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**The Patent Box: Technical Note  
and Guide to the Draft Legislation**

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Technical Note  
6/12/2011

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## **Foreword:**

This Technical Note accompanies draft clauses and explanatory notes published today, 6 December 2011. It should also be read alongside the response document to the June 2011 consultation on the Patent Box which has also been published today.

This note gives an outline of the structure of the legislation intended to deliver the policy set out in the response document. It aims to provide a guide to the draft legislation and where appropriate to explain the reasons for approaching the policy objectives in the way the legislation does.

The response document invites comments on how well the legislation succeeds in achieving the policy objectives. Comments on the legislation or this note specifically are very welcome and should be sent by email to:

**[corporatetaxreform@hmtreasury.gsi.gov.uk](mailto:corporatetaxreform@hmtreasury.gsi.gov.uk)**

And to **[richard.rogers@hmrc.gsi.gov.uk](mailto:richard.rogers@hmrc.gsi.gov.uk)**

Or, if you wish to respond by mail, please send responses to

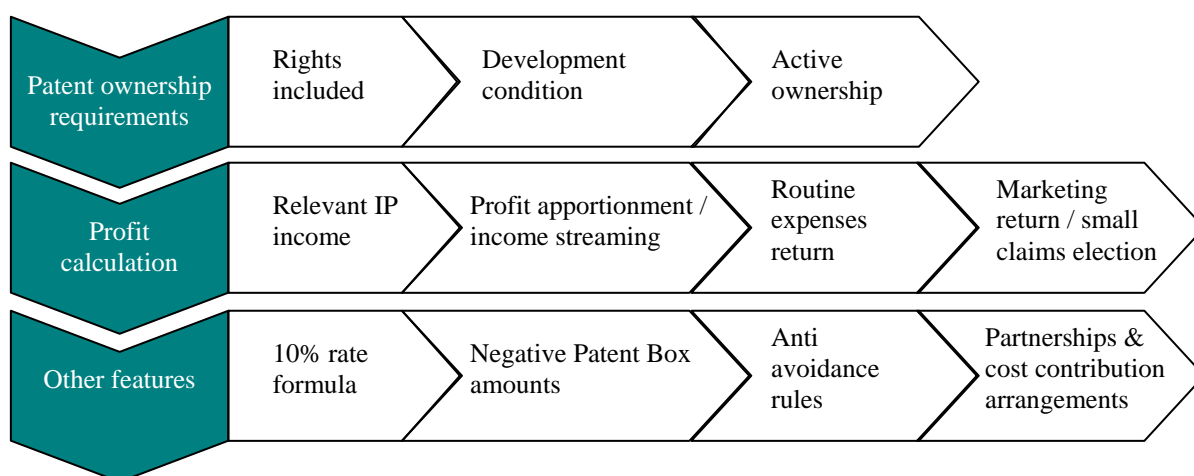
**CT Reform  
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## Chapter 1 – Introduction & Overview

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### Purpose of the Patent Box

- 1.1. The Patent Box provides a reduced corporation tax rate for companies exploiting patented inventions or certain other innovations protected by particular intellectual property (IP) rights.
- 1.2. The reduced rate applies to a proportion of the profits derived from the licensing or sale of the patent rights, or from the sale of the patented invention or products which incorporate the patented invention. Profits derived from routine manufacturing or development functions, and profits derived from exploitation of brand and marketing intangible assets, are intended to be excluded.
- 1.3. The Patent Box is an optional regime which companies can elect into. The reduced rate of tax is delivered by providing an additional deduction in the corporation tax computation.
- 1.4. To minimise administrative costs and compliance burden, Patent Box profits for many claims can be calculated using a largely formulaic approach. This is intended to identify in most circumstances a reasonable, albeit approximate, figure for profit derived from the patent. Companies can instead however opt to identify the profit through a more bespoke calculation.
- 1.5. The next section of this introduction is a broad outline of the main concepts of the Patent Box regime. These are then explained in more detail in the rest of this Technical Note, The main concepts are shown in the diagram below:



## **An Overview of the Patent Box**

### **(i) Qualifying Ownership Requirements**

- 1.6. A company can elect into the Patent Box if it owns or licenses-in UK or European Patent Office patents. There are two main conditions:
- (i) the company must have made undertaken qualifying development by making a significant contribution to:
    - the creation or development of the item protected by the patent; or
    - a product incorporating this item.
  - (ii) if the company licenses-in patent rights, the licence must give it exclusivity for those rights. This must extend at least country-wide.
- 1.7. Some other rights, such as plant variety and data exclusivity rights, can also qualify. These rights are treated in the same way as patents throughout the legislation, so unless specified otherwise references to “patented item” in this note should be read as also referring to items or products protected by any other type of qualifying IP right.
- 1.8. If the company is a member of a group, then in some circumstances it can qualify if another group company has undertaken the qualifying development. But only if it actively manages its portfolio of qualifying rights.
- 1.9. This requires a significant amount of management activity: forming plans and making decisions about the portfolio. However the company does not have to make all decisions concerning the portfolio.

### **(ii) Profits Benefitting from the Patent Box**

- 1.10. The profits benefiting from the Patent Box are calculated as a proportion of the corporation tax profit of the company’s trade.

#### *Relevant IP income*

- 1.11. The calculation starts by identifying how much of the company’s total gross income includes “relevant IP income” (RIPI), which is income derived from its qualifying patents.
- 1.12. Broadly there are five types of income that can qualify as relevant IP income:
- i. income from the sale of the patented item, or an item incorporating it;
  - ii. licence fees and royalties from rights that the company grants others out of its own rights over the patented item;
  - iii. income from the sale or disposal of the patent;
  - iv. amounts received from others accused of infringing the patent; and

- v. a notional arms-length royalty for use of the patent to generate otherwise non-qualifying parts of the company's total gross income, if they are derived from exploiting the patented item.

1.13. For these purposes, finance income is not part of the company's gross income. Additionally, neither ring-fence oil extraction income nor income from exploiting non-exclusive patent rights can qualify.

#### *Profit Apportionment/ Income Streaming*

1.14. The company can normally choose one of two routes to calculate how much of its profits derive from this qualifying income. Either:

- (i) it can apportion its total profits according to the ratio of RIPI to total gross income; or
- (ii) it can allocate its expenses on a just and reasonable basis to the two "streams" of income: RIPI and non-qualifying income, to arrive at an appropriate profit derived from its RIPI stream.

1.15. Profits apportioned or expenses attributed should exclude finance income and expenses. They should also exclude any additional deduction above actual cost for research and development costs given under the R&D tax credits regime.

#### *Removing a Routine Return*

1.16. Two further stages are necessary in the calculation. The first is to remove a routine return on certain specified costs from the apportioned or streamed patent-derived profits. This leaves an amount called "Qualifying Residual Profit" (QRP).

1.17. The relevant costs include costs of personnel, premises (if tax-deductible), plant and machinery (including capital allowances) and miscellaneous services. Expenditure qualifying for R&D tax credits is excluded.

1.18. The return is set at 10% of these costs, and the profit is reduced by this amount.

#### *Removing a Marketing Assets Return*

1.19. The final stage is either:

- to remove a return on marketing assets used to derive profits, by deducting a notional marketing royalty; or
- to apply small claims treatment to the QRP, which removes 25% of QRP as a deemed marketing return, leaving the remaining 75% (up to a maximum of £1m) inside the Patent Box.

- 1.20. In either case the result is a profit figure called Relevant IP Profits (RIPP) which can then benefit from the Patent Box

### **(iii) Applying the Patent Box to Relevant IP Profits (RIPP)**

- 1.21. The Patent Box taxes RIPP at a reduced rate. This is effected by including an additional deduction in the company's corporation tax computation, calculated from the RIPP figure.
- 1.22. Although the resulting profits chargeable to corporation tax are then charged at the normal corporation tax rate, the extra deduction has the effect of reducing the rate.
- 1.23. If the Patent Box RIPP calculation produces a negative figure, then there is no change to the company's normal corporation tax computation. However, the negative amount of RIPP must be offset against any other RIPP of the company derived from a different trade, of other group companies, or against future RIPP of the company or other group companies in working out Patent Box benefits in these cases.
- 1.24. A company cannot benefit immediately from the Patent Box on profits from items pending patent approval. But, for up to six years before grant, the company can calculate what the relevant RIPP would have been had the patent been granted at that time. These amounts are aggregated over the six years, and then they can be added to the RIPP of the year in which the patent is granted when calculating the Patent Box deduction.

### **(iv) Other Aspects of the Patent Box**

- 1.25. There are a number of rules to determine how patented and non-patented items sold or licensed together, are taken into account in arriving at RIPI.
- 1.26. In some cases it may be obligatory for the company to "stream" its profits rather than apportion them.
- 1.27. The Patent Box has an anti-avoidance rule to prevent unreasonable tax benefits arising from tax- motivated schemes which aim to create mismatches of income and expenditure or to avoid particular provisions of the Patent Box. And there are anti-avoidance rules to stop commercially irrelevant patented items being included in or with a product or spurious exclusive rights being added to licence agreements solely to enable income to qualify.
- 1.28. There are rules enabling partnerships and cost-sharing arrangements to qualify for the Patent Box.

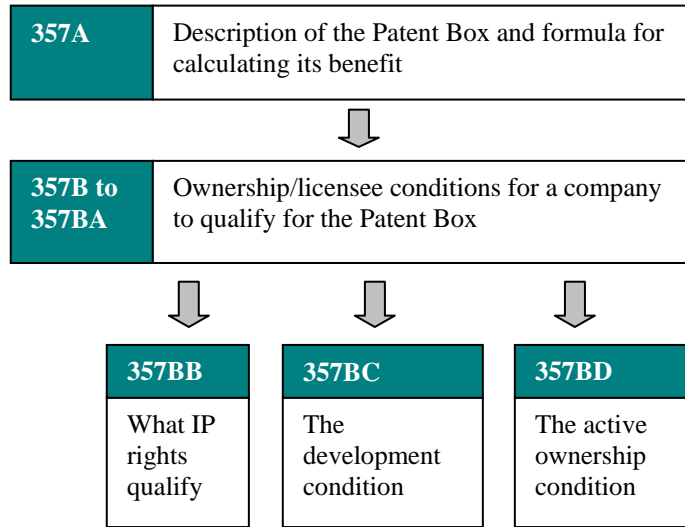
- 1.29. In some circumstances RIPP in the first four years for which a company qualifies for the Patent Box may be reduced by additional deemed R&D expenditure.
- 1.30. The full benefits of the Patent Box are being phased in over a number of years from April 2013.

