GNT 7 Patent Box

This note provides a high level overview of the UK Patent Box, drawing out the most relevant points of interest and concern for a life science company.

The Patent Box was introduced in Finance Act 2012 to provide a tax incentive for companies to develop and exploit patents and other qualifying IP rights in the UK. It provides a reduced rate of corporation tax of 10% for profits attributable to patents. The relief was introduced on 1 April 2013 and is being phased-in over four years.

Companies that wish to benefit from the Patent Box would need to elect in. However, it may not necessarily be beneficial to do so, for example, if the company is loss making (see commentary on Patent Box losses below). The reduced rate of tax of 10% is achieved by way of creating an additional tax deduction and so companies with significant tax losses may also choose not to elect in if the benefit cannot be realised for the foreseeable future. For further information on how and when to claim, please refer to the HMRC Guidance.

Only qualifying companies can benefit from the regime. In overview, this requires companies to hold a qualifying IP right (or an exclusive license to such a right) and, if part of a group, to satisfy the active ownership condition (covered below).

Qualifying IP Rights

Ownership Condition

A company can benefit from the Patent Box if it owns or has an exclusive license in respect of “qualifying IP right” which is a patent granted by:

- UK Intellectual Property Office;
- European Patent Office; and
- Certain specified EEA states.

The regime is also extended to other rights that grant additional market or data protection. This includes: supplementary protection certificates, data protection rights together with orphan drug and paediatric extensions. This is to help compensate life science companies for long development timelines such that there are often only a few years of patent protection remaining at the point at which a product is first approved.

Exclusive Licence

A claimant need not own the patent outright but, instead, have licenced rights.

To qualify, the licensee must have rights over the patent to the exclusion of all other persons, including the patent licensor. The rights must extend throughout at least an entire national territory. Furthermore:

- The licensee must be able to bring infringement proceedings to enforce its right in the patented invention, or
- The licensee must be entitled to most of the damages of any infringement.

For further information on exclusive licences, please refer to the HMRC Manual.

Development Condition

The aim of this condition is to limit the regime to companies that have been involved in the creation of IP. Qualifying development requires a significant contribution to the creation of the patented invention or any product of a process incorporating the invention. It is sufficient for the company to satisfy one of four conditions.

If the company is a member of a group, it must also actively own the patented inventions by taking a significant role in managing its eligible patents. For further information on the active ownership condition, please refer to the HMRC Manual.

Streaming

The new rules introduced in Finance Act 2016 require a company to stream its income as detailed below, and in general the IP stream needs to be divided further between sub-streams corresponding to qualifying IP rights, products or product families (CIRD271500). Expenditure is assigned to those streams on a just and reasonable basis and deducted from that income.

Consideration needs to be given as to how the company will stream its income in the new regime as this affects how R&D expenditure should be tracked and traced, unless the qualifying IP right is not going to be in the new regime (for example if the patent expires before 2021).

Mandatory Streams

- Standard income which is not Relevant IP income (see below): If the company has income which is not relevant IP income, there needs to be a stream of non-relevant IP income. This does not form part of the Patent Box profits, but ensures that all expenses are accounted for as they are allocated across all the streams and sub-streams.
- Old regime IP income: As soon as there is new IP, relevant income from old IP needs to be allocated for consistency into a single stream. There will be no R&D fraction applied to this stream, but it is mandatory to stream the calculation instead of using the ‘proportionate or formulaic method’ of the old regime.
- Sub Streams: Choices of how to stream new IP, as follows:
  - Qualifying IP right level streaming
  - Product or Process level streaming
  - Product family level streaming
  - Global streaming: There is an exception to the requirement to separate qualifying IP rights into separate streams when a company meets Small Claims Treatment criteria. This is designed to avoid numerous streams consisting of low income whereby the administrative burden might outweigh the benefits of the Patent Box.

Relevant IP Income

Relevant IP income (‘RIPI’) is the income derived from the exploitation of qualifying IP rights. To be relevant, the IP income must fall into one of the following categories:

- Head 1 – Sales income – worldwide income of the claimant from the sale of patented inventions or items incorporating patented inventions
- Head 2 – Licence fees and royalties – where the income received derives from an agreement giving rights over qualifying IP rights
- Head 3 – Proceeds of sale – income from the sale or other disposal of a qualifying IP right
- Head 4 – Damages for infringement – whether actual or alleged infringement

- Head 5 – Other damages - income that is received by way of insurance, compensation or other damages

Extension to Other Rights

Royalty income arising from the licence of qualifying patent rights can include other rights, such as: designs, trademarks and know-how, provided that these are granted for the same purpose and therefore be relevant IP income under Head 2.

