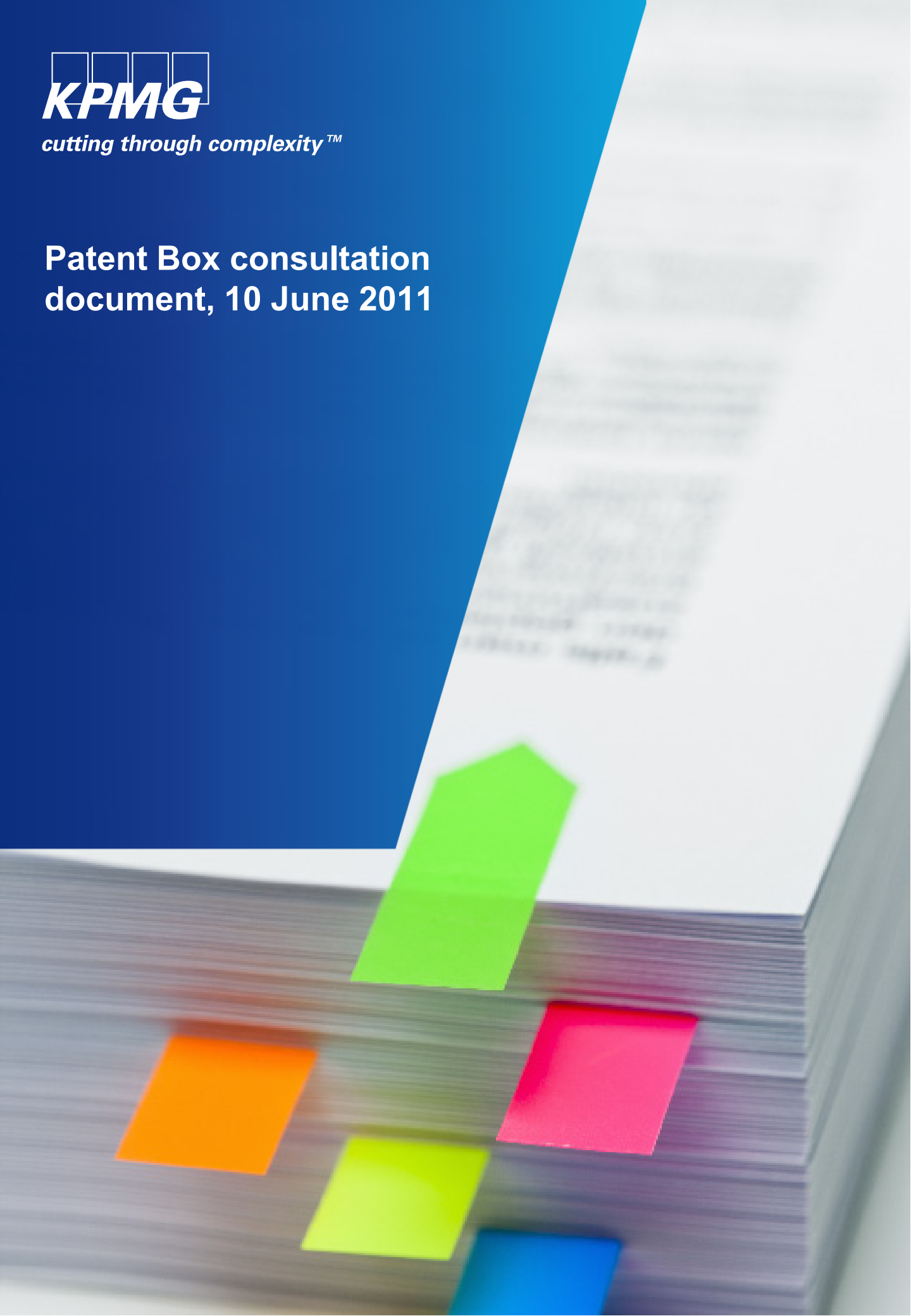




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Patent Box consultation document, 10 June 2011



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Key proposals

A consultation document issued by HM Treasury on 10 June 2011 considers the proposed operation of a "Patent Box" regime under which profits arising from patents would be taxed at a preferential rate of 10 percent. The purpose of the consultation is to seek views on the policy options developed as a result of stage 1 (the November 2010 consultation document was stage 1), and the likely impacts of implementing these proposals. The consultation document can be found [here](#).

