HM TREASURY

HM Revenue & Customs

The Patent Box:

response to consultation

December 2011

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Contents

1 Introduction

Key Points

- The Government is introducing a Patent Box from 1 April 2013, which will apply a reduced 10 per cent rate of corporation tax on profits attributed to patents.
- UK businesses will be able to benefit regardless of how they use their patents – whether they are licensed, included in patented products, or used in internal processes or to provide services.
- Worldwide income from existing as well as new IP will be included. To enable this, the full benefits of the Patent Box will be phased in over five years from 1 April 2013.
- In many cases the profit attributed to patents is calculated from total profits using a step-by-step method. This structured approach will increase certainty for businesses using the regime and reduce administrative burdens compared to requiring businesses to value each patent individually. Smaller claims can benefit from a simplified calculation.
- In response to business' comments on the June 2011 consultation, the Government has made a number of technical changes which will result in a more competitive and accessible regime.

Aim of the Patent Box

1.1 The Government is committed to providing the most competitive corporate tax system in the G20, in order to support strong and sustainable private sector growth. As outlined in the Corporate Tax Road Map and the June consultation, the introduction of the Patent Box is a key element of this strategy. The Patent Box will create a competitive tax environment for companies to develop and exploit patents and other similar intellectual property (IP) in the UK.

1.2 The Patent Box will provide an additional incentive for companies in the UK to retain and commercialise existing patents and to develop new innovative patented products. This will encourage companies to locate the high-value jobs associated with the development, manufacture and exploitation of patents in the UK and maintain the UK's position as a world leader in patented technologies.

Overview of the Patent Box regime

1.3 The Patent Box is expected to benefit a large number of UK companies in a wide range of sectors. Businesses will be able to benefit regardless of how they use their IP – whether it is licensed to others, included in products they sell, or used in internal processes or to provide services. Worldwide profits from qualifying IP will be eligible for the reduced 10 per cent tax rate.

1.4 Qualifying IP includes patents granted by the UK Intellectual Property Office and the European Patent Office, as well as supplementary protection certificates, regulatory data protection and plant variety rights. It will also include patents granted by other EU Member

States that have comparable patentability criteria and search and examination practices to the UK. The Patent Box will apply to existing as well as new IP, and to acquired IP provided that the group has further developed the IP or the product which incorporates it.

1.5 In many cases companies will be able to benefit where they themselves have rights to the IP owned by others. A UK Patent Box company could, for example, own European rights to exploit a patent while the rights to other territories are held by other companies. Alternatively a UK Patent Box company may have rights to IP developed in collaboration with another company or a university.

1.6 The Government has chosen a structured approach to calculate the profits from qualifying IP. In many cases the calculation starts from the total profit from the sale of products incorporating the patented invention, or the profit from licensing the invention. The full rate of corporation tax will still be charged on a 10 per cent routine return on certain costs and on any part of those profits which is attributable to a valuable brand. Companies making smaller claims can choose a simpler calculation avoiding the need to value their brand. All remaining profit will be eligible for the Patent Box rate.

1.7 Companies which use their IP to perform processes or provide services will benefit from the Patent Box up to the level of an arm's length royalty for the use of the qualifying IP.

Consultation

1.8 The Government is grateful for the comments and proposals put forward by individuals, companies, representative bodies and others to the June 2011 consultation document. This document gives the Government's response to that consultation. In addition, the Government is setting out the details of changes to the proposals which have been made as a result of the consultation, and is seeking further views on some specific policy proposals. These changes will make the Patent Box significantly more competitive and accessible to a greater number of businesses.

1.9 The proposals set out in this document are at stage 3 (drafting legislation to effect the proposed change) of the Government's approach to tax policy making. The November 2010 consultation document was stage 1 of the process and the June 2011 consultation was stage 2. Draft legislation on the Patent Box, together with draft Explanatory Notes and a Technical Note, have been published separately and are available here http://www.hm-treasury.gov.uk/consult_patent_box_stage2.htm.

Next Steps

1.10 The Government welcomes responses to this technical consultation by 10 February 2012. Details on how to get involved with this consultation are given in Chapter 4 of this document. This consultation will be focused on delivering legislation to implement a Patent Box based on these proposals, with the aim of including final legislation in Finance Bill 2012.

