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Patent Box - the end of grandfathering

This webinar will begin shortly

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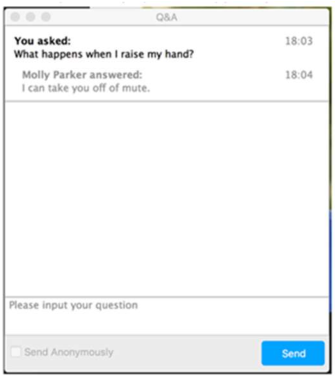
Housekeeping



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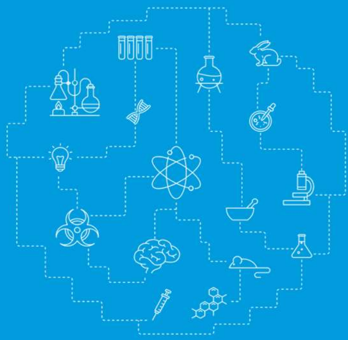

PATENT BOX WEBINAR
END OF GRANDFATHERING

26 August 2021

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Your presenters

Graham Steele
Partner
Innovation Reliefs
T +44 (0)161 830 4168
M +44 (0)7917 596698
graham.steele@rsmuk.com

Will Rainford
Associate Director
Innovation Reliefs
T +44 (0)161 830 4113
M +44 (0)7467 009758
will.rainford@rsmuk.com

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Agenda

- Recap of the Patent Box regime
- Patent Box calculations during the grandfathered period
- What changed on 1 July 2021?
- What is the impact on existing claimants?
- Worked example

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RECAP ON THE PATENT BOX REGIME

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Patent Box - Summary of the basics

- Reduced **10% corporation tax rate** on profits made using patents or other qualifying IP
- Patent could cover a physical aspect of product sold or a process used by the business (e.g. manufacturing)
- Elective regime
  - Patent box can apply if the company holds a qualifying IP right, or has an exclusive license to exploit such a right
  - Development and ownership requirements apply
- Formulaic calculation:

Identify profits attributable to relevant IP → Exclude routine return → Exclude profits attributable to marketing assets → Reduce benefit by applying R&D fraction

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Eligibility conditions overview

In order to be a qualifying company the company must meet the following conditions:

Qualifying IP right

Company must hold any 'qualifying IP rights' at any time during the accounting period

Or

Hold an 'exclusive licence' in respect of qualifying IP rights.

Or

Held a qualifying IP right/exclusive licence in a previous period in which an event occurred that led to income received now.

Development condition

Claimant company must have undertaken qualifying development for the patent, making significant contribution to either

- The creation or development of the patented development or
- A product incorporating the patented invention.

Alternatively another company in the group could have developed the IP and the claimant company undertakes active ownership

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Qualifying IP rights

Patent Box relates to the following qualifying IP rights:

A patent granted by the UK Intellectual Property Office (IPO)

A patent granted by the European Patent Office (EPO)

A patent that is granted under the law of a specified European Economic Area state

Rights similar to patents (medicine related and plant breeding rights)

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What is qualifying patent box income?

Sales income from:

- items protected by a qualifying patent
- items incorporating qualifying item (e.g. a car)
- items to be incorporated into the above (e.g. spare parts)

Licence fees and royalty income for granting rights over qualifying patents

Disposal proceeds from qualifying IP

Damages, compensation or income from **infringement**

Notional royalty (process patents) – value a third party would pay to use this process – a Transfer Pricing exercise

Can also elect to bring in profit made during patent pending phase

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GRANDFATHERING PERIOD

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Patent Box grandfathering period

- Patent Box initially introduced 1 April 2013
- New version of rules introduced 1 July 2016
- R&D nexus key requirement in global IP tax
- Existing claimants with IP that existed pre-1 July 2016 were allowed to continue applying the original rules for 5 year period
- This grandfathering period ended on 30 June 2021

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Difference between old (grandfathered) and new rules

In order to be a qualifying company the company must meet the following conditions:

Old/grandfathered rules	**New rules**
Streaming income and expenditure optional. Can use profit apportionment method instead.	**Streaming** is the only allowable method to arrive at IP profit.
Streaming could be done with just 2 buckets – patented and non-patented.	May need to calculate using several distinct streams relating to each patent/product.
No restriction caused by R&D done elsewhere in group.	**The R&D fraction** must be calculated to cumulatively track R&D expenditure associated with each stream. Restriction on Patent Box benefit where the wrong type of R&D expenditure incurred.

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PATENT BOX DURING THE GRANDFATHERED PERIOD

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Claims during grandfathered period

- As the new rules are likely to be more time consuming to comply with, many companies have chosen to continue applying the original rules where possible
- In some cases the benefit is higher when calculated using profit apportionment
- Even if benefit similar with either profit apportionment or streaming, little incentive to stream for small claims
- Often no steps have been taken to start tracking R&D expenditure

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Changes on 1 July 2021

- New rules to be applied to IP profits from 1 July 2021
- If accounting period straddles this date, could claim part of period under old rules
  - Only worth it if better outcome under old rules, otherwise the 2 different calculations adds time/complexity
- Where part or all of period under new rules, R&D fraction applies
- If already streaming, may need to alter approach to look at each patent as separate calculation
- Consider small claims election for global streaming

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Streaming basis

- Patent Box calculations require income and expenses in the P&L to be streamed
- The streaming basis should be as detailed as reasonable based on the fact pattern and information available
- The choice of streaming basis takes the following priority:

Patent by patent basis (qualifying IP right level)
↓
Product or process level
↓
Product family basis