## Draft Legislative Structure of the Patent Box

- 1.31. It is proposed to include the main Patent Box legislation as Part 8A of CTA 2010, between other parts specifying the rules for the corporation tax treatment of profits from particular activities (oil and gas exploration and leasing of plant or machinery).
- 1.32. This primary legislation is set out in 7 chapters:
- Chapter 1 provides an introduction;
  - Chapter 2 sets out qualifying conditions for a company;
  - Chapter 3 provides the main rules for calculating profits eligible for the reduced rate (“relevant IP profits”);
  - Chapter 4 specifies a more bespoke alternative method of identifying these profits (“streaming”);
  - Chapter 5 provides rules for dealing with companies that have relevant IP losses in some periods (“relevant IP losses”);
  - Chapter 6 contains targeted anti-avoidance rules to prevent abuse of the regime; and
  - Chapter 7 sets out the rules regarding elections into the Patent Box regime, its application to partnerships and cost-sharing arrangements and provides definitions.
- 1.33. Additionally a Treasury Order will specify certain other rights that will qualify for the Patent Box.
- 1.34. The remainder of this Technical Note goes into more detail about the legislation, following the legislative structure described above.
- 1.35. An outline summary of the legislative structure is provided at the back of this Technical Note.

## Chapter 2 – Qualifying for and Giving Effect to the Patent Box

2.1 The structure of this part of the legislation is set out below:



### 357A – Election into the Patent Box

2.2 Companies can elect into the Patent Box if they satisfy qualifying conditions about ownership of patent rights. These are set out in sections 357B to BD.

2.3 If the company elects into the box, it is entitled to an additional trading deduction in computing its corporation tax profits. The deduction is the amount obtained from the formula set out in 357A(3).

2.4 The deduction in 357A(3) achieves the same result as charging the relevant IP profits of the company (which are the profits “in” the Patent Box) directly at 10%.

For example, if a company has trade corporation tax profits of £1000, which qualify in full for the Patent Box when the main rate of tax is 23%, then instead of arriving at a tax charge of £100 by multiplying £1000 by 10%, the calculation proceeds as follows:

Profits of Company’s trade chargeable to CT	1000
Patent Box Deduction $1000 \times (23-10)/23$	<u>565</u>
<b>Profit Chargeable to corporation tax</b>	<b><u>435</u></b>
<b>Tax Payable</b> <b>£435 x 23%</b>	<b>£100</b>

2.5 This approach is used, rather than directly charging the relevant profits at 10%, to avoid complications if the company claims losses or other reliefs and to simplify the way the Patent Box will be administered on corporation tax returns.

- 2.6 The formula is the same for companies charged at the main rate of corporation tax and for companies is charged at the small profits rate, or at the main rate with marginal relief. This means that in some cases Patent Box profits may be charged at a little below 10%.
- 2.7 If, rarely, a company has more than one trade the Patent Box deduction is calculated for each trade separately. If any one trade produces a negative amount of relevant IP profit, referred to in the legislation as relevant IP losses, this will need to be deducted from the relevant IP profits of the other trades, under 375E to 375EE (see chapter 5 below).

### **357B - Qualifying company conditions (holding, licensing-in, developing and managing IP)**

- 2.8 Patent holders may wish to license their invention for others to develop. The Patent Box is designed to benefit both the licensor and any licensee who has been given exclusive rights under which it develops and exploits the invention.
- 2.9 A company can elect into the Patent Box if it qualifies by holding, or licensing-in exclusively, IP rights of the types specified under the legislation. This is so long as:
- it satisfies the “development condition” in relation to those rights, so that the rights count as “qualifying IP rights”; and
  - if it is a member of a group, it satisfies the “active ownership” condition in relation to substantially all of its qualifying IP rights.
- 2.10 The meaning of an exclusive licence is set out in 357BA (explained below).
- 2.11 In the normal situation, a company can elect into the Patent Box if it has qualifying IP rights at any time in the relevant accounting period. This is “Condition A” in 357B.
- 2.12 To cater for situations:
- where a company disposes of qualifying IP rights, but receives income from the disposal in a later period; and also
  - where income is received as a result of infringement of a patent, but not until after the expiry of that patent.

357B also allows a company to qualify for the Patent Box if it has previously elected into the Box, and is taxed in a current period on income derived from an event at that earlier time concerning a then qualifying IP right. This is “Condition B”.

### 357BA – Meaning of exclusive licence

- 2.13 The key aim is that to qualify for the Patent Box, a licensee must have some unique rights to develop, exploit and defend rights in the invention.
- 2.14 The rules however aim to recognise that a patent holder may grant licence rights in different territories or in different fields of application.
- 2.15 So a licensee does not need to be given all rights in the patented invention. The rights might, for instance, be limited to development and exploitation in a particular application. An example is below

- An inventor develops and patents a chemical compound, to be used on its own in a product that the inventor manufactures and sells. Recognising that other companies may wish to develop other applications by mixing the compound together with other chemical ingredients, it grants a licence to another company to develop such mixtures. But not the right to sell the unmixed compound.
- The licensee will be treated as having an exclusive licence provided that the licence specifies that only the licensee, or persons authorised by it, have the right to exploit the compound as mixtures.
- If the licence does not specify that the right is exclusive, perhaps to allow others to be licensed in future to develop similar mixtures, then the licence will be non exclusive.

- 2.16 To be an exclusive licence, the licence must give the licensee exclusivity for its rights extending throughout an entire national territory at least. So a licence that gives sole rights to manufacture and sell an item within part of a country only, as opposed to the whole country, will not be exclusive.
- 2.17 The draft legislation restricts the required exclusivity to persons who carry on the same or similar description of trade. This is to acknowledge that different licensees may be given superficially very similar (and therefore potentially not exclusive) rights to develop IP but in very different applications. The legislation is intended to allow different concurrent licensees to each be eligible for the Patent Box in this situation.
- 2.18 If similar rights to develop the IP or a product incorporating it are granted to two or more persons working in the same field of application, then HMRC considers it is reasonable to regard them as carrying on the same or similar descriptions of trade for this purpose, irrespective of the means of exploitation of the development or the wider nature of their trades.
- 2.19 Additionally the licensee must either:
- be able to bring infringement proceedings to defend its rights in the patented invention, or (if the patent owner retains control over defence of the patent); or

- be entitled to most of the damages relating to its rights that would be awarded in successful proceedings.

2.20 Groups of companies may hold legal ownership of a portfolio of patents in one company. The legal owner may confer rights in particular patents on another group company to develop and exploit the patent and derive income from it. But it may retain some rights it needs to manage its portfolio. To accommodate this, 357BA(4) and (5) allow the other group company to elect into the Patent Box as if it held an exclusive licence, if it has all rights in the patented invention, or all rights apart from rights to enforce, assign or licence the patent.

### **357BB – What patents and other rights can qualify**

2.21 Patents granted by the UK Intellectual Property Office ('IPO') under the Patents Act 1977 and patents granted by the European Patent Office can qualify for the Patent Box.

2.22 Additionally if a patent is not granted by the UK IPO, on grounds of national security or public safety, then the applicant is to be treated as if it had been granted the patent.

2.23 The scope of the Patent Box also extends to rights similar to patents. The legislation includes an Order of the Treasury published on 6 December 2011. This Order specifies rights in addition to those set out in section 357BB, the income from which is subject to the tax regime in Part 8A. This power is being used to include the additional rights set out below:

- supplementary protection certificates, ('SPC') which are granted by the UK Intellectual Property Office or by the European Patent Office, including paediatric extensions;
- UK and European Community Plant Variety rights; and
- certain UK and European regulatory exclusivity rights, for example regulatory data exclusivity rights granted in respect of medicinal, veterinary and plant protection products, and marketing exclusivity granted to orphan status medicines and medicines for paediatric use.

### **357BC – The development condition**

2.24 The key aim of the development condition is to limit the Patent Box to companies and groups which have been properly involved in the innovation lying behind the patent or the application of the patented invention.

2.25 The definition of qualifying development set out in 357BC(7) (8) and (9) requires:

- creating, or significantly contributing to the creation of, the patented invention; or
- performing a significant amount of activity to develop the patented invention, any product incorporating the patented invention, or the way in which the patented invention may be applied.

2.26 Whether activity is significant will be determined in the light of all the relevant circumstances. Simply acquiring rights to and marketing a fully developed patent or invention, or product incorporating the invention, will not be sufficient.

2.27 However there may be a number of ways in which activity could be significant. For example it could be coming up with the breakthrough idea. Or it could be work to test or enhance the viability or usefulness of the idea. A contribution could be significant by virtue of the costs, time or effort incurred. Alternatively it could be significant due to the value or impact of the contribution.

2.28 In certain circumstances a company may acquire fully developed qualifying IP as part of a wider project. For this reason the development condition can be met if the development activity took place before or after acquisition of or licensing-in the qualifying IP.

- For example, a company conducts a project to develop a more efficient light bulb and undertakes a significant amount of research and development. But then the project discovers that the design of the light source they intended to use is already the subject of a third party patent which the company then acquires.
- The development activity will satisfy the development test, even though it took place before acquiring the patent.

2.29 There are four potential ways that a company can pass the development condition.

2.30 The first (Condition A) is where a company has itself carried out the qualifying development activity. The company may be a singleton company, or a member of a group. If the latter it must have remained in the same group since undertaking the qualifying development: this prevents company sales being used to “envelope” sales of patent rights.