2 Summary of responses

Responses received

2.1 The Government received 61 responses to the consultation. Of these, 18 were received from businesses which use patents; 17 from professional services or consultancy businesses; 21 from representative bodies; one from an academic institution and four from individuals. A full list of respondents is given in Annex A. The Government is also grateful for the assistance of the working group in developing these proposals. A list of working group members is also given in Annex A. A list of responses by question is given in Annex B.

Overall response to the regime

2.2 Most responses welcomed the introduction of the Patent Box, stating that it would improve the competitiveness of the UK corporate tax system for patent income and that it would encourage firms to invest in the UK rather than developing patents offshore. However, some responses suggested that the regime was insufficiently generous or too complex to have a significant effect on behaviour. A small number of responses disagreed with the introduction of the Patent Box as they do not consider it to be effectively targeted at encouraging innovative behaviour.

Qualifying Patents

2.3 The Government proposed that patents granted by the UK Intellectual Property Office and the European Patent Office would qualify for the regime, together with supplementary protection certificates, regulatory data protection and plant variety rights. The Government also proposed that companies should meet active ownership and development conditions in relation to their IP in order to qualify for the Patent Box.

Response to consultation

- Many respondents welcomed the proposed scope of the regime, in particular the inclusion of exclusive licences and the commitment to ensure that collaborative development arrangements were included. Some respondents preferred a "beneficial ownership" test to a requirement to put in place an exclusive licence agreement between group companies.
- Although some felt that the current scope was appropriate, several respondents felt that the scope should be wider, and should include all EU patents, all patents, or other types of IP.
- Some concerns were raised that the development criteria may be difficult to apply to acquired patents in practice.
- Some respondents commented that the active ownership rules, as set out in the consultation document, would prevent some innovative businesses involved in early stage research from benefiting because of the nature of their commercial activities. A few felt that tracking the decision-making process on each patent individually may be very difficult or administratively onerous in practice.

Government response

2.4 The Government has considered requests for a broader scope and will include patents granted by certain other EU national patent regimes. However, the Government does not currently intend to extend the regime to other types of IP. The Government has simplified the active ownership and development criteria, and the changes are detailed in Chapter 3.

Qualifying Income

2.5 The Government proposed that qualifying income would include licence and royalty income relating to qualifying IP; income from the sale of products incorporating a patented invention; income from the sale of patents; infringement income; and notional royalty income for the use of qualifying IP in processes or services, but that financial income would be excluded. The Government also proposed that companies would be able to include income received after application of the patent for up to four years prior to the patent being granted.

Response to consultation

- Almost all respondents who commented welcomed the approach of including profits based on entire products or commercial licences rather than identifying the profit associated with each patent individually. One response said that the scope should be significantly narrower and cover only individual patent royalties. Most responses preferred a principles-based approach rather than a set of tightly defined rules to identify a single product.
- Several responses commented that the proposed approach to calculating patent profits embedded in services income was potentially unfair and that service income should be included in the regime in the same way as income from patented products.
- Several responses commented that a four year look-back period to claim profits arising prior to grant of a patent would be insufficient.

Government response

2.6 Although the Government recognises that the provision of services using patented technologies is a common way of commercialising patents, it does not feel that using the same model for calculating patent income embedded in services and in products would result in an appropriate answer in the majority of cases. In particular, some services include a particularly high level of added value from valuable skills unrelated to the patents themselves, and it would be inappropriate for this profit to be included in the Patent Box. The Government intends to retain the notional royalty basis for calculating Patent Box benefits relating to patents used in internal processes or to provide services.

2.7 Responding to the feedback, the Government intends to extend the period over which a company can claim profits arising prior to grant of a patent from four to six years.

Calculation of Patent Box benefits

2.8 The Government proposed to calculate the profit attributable to patents using a largely formulaic approach. The model starts from the taxable profit made on qualifying income. Deductions are made for the part of those profits attributable to routine activities, as well as the part related to valuable brands. All remaining profit will be eligible for the Patent Box rate.