- Potentially any number of patent box streams
- Small claims election – possible if expected QRP under £1m – only need 1 patent stream

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R&D nexus fraction

- Percentage to be calculated separately for each stream
- Potentially reduces benefit claimable

$$\frac{(D + S_1) \times 1.3}{D + S_1 + S_2 + A}$$

D = Direct in-house R&D expenditure (staff, EPW, consumables etc)
S1 = R&D activity cost subcontracted to a third party
S2 = R&D activity cost subcontracted to a connected entity
A = IP acquisition costs, including ongoing IP licencing costs

- R&D fraction is cumulative and calculated for each IP stream each period
- The same R&D costs can be allocated to multiple patent streams
- Backward looking from 1 July 2016 onwards in most cases
- Need to put in place methods for 'tracking and tracing' R&D expenditure with future PB calculation in mind

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Worked example

- Company with patents over features of 2 products
- Manufacturer of patented widgets:
  - Product 1 revenue £5m
  - Product 2 revenue £3m
  - Other non-patented products £2m
- R&D conducted entirely in-house for Product 1 (£500k)
- Out of total development costs for Product 2 of £1m, £600k in house, £400k was subcontracted to subsidiary in France

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Step 1 – Stream income from qualifying IP

- Setup IP stream for each patent (in this case aligns with separate products)

	Patent 1 (£k)	Patent 2 (£k)	Non-pat (£k)
Revenue	5,000	3,000	2,000

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Step 2 – Stream tax deductible costs

- Allocate accounting debits and credits
- Allocate tax adjustments

	Patent 1 (£k)	Patent 2 (£k)	Non-pat (£k)
Revenue	5,000	3,000	2,000
CoS	(1,000)	(1,000)	(1,000)
Other costs	(1,500)	(900)	(600)
R&D tax relief	-	-	-
Other tax adj	200	100	
IP Profit	2,700	1,200	

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Step 3 – Deduct routine return

	Patent 1 (£k)	Patent 2 (£k)	Non-pat (£k)
Routine costs	1,200	800	550
Routine return	120	80	55
IP Profit	2,700	1,200	
Deduct routine return	(120)	(80)	
Residual IP profit	2,580	1,120	

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Step 4 – Deduct marketing asset return ('MAR')

- All sales made to other businesses based on product performance specification
- Spend on marketing per year £50k compared with £800k on R&D
- Reasonable to conclude that a negligible proportion of the profit relates to marketing assets, therefore MAR is assumed to either nil or below 10% of qualifying residual IP profit
- MAR therefore = £nil

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Step 5 – Apply R&D nexus fraction

$$\frac{(D + S_1) \times 1.3}{D + S_1 + S_2 + A}$$

- Patent stream 1 – all R&D done in house – R&D fraction = 100%
- Patent stream 2 – D=£600k, S_2=£400k (S_1 and A are n/a)
- R&D fraction = (£600k)x1.3/(1,000k) = 78%

	Patent 1 (£k)	Patent 2 (£k)	Non-pat (£k)
IP profit	2,580	1,120	-
R&D fraction	100%	78%	-
Remaining IP profit	2,580	874	-

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Step 6 – Additional trading deduction calculation

$$\frac{(CTrate\ - 10\%)}{CTrate} \times Relevant\ IP\ Profit$$

- Total Qualifying IP Profit = £3,454k
- Patent Box trading tax deduction =

$$\frac{(19\% - 10\%)}{19\%} \times £3{,}454k = £1{,}636\text{k}$$

- Tax benefit = £1,636k x 19% = **£311k**

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Example – What if IP was also acquired?

- Additional IP had to be initially acquired (for use on both product lines)
- £1m was spent on this IP before annual R&D on products 1 and 2
- R&D fraction altered to include the £1m in denominator ("A") for both product streams – full amount used for all products to which the IP relates

R&D fraction	Patent 1	Patent 2
Without IP acquisition cost	100%	78%
Adjusted calculation – 1 year after IP acquisition	(500x1.3)/ (1,000+500)	(600x1.3)/ (1,000+600+400)
	43%	39%
2 years after IP acquisition (assuming R&D spend continued)	(1,000x1.3)/ (1,000+1,000)	(1,200x1.3)/ (1,000+1,200+800)
	65%	52%

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Example – What if IP was also acquired?

- Assume same profitability in each of year 1 and 2

R&D fraction	Patent 1	Patent 2
IP profit	£2,580k	£1,120k
Year 1 R&D fraction	43%	39%
IP profit	£1,118k	£437k
Patent box benefit	£140k	
Year 2 R&D fraction	65%	52%
IP profit	£1,677k	£582k
Patent box benefit	£203k	

- After 7 years of continued R&D expenditure, R&D fraction will = 100% for product 1
- R&D fraction for product 2 will never rise above the 78% previously calculated without increase in in-house R&D

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Points to consider – existing claimants

- Take the time to understand how the move to the new Patent Box rules impacts on your calculation
- Select the most appropriate streaming method
- Establish revised calculation methodology using available or new information – steps to capture new data if required
- Take action to implement R&D tracking and tracing
- Track R&D even if fraction currently 1 – be prepared for future transactions or changes

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Conclusions – the future of Patent Box

- The benefit available is in most cases going to be the same under the new rules
- A little extra analysis and administration – weighted to year 1 process setup effort
- Significant benefit might be available in less obvious circumstances, particularly with process patents
- Plan where IP will be owned and which entity will incur R&D expenditure

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QUESTIONS?

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Thank you for attending

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Contact the Tax Faculty

Phone: +44 (0)20 7920 8646

Email: taxfac@icaew.com

Web: icaew.com/taxfac

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