2.31 Condition B deals with changes of ownership. It allows a company that continues with development activity of the same description (although not necessarily on the same invention) for at least 12 months after a change of ownership to continue to qualify.

2.32 The development condition is extended further in group situations by Condition C. A company within a group satisfying the ownership

requirements can qualify if another company in the group has carried out the qualifying development activity.

- 2.33 This accommodates arrangements within groups where for example one group company carries out R&D activity, but the IP arising out of that activity is owned by, or transferred to, another group company which holds the group's intangible assets.
- 2.34 Condition D extends Condition B to allow a group which acquires a company which developed the patent to transfer the qualifying IP to another company in the group. Activity done in the acquired company before acquisition can satisfy the development condition if the acquired company continues with the same description of qualifying development for at least 12 months after acquisition.
- 2.35 357BC(6) ensures that conditions B and D can be satisfied during the relevant 12 month period.
- 2.36 A company may meet the development condition for some of its IP rights but not for others. If so, then the company will still be a "qualifying company" able to elect into the Patent Box. However, 357B(4) ensures that only those rights for which the company meets the development condition are "qualifying IP rights" which may give rise to relevant IP profits.

### **357BD – The active ownership condition**

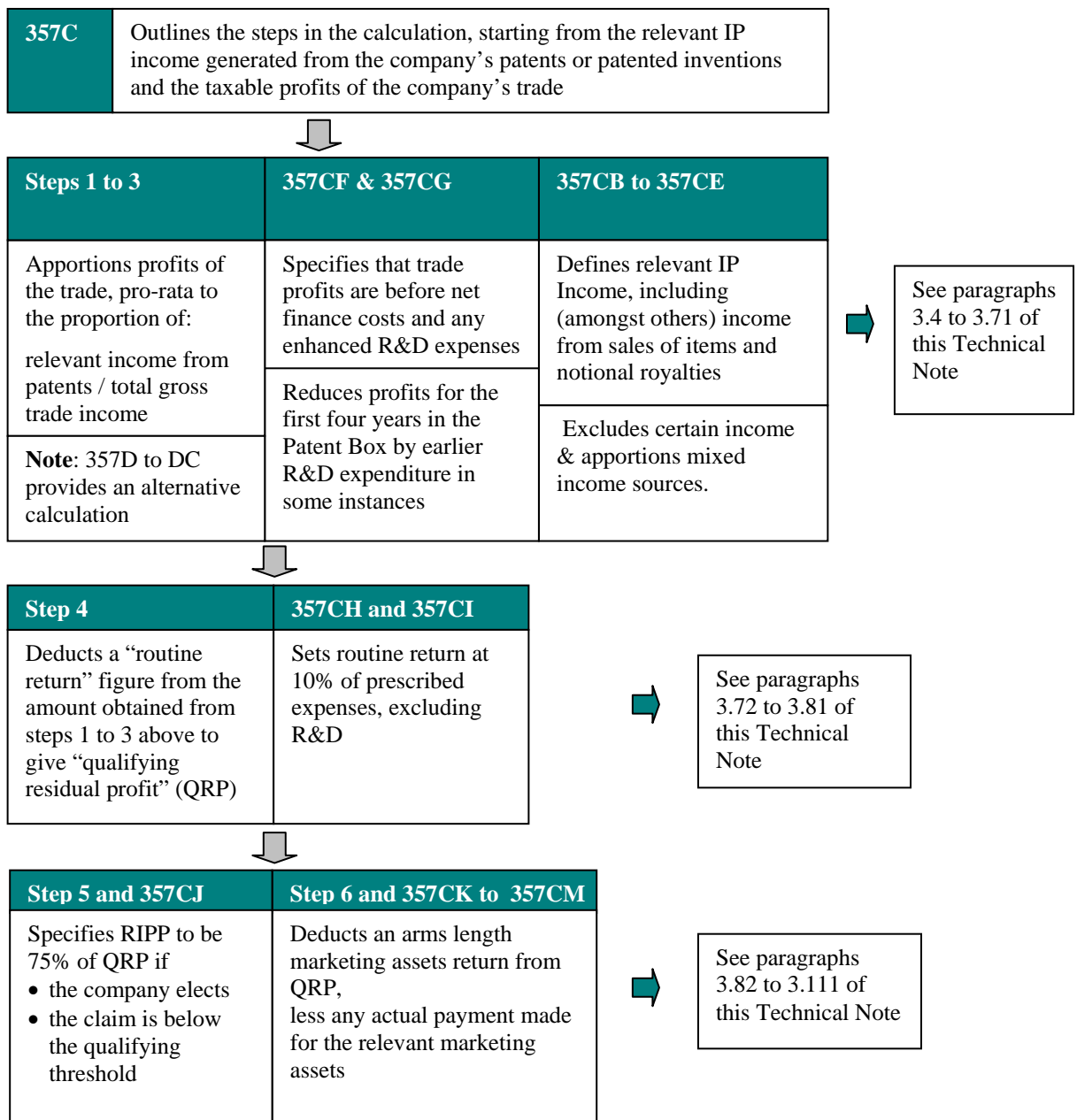
- 2.37 The key aim of the active ownership condition is to ensure that the company qualifying for the Patent Box is not a passive IP holding company, but must either have developed the IP itself or be actively managing it. If the company does not meet the active ownership condition for its portfolio of qualifying IP rights then it will not be able to elect into the Patent Box.
- 2.38 Only qualifying IP rights (i.e. rights of a type listed and for which the company meets the development condition) are considered when determining whether the active ownership condition is met. The amount of development or management activity carried out in relation to any other IP rights is irrelevant.
- 2.39 The test does not apply for singleton companies outside a group, because the company will itself have to meet the development condition outlined above. If it does so it will have to have undertaken significant activity and so will not be passive.
- 2.40 However, a company which satisfies the development condition only because of the activity of a fellow group company must show that it plays an active role in managing the qualifying IP rights it holds. This means it must be involved in the planning and decision making activities associated with

developing and exploiting substantially its qualifying IP portfolio.

- 2.41 Activities such as deciding on whether to maintain protection in particular jurisdictions, grant licences, research alternative applications for the innovation or licensing others to do so count as management activity.
- 2.42 Whether what is done is a significant amount of management activity is to be determined in the light of all the relevant circumstances, given:
- the resources the company employs;
  - the breadth of its responsibilities for the IP; and
  - the significance and impact of the decisions and plans it, as opposed to other group companies, makes in relation to that IP.
- 2.43 It is hoped that normally it will reasonably clear in practice whether the company's activity is significant.
- 2.44 The company does not necessarily have to take all decisions relating to the IP's management, particularly if normal group governance requires reference to the parent Board. But it must be actively involved in making plans and decisions and have clear substantive responsibilities. Neither does there have to be activity in each accounting period in relation to each right, if this is commercially unnecessary for the group's holding of that right.

## Chapter 3 – Calculating Profits Eligible for the Patent Box Rate

- 3.1 None of the rules in Chapter 2 determine whether any profits of the qualifying company in an accounting period qualify for the reduced rate.
- 3.2 This is achieved by Chapter 3 of the draft legislation. It provides rules to calculate the part of its profit that will be eligible for the Patent Box rate.
- 3.3 The structure of this part of the legislation is set out below:



### **357C – Calculation of relevant IP profits**

- 3.4 There are three stages to calculate the profit to which the Patent Box tax rate applies. These are broken down in the legislation into a total of 6 steps.
- 3.5 A seventh step may apply if profits were made previously from inventions awaiting grant of a patent. This is dealt with later in this Technical Note.
- 3.6 The first stage is steps 1 to 3 in the draft legislation. This:
- starts with the “total gross income” of the trade, which includes revenue receipts; and any profits from the realisation of trade intangibles or patent rights, but excludes any finance income;
  - works out the proportion of RIPI (relevant IP income that forms part of total gross income) to the total gross income of the trade; then
  - attributes the same proportion of the profits of the trade (adjusted by excluding finance returns and costs, and R&D additional deductions) to the RIPI.
- 3.7 The second stage is the removal of a routine return on expenses, described at step 4 in the legislation, from the attributed profits to get a figure of “Qualifying Residual Profit (QRP)”.
- 3.8 The third stage, steps 5 and 6 in the draft legislation, removes a marketing assets return from QRP, or 25% of the QRP figure in some cases. The remainder is then the “Relevant IP Profits” (RIPP) which are subject to the reduced rate.
- 3.9 Note that as an alternative, the company can allocate profits to RIPI using the “streaming” rules set out in Chapter 4 of the draft legislation. And in some circumstances the company has to use this approach.

### **357 CA to 357 CG - Steps 1 to 3 of 357C:**

- 3.10 Key aspects to steps 1 to 3 are:
- the definition of total gross income;
  - the classes of income that are RIPI, and the types of income that are excluded from being RIPI. Specifying this includes defining items whose sale generates the relevant IP income;
  - the concept of notional royalties. This enables some part of otherwise non-qualifying types of income to be treated as qualifying income. An example is income from services and processes that are carried out using patented inventions; and
  - adjustments which need to be made to taxable profits before apportionment. In the first four years after electing into the Patent Box this may include adjustments which take earlier R&D costs into account

if actual R&D expenditure has fallen to 75% or less than its level before the election.

### **357CA – Total Gross income of a trade**

- 3.11 The total gross income of the trade is the aggregate of:
- amounts that are recognised as revenue under GAAP and taken into account as credits in calculating the profits of the trade in an accounting period. IAS 18 defines revenue as the gross inflow of economic benefits such as sales of goods and royalties;
  - credits brought into account for tax purposes on realisation of intangible assets under the intangible fixed assets rules in chapter 4 of Part 8 of CTA 2009 (sales proceeds less allowable asset costs if any); and
  - profits from the sale of pre-2002 patents patent rights charged to tax in the accounting period under section 912 of CTA 2009. The company can choose to bring those profits into charge over six years. If so, total gross income each year will include the amounts charged in each accounting period.
- 3.12 Finance income is excluded from the Patent Box. Any trading loan relationships credits are therefore excluded from total income for the Patent Box calculation. In this respect finance income also includes:
- any amounts that GAAP treats as arising from a financial asset (such as dividends or the sale of shares); and
  - any return that is economically equivalent to interest (using definitions set out in s486B CTA 2009 (disguised interest)).