Response to consultation

2.9 The majority of responses continue to support the formulaic approach to calculating the profit attributable to patents. However, several serious concerns were raised about the details of the proposed model. These included:

- Most respondents felt that the mark-up rate used to calculate the routine return was too high, and some suggested that that no routine profit should be attributed to certain costs such as R&D costs.
- Many respondents also felt that the proposals to separate profits attributable to patents from those relating to valuable brands were flawed and did not generally give a sufficiently close approximation to the actual profit related to the qualifying IP.
- Although most responses welcomed divisionalisation as a means of providing greater flexibility, some felt that it would be too complex for most companies to use, while others felt an arm's length alternative should be available if the model produced an inappropriate result.
- Several respondents commented that the proposals for Patent Box losses were restrictive.

Government response

2.10 The Government is proposing a number of changes to the detailed rules for calculating the profit attributable to patents, which will substantially increase the competitiveness of the regime. These new rules are detailed in Chapter 3.

Computational Issues

2.11 The Government proposed to implement the reduced rate using a computational tax deduction. The Government also asked for views on anti-avoidance rules and implementation issues.

Response to consultation

- Most respondents were happy with the proposed computational deduction, although a few felt that a direct 10 per cent rate would be more accessible. A few respondents also asked for the Patent Box to be delivered as a payable credit so that it could be recognised in companies' income statements and would increase the pre-tax operating profit of qualifying companies.
- Several respondents commented that anti-avoidance rules could potentially have a serious impact on the attractiveness of the regime, with respondents urging the Government to ensure that these are targeted only at artificial tax avoidance behaviour.
- A number of comments were also made that some sort of clearance or pre-agreement process with HMRC would be critical to the success of the regime by ensuring that businesses could invest in the UK with a reasonable degree of certainty over their future tax position.

Government response

2.12 The Government proposes to retain the computational deduction, as introducing a direct 10 per cent rate would be operationally complex. In order to avoid computational problems for smaller businesses, especially those claiming marginal rate relief, the Government intends to use the main rate of CT in all Patent Box tax deduction calculations. This will slightly increase benefits

to companies paying tax at the small profits rate or who are eligible for marginal rate relief. The Government does not intend to introduce the Patent Box as a payable credit rather than a tax deduction as this would significantly increase costs.

2.13 The Government's proposals for anti-avoidance rules and its approach to engagement with customers using the Patent Box are detailed in chapter 3.

Commencement

2.14 The Government proposed to include existing IP as well as the newly commercialised IP originally included, but to phase the regime in over the first five years of operation in order to manage the impact on tax receipts as required in the current financial environment.

Response to consultation

2.15 Almost all responses welcomed the proposals. Some responses called for the regime to be phased in faster to provide a greater incentive for groups to invest in the UK in early years.

Government response

2.16 The Government will include existing patents within the regime rather than applying the regime only to newly commercialised patents. As previously proposed, in order to mitigate the short term economic impact of this change the regime will be phased in over five years.

Tax Impact and Information Note

2.17 Most responses said that the introduction of the regime would have a positive impact on investment in the UK and would be likely to make groups consider the UK more favourably as a location for holding and exploiting their IP, with some giving specific examples of possible new investment which is contingent on the Patent Box. Some, however, felt that the regime was insufficiently generous in comparison with other international regimes to have a significant effect on behaviour.

Government response

2.18 The Government is grateful for the comments made on the expected impact of the regime. These comments have been taken into account in producing the revised Tax Impact and Information Note which has been released alongside the draft legislation.

3 Proposed changes and further consultation

Key changes to regime as a result of consultation

In response to the consultation, the Government is proposing to make the following improvements to the proposed Patent Box regime:

- Extending the regime to include patents issued by other EU national patent authorities which have comparable patentability criteria and search and examination practices to the UK or European patent office.
- Amending rules on exclusive licensing so that groups can qualify where IP is held centrally but actively owned and managed in the UK. This will avoid the need for innovative groups to restructure in order to qualify for the Patent Box.
- Modifying the proposed development criteria, which will ease compliance for innovative companies and more specifically target groups which are not involved in creating or developing IP.
- Reforming the "active ownership" rules to more specifically target artificial profit shifting. This will ensure that companies involved in early stage development are not excluded from the Patent Box.
- Reducing the mark-up rate used to calculate routine profit, and excluding R&D costs from the costs marked up. This will mean that significantly more profit is eligible for the reduced Patent Box rate, making the regime more competitive.
- A new approach to excluding profit attributable to valuable brands, to achieve a more consistent and fair allocation of profit to the Patent Box.
- Improving the level and rate of the small claims safe harbour for allocating residual profit between patents and brands.
- Simplifying the divisionalisation rules which allow companies to allocate profit more accurately to qualifying income, to make them more accessible.

