

Patent Box – Consultations – July 2011

Capital Allowances
Sustainability Incentives
International Tax Depreciation
R&D Tax Relief

In a nutshell:

- UK corporation tax of 10% available within the 'Patent Box'.
- This rate will apply to patent and license income but not income received from trademarks or copyrights
- Proposal includes a phased introduction from 1 April 2013.
- Will apply to existing patents (not just those commissioned post-2013).
- The consultation continues...and will end on 2 September 2011.

Introduction

The amended Patent Box proposals arrived somewhat under the radar at the end of May and for such a radical and generous proposal, one would expect much more coverage in the media.

Originally conceived by Labour, the Patent Box is a corporation tax system for ring-fencing income from patents, licenses and other forms of intellectual property (IP) and applying a lower rate of corporation tax to that income.

Indeed, whilst the UK has generously rewarded research and development (R&D) through the R&D tax credit system, the actual vesting of the IP within the UK was not adequately incentivised. As such, companies may undertake the R&D to develop new products, processes and services within the UK but it was often apparent that the resulting IP was taken 'offshore' to lower taxation regimes including the Republic of Ireland and Luxembourg.

Proposed Model

In order to provide *'the most competitive corporate tax system in the G20'*, the Government believes *'it will be critical to create and attractive regime for companies to develop and exploit IP in the UK'*.

To achieve this, a corporation tax rate of 10% will apply to patent profits from April 2013. The consultation seeks to investigate the introduction of this measure in an efficient and effective manner, free from possible exploitation but without overbearing complexity.

Any business within the scope of UK corporation tax may be eligible to elect for the Patent Box regime to apply to their profits. The business must hold the IP in the UK and receive income from it.

The claimant must apportion profits to 'qualifying income' (which may be pro-rata or divisional apportionment of profits), deduct overheads and identify how much of the 'residual income' is attributable to 'qualifying patents'.



Qualifying Patents

It is proposed that the Patent Box will include patents granted by the UK and EU patent offices but will apply to worldwide income received from a qualifying patent. The Government is considering allowing patents granted by other EU member states as well.

The Patent Box will also be extended to include regulatory data protection and Supplementary Protection Certificates, but other forms of IP such as trademarks and copyrights will not be included.

Patents and licenses developed as joint-ventures, partnerships and other arrangements will qualify, whether the patent was developed or acquired by the entity. However, companies benefiting from the Patent Box must be actively involved within the 'patent development cycle' meaning they must be part of the decision making process and not merely passively holding the IP.

Patents developed elsewhere in the group and those which were acquired may be included, although the Government is consulting on the actual methodology required to determine whether 'acquired' patents would be qualifying.

Qualifying Income

Net income should be calculated to derive the qualifying income for all inventions covered by a qualifying patent and will include licenses and income embedded in patented products. Interestingly, any damages or compensation received as a result of an infringement action will also qualify for the Patent Box, as will income received from the sale of intellectual property rights.

Companies which utilise patented products in an industrial process may be able to use the divisionalisation rules to impute an arm's length transaction between cost centres and claim the income within the Patent Box.

Service, financial and North Sea Ring fence income are not generally covered by patents within UK law and the Government has decided to exclude these sources from the proposals.

The 'qualifying income' section of the consultation does end with a sting in the tail – despite calls for the contrary, only income with a valid patent in place will qualify, meaning all 'patent pending' income will not qualify.

Patent Box Profits

The reduced rate of corporation tax will relate to net profits only (rather than gross income) using a three-step calculation:

Step one: Total taxable trading profit and expenses will be apportioned pro-rata based on the amount of 'qualifying income' included within total trading income.

Step two: Reflect the additional profit generated by exploiting valuable patents (known as residual profit) – this step is obtained by deducting a fixed percentage of 15% on routine activities from the qualifying income.

Step three: Splitting the residual profit between qualifying patent income and other valuable IP which cannot be included within the Patent Box.

Allocation of profits in step one, may also be completed on a so-called 'divisionalisation' basis which would help to exclude anomalies in a company with differing divisional reporting.

Patent Box losses will not be taken into account in computing the current year profits, however the losses will be calculated and carried forward against Patent Box profits.

A company may opt-out of the scheme, but will not be able to re-join the scheme within five years.



Computation

Somewhat confusingly (although perhaps to ease administration) after all the 'ring-fencing' work undertaken, instead of simply applying the 10% rate to 'patent profits', the Patent Box will provide an additional tax deduction calculated as follows:

$$\text{Total Patent Box Profit} \quad \times \quad \frac{\text{Main CT rate less Patent Box Rate}}{\text{Main CT rate}}$$

The measures will apply on a company by company basis, rather than on a consolidated group level and therefore, HMRC will be provided with extra powers to apply the transfer pricing regulations regardless of group size.

HMRC envisages that companies will be able to take part in a formal clearance process, especially when particular rules would apply. It is also likely that significant anti-avoidance legislation will be attached to any measures.

Commencement of the Patent Box

The initial consultation proposed to introduce the Patent Box for all qualifying intellectual property commercialised after 29 November 2010, however following a number of negative responses, the Government has decided to apply the rules to all qualifying patents but on a transitional basis.

From April 2013, only 60% of the Patent Box benefit will be available but this will rise by 10% per annum before full introduction from April 2017. The introduction will be presented as a 'line in the sand' and will apply to only profits after 1 April 2013 (rather than on a proportional basis for straddling accounting periods).

Conclusion

The secondary consultation to these proposed measures will close by 2 September 2011. Whilst the original consultation was very much a fact-finding mission, the May version was much more forthright in opinion and language.

The Government now hopes to gather information on the workability of the proposals, the expected resources required for implementation as well as 24 detailed questions included on various pertinent issues.

The Patent Box would appear to adequately incentivise businesses within the UK, however, the complexity and introductory timescale of the measures must be brought into question. If the proposals would be beneficial to UK business, particularly as many struggle to grow following the credit crunch, why aren't these proposals introduced sooner?

Perhaps the expected £1.1bn per annum 'steady state' cost is sufficiently off-putting for the Treasury, but unfortunately it would appear that the lag in introduction will achieve little with respect to those entities willing to relocate for lower taxation reasons. There is little doubt that the interesting idea will have provided hope to many, but unfortunately at present, we could accuse the Government of shadow Patent Boxing, rather than a full-blooded measure to boost competitiveness and enterprise. For more information, please contact Andrew Reid reid@capitus.co.uk