### **357CB – Relevant IP income (RIPI)**

- 3.13 Relevant IP income is defined in 357CB. In many cases “RIPI” and “relevant IP income” will be synonymous. However RIPI is defined in 357C and in order for relevant IP income to be RIPI it must be included in the total gross income of the trade.
- 3.14 Therefore, finance income cannot be RIPI, as it is excluded from total income. Similarly any non-taxable income cannot be RIPI.
- 3.15 Relevant IP income can arise from four different ways of exploiting IP rights:

### **Head 1: Income from sale of qualifying items etc**

- 3.16 Head 1 is income from the sale of:

- qualifying items;
- items incorporating a qualifying item, (or designed to incorporate a qualifying item, if sold together with that item as a single unit and at a single price); and
- items wholly or mainly designed to be incorporated into a qualifying item or an item incorporating a qualifying item.

3.17 A qualifying item is an item which is protected by a qualifying IP right. For a patent, this will be the patented invention.

3.18 The June 2011 Consultation Document explained that as well as sales of the invention itself, the Patent Box is intended to extend to income from the sale of items that include the patented invention and to spare parts.

3.19 To achieve this, the draft legislation uses the concepts of items incorporating a qualifying item and items designed to be incorporated into a qualifying item.

3.20 In HMRC's view, to be incorporated, the item must be physically part of the larger item and intended to be so for its operating life. Examples of what this might mean in practice are below:

- 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 RIPI, even if there were no patent over the printer itself.
- Conversely, if the printer includes a patented invention and the printer cartridge does not, then sales of the cartridges on their own will qualify as items wholly or mainly designed to be incorporated into the printer.

- 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 RIPI. And similarly, if the DVD player is patented and DVDs are not, sales of the DVDs will not produce RIPI.

3.21 Items wholly or mainly designed to be incorporated into qualifying items or products including qualifying items are included to encompass sales of a variety of bespoke spare parts etc. The company must hold the qualifying IP rights in the item the spare parts are designed for.

## Containers and packaging

- 3.22 The contents of a container will not normally be incorporated in that container, as they will be intended to be removed from it for use.
- 3.23 But, to avoid doubt, 357CB specifically defines packaging and its contents to be separate items, unless the packaging performs a function other than just the normal function of packaging: to contain, protect, facilitate delivery or handling of an item or to enable the item to be presented in a particular way.
- 3.24 The reason for this is primarily to deal with cases where a non-patented product is sold in a patented container or packaging.
- 3.25 Packaging may in some instances however be an integral part of the product throughout its operating life, if it has a particular function aside from its packaging function. To deal with this, the draft legislation allows packaging to be regarded as incorporated with its contents if it performs a function that is essential to allow its contents to be used in the particular way they are intended to be used. An example is below:

- A 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.

- 3.26 Where the packaging is not patented but the contents are, there will generally be no need in practice to distinguish income from packaging separately. 357CE(6), explained later in this Technical Note, in most instances will allow the packaging to be ignored and all income to be treated as arising from the contents.
- 3.27 Note also that if packaging is patented, and materially contributes to the sale value of a non-patented product, then 357CE will allow the income that is reasonably attributable to the packaging to qualify as RIPI.

## Head 2 – Licence fees or royalties for granting rights over qualifying IP rights

- 3.28 Head 2 is licence fees or royalties received for a right granted over qualifying IP of the company (including where the company grants rights out of an exclusive licence it has over qualifying IP).

3.29 It also includes licence fees or royalties from granting of rights over non-patented items, if the purpose of granting of those rights is the same as for the rights over the qualifying IP

3.30 For example:

- The owner of the patent rights over a silicon chip licenses others to manufacture and sell products containing the chip. At the same time it licenses them to use designs, trademarks, know how and technical information to allow them to manufacture and market those products effectively.
- These other rights granted are not themselves in respect of qualifying IP rights. But they will be other rights licensed for the same purpose as the licence over the qualifying IP right. Fees and royalties in respect of these other rights will therefore be relevant IP income in the same way as fees and royalties received in respect of the right to exploit the patented invention.

### **Head 3 – Proceeds of realisation of a qualifying IP right.**

3.31 Head 3 is the income from the sale or other disposal of a qualifying IP right or exclusive licence.

3.32 RIPI under this Head will be the amounts included in total gross income.

3.33 So for post-2002 IP, RIPI will therefore normally be the taxable credit equal to the excess of proceeds of realisation over the accounts carrying value of the qualifying IP right, as set out in sections 735 and 736 CTA 2009.

3.34 And for disposals of pre-2002 patents, where the company chooses to spread the profit on a disposal for tax over a six year period, RIPI will be the part brought into charge to tax in the relevant year.

### **Head 4 – Infringement income.**

3.35 Head 4 is compensation payable to the company from an infringement or alleged infringement of the company's qualifying IP rights.

3.36 The company can qualify (Condition B of 357B) and the income can be relevant IP income even if it is received after expiry or sale of the relevant patent right, if the infringement took place when the right was a qualifying IP right and the company was then elected into the Patent Box.

3.37 Where a company receives compensation that relates partly to a period when both the company and the rights were qualifying, and partly for a period when one or both these were not qualifying, then a reasonable apportionment of the receipt should be made. A reasonable apportionment will also need to

be made for any compensation which relates to a period when the company was not elected into the Patent Box, including to any period before 1 April 2013.

### 357CC – Notional royalties

3.38 The key aim of the notional royalty provisions is to deliver Patent Box benefits to a company using its patented invention in a way that does not generate RIPI, but. does result in the company deriving income and profits. This was proposed in the June 2011 consultation document, in particular to cover patents used in processes that create non-patented products or to provide services.

3.39 Examples could be:

- A patented tool is used in the manufacturing process of non-patented items which are sold by the company.
- An airline company may develop 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 training facility provision are both non-RIPI income that for the purposes of the notional royalty provision is “IP- derived income”.

3.40 357CC applies only to patents: it is not thought that qualifying data exclusivity and plant variety rights will be used in a way that generates income that isn’t RIPI.

3.41 The draft legislation allows part of the income generated (termed “IP-derived income”) to be treated as RIPI. This is an amount equal to the royalty that would be paid to an independent owner of the qualifying IP rights for the company’s exclusive use of those rights to generate the IP-derived income.

3.42 Some assumptions must be made in calculating this amount, to specify certain circumstances which would affect the level of royalty payable at arm’s length.

3.43 These set out in 357CC (7). Some points to note are set out in the following paragraphs.

3.44 In addition to making the assumptions in 357CC(7), the notional royalty must be calculated in according with Article 9 of the July 2010 OECD Model Tax Convention and the OECD’s Transfer Pricing Guidelines, or any successor documents.

3.45 The licence is assumed to be entered into on the later of the first day of the accounting period and the day the company obtained the IP right. This is so

that in each accounting period the royalty corresponds closely to the current value of the rights, without requiring recalculation on a more frequent basis if the value changes during the accounting period.

- 3.46 In practice it should not normally be necessary to determine a new royalty rate for each new accounting period if none of the relevant facts and circumstances have changed from a previous accounting period.
- 3.47 The notional licence is assumed to be granted for a period matching the period for which the company actually holds rights. This allows the amount of the royalty to properly reflect the actual value of the patent rights: a longer term licence tends to be more valuable, on an annual basis, than a shorter term but otherwise equivalent licence.
- 3.48 The notional royalty must take the form of a fixed-rate periodic royalty in order to unambiguously match payments under the licence to the accounting periods in which the IP-derived income is generated. The royalty must be calculated as a percentage of the IP-derived income from the patent rights for their remaining life. This precludes any lump-sum upfront or milestone payments, and tiered or front-loaded or back-loaded royalties which could distort the Patent Box calculation in particular years.
- 3.49 The royalty is only calculated based on income that is not itself RIPI to prevent double-counting. It is not calculated on “excluded income” because no part of this income can qualify for the Patent Box.
- 3.50 The notional royalty can never be greater than the IP-derived income from which it is calculated.

### **357CD – Excluded income**

- 3.51 Certain types of income which might otherwise qualify as RIPI are excluded. These are:
- any income arising from oil extraction activities or oil rights (as defined in part 8 of CTA 2010); and,
  - income from exploiting non-exclusive licences.
- 3.52 Licences which include some exclusive rights along with other rights which are not exclusive are treated as two separate licences, one an exclusive licence that does not confer any rights other than those that are exclusive, and the other a ‘non exclusive licence’ which confers the balance of non exclusive rights. Income from these ‘non exclusive licences’ is not RIPI.

3.53 For example:

- A company may hold non-exclusive rights under a licence to improve, manufacture and sell a new patented laser device to use in fibre-optics. It may also have an exclusive licence to use the patented technology to develop an entirely new application in medical diagnostics.
- Income from the latter application would be relevant IP income, but income from the former would be excluded income.

### **357CE – Mixed sources of income**

3.54 This section deals with the following situations:

- items which would give rise to RIPI are sold together with other items as part of a single unit and/or for a single price;
- a single agreement is made which covers the sale of items or the grant of rights some of which would give rise to RIPI and some of which would give rise to other income.

3.55 Income arising in these circumstances is designated as either mixed income or income paid under a mixed agreement. Such income should be apportioned between qualifying and non qualifying elements on a just and reasonable basis.

3.56 Where any non-qualifying elements of such income comprise only a trivial proportion of it, then the whole of the income is to be regarded as RIPI, so no apportionment will be necessary.

3.57 “Trivial” is not defined, but in practice this can be assumed where realistically the cost and expense of trying to make an apportionment would be disproportionate to the likely impact on the Patent Box calculation. As noted earlier in this Technical Note, this will generally be the case for packaging around a patented product, which will usually have minimal value.