Introduction

3.1 This chapter provides further details on the policy changes proposed as a result of the consultation or ongoing policy development. It also aims to provide clarification on issues which were not fully developed at the time of the June consultation. Full technical details on the new rules are available in the draft legislation and Technical Note which the Government has also published. The Government would welcome views on the issues set out in this chapter as well as on the draft legislation.

Qualifying Intellectual Property

Patent authorities

3.2 The Government intends to compile a list of other EU Member States that have patent regimes with comparable patentability criteria and search and examination practices to the UK, with the intention of extending the Patent Box to include those regimes. A draft list is expected to be released in spring 2012.

IP ownership and exclusive licensing

3.3 Companies can qualify for the Patent Box if they own or hold an exclusive licence for the IP. The Government proposes to amend the rules on exclusive licensing to make it easier for groups to qualify when IP is held centrally but actively owned and managed in the Patent Box company. A company will be eligible if there is a group agreement which confers on it the rights to use, sell or license the invention, and to receive the economic profits related to the IP.

Development criteria

3.4 The development test requires acquired IP to be developed further by the new group before qualifying for the Patent Box. Rather than requiring companies to quantify the effect of this development, the Government proposes that acquired IP will qualify provided that the new group carries out an activity of creating or developing the IP or its application; and that the acquired IP has been further developed as a result of these activities.

3.5 The development test will need to be met whether IP is sold to a new group as an asset or within a company. However, to prevent commercial acquisitions from causing companies to lose their eligibility for the Patent Box, development activities carried out in a company before a change of ownership will continue to count towards satisfying the development criteria provided the activity continues for at least 12 months afterwards.

Active ownership

3.6 Companies claiming Patent Box benefits must be actively involved in developing or managing the IP. The Government proposes to change this test from a test on each individual IP right to a company level test to make it clearer and easier for companies to comply, as well as more specifically targeting passive IP holding companies. A company will qualify if for substantially all of its IP rights it has either developed the IP itself, or it performs a significant amount of the management activities. "Management activities" will mean formulating plans and making decisions in relation to the development or exploitation of the IP rights.

Question 1: Do the proposed changes to IP ownership, development and active ownership rules now ensure that all innovative companies involved in the development of qualifying IP can potentially benefit from the Patent Box?

Qualifying Income

Leasing of patented products

3.7 Income from leasing arrangements typically includes an element of finance return as well as income from the provision of a product and often income relating to associated services. The Government has previously said that finance returns will not qualify for the Patent Box, and that service income will only qualify through the notional royalty method. The Government proposes that income from leasing transactions will be qualifying income to the extent that it relates to the provision of a patented product rather than to the provision of finance or services, and would like to explore further with business how this division could be achieved in practice.

Question 2: Do businesses have any comments on how qualifying income within leasing transactions should be calculated?

Calculation of Patent Box benefits

Division of taxable profit between qualifying and non-qualifying income

3.8 The divisionalisation rules allow companies to divide taxable profits between qualifying and non-qualifying income in a fairer way than is achieved by the standard pro-rata allocation. To simplify these rules, the Government is 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 streams they receive on a just and reasonable basis (including, if they wish, to notional royalty income from patents used in processes or services).

Calculation of notional routine return

3.9 The full rate of corporation tax is payable on profits attributable to routine activities, which is calculated as a mark-up on certain defined costs. The Government recognises that despite the narrow cost base the proposed 15 per cent mark-up may have been too high in some situations. Rather than introduce a variable rate, which would add complexity, the Government proposes to reduce the mark-up rate on all relevant expenses from 15 per cent to 10 per cent.

