Explanatory Note

Clause 31 and Schedule: Exploitation of patents etc - profits arising from the exploitation of patents etc

Summary

1. This clause amends the design of the Patent Box legislation in Part 8A of Corporation Tax Act (CTA) 2010. The Patent Box provides a reduced rate of Corporation Tax on profits from patents and similar intellectual property (IP). The changes are to ensure compliance with the new international framework developed by OECD (see Chapter 4 of "Countering harmful Tax Practices More Effectively, Taking Into account Transparency and Substance", OECD, Paris, 2015).

2. The amended rules will require profit for the purpose of the Patent Box to be calculated at the level of an IP asset (for example a patent), or a product or a product family relying on an IP asset or assets. The profit will be adjusted to reflect the proportion of the development activity on the asset (or product, or product category) undertaken by the company itself. The measure will have effect for new entrant companies to the Patent Box on or after 1 July 2016, and also for some IP assets acquired on or after 2 January 2016. The new rules are being phased in, with the current Patent Box rules applying to some companies and IP during a transitional period lasting until 2021. The new rules will apply to all companies and IP after 2021.

Details of the clause

3. Clause 31 introduces new Chapters 2A and 2B to CTA 2010.

4. Subsection 2(a) amends Section 357A to set out the circumstances in which new Chapter 2A or new Chapter 2B apply instead of the current provisions in Chapters 3 and 4.

5. New Chapter 2A contains the new rules in their default form, which applies to all accounting periods beginning on or after 1 July 2021 and to any company entering the Patent Box for the first time for an accounting period beginning on or after 1 July 2016 - a "new entrant" (but see also clause 32 which provides that periods straddling 1 July 2016 are to be split for this purpose).

6. New Chapter 2B provides modifications to the rules in new Chapter 2A to accommodate a company which has both new IP (defined in new section 357BP) and preexisting IP. Both new Chapter 2A and new Chapter 2B require profits to be calculated using the "streaming" method, currently optional.

7. The current Chapters 3 and 4, which set out how profits are to be calculated using the "proportional split" and "streaming" methods respectively, continue to apply during the transitional period but only to companies which are not new entrants and which have no new

IP.

8. Subsection (2)(b) inserts the definition of a new entrant company for this purpose into section 357A.

New Chapter 2A

New Chapter 2A contains sections 357BF to 357BN which provide new Patent Box rules applying to accounting periods beginning on or after 1 July 2021 and to companies making a Patent Box election first having application on or after 1 July 2016. (See also clause 32 which provides that accounting periods straddling 1 July 2016 and 1 July 2021 are, for Patent Box purposes, to be split). These are the default rules for the Patent Box which apply once the transitional period ends.

9. New Section 357BF provides the method of calculating the profit to which the reduced rate of Corporation Tax applies.

10. New Subsection 2 sets out 9 steps to be followed in calculating the relevant IP profit or the relevant IP loss of the trade for the period

    - Step 1 specifies that the company must separate its credits into two streams, those that are relevant IP income and those that are not. The definition of relevant IP income remains as in the current Patent Box rules at S357C;
    - Step 2 divides the relevant IP income stream into sub-streams corresponding either to individual IP assets (such as patents) or to particular kinds of multi-IP items (products or product families);
    - Step 3 allocates debits between the sub-streams;
    - Step 4 deducts from each sub-stream the debits allocated at Step 3 and a routine return. These are calculated in the same way as under the current Patent Box rules;
    - Step 5 deducts from each sub-stream the small claims figure where the company is eligible for, and has elected to use, small claims treatment. This is a simplified alternative to calculating the marketing assets return;
    - Step 6 deducts from each sub-stream the marketing assets return where the company is not eligible for or has not elected for small claims treatment;
    - Step 7 multiplies the figure for each sub-stream by the corresponding research and development (R&D) fraction, calculated at new section 357BM;
    - Step 8 adds together the amounts of the sub-streams;
    - Step 9 is the point at which a company includes in its relevant IP profits for the period any additional amount in respect of profits arising in the period where grant of a patent is pending when the patent is granted. The way in which this amount is calculated is set out at new section 357BN.