### **357CF – Adjustments to profits or losses of trade**

3.58 Certain adjustments must be made to the taxable profits of the trade for the purposes of computing relevant IP profits. These are:

- R&D relief: the amount of any additional deduction provided by way of R&D tax credit relief is added back to the profits featuring in the Patent Box calculation, so that none of the benefits of the relief is clawed back by the Patent Box;
- Trading loan relationship credits, and other financial returns which are economically equivalent to interest or accounted for as arising from financial assets. These are deducted as they are not eligible for the Patent Box; and

- Trading loan relationship debits, which are added back.

3.59 This adjustment is to be made before the profits are apportioned using the ratio of RIPI to total gross income at step 2 of the formula used to arrive at relevant IP profits set out in S357C.

3.60 It is perhaps worth noting, for clarity, that this of course is **only** done in order to compute Relevant IP profits. The only adjustment that will be made to the actual taxable profits of the trade as a result of electing in to the Patent Box will be the Patent Box deduction referred to in 357A.

### **357CF(7) & (8) and 357CG – Pre-commercialisation expenses and the R&D expenditure condition**

3.61 Paragraph 4.32 onwards of the June 2011 consultation proposed that there should be a mechanism to take account of prior year R&D costs if current year costs do not provide a reasonable proxy for development costs of current products.

3.62 The key aim of 357CF(7) is to provide this mechanism.

3.63 It calculates the average amount of R&D expenditure in the four years before the election into the Box. It applies if the actual amount of R&D expenditure in an accounting period starting within the first four years after entering the Patent Box is less than 75% of the average amount. If an accounting period is less than 12 months long, the average amount of R&D expenditure is proportionately reduced.

3.64 Where this is the case, the actual R&D expenditure is increased to 75% of the previous average annual R&D expenditure, before the profits of the year are apportioned in step 2 of the calculation set out in S357C to arrive at relevant IP profits.

3.65 R&D expenditure for this purpose is the expenditure recognised in the company's statutory accounts under generally accepted accounting practice in the UK. The relevant UK accounting standard will be SSAP 13 or where the company has accepted International Accounting Standards IAS 38.

3.66 If the company has traded for less than four years before electing into the Patent Box, the average amount of R&D expenditure is calculated over the period between the trade commencing and the first day of the first accounting period for which the company comes into the regime.

3.67 The figure is calculated using the formula  $365 \times E/N$ , where E is R&D expenditure over the whole of the relevant period and N is the number of days in that period.

- 3.68 The amounts of actual R&D expenditure in the four years after a company elects in to the Patent Box may fluctuate. If actual R&D expenditure in any of the first four years after election exceeds the average R&D expenditure, the excess can be carried forward.
- 3.69 This carried forward amount can be added to actual R&D expenditure in future years in testing whether the company meets the 75% condition in those years.
- 3.70 If it takes the company's actual R&D expenditure later in one of the four years to over 75% of the average R&D expenditure, when it otherwise wouldn't then a part equal to the difference between that 75% figure and the actual expenditure in the year cannot be further carried forward. The remainder can.

For example: a company has 'average R&D expenditure' of £1,000. 75% of this is £750.

Its results for the first four AP's (each of 12 months) after electing in to the regime are:

AP	1	2	3	4
Total Gross Income	£3,000	£10,000	£15,000	£20,000
R&D	£1,500	£800	£350	£200
Other Costs	£800	£5,200	£11,150	£15,200
PCTCT	£700	£4,000	£3,500	£4,600

- In AP1 actual R&D exceeds 'average R&D expenditure' by £500, so this £500 can be carried forward.
- AP2's actual R&D is £800 which is less than 'average R&D expenditure' but greater than 75% of 'average R&D expenditure' so no adjustment is required. £500 continues to be carried forward.
- In AP3 actual R&D is only £350, which is £400 below the 75% threshold. The brought forward £500 is added to the actual amount so there is no need to make any adjustment. £400 of this cannot be carried forward further, but £100 can.
- In AP4 actual R&D spend falls again to £200. The brought forward £100 can be treated as R&D spend of AP 4. As the total is £300, for patent box purposes the R&D spend in AP4 is deemed to be £750. The profits of the trade for the purposes of step 3 of 357C will become:

AP	4
Turnover	£20,000
R&D	£750
Other Costs	£15,200
Step 3 profits	£4,150

- 3.71 If, despite adding the brought forward amount, the R&D expenditure in one of the later years is less than 75% of the average, then the average figure is

substituted for the actual. The brought forward amount can be carried forward to the next year.

### **357CH and 357CI – The routine return figure and routine expenses**

- 3.72 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 routine return element must be deducted from the profit attributed to RIPI to arrive at the amount of that profit that is attributable to the intellectual property (both patent-related IP and other, such as marketing assets, IP).
- 3.73 A cost plus methodology is a recognised way to determine an arms length return that might be expected from a trader without access to unique IP.
- 3.74 The Patent Box adopts, for simplicity, a 10% return on certain specified costs as a representative routine return in respect of businesses across all sectors.
- 3.75 The routine return is calculated by:
- (i) aggregating routine expenses (as defined in 357CI, see below) deducted in calculating the profits of the trade (excluding any R&D expenses or loan relationship debits) and taking 10% of that figure; and
  - (ii) apportioning the result, by applying the same percentage of RIPI/ Total Gross Income used to apportion the profits of the trade in Step 2 of the calculation in 357C.
- 3.76 The resulting amount is deducted at step 4 of the formula outlined at 357C to gives the “Qualifying residual profit” (QRP) of the company.
- 3.77 Routine expenses are defined in 357CI as amounts in the categories below, excluding any loan relationship amounts and R&D expenses:
- any allowances under CAA2001. This will be the amount of any such allowances deducted from trading income in arriving at the taxable profits of the trade; since only such amounts will have been ‘brought into account in calculating the profits of the trade’;
  - premises costs – all deductible expenses incurred in respect of land and premises which the company occupies. This will include rent, rates, repair and maintenance, water fuel and power costs etc;
  - personnel Costs – this includes any expenditure incurred by the company in respect of directors or employees. It also includes amounts paid in respect of externally provided workers supplied to the company as defined by S1128 of CTA 2009;
  - plant and machinery costs – this includes any deductible costs associated with plant and machinery owned or leased by the company (e.g. costs of leasing, constructing, modifying, maintaining, servicing, operating etc); and

- miscellaneous services – computer software costs, consultancy and professional costs, telecommunications, postal, computing, transport and waste disposal services.
- 3.78 Routine expenses incurred by another group company on behalf of the Patent Box company are included as if they had been included directly. However if the other group company provides a service to the Patent Box company, costs incurred to provide this service will not be treated as routine expenses of the Patent Box company as they are incurred as part of the trade of the other company.
- 3.79 R&D expenses are excluded from the calculation. This recognises that these expenses are likely to have a direct correlation to the creation and development of qualifying IP. The 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.
- 3.80 If, in one of the first four years after electing into the box, the company's R&D expenditure is increased to the average R&D expenditure of the four years before electing into the box, the additional amount brought into account is also excluded.
- 3.81 At step 4 of the calculation outlined at 357C, the routine return is deducted from the profit attributed to RIPI to arrive at a figure called the "Qualifying Residual Profit" (QRP) of the company.

### **357CJ - Election for small claims treatment**

- 3.82 The QRP represents the part of the profits of the trade that relates to qualifying IP rights and also to ability to access other unique IP or intangible assets such as brand and other marketing assets. The regime aims to ensure that the profits attributable to these other types of IP are excluded from the Patent Box.
- 3.83 The legislation provides two possible methods for determining how much of the QRP of a company for an accounting period represents profit from qualifying IP rights and how much relates to brand and marketing assets. The latter part of the profit is deducted from QRP, with all remaining profits being relevant IP profits ("RIPP") which are then used to calculate the 357A Patent Box deduction.
- 3.84 The simpler of these two methods allows company to elect to adopt a formulaic approach.
- 3.85 This approach, set out in 357CJ, stipulates the relevant IP profits for the accounting period to be the lower of two amounts:
- (i) 75% of QRP ; or

(ii) The small claims threshold (£1 million).

- 3.86 A company with QRP of less than £1.3m may of course believe that it does not in reality exploit any marketing assets or the value of any marketing assets is only small. If it is able to demonstrate that this is so, applying the provisions at 357CK to 357CN may be relatively straightforward and it may choose not to elect for small claims treatment.
- 3.87 Conversely, it is possible that a company with QRP significantly in excess of £1.3m may still wish to opt for small claims treatment to make the RIPP calculation simpler, provided that it does not wish to claim any more than £1 million as relevant IP profits.

### **357CK to 357CM - Marketing assets return, notional marketing royalty and actual marketing royalty**

- 3.88 The provisions to exclude the return from marketing assets are intended to focus the benefit of the regime on technologies covered by relevant IP rights. They aim to exclude the sometimes very substantial profits that can be generated using established brands. The legislation is limited to marketing assets in order to minimise computational complexity while excluding what is believed to be the largest source of profit not directly related to qualifying IP rights.
- 3.89 If a company does not elect for small claims treatment, it must deduct a marketing assets return figure from QRP to arrive at relevant IP Profits (RIPP).
- 3.90 The legislation uses two figures, the notional marketing royalty (NMR) and the actual marketing royalty (AMR) to calculate the profit attributable to marketing assets.
- 3.91 However if AMR is greater than NMR, or the difference between the two is less than 10% of QRP for the accounting period, 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.

### **357CL – Notional Marketing Royalty**

- 3.92 The NMR is the appropriate percentage of the relevant IP income for the accounting period that a company would pay a third party for the exclusive right to exploit the relevant marketing assets if they were not otherwise able to exploit them.
- 3.93 As an indicator of what, subject to consultation, might be the appropriate categories of marketing assets the legislation uses a definition that the

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

- any trade mark (registered or unregistered);
- signs or indications of geographical origin of goods or services; and
- information about actual or potential customers.