3.10 The Government also proposes to exclude expenses qualifying for R&D tax credits from the costs 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 be to significantly increase the profits eligible for the Patent Box, improving the competitiveness of the regime.

Allocation of residual profit to patent and non-patent drivers

3.11 Businesses did not respond favourably to the proposed formulaic rules to allocate residual profit between patents and brands, so the Government is proposing a new approach which should give a more accurate and so fairer result. Companies with marketing intangibles that contribute 10 per cent or more of their residual profit will be required to calculate an arm's length royalty for the use of those intangibles in generating qualifying income. This notional royalty, less any actual royalty paid, will then be taxed at the full corporation tax rate.

3.12 Many companies will not have to perform this calculation either because they have no commercial brand or because they license out their IP to other businesses without including the right to use any marketing intangibles. The Government also proposes to increase the level of profits eligible for the small claims safe harbour from £0.5 million to £1 million; as well as increasing the safe harbour rate from allocating 50 per cent of residual profits to the Patent Box to allocating 75 per cent, so that a greater proportion of small claim profits will be eligible for the Patent Box. This will mitigate any additional complexity for smaller claims.

Question 3: Do businesses have any comments on the new proposals for removing profits attributable to marketing intangibles?

Treatment of Patent Box losses

3.13 Companies which have elected into the Patent Box and which make corporation tax losses will be able to use these losses in the normal way at the full rate of corporation tax, without any restriction or reduction. Normal group relief, carry-back and carry-forward rules therefore apply.

3.14 However, to prevent unfairness and abuse there must be symmetry between the taxation of profits and losses within the Patent Box. The Government proposes that where there are more

Patent Box expenses than income, the surplus expenditure must be deducted from the Patent Box profits of other group companies in the same accounting period. Any remaining amount must be carried forward and deducted from any future Patent Box profits.

R&D Floor

3.15 In the previous consultation, the Government proposed that in cases where ongoing research and development (R&D) costs do not provide a reasonable proxy for the prior year costs of developing current products, some pre-commercialisation development costs would need to be clawed back. The Government intends to retain the focus on R&D costs as these represent the greatest risk of significant timing mismatches between income and expenses.

3.16 The Government proposes that in the first four years of a company electing into the Patent Box, the actual R&D expenses will be compared to the average R&D expenses incurred in the four years prior to electing into the Patent Box. If the actual expenditure drops below 75 per cent of the pre-Patent Box level (the "R&D floor"), then the R&D floor level will be substituted for the actual R&D expenditure at all points in the Patent Box calculation.

Question 4: Do businesses have any comments on the proposed rules on the R&D floor?

Computational Issues

Anti-avoidance

3.17 Effective anti-avoidance rules are critical to the long term success and stability of the Patent Box, but the Government recognises that these should be designed so that they do not create unnecessary uncertainty for businesses undertaking genuine commercial transactions. The Government is therefore proposing a targeted anti-avoidance rule (TAAR) for the Patent Box which will target companies seeking to obtain an artificial tax advantage by artificially inflating their Patent Box tax deduction. The Government welcomes views on whether the proposed TAAR, which is set out in full in the draft legislation and accompanying technical note, is expected to be appropriate and effective.

Question 5: Are the proposed anti-avoidance rules appropriate and effective?

Double Tax Relief (DTR)

3.18 The Government does not believe that changes are required to the current rules on DTR to integrate this with the Patent Box, although this will be kept under review. The current rules will already take an appropriate proportion of the Patent Box tax deduction into account when calculating the amount of DTR which can be claimed.

Clearances and HMRC engagement with customers

3.19 HMRC intends to publish comprehensive guidance on the new regime in summer 2012 and will embark on a programme to explain the Patent Box to both large and small businesses. The aim of this programme will be to enable the majority of customers with simple claims to confidently self-assess their Patent Box tax deduction. The largest and most complex claims are likely to require real-time engagement and dialogue with HMRC in order to provide certainty for businesses.

Question 6: Do businesses have any further comments on the proposals to implement the Patent Box, or on the draft legislation which has been published separately?

4 Next steps

Introduction

4.1 The Government welcomes views by 10 February 2012 on the technical issues raised in this document, as well as comments on the draft legislation and Technical Note published separately.