11. New Subsection 5 sets out when income may be allocated at Step 2 other than to an individual

IP right sub-stream (for example to a sub-stream representing a particular patent or other IP asset). There are two cases. The first is where it is not reasonably practicable to apportion income between individual IP rights. The second is where the income can be so apportioned, but it would not be reasonably practicable to apply any of the later steps in the calculation. This allows a company to track and trace expenditure to the level of a product (rather than an IP right) if it is not reasonably practicable for it to calculate its R&D fraction at the level of the IP right.

12. New Subsection 6 defines multi-IP items as items incorporating more than one qualifying item (defined in line with the existing Patent Box rules).

13. New Subsection 7 makes provision for similar multi-IP items to be of the same kind (and therefore streamed together) if they are substantially the same. This allows tracking and tracing at the level of product families.

14. New section 357BG defines finance income, excluded in Step 1 of new section 357BF. The definition follows that in the current Patent Box rules (see S357CB)

15. New sections 357BH to 357BHC define relevant IP income for the purpose of Step 1 in new section 357BF. The definition follows that in the current Patent Box rules (see S357CC - S357CF)

16. New section 357BI defines excluded debits for the purpose of Step 3 of new section 357BF. The definition follows that in the current Patent Box rules (see S357CG(3))

17. New section 357BJ defines the routine return figure for Step 4 of new section S357BF. The definition follows that in the current Patent Box rules (see S357DA(4)) but is modified to reflect its application to separate sub-streams.

18. New sections 357BJA and 357BJB define routine and non-routine deductions for new section 357BJ. The definitions follow those in the current Patent Box rules (see S357CJ and S357CK).

19. New section 357BK sets out eligibility for small claims treatment. This is broadly in line with the current Patent Box rules in S357CL, but as the provisions now need to be applied where profit is calculated across a number of sub-streams, an additional simplifying condition is applied, requiring that the company only carries on one trade in the period.

20. New section 357BKA provides rules for calculating the small claims figure for each sub-stream - the reduction in the sub-stream amount that takes the place of the marketing assets return. 75% of the qualifying residual profit (QPR) - defined in subsection 7 as the sum of the positive sub-stream amounts established after the deductions at Step 4 of section 357BF(2) - is compared to the small claims threshold.

    - If it is lower than that threshold, then the small claims figure is simply 25% of the amount of the sub-stream following Step 4 in S357BF;
    - Otherwise, the amount is obtained by distributing the small claims threshold between the different sub-stream figures following step 4 in proportion to those figures.

21. New sections 357BL, 357BLA and 357BLB contain the provisions needed to calculate the marketing assets return figures for relevant IP income sub-streams. They follow the same

principles as the current Patent Box rules (see S357CN - S357CP) but are modified to reflect their application to separate sub-streams.

22. New sections 357BM to 357BMG contain the rules for calculating the R&D fractions that apply to the separate sub-streams. The R&D fraction is what is referred to in the OECD document as the "nexus fraction" or "nexus ratio".

23. New section 357BMA defines the R&D fraction as the lesser of 1 and (D + S1) * 1.3 / (D + S1 + S2 + A) where the various terms represent different sorts of expenditure potentially incurred by the company on developing or acquiring the IP.

    - D is the company's qualifying expenditure on in-house relevant R&D;
    - S1 is the company's qualifying expenditure on relevant R&D subcontracted to unconnected persons;
    - S2 is the company's qualifying expenditure on relevant R&D subcontracted to connected persons;
    - A is the company's qualifying expenditure on acquiring relevant qualifying IP rights.

24. The multiplication by 1.3 applies a 30% "uplift" to the numerator, which is permitted by the OECD rules, increasing the fraction to allow for various circumstances in which substantive activity by the company would not contribute to qualifying expenditure, for example because of its group structure.

25. New section 357BMB defines D, qualifying expenditure on R&D undertaken in-house. This is expenditure which is attributable to relevant R&D undertaken by the company and incurred on staffing costs, software or consumable items, externally provided workers or to the subjects of clinical trials. The definitions of these different types of expenditure follow those used in CTA2009 for the purposes of the R&D tax reliefs. Expenditure which must be included is that incurred in the relevant period - this is defined in new section S357BMF.

