Overview of the UK Patent Box regime

The UK Patent Box is a very generous, but under claimed relief.

The UK Patent Box regime for companies exploiting UK or European patents, commenced on 1 April 2013. It was introduced to incentivise companies to retain and commercialise existing patents, and to develop new innovative patented products. It does this by taxing the profits generated from qualifying patents at a preferential rate of 10%.

It is necessary to carry out a multi-step calculation to determine the amount available for patent box relief. An additional deduction is claimed in the company’s tax computation to give an effective tax rate on qualifying intellectual property profits of 10%. This represents a significant tax saving when compared to the current rate of corporation tax payable of 19%.

The Patent Box rules were amended on 1 July 2016, although grandfathering provisions will apply until 30 June 2021. The main change was to add a link between the patent on which the relief is being claimed and the company carrying out the R&D. There are also some additional administrative requirements in calculating the relief available.

A beneficial aspect of the relief is that it applies to profits from the worldwide sales of patented products, even if the patent only applies to a small part of the total product. It can also apply where patents have been acquired, but there are some additional conditions to meet and the relief may be restricted under the revised rules.

Who and what qualifies for the Patent Box regime

Patents can only qualify if they are granted by the UK Intellectual Property Office, the European Patent Office, or specified EEA countries. The regime notably excludes patents granted by patent offices in France, Spain, Italy, the US, and Japan.

The benefit of the Patent Box is available through legal ownership of the patent or through holding an exclusive licence to commercially exploit a patent.

The regime can apply to existing, newly granted or acquired patents, however the UK claimant company must have had, or intend to have, a significant involvement in development of the patented invention, or a product incorporating the patented item. If this development condition is only met because of activities of another group company, the claimant company must also actively manage its portfolio of qualifying patent rights. This may include activities such as protecting the patent, researching alternative applications for the patent or licensing others to use the patent.

How to determine income derived from patents

The method for determining the profit eligible for the 10% rate is outlined below.

Step 1: Identification of relevant Intellectual Property (IP) income and profits

Relevant IP income includes worldwide licensing and royalties, worldwide sales income from the patent or patent protected products, patents used in processes or services and damages for infringement.

Under the original regime relevant IP profits were generally found by firstly identifying the proportion of relevant IP income as a percentage of gross income of the trade. This percentage was then used to apportion the company’s adjusted total taxable trading profit into an amount that relates to relevant IP and an amount that does not. In some cases this approach under or over allocated trade profits to relevant IP income so a ‘streaming’ method was available, which required a just and reasonable apportionment of a company’s expenses.

Under the revised rules, the only method of apportionment is the streaming approach. A higher level of detail is therefore now required as for each IP right or patented product a calculation will be required in which income and expenditure is allocated to each sub-stream. This level of computational detail may not be necessary if the company is entitled to make a global streaming election. This will depend on the level of qualifying residual profit in the period.

Step 2: Deduction of routine profit

A ‘routine profit’ is calculated by deducting a notional 10% return on certain operating expenses from profit for each sub-stream, determined in step 1 above. These expenses include capital allowances, premises costs, personnel costs, plant and machinery costs and miscellaneous services.
Step 3: Reduction for profit derived from marketing assets
The resulting figure after step one and two is called the qualifying residual profit (QRP).

A business needs to identify how much of the QRP for each sub-stream is due to the patent and how much would have arisen simply because of its brand. This is done by deducting a notional marketing royalty based on transfer pricing principles.

Where companies operate in a highly specialised niche market with few competitors, HMRC may accept the profit attributable to the brand is minimal and so no detailed calculations will be required.

A small claims election may also be possible which simply calculates the marketing assets return figure as 25% of QRP.

Step 4: R&D fraction
The resulting figure for each sub-stream is multiplied by the R&D fraction.

This essentially limits the benefit of the Patent Box by reference to the proportion of the R&D that the company itself has undertaken in developing the qualifying IP right. This therefore requires companies to track R&D expenditure incurred to the level of every IP right, patented product or product family as appropriate, in order to calculate an R&D fraction. The figures are calculated on a cumulative basis and records will need to be maintained for up to 20 years.

Companies which carry out all R&D in-house and have acquired no IP rights should have no reduction in the amount available for Patent Box relief.

Step 5: Patent Box relief
The resulting figure from step four above is the amount eligible for the reduced corporate tax rate. The Patent Box reduces the rate of tax by allowing an additional deduction in the tax computation.

How to claim
An election into the Patent Box regime must be made by the company within two years after the end of the relevant accounting period in which relief is claimed. A company can elect in early, before a patent has been granted, to enable the company to claim tax relief on qualifying profits generated in the period from filing the patent application and the patent grant - the patent pending period. The accumulated relief is claimed in the tax return for the year the patent is granted.

How can Smith & Williamson help?
The Patent Box may be complex but the savings can be substantial. In order to maximise the benefit of the regime, it is worthwhile taking the time to consider the issue now.
We can help review your patents, pending patents and development activities to determine whether or not they fall within the UK Patent Box Regime and advise you on how Patent Box relief can be claimed in your tax returns.

For more information please contact:

Clare Anderson
Senior Manager, Business Tax
Smith & Williamson LLP
 t 0117 376 2409
e clare.anderson@smithandwilliamson.com

Dave Mouncey
Partner, Business Tax
Smith & Williamson LLP
 t 0117 376 2133
e dave.mouncey@smithandwilliamson.com

Matt Watts
Partner, Business Tax
Smith & Williamson LLP
 t 020 7131 4790
e matt.watts@smithandwilliamson.com

Whether you are interested in accountant, tax or investment issues, subscribe to our insights to receive regular updates smithandwilliamson.com/subscribe