4.2 The Government will hold an open event at HM Treasury at 10am on Tuesday 10 January to discuss the Patent Box proposals and draft legislation. If you would like to attend this event please contact corporatetaxreform@hmtreasury.gsi.gov.uk.

4.3 Officials will spend time between now and spring 2012 consulting with businesses and other stakeholders on these proposals, with the aim of including final legislation in the 2012 Finance Bill. The current working group will also continue to meet to take these proposals forwards.

How to respond

4.4 Any comments or technical queries on the proposals in this document should be addressed to Anna Floyer-Lea (HM Treasury) or Richard Rogers (HMRC). Responses by e-mail to corporatetaxreform@hmtreasury.gsi.gov.uk are preferred. All responses will be acknowledged. However, if you wish to respond by mail please send responses to:

CT Reform
Corporate Tax Team
HM Treasury
1 Horse Guard's Road
London
SW1A 2HQ

Telephone (Treasury switchboard): 020 7270 5000

The Consultation Code of Practice

4.5 This consultation is being conducted in accordance with the Code of Practice on Consultation. A copy of the Code of Practice criteria and a contact for any comments on the consultation process can be found in Annex C.

Confidentiality

4.6 Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes. These are primarily the Freedom of Information Act 2000 (FOI), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004.

4.7 If you want the information that you provide to be treated as confidential, please be aware that, under the FOI, there is a statutory Code of Practice with which public authorities must comply and which deals with, amongst other things, obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided

as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on HM Treasury and HM Revenue and Customs (HMRC).

4.8 HM Treasury and HMRC will process your personal data in accordance with the DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

A List of responses

Companies
Archimedes Pharma
AstraZeneca
BT
BTG
Cambridge Silicon Radio
Eisai
Futura Medical
GE
GSK
Inmarsat
Johnson Matthey
John Turner Seed Developments
Qualcomm
Rolls-Royce
Sky
Spectris
Unilever
Westinghouse
Professional Services and Consultancy Firms
Aiglon Consulting
Baker Tilly
BDO
Clifton Cowley Group
Deloitte
Ernst & Young
Grant Thornton
Green Resources
IplusF
Kingly Brookes
KPMG
Murgitroyd & Company
Olswang
PwC
RSM Tenon
Smith & Williamson and Haseltine Lake
True Research

Representative Bodies
Association of the British Pharmaceutical Industry (ABPI)
BioIndustry Association (BIA)
British Generic Manufacturers Association (BGMA)
British In Vitro Diagnostics Association (BIVDA)
British Society of Plant Breeders (BSPB)
British Universities Finance Directors Group (BUFDG)
Confederation of British Industry (CBI)
Chartered Institute of Patent Attorneys (CIPA)
City of London Law Society (CLLS)
Chartered Institute of Taxation (CIOT)
Ethical Medicines Industry Group (EMIG)
Forum of Private Business (FPB)
Institute of Chartered Accountants in England and Wales (ICAEW)
Institute of Chartered Accountants of Scotland (ICAS)
Institution of Chemical Engineers (IChemE)
Intellect
LifeSciencesUK
PraxisUnico
Quoted Companies Alliance (QCA)
Scottish Lifesciences Association (SLA)
SME Innovation Alliance (SMEIA)
Individuals / Academics
Institute for Fiscal Studies (IFS)
4 individuals
Working Group Members
Andy Wood (Shell)
Colin Dalton (Vectura)
Gerd Koenigsmann (EISAI)
Helen Jones (GSK)
Martyn Smith (Dyson)
Michele Nash (ARM)
Mike Sufrin (formerly Rolls-Royce)
Peter Denison-Pender (Fusion IP)
Sarah Carter (Syngenta)
Valerie Thorn (AND Technology Research)

B Consultation responses by question

Chapter 2: Qualifying patents

Question 1: Will the requirement for a patent granted by the IPO or EPO cause significant commercial distortion? Do you believe that patents granted by any other EU national patent offices should be included, and if so which jurisdictions?

Summary of responses

B.1 Around a third of respondents thought that the current scope was reasonable, and should not be extended. However, most supported some extension, in particular to patents granted directly by other EU national patent offices. A smaller number felt that all worldwide patents, particularly those from the US and Japan, should be included. A few suggested that inventions should remain in the Box until the expiry of the last patent worldwide, or for the rest of their commercial life regardless of patent expiry.