Core characteristics	Highlights from consultation document				
Start date	1 April 2013 (phased benefit for relief)				
	2013/14	2014/15	2015/16	2016/17	2017/18
	60%	70%	80%	90%	100%
Qualifying patents	<ul style="list-style-type: none">• Self developed and acquired UK and EPO patents;• Regulatory data protection granted to new pharmaceutical or agrochemical products; and• Plant variety rights.				
Ownership criteria	Legal and beneficial ownership or just beneficial ownership of patent.				
Qualifying income	<ul style="list-style-type: none">• Pure royalty income streams;• Embedded royalties;• Patent sale income; and• Compensation payments.				
Profit quantification	Formula approach (proxy for residual profit split) on WW income.				
Clearance mechanism	Yes				
Anti-avoidance provisions	Yes				

Qualifying patents

It is proposed that the Patent Box will include patents granted by the UK Intellectual Property Office (IPO) and the European Patent Office (EPO). The Government is also considering whether some other EU Member States that have similar patent examination processes to the UK should be eligible for the Patent Box too. A white list of such territories is being considered, however, the Government has ruled out extending the regime to patents granted by other authorities, citing the associated administrative burden on HMRC and the risk of bringing the wider UK patent system into disrepute if patents are tested in tax tribunals as well as in patent courts.

Owing to the similarity to patents, the Government is also proposing to include regulatory data protection granted to new pharmaceutical and agrochemical products which cannot be patented; and plant variety rights.

The Government has confirmed that either the legal and beneficial ownership of patents or just the beneficial ownership of patents will qualify for the regime reflecting normal commercial arrangements. The regime will also extend to patents developed under partnership, joint venture and cost sharing arrangements.

Patents that are acquired from third parties will also be included in the regime. However, companies benefiting from the Patent Box must demonstrate they are actively involved in the patent development cycle. In the case where a company has acquired the patent it may be difficult to determine whether there is significant development activity, therefore the Government has outlined a couple of options to monitor this:

- The group's expenses associated with the development of the patented invention must exceed a pre-defined proportion of the value of the patent on acquisition or the total costs of the joint project; or
- Judgement will be made on a case by case basis, taking into account all circumstances.

Qualifying income

The proposals for determining qualifying income focus on products rather than identifying income from individual patents. Furthermore, the Patent Box will extend to worldwide income earned by UK businesses from inventions covered by a currently valid qualifying patent. The following types of patent income will be included in the regime:

- All royalties or licence fees received for use of an invention (product or process) covered by a valid qualifying patent.
- Income from the sale of any products incorporating at least one invention covered by a valid qualifying patent.
- Income from selling spare parts for a qualifying product.
- Income from the licensing of a bundle of intangible assets which incorporate rights to use at least one invention covered by a valid qualifying patent.
- Compensation for lost income paid by third parties for infringing a qualifying patent.
- Income from sale of patents in the Patent Box.

However, the Patent Box will not extend to income arising from the provision of services or financial arrangements due to the peripheral nature of this income.

Calculation of Patent Box profit

The calculation of the Patent Box profit will be a three step process whereby the profit identified should reflect the residual profit generated from patents.

1. Determine qualifying income from taxable profits of the company. The total taxable trading profits will be apportioned based on the proportion of the company's total trading income which is qualifying income for the Patent Box.
2. Calculate the residual profit by deducting a 15 percent return on routine activities from the qualifying income.
3. Identify how much of the residual profit on a qualifying product relates to the patent and closely related IP and how much from other forms of IP.

In step 1 it is acknowledged that the proposed method may give rise to irregular results for some companies, therefore a divisionalisation approach may be used instead. In some cases, divisionalisation will be mandatory if the standard apportionment generates excessive qualifying income. It is not anticipated that adjustments will be made for one-off receipts and expenses in step 1.

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Although the model will operate on a current year basis for receipts and expenses there may be occasions where companies with a small number of patents and irregular pre-commercialisation costs may need to claw back these expenses if qualifying profits are distorted. Under step 1, R&D tax credit enhancements (i.e. 30% percent enhancement under the large company R&D tax credit scheme) will be added back to increase the qualifying income.

The calculation includes a deduction from qualifying income for profits arising from routine activities fixed at 15 percent (step 2). Some expenses will be excluded from the mark-up calculation such as outsourced costs, inventory costs and licence fees paid to use patents or trademarks.