Licensing and Milestones

Milestones and up-fronts received as a result of out-licensing technology should also be relevant IP income under Head 2.

Incorporated Items

Sales of items that are not patented but incorporate patented inventions also qualify and vice versa (for example, a patented delivery device and generic consumable). To be incorporated, the item must be physically part of the larger item and intended to be so throughout its operating life. It is generally expected that the item will be sold as a single unit and/or at a single price. The sale of bespoke spare parts for a qualifying item will also qualify.

Packaging

Packaging is not a qualifying item unless it performs a function that is essential for the use of the product or is patented itself. The function of packaging must go beyond the normal function of packaging, namely, to contain, to protect, or for delivery or presentational purposes. However, in cases where the non-qualifying element is considered trivial (<5%) it does not need to be separated.

Notional Royalties (HMRC Manual)

A company which uses a patented process or provides services through the use of patented technology can claim Patent Box benefit through notional royalties. This is calculated as the royalty that would be paid to a theoretical independent owner of the patented processes or tools for the exclusive licence to use those rights. The value should be determined using OECD Transfer Pricing Guidelines.

Leasing Income

Lease or rental income does not qualify. It may be possible to compute a notional royalty in respect of patents used in generating such income. Therefore, renting medical devices/equipment may not afford as great a Patent Box benefit as selling the products outright.

Mixed Sources of Income (HMRC Manual)

Where qualifying and non-qualifying products and services are bundled and sold together, income must be apportioned between relevant IP income and non-qualifying income on a just and reasonable basis.

Calculation of Relevant IP Profits

A series of calculations determine relevant IP profits on which the additional Patent Box deduction is calculated. The objective is to determine income attributable to patented technology by:

- Excluding:
  - Profits on income from non-patented technology

  - Profits from routine activities
  - Profits attributable to marketing assets
- Adjusting for any shortfall in R&D expenditure
- Applying a limitation to acquired IP rights or R&D undertaken by connected parties (R&D fraction – introduced in 2016)

Routine Activities (HMRC Manual)

A routine return is the profit a business might be expected to make if it did not have access to unique IP and other intangible assets. This return must be deducted from the profit attributed to relevant IP income to arrive at the amount of that profit that is attributable to intangible assets. The routine return is calculated by aggregating routine deductions (as defined below) that have been subtracted in calculating the profits of the trade and taking 10% of that figure.

- Head 1 – Capital allowances: includes all allowances claimed in the period other than research and development allowances.
- Head 2 – Premises costs: includes rent, rates, repairs and maintenance, water fuel and power costs etc.
- Head 3 – Personnel costs: includes salaries, Class 1 and Class 1A National Insurance contributions, share scheme and pension deductions. It also includes amounts paid in respect of externally provided workers ('EPW') employed by the company as defined within the legislation for R&D incentives.
- Head 4 – Plant and Machinery costs: includes costs of leasing, constructing, modifying, maintaining, servicing, operating etc.
- Head 5 – Professional services: includes legal services; financial services including accounting, audit and valuation functions and costs associated with the administration and management of the company. It specifically excludes payments to CROs.
- Head 6 – Miscellaneous services: includes computer software costs, consultancy and professional costs, telecommunications, postal, computing, transport and waste disposal services.
- Specific exclusions
  - Debits in respect of loan relationships or derivative contracts
  - R&D expenses excluded are the amounts on which R&D tax credits are given, plus any additional deduction given by the R&D tax credit regime. For EPWs and sub-contract expenses, only 65% of the actual costs are eligible for relief then the non-eligible 35% of the costs should be marked up in the same way that non-R&D EPW expenditure would be.
  - Deductions relating to relief given for employee share acquisitions under Part 12 of CTA 2009 are allowable to the extent that the employee is engaged in relevant R&D activities.

In the new regime the removal of routine return applies to each sub-stream.

Marketing Assets Figure Return ('MARF') (HMRC Manual)

A further restriction is applied to exclude the profits that can be generated by using established marketing assets such as brand names. The legislation uses two figures, the notional marketing royalty ('NMR') and the actual marketing royalty ('AMR') to calculate the profit attributable to marketing assets. In the new regime the removal of marketing assets return applies to each sub-stream.

The marketing assets concerned are those that are exploited in generating the relevant IP income and which come under the following headings:

- Anything in respect of which proceeding for passing off could be brought;
- Equivalent rights recognised under the law of another country, preventing passing off;

- Signs or indications of geographical origin of goods or services; and
- Information
- About actual or potential customers which is used for marketing purposes.