26. "Relevant research and development" is defined at new subsection (4) and (5). This is R&D which relates to the qualifying R&D right or rights in question - not to the company's trade as a whole.

27. New section 357BMC defines qualifying expenditure on R&D sub-contracted to unconnected persons. This is expenditure incurred making a payment within the relevant period to a sub-contractor with whom the company is not connected, the payment being attributable to relevant R&D.

28. New section 357BMD defines qualifying expenditure on R&D sub-contracted to connected persons. This is expenditure incurred within the relevant period on the qualifying element of a sub-contractor payment to a connected person to carry out R&D. The qualifying element is either the entire payment or, if less, the actual amount spent by the sub-contractor to carry out the R&D.

29. The rules for establishing the qualifying element of the payment and the definitions of "sub-contractor", "sub-contractor payment" and "connected" are the same as those used for the R&D tax reliefs, at section 1133 CTA2009 and section 1122CTA2010, except that in new section

357BMC the option for the company and the sub-contractor to jointly elect to be treated as "connected" persons is disapplied.

30. New section 357BME defines qualifying expenditure on acquisition of a relevant qualifying IP right, such as a patent, as expenditure incurred within the relevant period to acquire the right or rights or an exclusive licence to it or to them.

31. New section 357BMF defines "the relevant period" for the purpose of new sections 357BMB-357BME. This is the period from the "relevant day" up to the end of the accounting period in question. The "relevant day" is 1 July 2013 if the accounting period began before 1 July 2021 and the company is a new entrant, or 1 July 2016 otherwise until 2031, after which the relevant period is simply the 15 year period leading up to the end of the current accounting period. In either case the company may elect to use an earlier date, allowing it to include earlier data in the R&D fraction if they are available at an appropriate level of detail. The company may go back no more than 15 years.

32. New section 357BMG makes special provision for cases where a new entrant has insufficient data for the period 2013 to 2016 to enable it to calculate an R&D fraction in accordance with the usual rules. This is based on the transitional provision in paragraph 60 of Chapter 4 of the OECD document.

33. If the accounting period to which the sub-stream relates began on or after 1 July 2019 the company may make an election under subsection (2) of new section 357BMG.

34. The effect of an election under subsection (2) is that, for the purposes of determining the R&D fraction for the sub-stream, the "relevant period" will be treated as the period which runs from 1 July 2016 to the end of the accounting period concerned. This means that for accounting periods beginning on or after 1 July 2019, a new entrant will (where necessary) be able to calculate a R&D fraction even if it has no information about its expenditure from 1 July 2013 to 1 July 2016. (But new entrants will need to "track and trace" to individual IP/ multi-IP items from 1 July 2016).

35. If the accounting period to which the sub-stream relates began before 1 July 2019 the company may instead make an election under subsection (3) of new section 357BMG. The effect of an election under subsection (3) is that, for the purpose of determining the R&D fraction for the sub-stream, sections 357BM to 357BME are to have effect with 3 modifications.

- The first modification is that any reference to "the relevant period" in sections 357BM to 357BME is to be read as a reference to the period of three years ending with the last day of the accounting period concerned. This means that if the accounting period concerned ended on, say, 10 July 2016 the company will have to take into account expenditure which was incurred between 11 July 2013 and 10 July 2016 (inclusive). If the accounting period concerned ended on, say, 10 July 2017 the company would instead have to take into account expenditure which was incurred between 11 July 2014 and 10 July 2017. Accordingly, for each subsequent accounting period one year's expenditure will drop off.

- The second modification has the effect of altering the definition of "relevant research and development" so that any expenditure on R&D which relates to the trade (rather than to the particular qualifying IP right) will be taken into account.

This means that it will not matter that for the years during the three year period just described the company kept records about its "global" research and development expenditure but did not "track and trace".

- The third modification has the effect that any expenditure on acquiring qualifying IP rights will be able to be taken into account. This means that it will not matter that during the three year period just described the company kept records about its "global" expenditure on acquiring qualifying IP rights.

36. New section 357BN allows a company to include profits arising before a right was granted (for example, during a period when a patent had been applied for, but not granted). This is a general provision that requires the company to rework the calculation set out at new section 357BF taking account of the additional income. It is similar to existing S357CQ which applies in similar circumstances.