Government's position

B.2 The Government recognises that including other EU patent authorities would improve the regime's competitiveness and aims to compose a list of other EU regimes with similar patentability and examination criteria. Patents granted by these authorities will then also be eligible for the Patent Box. The Government does not currently intend to include patents outside the EU due to the difficulties in creating and maintaining a list of all comparable worldwide patent regimes. Patents will cease to qualify once the qualifying patent has expired in order to maintain a level playing field for companies using generic technology.

Question 2: Do the ownership criteria adequately permit on-licensed patents and patents developed or commercialised in commercial cost sharing, partnership and joint venture arrangements to qualify for the Patent Box?

Summary of responses

B.3 Many responses welcomed the inclusion of acquired and collaboratively developed IP. Some felt that a requirement for an exclusive licence, particularly where the patent is owned within a group, was unduly restrictive. Some of these respondents indicated a preference for a test based on beneficial rather than legal ownership. A few felt that non-exclusive licences should also be included. Clarity was requested on how exclusivity could be limited by field or territory.

Government's position

B.4 The Government accepts that IP may be held centrally within a group for commercial reasons, and has simplified the rules within groups to avoid requiring groups to restructure to comply. "Beneficial" ownership is not legally well defined in respect of IP, therefore the Government has decided not to use this concept as a basis for qualification for the regime but to retain the requirement for exclusive licensing between third parties. The Government does not consider that the Patent Box should be extended to non-exclusive licences as this may extend the regime to significant numbers of companies in respect of the same underlying technology.

Question 3: Do businesses think that the development criteria are workable or are there commercial situations which should be included but would fall outside these rules?

Summary of responses

B.5 Most responses accepted that the requirement for groups to further develop acquired IP was reasonable. The majority supported a judgemental approach rather than one based on a precise level of expenditure. However, some were concerned that it may be onerous to identify the specific development activities related to each patent individually in order to provide evidence of meeting this test. A significant number were concerned that the proposed requirement to remain actively involved in the ongoing decision making related to the IP would inadvertently prevent some companies from benefiting due to their commercial arrangements.

Government's position

B.6 The purpose of both these rules is to ensure that companies benefiting from the Patent Box are actively involved in the patent development cycle and are not merely passive recipients of income from holding patents. The Government has simplified both of these tests to better target non-innovative groups and passive IP ownership and make it easier for innovative companies to comply, as well as ensuring that companies performing early stage research are not excluded.

Chapter 3: Qualifying income

Question 4: Do businesses believe that it is necessary to set out rules to more closely define the circumstances where a composite tangible or intangible product should be considered a single functionally interdependent item? Or can this requirement be tested through a motive test on a case-by-case basis?

Summary of responses

B.7 The majority of responses felt that detailed rules would be likely to be cumbersome and that a simple legislative definition with a motive based test would be preferred, provided that additional guidance was available for complex cases.

Government's position

B.8 The Government will legislate using a general principle rather than detailed rules. Technical details are available in the draft legislation and technical note, and the Government will aim to provide more detailed guidance on specific issues by summer 2012.

Question 5: The Government would welcome views on how the arm's length profit attributable to patents used in processes or to provide services should be calculated.

Summary of responses

B.9 A significant number of responses said that a notional royalty approach was the most consistent and fair method of determining the reward to patents used in services and processes. However, several others disagreed and felt that these rules would be difficult to apply and may unfairly disadvantage companies which use patents in this way. Particular comments were made that services performed using patented tools and technologies are covered by patent law, and that these should be included in the same way as products.

Government's position

B.10 The Government is mindful of the concerns about unfairness and administrative burden. However, it does not consider that the formulaic approach is likely to consistently result in a reasonable proportion of profit being attributed to patents used in services and processes if all such income is included, and therefore proposes to maintain the notional royalty approach. The

new rules on divisionalisation represent a significant simplification which will help ensure that companies who exploit patents through services or processes are able to benefit from the Patent Box on an appropriate proportion of their profits.

Question 6: Do businesses think that the proposed claim of retrospective benefits for the period while a patent is pending is fair and workable?