- 3.94 The definition of trade mark referred to in the legislation includes any sign capable of distinguishing goods or services of one undertaking from those of other undertakings. This includes words (including personal names), designs, letters, numerals or the shape of goods or their packaging.
- 3.95 The legislation requires the assumption to be made that an agreement can be made for the company to exploit the assets to the exclusion of all others including the notional owner, even if the assets cannot in fact be separately transferred or assigned.
- 3.96 In determining what an arms-length royalty will be, and as for the notional royalty described earlier in this note on page 22, certain assumptions need to be made to set the conditions under which the parties are deemed to transact.
- 3.97 These assumptions include:
- the company and the notional IP owner are dealing at arms length;
  - the company have the right to exploit the marketing assets, to the exclusion of all others including the notional IP owner;
  - the right to exploit the marketing assets is conferred at the start of the accounting period, or if later when the relevant assets were acquired;
  - the rights to the assets being notionally considered are the same as in fact exist;
  - the appropriate percentage figure for the royalty, as a percentage of relevant IP income is determined at the start of the accounting period and it will be assumed that it will remain unchanged for the time that the company holds the rights in fact. In other words, as for the notional royalty, the marketing assets royalty is deemed to have an even profile over its life;
  - note however that the royalty needs to be reassessed for each accounting period, using the same assumptions. In practice it is expected that the percentage royalty might well stay the same for several years; and
  - the company must value the royalty on the assets in accordance with OECD article 9 and model tax convention, and the OECD transfer pricing guidelines.

### **357CM – Actual Marketing Royalty**

- 3.98 The actual marketing royalty is to be subtracted from the notional marketing royalty to give the deduction from QRP. This is so that the marketing assets return is limited to profits which accrue to the company. The actual

marketing royalty is the part of the return to marketing assets which accrues to third parties.

- 3.99 It is defined as a proportion of the aggregate amounts paid in the accounting period and brought into account as debits in the corporation tax computation for the relevant marketing assets. This amount could be a royalty paid to use a marketing asset or an amortisation charge in relation to an acquired marketing asset.
- 3.100 The proportion is X%, where this is the percentage given by step 2 in the calculation of QRP. In other words this is the ratio of RIPI to total gross income, as a percentage. Where a streaming election has been made, this provision is modified by 357DA(7), which substitutes for X% the amount of such debits that have been allocated to the RIPI stream.

### **357CN - Profits arising before grant of right**

- 3.101 There may be a number of years between application for a patent and grant. This is usually known as the patent pending period.
- 3.102 The legislation allows a company to claim additional relief in the accounting period in which a patent is granted in order to recognise any qualifying income and profits from exploiting the patented invention after application for the patent, for up to six years prior to the grant of the patent.
- 3.103 A company is entitled to elect to add an additional amount to its relevant IP profits in any accounting period in which a patent is granted to it or in which a patent to which it holds an exclusive licence is granted.
- 3.104 A company is also entitled to make such an election if it received income while the patent is pending, but disposes of its rights before the patent is granted.
- 3.105 The additional amount is the difference between:
- the aggregate of the relevant IP profits of the trade for each accounting period for which the patent application was pending and which ended no more than 6 years prior to the grant; and
  - what the aggregate of the relevant IP profits of the trade would have been, for those accounting periods, if the patent had been granted at the date of application (or 6 years before the date of grant if later).
- 3.106 Any profits that are or would not be taken into account in the Patent Box because they are off-set by a relevant IP loss amount are disregarded in this computation.

- 3.107 Additionally any accounting periods where the company was not elected into the regime or was not a qualifying company are disregarded.
- 3.108 However where a company would have been a qualifying company for an accounting period but for the fact that the patent in question had not been granted, it is to be treated as a qualifying company for the purposes of this section.
- 3.109 So a company will need to have stated when completing its corporation tax returns for these earlier periods that it would have elected into the patent box had the patent been granted at that time. It may be sensible also to calculate at that earlier time what the RIPP would have been.
- 3.110 Similarly where a company would have been a qualifying company for the accounting period in which the patent was granted but for the fact that it disposed of the patent, or exclusive licence over the patent, before the date of grant, it is to be treated as qualifying for the purposes of this section.
- 3.111 If a relevant patent pending period produces a negative figure for RIPP (known as a “relevant IP loss” (RIPL) – see Chapter 5 below), then if a company has elected to include this patent pending period in its Patent Box calculation this RIPL must be deducted in calculating the aggregate profit figure.

## Chapter 4 – Streaming

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- 4.1 In some instances apportioning the profits of a trade by using a simple ratio of RIPI to total gross income will not give an acceptable estimate of the company's actual profits from exploitation of its qualifying IP rights.
- 4.2 This may occur to a company's disadvantage in circumstances where it has a significant amount of non-IP income that produces relatively little profit and a smaller proportion of income that is relevant IP income but produces a much larger level of profit. For example:

- A company which manufactures and sells a range of established products, none of which incorporate items protected by qualifying IP. Turnover from this activity is £900,000 but its net profits are only £50,000. The company also owns qualifying IP which it developed many years previously and has licensed out to another business which takes care of manufacturing, marketing, distribution and sales. It receives an annual licence fee of £100,000.
- If the trade profits of £150,000 are apportioned by the ratio of RIPI to total gross income the result will be:  $\text{£}100,000/\text{£}1,000,000 \times \text{£}150,000 = \text{£}15,000$
- But clearly in this example the company will want profits of £100,000 to qualify for the Patent Box.

- 4.3 There may also be converse situations where a company manufactures and sells items which rely on qualifying IP rights and also receives licence royalties in respect of non-qualifying IP:

- A company's receipts from exploiting qualifying IP rights is £1 million on which it generates a profit of £200,000. Its licence income is £1 million all of which is profit.
- If the trade profits of £1,200,000 are apportioned by the ratio of RIPI to total income the result will be:  $\text{£}1,000,000/\text{£}2,000,000 \times \text{£}1,200,000 = \text{£}600,000$
- So £400,000 of profit from non-qualifying IP will potentially qualify as RIPP.

### 357D – Alternative method of calculating relevant IP profits: “streaming”

- 4.4 The June 2011 Consultation Document recognised these potentially anomalous results from the normal formulaic way of apportioning profits. The proposed approach to deal with them was “divisionalisation”: where the company's trade could be split into notional divisions that transacted at arms length with each other.
- 4.5 Following consultation, the draft legislation takes a slightly different and more straightforward course. This is to allocate expenses and profits to particular income streams on a just and reasonable basis.

- 4.6 This approach can be applied if the company elects to do so. This is known as a streaming election.
- 4.7 The draft legislation specifies also that the alternative streaming basis **must** be used in certain situations: where ‘the mandatory streaming condition’ set out in 357DC is met.
- 4.8 Where a company makes a streaming election the election applies for each of that company’s trades and all subsequent accounting periods (subject to an exception provided for in 357DB – see below).

### **357DA – Relevant IP profits**

- 4.9 This alternative basis works by replacing steps 1 to 4 of 357C with three alternative steps as follows:

#### **Streaming step 1**

- 4.10 The total gross income of the trade is divided into two ‘streams’ of income, by identifying how much of that total gross income is relevant IP income (this will include any notional royalty allowed by 357CC) and how much is not relevant IP income.

#### **Streaming step 2**

- 4.11 The debits deducted from total gross income in arriving at taxable trading profit (excluding any additional deduction under Part 13 of CTA 2009 for R&D expenditure and any deduction for trading loan relationship debits) are then allocated against the stream to which they relate on a just and reasonable basis.
- 4.12 The aim is that debits that arise in generating the relevant IP income are allocated against the relevant IP income stream and debits that arise in generating the non relevant IP income stream are allocated against the non-relevant IP income stream.
- 4.13 Clearly, what is just and reasonable will depend on the specific circumstances. However all expenses must be allocated, and so for instance R&D (but not the additional Part 13 deduction), which may of course relate to future income, must still be fairly allocated to the current income streams.

#### **Streaming step 3**

- 4.14 This requires the company to deduct the debits allocated against the relevant IP income stream from that income stream to give a figure to carry forward to step 4.

#### **Streaming step 4**

- 4.15 The company must now apply the 10% routine return percentage to any routine expenses included in the debits allocated against the relevant IP income stream (other than R&D expenses) and deduct the resulting figure from the figure produced by step 3 to give the figure of QRP.
  
- 4.16 Steps 5 and 6 follow the same approach as the same as for the normal calculation in 357C, other than in Step 6 where it is the aggregate of any actual marketing royalty allocated to the relevant IP stream that is deducted from the notional royalty in calculating what should be deducted from QRP.

#### **357DB – Method of allocation**

- 4.17 357DA also makes clear that to be just and reasonable, normally a method of allocation must be consistent between one year and the next, unless there is a change of circumstances that make the method inappropriate.
  
- 4.18 In this case, the company can choose to use a different method that does produce a just and reasonable result, or to exit from streaming and use the simple apportionment formula.
  
- 4.19 If the company chooses to use the simple apportionment formula it can however make a fresh streaming election for any subsequent accounting periods if it wishes to do so. However, once it re-elects to stream then it must apply this consistently year on year unless there is a change of circumstances.

4.20 An example to illustrate streaming is below:

A company develops, manufactures and sells a range of branded patented products in the UK. It also licenses out the right to manufacture the products in other countries using its patented technology, know-how, and brand. In addition, the company uses its excess manufacturing capability to provide manufacturing services on a contract basis to other group companies.

- The company allocates its cost of goods on a direct basis
- The company determines that other manufacturing costs are incurred equally whether patented or non-patented goods are being manufactured. It therefore determines that these costs should be allocated based on the number of units produced.
- The company allocates all its R&D department costs to the RIPI stream. NB: It does not matter how these costs are allocated to manufacturing and licensing within this stream, as both produce fully qualifying income
- All “other manufacturing costs” are “routine expenses”, while none of the cost of goods are. R&D costs are outsourced.