Step 3 identifies how much of the qualifying residual profit relates to patents. The Government's preferred approach will look at current year expenditure in the whole company as a proxy for costs incurred in relation to specific products. Under this method, the residual profit will be allocated to patent or brand IP according to the ratio of expenses that are classified as "patent" or "brand" expenses. It is proposed that patent expenses will include all R&D expenses recognised in the statutory accounts (i.e. broader in scope than those eligible for R&D tax credits).

If this option is not supported by business, companies may apportion the qualifying residual profit by identifying the relative contribution of the brand and the qualifying patents to the success of the product. Small companies with limited experience of identifying the relative contribution of patents and brands may simply allocate 50 percent of their qualifying residual profits to patents (assuming claims for the year are below £500,000).

The Patent Box profit calculation may, in some circumstances, produce a loss. If the loss is given immediate effect it would increase the profits chargeable to corporation tax, therefore the Government is proposing that the Patent Box losses are calculated and carried forward to be set against Patent Box profits in the future.

The 10 percent Patent Box rate will apply to Patent Box profits by way of deduction from taxable profits. The deduction will give the same tax result as a direct application of the 10 percent rate.

Targeted anti-avoidance provisions may also be introduced. The Government is considering whether rules are required in the following areas:

- Inclusion of patented inventories in products or combinations of qualifying and non-qualifying products which are not functionally interdependent for the main purpose of securing qualifying income.
- Artificial manipulation of income and expenses.
- Transfer of patents within groups to avoid restrictions on losses.

A non-statutory clearance procedure is expected to operate on the Patent Box.

Who is affected?

All businesses which hold or may in the future hold patents in the UK.

Timing

The consultation process is open until Friday 2 September 2011. It is expected that draft legislation is published in autumn 2011 with a view to being enacted in Finance Bill 2012.

It is proposed that the regime will come into effect from 1 April 2013 for any existing qualifying patents. There will be transitional rules phasing in the benefits over the first five years of the regime i.e. 60 percent of the Patent Box benefit will be available in 2013/14 increasing to 100 percent by 2017/18.

Income arising before a patent is granted will be available for the Patent Box benefit, however it will be deferred until the patent is granted and will be limited to income arising between the patent application and the date of grant up to a maximum of four years before the patent is granted.

The Patent Box benefit will cease when the patent or SPC expires, or the company decides to opt out of the regime. In order to prevent manipulation, it is proposed that companies will not be able to opt back into the regime for five years.

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Our view

The consultation document on the patent box regime is overall very positive for businesses deriving profits from UK IPO or EPO patents. It seems that the Government is making a real attempt to create a workable regime around a complicated issue.

And in deciding on core characteristics of the new regime, the Government has in a number of areas opted for a broad application of the rules. Notably profits on the sale of patent rights will benefit from the 10 percent rate which will be welcomed by smaller R&D focused start ups selling on pre-commercialised products.

But anyone hoping to see the scope of the regime extended beyond UK IPO or EPO patents will be disappointed. The document makes clear that the Government only intends that the regime should apply to these patents. Some had been arguing that other types of intellectual property (brands, trademarks and so on) and patents registered in other jurisdictions (for example the US) could be included. Their exclusion means that some industries will find they cannot benefit from this regime, among the most notable being the software industry as UK patent rules tend not to cover software whereas in the US they do.

Following our initial review of the consultation document it appears likely that calculating the qualifying income may be a complex process for some businesses, for example, royalty income streams that have several components some of which are patented and some that are not. Identifying the qualifying income in these circumstances will be a time consuming exercise that may negate the benefits of the regime.

The fixed percentage of 15 percent used to calculate routine activities appears to be a relatively high mark-up. We understand that this rate has been chosen to avoid the administrative burden of justifying rates for different types of activity; however this over simplification may detract from the overall benefits of the regime.

The apportionment method proposed to identify the residual profit that relates to patents (step 3) may be of concern to some businesses that do not have consistent current year expenditure; nor the experience in-house to identify the relative contribution of the brand and patents to the success of a product. Consequently qualifying income may be curtailed if that expenditure has been incurred pre-commercialisation.

For more information contact

Jonathan Bridges

Tel. +44 (0)20 7694 3846

jonathan.bridges@kpmg.co.uk

Christine Hood

Tel. +44 (0) 121 232 3381

christine.hood@kpmg.co.uk

Rhiannon Jones

+44 (0) 20 7694 8585

rhiannon.jones@kpmg.co.uk

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