so, will be affected to some degree.

We set out below a summary of the key changes and their potential impact.

## KEY CHANGES TO PATENT BOX

The fundamental change being made to the UK Patent Box is to link Patent Box profits more directly to underlying Research and

Development ('R&D') activity undertaken by the company itself in developing the relevant patented technology. For these purposes, HM Treasury has decided to use R&D expenditure as a proxy for R&D activity; hence the Patent Box benefit is restricted to the extent that expenditure relates to R&D subcontracted to related parties or to the acquisition of intellectual property ('IP') rights.

This core change in approach results in various changes to the Patent Box calculation, which in turn also have some implications regarding the collation of relevant information.

### THE R&D FRACTION

An 'R&D fraction' will need to be calculated under the new regime which will be applied to Patent Box profits (and may therefore reduce the Patent Box benefit).

The R&D fraction is based on expenditure on in-house direct R&D costs plus expenditure on R&D sub-contracted to third parties (all of which is uplifted by 30%), as a proportion of total R&D expenditure. Any expenditure on acquired IP or on R&D subcontracted to related parties could result in a fraction of less than one, resulting in a reduction in Patent Box profits.

As the nature of the underlying R&D expenditure may be different for each of the company's patents, a separate R&D fraction must be calculated for each patent (or for each product line in some cases).

Group companies in particular will need to look carefully at their position; expenditure on R&D subcontracted to related parties, even those located within the UK, could result in reduced Patent Box benefit under the new rules.

### 'STREAMING' OF PROFITS

Under the current rules, the default position for calculating Patent Box profits is based on an apportionment of taxable profits; the apportionment is based on the proportion of income derived from the sale of patented goods compared to total turnover.

Such an apportionment of total profits as a starting point for the Patent Box calculation will no longer be possible under the new rules. As Patent Box profits will be dependent on the underlying R&D expenditure, profits from sale of patented products are required to be prepared on a 'streaming' basis i.e. identified on a patent by patent basis, such that the R&D fraction relating to the particular patent can be applied to the appropriate amount of profit.

For companies whose products include more than one patented item (referred to in the legislation as 'multi IP items'), the new rules permit streaming of income and profits at a product/product family level in certain situations where identification at a patent level would give rise to practical difficulties.

## 'TRACK AND TRACE' RECORD KEEPING

In order to calculate the 'R&D fraction' for each patent/product, companies will be required to track and trace their R&D expenditure to this level.

In principle, this tracking and tracing should identify R&D expenditure from 1 July 2013, but there are special provisions which apply to allow for a later date where there is insufficient data for the period 1 July 2013 to 1 July 2016. In any event, all companies that have elected/ will elect in to the Patent Box will be required to track and trace R&D expenditure from 1 July 2016 onwards.

A company can choose to apply tracking and tracing of expenditure from an earlier date, up to 20 years before the end of the accounting period. This is consistent with the 20-year period over which R&D expenditure must be accumulated (amended from 15 years stated in previous announcements).

## EXCEPTIONAL CIRCUMSTANCES

The new rules contain a provision allowing a company to elect to increase the R&D fraction where exceptional circumstances have led to the fraction not representing the company's contribution to the intellectual property.

There are no examples of such 'exceptional circumstances' but it is expected that any Patent Box calculation using this option would be carefully scrutinised by HM Revenue and Customs. In addition, the company must have an R&D fraction of at least 0.325, under the normal rules, to request an uplift.

## WHEN DO THE CHANGES TAKE EFFECT?

### NEW ENTRANTS

'New entrants' to the Patent Box scheme must apply the new rules (when they have been enacted). These are companies which have not already elected in to the current Patent Box scheme, and whose first Patent Box accounting period begins on or after 1 July 2016.



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## COMPANIES ALREADY ELECTED IN TO THE PATENT BOX

All companies will be required to apply the new rules for accounting periods beginning on or after 1 July 2021.

Until then, if the company is not a 'new entrant', it may continue to apply the existing rules (i.e. without applying the 'R&D fraction') unless it has a new qualifying IP right.

For these purposes, a 'new qualifying IP right' includes:

- IP rights granted to the company in respect of applications made on or after 1 July 2016;
- IP, or an exclusive licence to IP, acquired by the company on or after 1 July 2016; and
- IP, or a licence, acquired for tax avoidance purposes on or after 2 January 2016 from a connected person which is not within the charge to corporation tax nor liable to a foreign tax designated by the Treasury as similar to the UK Patent Box.

A company which has new qualifying IP rights during the transitional period must apply the new rules with certain modifications. The broad effect of these modifications is to apply the R&D fraction only to the new IP; the old IP remains unaffected during the transitional period. However, the company is required to adopt the streaming of profits and may no longer apply the profit apportionment method as a starting point to identifying Patent Box profits.

There are particular rules which address situations where a particular product contains both old and new IP ('multi IP items'). Provided the core IP of the product remains unchanged, it will continue to be treated wholly as 'old IP' such that no R&D fraction need be applied to it. The rules are more complex where the core IP in the product has changed, and professional advice should be sought in these instances.

## SUGGESTED ACTIONS

We would recommend the following actions to companies that are or might be eligible for Patent Box:

- Consider possible acceleration of UK and European patent applications and exclusive licence arrangements – can they be filed before 1 July 2016, such that they are not 'new IP' for Patent Box purposes?
- Group companies should consider their intra-group arrangements as soon as possible. Any intra-group transfers or licences of IP after 30 June 2016 are likely to constitute 'new IP' and trigger the application of the new rules.
- For companies that have not yet elected in to Patent Box: consider eligibility as soon as possible, with a view to possible election for periods beginning before 1 July 2016 such that the company is not a 'new entrant'.
- Review internal processes and systems
  - Are they capable of 'tracking and tracing' R&D expenditure at an individual patent level? All companies will need to track and trace for R&D expenditure from 1 July 2016 onwards
  - Are they capable of identifying income/profits at an individual patent level as required under the new 'streaming' rules? This will apply to all Patent Box companies from 1 July 2021; sooner if the company is a 'new entrant' or if it has 'new IP' (see above).
- Review any existing patented products for which additional patent protection is sought. Could this constitute a change in the 'core IP'? If so, you may need to take advice on the new 'multi IP items' rules and how these might impact the Patent Box calculation.
- Seek professional advice and assistance! The Patent Box was already complex and it is about to become even more so. However, in our experience the tax savings can be substantial, so it is worth considering. Early planning is to be advised.

Please contact us and we will be happy to assist you.

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