Patent Box Draft Legislation Published

On 6 December 2011 HMRC published its response to the June 2011 consultation on patent box together with draft legislation and a helpful technical note and guide to the draft legislation.

Under the proposed patent box regime worldwide profits, made from the exploitation of inventions protected by qualifying patents, will be eligible for a reduced rate of corporation tax of 10 percent from 1 April 2013. Qualifying income can be licence fees, turnover generated from the sale of products either embodying the patented invention or the making of which used a patented process.

The main changes which the government is proposing to make following the consultation process are as follows:-

(i) The regime will extend to include patents issued by other EU national patent authorities which have comparable patentability criteria and search and examination practices to the UKIPO or the EPO.

The June 2011 proposals required there to be grant of a patent either by the UK IPO or by the EPO. Once this qualifying criteria had been met then qualifying income could derive from the worldwide exploitation of the inventions covered by the UKIPO or EPO patents and indeed be backdated up to 4 years prior to grant. Under the new proposals providing an approved EU national patent authority has granted a patent then income derived from exploitation of the invention on a global basis will now qualify for the patent box relief. The look back period for the relief has also been extended from 4 to 6 years prior to patent grant, but obviously the would-be patentee still has to wait until grant to be able to claim the back relief.

(ii) The rules relating to exclusive licensing have been amended so that groups can qualify were patents are held centrally but actively owned and managed in the UK. The aim of this provision is to avoid the need for groups to restructure how they hold and manage patents so as qualify for patent box relief.

Under the new proposals a company subject to UK Corporation tax will still qualify for patent box providing it actively owns and manages the relevant patents even if they are in fact owned by another group holding company.

(iii) The proposed development criteria are being modified to make compliance easier for innovative companies.

The patent box regime is not open merely to those companies which come up with an invention the subject of a qualifying patent but is also available to those who subsequently acquire patents provided that (i) they carry out an activity of creating or developing the inventions and their application and (ii) that the acquired patents are in fact further developed as a result of such activities.

These development criteria will need to be satisfied for patents which are either acquired by purchaser on an asset sale or on a share sale of the corporate owner of the patent. Development activities carried out in a company before a change of ownership will continue to count towards satisfying the development criteria providing that the activity continued for at least 12 months after the asset transfer.

(iv) Reforming the active ownership rules to more specifically target artificial profit shifting.

A company claiming the patent box relief must be actively involved in developing and managing the invention. HMRC now proposes that this active ownership test will apply not on an individual patent basis but rather on a company level basis: a company will qualify if it has either developed all or substantially all of its inventions itself or if it performs a significant amount of the management activities relating to such patents. Management activities means formulating plans and making decisions in relation to the development and exploitation of the inventions.

(v) Reducing the mark up rate used to calculate routine profit and excluding R&D costs from the cost marked up, meaning that significantly more profit will be eligible for the reduced patent box rate.

The full rate of corporation tax is payable on profits attributable to routine trading activities: in practice profits from such routine trading activities are calculated as a mark up of certain defined costs. The June proposals were criticised for applying a mark up rate of 15 percent, thus materially reducing the profits available for the patent box regime. The government has reduced the market rate on relevant expenses from 15 to 10 percent.

The government also now proposes to completely exclude expenses, which would qualify for R&D tax credits, from the costs (which are marked up) in order to avoid creating an incentive for patent box companies to outsource their R&D activities to other group companies. The effect of these changes will potentially be quite significant and will materially increase the profits eligible for the patent box regime.

These two changes will be much welcomed by patentees.

(vi) A new approach has been adopted to excluding profits attributable to valuable brands so as to avoid profits attributable to such brands being picked up by the patent box regime.

Companies with marketing intangibles that contribute at least 10 percent of their residual profit will be required to calculate an arm's length royalty for the use of those marketing intangibles in generating qualifying income. That notional royalty, less any actual royalties paid, will then be taxed at the full Corporation tax rate. These proposals replace the June 2011 formulaic rules used to allocate the residual profit between patents and trade marks.

(vii) Improving the level and rate of the small claims safe harbour for allocating residual profit between pounds brands.

The government also proposes to increase the level of profits eligible for the small claims safe harbour from £0.5m to £1m as well as increasing the safe harbour allocation rate from 50 percent of residual profits into patent box to 75 percent of such profits. These changes will have the effect of making a greater proportion of small claim profits eligible for the patent box relief.

(viii) Simplifying the divisionalisation rules which allow companies to allocate profit more accurately to qualifying income.

HMRC is now proposing a streaming approach rather than a full transfer pricing methodology for determining divisional profits. Companies will be able to allocate profits to the income stream they receive on a just and reasonable basis, including if they so wish, by the use of a notional royalty income from process inventions.

The key take home point is that although the patent box rate of relief remains at 10%, the changes to the way qualifying income is calculated and the relaxation of certain qualifying criteria should together now make the regime a driver of patent filing activity. That is a step in the right direction for UK plc.

The legislation does however contain very detailed anti-abuse rules, which will make obtaining patent box relief a challenge for the uninitiated. Happily HMRC intends to publish comprehensive guidance on the new regime in the summer of 2012 and to embark on a program to educate taxpayers and explain the patent box regime to both large and small businesses. Such guidance is going to be sorely needed.

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