The NMR is an amount, derived as a percentage of relevant IP income, which the company would pay for the right to exploit the relevant marketing assets of the company in the accounting period, if it could not exploit them without that payment. The marketing assets return figure, MARF, is the difference between this and amounts that are deductible in the accounting period for payments actually made to acquire or exploit the relevant marketing assets (the AMR).

If the NMR is less than 10% of qualifying profits after the adjustment for the routine return, the marketing assets figure is nil. This rule is intended to avoid expensive evaluation of the value of marketing assets where they make only a small contribution to overall profit.

The NMR for a company may fall below the de minimis for a combination of the following reasons:

- The relevant income is derived from the licence of patent rights and does not extend to any brand name or trademark.
- The brand is not used for marketing purposes. In the pharmaceutical sector, brands generally remain low value while the product remains under patent or retains other market exclusivity. Their value typically increases when generic competition is introduced at which point the claimant will no longer be generating relevant IP income from that product stream.
- The brands under which the products are marketed are owned by the licensee and not the company.

Shortfall in R&D Expenditure (HMRC Manual)

- For companies newly entered into the Patent Box, there is a mechanism to take account of prior year R&D costs. A claimant must calculate the average amount of R&D expenditure in the four years before the election into the regime. It compares this to the actual amount of R&D expenditure in that accounting period.
- If the comparison shows that the actual amount of R&D is less than 75% of the average in the four years prior to entry into the Patent Box, then there is a shortfall of R&D expenditure. In this case the amount of the shortfall must be added to the actual R&D expenditure as an adjustment in calculating the Patent Box profits.
- For the purpose of calculating the four year average, R&D expenditure for this purpose is the expenditure recognised in the company’s statutory accounts under UK GAAP and brought into account in calculating the profits of the trade.

R&D Fraction

New rules have been introduced in 2016 as a consequence of international actions to combat potentially harmful regimes which include innovation incentives such as the UK Patent Box. The objective of this new measure is to ensure that international IP regimes only accrue to the extent that entities have incurred expenditure in developing that IP. To this end, IP acquired or in-licenced will potentially reduce the tax benefit. The same applies to R&D sub-contracted to other companies in the economic group.

The principle will be applied through the determination of the ‘R&D fraction’. This must be calculated for each type of IP asset (patent), product or product family depending on circumstances. The fraction is calculated as:

Qualifying Expenditure to Develop the IP Asset / Overall Expenditure to Develop the IP Asset

= (D+S1)*130%/(D+S1+S2+A)

D = R&D undertaken by the entity

S1 = R&D sub-contracted to 3rd parties

S2 = R&D sub-contracted to connected parties

A = Acquisition costs (including licenced IP)

This is calculated on a cumulative basis covering a 15 year period (going back to June 2013) over which the technology has been developed. The starting point is to track expenditure by specific patents. Only if this is demonstrably not 'practicable' to identify either expenditure or profits at this level, can the expenditure be tracked at a higher level by reference to a product or product family (or programme).

Tracking should be calculated from the following dates:

- New entrant companies where the accounting period begins before 1 July 2021: A new entrant company elects into the Patent Box. Subject to any exemptions, it must track and trace its expenditure from 1 July 2013 if possible.
- New entrant companies, new qualifying IP rights in accounting period starting after 1 July 2021: From 1 July 2016.
- Old regime companies, old and new qualifying IP rights: From 1 July 2016.

Patent Box Losses

A company may have a relevant IP loss if it has income from its qualifying IP rights but is not sufficiently profitable. As a result, the company will not be able to benefit from the regime for that period as it has no amount of relevant IP profit. Accordingly a company with a relevant IP loss will probably not elect into the regime in that period (if it has not previously done so). If a company has elected in and has an IP loss, it must be carried forward and offset against subsequent IP profits before a deduction is calculated.

Once a company has exited the regime it cannot re-join for a period of five years. As a result it is important to consider the election where the company makes losses or losses on patented items.

For further guidance please contact Richard Turner (Tel: +44 (0) 20 3727 1506).

FTI Consulting have significant experience in advising companies on how to access the Patent Box and optimise the benefit. We would typically recommend that companies initially undertake a feasibility exercise in which we would cover an overview of the implications of all the aspects set out above and model the approximate benefit. A second stage can then lead into a completed claim together with detailed calculations and a supporting report that cover any key assumptions/methodologies.

FTI Consulting have particular expertise in calculating notional royalties for process patents.

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