New Chapter 2B

New Chapter 2B contains sections 357BO to 357BQ which modify the rules in Chapter 2A for accounting periods beginning before 1 July 2021 for companies which are not new entrants and with a new qualifying IP right. This provides rules that apply during the transitional period for companies that have both preexisting and new IP. The rules are based on streaming, so there is no option for the company's preexisting IP to be dealt with following the proportional split method, but no R&D fraction is applied to the sub-streams corresponding to the preexisting IP.

37. New subsection 357BO(2) provides that for the purposes of sections 357BMF and BMG (which determine the relevant day, from which R&D expenditure must be included in the R&D fraction) the company is to be treated as if it were a new entrant. This means that the relevant day will be 1 July 2013 or such earlier day as the company may elect, but also that the company will be able to make elections under new S357BMG(2) or (3) as appropriate.

38. New section 357BP defines a new qualifying IP right. This includes IP rights granted to the company in respect of applications made on or after 1 July 2016. It also includes any IP (or any exclusive licence to IP) acquired by the company on or after 1 July 2016.

39. New subsections (6) and (7) define circumstances in which IP, or an exclusive licence to IP, acquired on or after 2 January is also treated as a new qualifying IP right. This is IP (or a licence) acquired from a connected company which is neither within the UK Patent Box nor entitled to benefit from a similar regime elsewhere (new subsection(6)) or from a connected individual (new subsection (7)). The inclusion of individuals is intended to prevent acquisition of IP indirectly from a connected company, and to achieve this purpose the definition of "connected" for this purpose may be widened in final legislation. (See also clause 32).

40. New subsection (8) allows a company to elect that non-new IP may be treated as new and so immediately brought into the modified Patent Box rules.

41. New section 357BQ sets out the modifications to Chapter 2A required for it to apply both to existing IP and to new IP. The existing and new IP are placed in separate sub-streams and no R&D fraction is applied to the "old IP rights sub-stream" which corresponds to the existing rights.

Details of the Schedule

42. Schedule X makes modifications to existing Chapters 3 and 4 which continue to apply to preexisting IP ("grandfathered" IP that existed before 1 July 2016) of a company that has no new IP.

43. In these circumstances the rules that apply are substantially the same as those currently in force. Unless the company makes a streaming election, or satisfies the requirements for mandatory streaming, the profits are calculated according to the rules in Chapter 3.

44. If it makes a streaming election, or satisfies the requirements for mandatory streaming, the profits are calculated according to the rules in Chapter 4.

Background note

45. The UK Patent Box gives companies a reduced rate of tax on their profits from patents and similar intellectual property (IP). It is intended to provide incentives for companies to patent IP developed in the UK and ensure new and existing patents are further developed and commercialised in the UK

46. The Organisation for Economic Cooperation and Development (OECD) has been coordinating a multinational effort to address Base Erosion and Profit Shifting (BEPS) - tax planning by multinational enterprises (MNEs) that exploits gaps and mismatches in tax rules to artificially shift profits to low tax locations where there is little or no economic activity. This has resulted in a new internationally harmonised framework for preferential IP regimes (like the UK's Patent Box). This framework is to apply from 1 July 2016.

47. The central point is that for a business to gain the benefit of a preferential regime, it should have conducted the substantial activities which generated the income benefiting from that regime. The agreed approach uses R&D expenditure as a proxy for substantial activity and links benefits to the requirement to have undertaken the R&D expenditure incurred to develop the IP. This is referred to as the nexus approach.

48. Following a consultation launched on 22 October 2015, the draft legislation sets out proposed modifications to the UK patent Box to implement this new approach. Final legislation, taking full account of the consultation responses and of comments on this draft, will be proposed in 2016.

49. The final legislation will include additional provisions relating to the calculation of the R&D fraction where

    - companies engage in collaborative development (such as a cost-contribution arrangement); or,
    - businesses with separate R&D histories combine (for example by acquisition of a trade).

50. It will also address the use of the "rebuttable presumption" allowed by the OECD framework.

51. If you have any questions about this change, or comments on the legislation, please contact David Harris on 03000 586834 (email: david.harris@hmrc.gsi.gov.uk).