The company’s streamed P&L may look like this:

		RIPI		Non-RIPI
	Total	Full-risk Manufacturing	Licensing	Contract Manufacturing
Income	10,000	6,000	1,000	3,000
Cost of Goods	4,000	2,000	-	2,000
Gross Profit	6,000	4,000	1,000	1000
Other Manufacturing costs	1,400	700	-	700
Profit before R&D costs	4,600	3,300	1,000	300
R&D Costs	2,600	2,600		
PCTCT	2,000	1,700		300

**Streaming Calculation**

Step 1: RIPI is calculated as £7000

Step 2: Total debits of £4,300 are allocated against RIPI (£2,000 + £700 + £2,600)

Step 3: Deduct debits from RIPI leaving stream profits of £1,700

Step 4: Apply routine return of 10% to routine expenses of £700 included in RIPI stream. Deduct this £70 from the £1,700 to give QRP of £1,640

Step 5: The company elects for small claims treatment, so its RIPP is 75% of QRP, or £1,230

The company’s Patent Box tax deduction is therefore  $£1,230 \times (23-10)/23 = £695$

The company’s corporation tax profit is therefore reduced to £1,305; and its corporation tax payable is reduced from £460 to £300

**357DC – The mandatory streaming condition**

4.21 The mandatory streaming condition is met where the total gross income of the trade includes not only relevant IP income but also a substantial amount of licensing income that is not relevant IP income.

4.22 Licensing income means generally any licence fee, royalty or other payment received in respect of intellectual property of the company which is not a

qualifying IP right.

- 4.23 “Substantial” in this context means the lower of £2 million or 20% of the total gross income of the trade for the accounting period.
- 4.24 However, if the lower of these two amounts is £50,000 or less then the mandatory streaming condition is not met.

## Chapter 5 – Companies with relevant IP losses

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### 357E to 357EE

- 5.1 Particularly in the early stages of IP development a company may derive income from its qualifying IP rights but not yet return a profit. Or it may produce a profit but this is less than a routine return on the costs of earning the income. In this case the calculation of relevant IP profits will result in a negative figure, referred to in the legislation as a relevant IP loss.
- 5.2 One consequence for the company is that there is no amount of RIPP. As a result the company will be taxed on its actual profits, or will be able to relieve its losses, as if it had made no election into the Patent Box.

### 357E – Company with relevant IP losses: set-off amount

- 5.3 Where a company has a relevant IP loss then the 357E sets out that a company has a set-off amount which is equivalent to this loss.

### 357EA – Set-off against RIPP of other trades carried on by the company

- 5.4 Where a company has a set-off amount and, unusually, the company has another Patent Box trade with RIPP, then the set-off amount must be reduced by the RIPP of that other trade.
- 5.5 The RIPP that has been used to reduce the set-off amount is then not included in the amount of RIPP that is used to calculate the Patent Box deduction in 357A(3).

### 357EB – Set-off against other group companies' RIPP

- 5.6 If, after the reduction of the set-off amount under section 357EA, there is still a set-off amount remaining, then the excess reduced by any RIPP of other relevant group companies for the relevant accounting period.
- 5.7 An accounting period of a company that has a set-off amount is a relevant accounting period if it ends at the same time as or within an accounting period of another group member. The other group member is a relevant group member if it has made an election under section 357A that has effect in relation to that period.
- 5.8 Again any RIPP used to reduce the set-off amount is no longer eligible to be included in calculating its Patent Box deduction for that accounting period.
- 5.9 Where there is more than one company within the group with RIPP which are subject to set-off the group may determine in which order the set-off is to

be made. If no determination is made the set-off amount will be reduced by the company with the greatest amount of RIPP first, then the next largest and so on.

### **357EC – Carry Forward of Set-Off Amount**

- 5.10 If, after the application of section 357EA and 357EB, the company has remaining set-off amounts, it carries these forward against any RIPP arising in the following accounting period.
- 5.11 If the set-off carried forward exceeds the RIPP of the company and the company is a member of a group the balance of the set-off should be reduced by RIPP of other group members applying the rules described in section 357EB above. Again, any RIPP which is used to reduce the carried forward set-off amount is no longer eligible for the Patent Box deduction.
- 5.12 Any set-off amounts which still remain unreduced are carried forward and reduced by RIPP of future accounting periods as described above.

### **357ED – Company Ceasing to Trade etc**

- 5.13 If a company ceases to trade, ceases to be within the charge to corporation tax in respect of the trade or the Patent Box election ceases to have effect, then any unreduced set-off amounts are transferred to any other group member that is a qualifying company at the relevant time.
- 5.14 The group can decide which group members with RIPP are to be allocated the set-off amount. If there are no companies with RIPP then the sum goes to the company with the largest set-off amount of its own.
- 5.15 If there are no companies elected into the patent box or which are qualifying companies, then the set-off amount is reduced to nil.

### **357EE – Transfer of trade intra-group**

- 5.16 The set-off amount goes to the transferee if in an accounting period the trade is transferred to another group company.

## Chapter 6 – Anti –avoidance

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### 357F to FB – Tax advantage schemes

- 6.1 This chapter contains anti-avoidance rules covering the regime.
- 6.2 The first rule, in 357F, is intended to prevent commercial irrelevant exclusivity being conferred under a licence in order primarily to ensure that income generated by the licensee qualifies for the Patent Box. It is not intended to apply if there is a commercially reasonable choice about exclusivity, and the two parties agree to opt for one because the licensee recognises that it will then qualify for the patent box.
- 6.3 The second rule, in 357FA, is aimed at cases where a patented item is incorporated into a product for a main purpose of securing that income arising from sale of the product is relevant IP income. Again, it 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.
- 6.4 The main anti-avoidance rule is section 357FB. It applies where a company which is entitled to make a deduction under 357A is party to a scheme and one of the main purposes of the scheme is to obtain a relevant tax advantage.
- 6.5 A relevant tax advantage arise where:
- relevant IP profits are increased as a result of the scheme; and
  - the scheme is of a specified type
- 6.6 Specified types of schemes are:
- schemes designed to avoid the application of any provision in Part 8A;
  - schemes designed to create a mismatch between the expense of acquiring or developing a qualifying IP right (or exclusive licence over a qualifying IP right) and the income arising from that right or licence. Such a mismatch would occur if the expense is incurred whilst the company (or a company with which it is grouped) is outside the regime, whilst the income arises once the company has elected in to the regime; and
  - schemes designed so that income that the company brings into account in computing its trading profits is not recognised as revenue but as some other item in the company's income statement or profit and loss account. Such schemes could be used to skew the proportion of profits qualifying for the patent box if for instance non patent-derived income was recognised other than in total gross income.

## Chapter 7 – Supplementary

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### **357G – Making of an election under section 357A**

- 7.1 To elect in to the regime under 357A a company must give notice in writing. The notice must specify the first accounting period for which the election will apply.
- 7.2 The latest time for providing notice of an election is the last day on which the company would be entitled to amend its tax return, under paragraph 15 of Schedule 18 of FA 1998, for the first accounting period to which it is intended to apply.
- 7.3 In practice this means within 12 months of the fixed filing date of the return for the first accounting period for which the company wishes to elect in to the regime.
- 7.4 An election will apply equally to all trades of the company and for all subsequent accounting periods until it is revoked.

### **357GA – Revocation of election made under section 357A**

- 7.5 A company must continue to calculate the relevant IP profits of each its trades for each accounting period following an election into the regime, until that election is revoked by giving notice in writing. The notice must specify the first accounting period for which the revocation is to have effect.
- 7.6 The latest time for revoking an election is the last day on which the company would be entitled to amend its tax return, under paragraph 15 of Schedule 18 of FA 1998, for the first accounting period to which it is intended to apply.
- 7.7 As with an election into the Patent Box, in practice this means within 12 months of the fixed filing date of the return for the first accounting period for which the company wishes to elect in to the regime.
- 7.8 The revocation will apply equally to all trades of the company and for all subsequent accounting periods until a new valid election is made.
- 7.9 Once an election has been revoked, a fresh election under 357A will have no effect for any accounting period which begins less than 5 years after the last day of the accounting period specified in the revocation notice.
- 7.10 This is to ensure that companies do not dip in and out of the regime for purposes which would amount to an abuse of the regime, for example to

exclude periods when a company would be required to register a set-off amount that would affect the relief available to other group companies.

### **357GB – Application to partnerships**

- 7.11 357A makes it clear that only a company may elect in to the regime. However a qualifying IP right may sometimes be developed on a collaborative basis using partnership arrangements. Where one of the partners is a company section 1259 CTA 2009 will be relevant. This requires trade profits to be computed as if the partnership were a company and each corporate to be allocated an amount of these profits based on its profit share.
- 7.12 The legislation provides a mechanism for a corporate partner in a partnership that meets both the development and active ownership requirements in respect of qualifying IP rights it holds to obtain the benefits of the Patent Box.
- 7.13 This is achieved by allowing the partners to elect to be taxed as if the partnership itself had elected into the regime. As a result of such an election the profit allocated to the partner will be reduced through the Patent Box calculation such that the effect will be that the actual profits are charged at 10%.
- 7.14 The election is made on a company-by-company basis. So some partners may elect in and some may not.
- 7.15 A partnership meets the development condition in relation to a qualifying IP right for the purposes of this section if it has itself carried out qualifying development in relation to the right, or if a ‘relevant corporate partner’ (entitled to at least a 40% share of profits or losses) has done so.

### **357GC – Application of this Part in relation to cost sharing arrangements**

- 7.16 Cost sharing arrangements (CSA) are a normal commercial arrangement allowing businesses to share the costs and risks of developing, producing or obtaining assets, services, or rights. The participants will contribute to the activities in proportion to the benefits each expects to obtain.
- 7.17 A CSA may establish a separate legal entity or simply amount to contractual arrangements. Where the CSA is a company or partnership then the Patent Box calculation will be applied to the entity. But where there is no such entity then section 357GC will be relevant.
- 7.18 CSAs are often entered into where R&D and/or funding for R&D is split between 2 or more companies. The reason for this may be that each of the participator companies has a specialist area of research or because one or more of the participators have R&D expertise and/or facilities but no capital to fund it and the other or others have capital but no R&D expertise or

facilities.

