Client Advisory Memo

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Patent Box

Reduced corporation tax

The UK Government legislation on the Patent Box tax incentive is a reduced corporation tax rate of 10% on net profits attributed to patents, with the aim of encouraging development of patentable technology in the UK. This presents a significant tax saving against the normal Corporation Tax rate of 19% with there being even further tax savings when the Corporation Tax rate increases to 25% from 1 April 2023.

Comment

Patents may be filed purely to gain a tax benefit: there is no need to enforce the patents against competitors.

UK national patents attract low official fees, so are a cheap way to qualify for the Patent Box without the need to file in other countries.

The scope of the qualifying patents needs only to cover the products for which the Patent Box regime is to apply, so can be narrow in scope and therefore more likely to be granted.

A qualifying patent may be directed to a minor feature which is nevertheless part of the product which is to be sold. If necessary, the product may be redesigned to include the patented feature.

Software-related inventions may be patentable in the UK or Europe, depending on the nature of the invention, so the Patent Box regime may be attractive to software companies.

The tax implications of the Patent Box are complex, and specialist tax advice will be needed to determine the proportion of profits that qualify.

Corporation tax savings with Patent Box regime

As of July 2016, HMRC applied a profit streaming method, whereby a separate calculation (or stream) is completed for each patent, or product or product category which uses one or more patents. Grandfathering rules have ended. As of 1 July 2021, only the 'new' rules can be applied, being the profit streaming method.

Qualification for Patent Box regime

To qualify for the Patent Box, a company must own, or be an exclusive licensee of, a granted patent: this can be a UK or European patent, or a patent granted by another EEA country with similar patentability criteria, such as a German patent. US patents do not qualify, as they may cover inventions such as business methods that would not be patentable in the UK.

The tax incentive is not limited to profits derived from countries where the patent is granted; instead, the existence of a qualifying patent is taken as an indication that the technology meets the requirements of technicality, novelty and inventive step.

Pending patent applications do not qualify, but once a patent is granted, profits arising up to 6 years before grant may qualify for the reduced tax rate.

The company must have undertaken 'qualifying development', by making a significant contribution to the creation or development of the invention claimed in the patent, or a product incorporating the patented invention; mere ownership of the patent is not enough. A company can also qualify if it actively manages the portfolio of patent rights for another company in the same group that has undertaken the 'qualifying development'.

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Calculation of net profits attributed to patents

Qualifying profits may arise from sale or licensing of products covered by the qualifying patent or sale of the qualifying patent itself. The qualifying profit is then reduced by removing a notional 'routine return' of 10% on relevant expenses, which is assumed to be the level of profit the company would have made without the qualifying patent. The qualifying profit is reduced further by removing a return due to marketing. The profit that qualifies for the 10% rate may then be a relatively small proportion of the overall profit of the company.

The patent need not cover the whole of the product, but must at least cover an item that is part of the product and intended to remain so for the life of the item. For example, if the patent covers an ink cartridge for a printer that is not intended to be removed until the cartridge is empty, profits from the sale of a printer including the cartridge can qualify, even if the printer itself is not patented. However, if a patent covers a DVD intended to be removed from a player after use, profits from the sale of the DVD player will not qualify. Packaging is not considered part of a product, unless the packaging performs a functional essential to the use of the product. The Patent Box is voluntary: a company may elect to joint the regime. The company then stays within the regime until it elects to leave, but cannot then re-enter for the next 5 years.

International corporations with UK subsidiaries

In the case of an international corporation, the benefit is linked to the R&D incurred in developing the IP asset in the UK subsidiary company claiming the tax benefit.

Profit streaming method

Some of the steps within the new streaming rules follow those that were included within the old (grandfathered) formulaic approach, however, there are some fundamental differences. These differences mainly relate to the following two changes:

Profit streaming:

These new rules require that the calculation is performed on a streaming basis, where a separate calculation (or stream) is completed for each patent. If this is not practical to do then it is possible to stream by each product or product category which uses patents. The company will therefore need to break down its income into a relevant IP income stream (which itself may need to be broken down into relevant IP income sub-streams) and a non-IP income stream.

R&D fraction:

Under these new rules the tax benefit is limited in accordance with the proportion of R&D undertaken by the claimant company in respect of the patent/product on which the patent box benefits are being claimed. The R&D fraction needs to be applied to each IP stream and is based upon in-house R&D expenditure and expenditure on subcontracted R&D to third parties, compared to the total R&D expenditure incurred and IP acquisition costs (if relevant). This fraction therefore creates a 'nexus' between the creation of the IP and the claiming of benefits under the regime.

An overview of the steps included within the new regime is set out in the box below.

The new regime therefore creates a requirement to track income and expenditure against relevant IP rights. In addition there is the need to track and trace R&D expenditure on each of the IP streams, as the R&D fraction is a cumulative calculation, taking into account past R&D expenditure from 1 July 2016 onwards.

The patent box regime is complex, however it could provide a significant tax saving if a company derives profits from qualifying IP rights, which will be further improved with the future increase in Corporation Tax rates.

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Profit streaming calculation

The “new” streaming rules require the application of the following steps:

Step 1: Identification of income streams

The taxable income of the company is apportioned into IP and non-IP income streams. The IP income stream itself is then divided into relevant IP income sub-streams (e.g. each sub-stream being in connection with an IP right or IP item).

Step 2: Allocation of company expenses between the income streams

The expenses of the business are allocated between the non-IP stream and each relevant IP income stream. This apportionment is to be performed on a just and reasonable basis. Expenses not treated as deductible for the purposes of the old regime continue to not be deductible within these new rules.

Step 3: Calculation of net relevant IP income (RIPI)

This is simply step 1 less step 2.

Step 4: Deduction of the routine return

The routine return is calculated as 10% of the relevant routine expenses that have been included within the relevant IP income sub-streams. This needs to be deducted from the result of step 3 to provide the qualifying residual profit (QRP).

Step 5: Deduct the marketing assets return

The marketing assets return can be calculated via the using the small claims treatment (if the company satisfies the relevant requirements) or by using a notional marketing royalty for each of the relevant IP income sub-streams.

Step 6: application of R&D fraction to each relevant IP income sub-stream

Under these new rules the tax benefit is limited in accordance with the proportion of R&D undertaken by the claimant company in respect of the patent/product on which the Patent Box benefits are being claimed. To do this an ‘R&D fraction’ is applied to each IP asset’s patent box profits arising from the previous steps.

The fraction to apply is the lower of:

$((D + S) \times 1.3) / (D + S + A + R)$ and 1

Where:

D = R&D costs incurred in-house

S = costs of R&D subcontracted to third parties

A = costs of acquiring or licensing IP

R = costs of R&D subcontracted to related parties

Step 7: Combine the profits from the above sub-streams to obtain the relevant IP profits of the trade

The above profits are then effectively taxed at a rate of 10% within the company’s Corporation Tax return. Profit streaming calculation.

Do you need assistance with claiming Patent Box corporation tax savings?

Get in touch with our attorneys for more information. We have extensive experience working with SMEs, start-ups and individual inventors who have the most to gain from this regime. Please see our website and contact details below.

We acknowledge the contribution of Azets in preparation of this guidance note.

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