- 7.19 The basic idea is that R&D is carried out by those participators best placed to carry it out, but the costs arising are borne by all of the participators in previously agreed proportions.
- 7.20 For example, 3 companies may have R&D facilities which allow them to carry on complementary R&D in different fields of research with a view to combining the results into one specific product. There is no guarantee that the costs of each specialist area of research will equalise, so the participators might agree that the income arising from any resultant IP (including, but not exclusive to, patents) will be split according to the relative costs incurred by each participator. Alternatively they may agree that the costs incurred by each participator should be recorded and that the greatest contributor will be reimbursed a proportion of their costs by the other participators. The income arising from the resultant IP would then be split equally between the participators.
- 7.21 Accordingly, each of the participators will have contributed to the development of the IP and will be entitled to a share of the income from that IP as a result. To the extent that this income includes income from a qualifying patent it should qualify for the Patent Box.
- 7.22 However, participators will not necessarily own the qualifying patent nor be an exclusive licensee since their entitlement flows from the CSA itself.
- 7.23 Section 357GC applies where one of the parties to the arrangement holds a qualifying IP right or exclusive licence and each of those parties is required to contribute to the development of the item to which the right relates or any product incorporating it. Provided that each party to the arrangement is entitled to a share of the income from exploiting the right then it is treated as if it held the relevant right itself.
- 7.24 The company will therefore be entitled to claim the benefits of the regime in relation to that right subject to the normal rules of Part 8A.
- 7.25 357GC is however specifically disapplied if the income that arises to the company from the arrangement is economically equivalent to interest. This is in keeping with the requirement that companies are actively involved in the development or management of qualifying IP rights and are not just passive investors, and that only profits attributable to the risks and rewards of such activity benefit from the Patent Box.

### **357GD – Meaning of Group**

- 7.26 The definition of group for the purposes of the regime is widely drawn so that it will allow joint venture entities and smaller groups that might not be

required to be fully consolidated in group accounts under section 399 of the 2006 Companies Act to fall within the definition.

- 7.27 The definition is relevant for the purposes of the development condition, the active ownership condition routine expenses, tax advantage schemes and the procedure for dealing with set-off amounts.

## Chapter 8 – Amendments of other legislation

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### Interaction with other Legislation

#### Transfer pricing

- 7.28 In the context of the Patent Box there is a risk of UK taxpayers shifting profits from one entity (the advantaged person) to another entity (the disadvantaged person) who is a Patent Box claimant.
- 7.29 However there is an exemption from transfer pricing rules for the vast majority of transactions carried out by businesses that are EU small or medium enterprises. There are some exceptions to this set out in TIOPA sections 167 and 168. Section 168 TIOPA can require a medium sized enterprise to use arms length principles on receipt of a notice from HMRC.
- 7.30 The draft legislation includes a provision to amend section 167. This will insert another exception to the small enterprises exemption. This will allow HMRC to issue transfer pricing notices to reapply TIOPA Part 4 to provisions of a small enterprise where at least one provision involves a transaction taken into account in an affected person's calculation of Patent Box profits.

#### Double taxation relief

- 7.31 Under sections 44-48 TIOPA 2010 double taxation relief (DTR) is allowed for withholding tax (WHT) on patent royalties up to the amount of corporation tax payable on the transaction, arrangement or asset in respect of which the royalties are paid.
- 7.32 The Patent Box deduction will be brought into the DTR calculation and by reducing the CT chargeable may result in a restriction of the DTR available.
- 7.33 A simple example of a DTR calculation including the Patent Box is given below:

A company has royalty income of £1000 from licensing one of its patents.

£400 of this comes from overseas territories, on which the company has suffered a total of £30 of overseas WHT.

The company incurs costs of £400 to generate its royalties, incurred equally for all royalties. It elects into the Patent Box and calculates its Patent Box tax deduction as £300.

The company's DTR calculation under section 44 would look like this:

Royalty	£400
Share of costs	£160
Share of Patent Box tax deduction	£120
Corporation tax profit	£120
CT @ 23%	£28
WHT Suffered	£30

The company's DTR is therefore limited to £28 and the CT computation will look like this:

Royalties	£1000
Costs	£400
Patent Box tax deduction	£300
Corporation tax profit	£300
CT @ 23%	£69
DTR	£28
CT payable	£41

## Chapter 9 – Commencement and Transitional Provision

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### Application

- 9.1 The regime has effect in relation to income and gains from 1 April 2013.
- 9.2 Where an accounting period straddles that date income or gains arising in that period are to be apportioned between the period prior to 1 April 2013 and the period from 1 April 2013 on a just and reasonable basis.

### Special treatment of profits to be phased in

- 9.3 The full benefit of the regime will be phased in over the first four financial years following commencement on 1 April 2013.
- 9.4 This will be done by applying an appropriate percentage by financial year to the relevant IP profits of the company for each accounting period.
- 9.5 The appropriate percentages for each financial year are:

Year	2013	2014	2015	2016
Percentage	60%	70%	80%	90%

- 9.6 Where an accounting period falls within more than one financial year the relevant IP profits of the company for that accounting period should be apportioned to each financial year.
- 9.7 For example for a company with relevant IP profits of £100,000 for an accounting period of 1 January 2014 to 31 December 2014, the effect will be:

Relevant IP profits of the period	£100,000
Profits falling in FY 2013 $90/365 \times £100,000$	£24,658
Profits falling in FY 2014 $275/365 \times £100,000$	£75,342
FY2013 60% x £24,658	£14,795
FY2014 70% x £75,342	£52,740
Adjusted Relevant IP profits of period	£67,534

## **Part 2 para 8 - Companies with relevant IP losses: interaction with phasing in of benefits**

- 9.8 To match the phasing in of the lower rate on profits, set-off amounts between 2013 and 2016 which are carried forward are reduced according to a formula. This reflects the fact that the Patent Box benefits increase each year by 10%, from the initial figure of 60%.
- 9.9 The formula is :  $10\% / P$  where P is the percentage applied in the following year to the Patent Box RIPP before substituting into the formula deduction.

## The Patent Box Legislation: an outline Guide

Does the company want to be in the Patent Box?	⇒ Chapter 1 <b>357A</b> specifies:	<ul style="list-style-type: none"> <li>Election for a lower rate</li> <li>Delivery by a profits deduction based on relevant IP profits (RIPP)</li> <li>The formula to calculate the deduction</li> </ul>
Does the company qualify to be in the Patent Box?	⇒ Chapter 2 <b>357B to 357BD</b> specifies:	<ul style="list-style-type: none"> <li>The types of IP right that the company can own</li> <li>Inclusion, and definition, of exclusive licences</li> <li>The development condition for these rights</li> <li>The active ownership condition for group companies</li> </ul>
How are the relevant IP profits calculated?	⇒ Chapter 3 <b>357C to 357CA</b> specifies:	<ul style="list-style-type: none"> <li>Apportionment of profits according to the proportion of “total income” that is relevant IP income (RIPI)</li> <li>Elimination of routine profit by mark up of certain costs, to give “qualifying residual profit” (QRP)</li> <li>If the company elects for small claims treatment, calculation of RIPP as a proportion of QRP</li> <li>Otherwise, the calculation of RIPP by removal from QRP of a return on marketing assets</li> </ul>
	<b>Main calculation approach</b>	
	Chapter 3 <b>357CB to 357CE</b> specifies:	<ul style="list-style-type: none"> <li>What income (and from what sources &amp; items) can be RIPI</li> <li>What other income can be deemed to be RIPI by way of a notional patent royalty</li> <li>What income cannot be RIPI</li> <li>Identification of RIPI arising from mixed agreements</li> </ul>
	<b>RIPI</b>	
	Chapter 3 <b>357CF to 357CG</b> specifies:	<ul style="list-style-type: none"> <li>Profits apportioned according to RIPI are before R&amp;D tax credits and net finance expenses</li> <li>Profits apportioned may be reduced by additional notional R&amp;D expenditure in the first 4 years after electing into the Patent Box if R&amp;D expenditure is significantly reduced from levels before then</li> </ul>
	<b>adjustments to profits</b>	
	Chapter 3 <b>357CH to 357CI</b> specifies:	<ul style="list-style-type: none"> <li>Routine profit is to be excluded from the Patent Box by assuming particular expenses generate a 10% return. This return is to be deducted in computing QRP</li> </ul>
	Chapter 3 <b>357CJ to 357CM</b> specifies:	<ul style="list-style-type: none"> <li>If a company elects for small claims treatment the relevant IP profits are 75% of QRP, up to a maximum of £1m</li> <li>Otherwise, RIPP are calculated by removing a return equivalent to a notional royalty for relevant marketing assets, less any actual marketing royalty paid in relation to these assets</li> </ul>
	<b>Small claims &amp; brand exclusion</b>	
What happens to income while the patent is pending?	⇒ Chapter 3 <b>357CN</b> specifies:	<ul style="list-style-type: none"> <li>Profits earned while a patent is pending, up to a maximum of 6 years before grant, can be treated as RIPP in the accounting period of the grant, if they would have been RIPP had the patent been granted at the time the profits were earned</li> </ul>
	<b>Pat. pending income</b>	
What if the pro-rata apportionment of profit to RIPI is inappropriate?	⇒ Chapter 4 <b>357D to 357DC</b> specifies:	<ul style="list-style-type: none"> <li>On election, a company can allocate expenses to RIPI and non-RIPI streams on a just and reasonable basis</li> <li>A company must do this for substantial licensing income</li> <li>The calculation then proceeds as above, but using these expenses and the profit identified using them</li> </ul>
	<b>Alternative calculation</b>	
How are elections made, what happens for partnerships etc and how are matters defined in the legislation?	⇒ Chapters 5, 6 and 7 <b>357E to 357GE</b> specify:	<ul style="list-style-type: none"> <li>Negative RIPP amounts must offset other Patent Box profits</li> <li>Anti-avoidance rules</li> <li>Mechanics of electing into the Patent Box and revocation (including a subsequent 5 year exclusion)</li> <li>Rules for partnerships and cost sharing arrangements</li> <li>Definitions of “group” and “protected item” and certain other terms used in the legislation</li> </ul>