Summary of responses

B.11 Most responses felt that the proposals were reasonable, although a significant number preferred a six year period rather than four years in order to ensure that the full patent pending period for IPO patents would normally be covered. A few felt that companies should be able to claim back indefinitely, or that the benefits should be given on application and only clawed back if the application is refused.

Government's position

B.12 The Government proposes to increase the allowed time for claiming benefits prior to grant from four to six years. Allowing indefinite claims would be inconsistent with record keeping requirements and allowing patents to qualify at application would risk increasing tax-motivated patent applications which are unlikely to be granted.

Chapter 4: Calculation of Patent Box profits

Question 7: Do businesses agree that the proposed model will produce an acceptable result in most circumstances, given the flexibility provided by the ability to apply the model to company divisions separately if required?

Summary of responses

B.13 The majority of responses welcomed the formulaic approach as providing greater simplicity and certainty to taxpayers, although some questioned whether there was sufficient flexibility for all circumstances. Some responses requested an optional arm's length alternative or preferred an arm's length approach. A very small number felt that a formulaic approach was never appropriate. Several specific issues were raised which are covered in questions 8 – 14 below.

Government's position

B.14 The Government continues to believe that a structured approach offers the best balance between accuracy and certainty. In many cases a wholly formulaic approach will be possible. It is proposing some significant changes to the detailed rules to make the regime more competitive and closer aligned to the arm's length answer. The Government considers that offering both formulaic and fully arm's length alternatives would increase costs and administrative burdens on both business and HMRC without significantly improving the competitiveness of the regime.

Question 8: Is there any alternative basis of apportioning residual profits between different products which is more appropriate without introducing excessive complexity?

Summary of responses

B.15 Almost all responses supported the pro-rata split, provided that the option of more accurate apportionment was available if desired.

Government's position

B.16 The Government has significantly simplified the divisionalisation rules which should make the option of more accurately apportioning expenses to income more accessible.

Question 9: Should there be special rules for any one-off items of income or expenditure? If so what form should the rules take?

Summary of responses

B.17 The majority of responses preferred no special rules for one-off items, but a significant minority were concerned that the volatility created by large items may cause distortion.

Government's position

B.18 The rules for sales of qualifying IP rights will operate on a net profit rather than gross income basis. The Government is not currently proposing any other special rules for one-off items, but will keep this under review.

Question 10: Is divisionalisation the most effective and least burdensome way to deal with a wide range of situations in which pro-rata allocation of profits and expenses would produce an inappropriate result? Are the conditions set out above to govern the use of divisionalisation appropriate? The Government would welcome any alternative suggestions, and would appreciate sufficient detail that these can be evaluated by HMT and HMRC.

Summary of responses

B.19 Most responses welcomed the flexibility provided by divisionalisation, but concerns were raised over the complexity of conducting a transfer pricing analysis for each division.

Government's position

B.20 The Government has significantly simplified the divisionalisation rules, so that companies can now apportion expenses between income sources on a just and reasonable basis rather than having to carry out a full transfer pricing analysis of the new division.

Question 11: Are there any other circumstances in which divisionalisation should be mandatory?

Summary of responses

B.21 No specific circumstances were suggested where divisionalisation should be mandatory. Several responses suggested that mandatory divisionalisation should be kept to a minimum to avoid adding additional complexity and administrative burden.

Government's position

B.22 The Government does not intend to expand the circumstances where divisionalisation is mandatory, but will keep any inadvertent opportunities for tax avoidance under review.

Question 12: The Government would welcome views and evidence on the appropriateness of step 2 in identifying residual profits, as well as on how outsourced functions should be defined and whether there are any other costs which should be excluded from the mark-up.

Summary of responses

B.23 Almost all responses suggested that the proposed 15 per cent mark-up was too high. Several suggested that R&D costs should not be marked up. Several others suggested that defining outsourcing may be difficult.

Government's position

B.24 The Government is proposing to reduce the mark-up rate from 15 per cent to 10 per cent; and to exclude R&D expenses eligible for R&D tax credits from the regime. This should improve the competitiveness of the regime and reduce incentives to outsource R&D activity to other group companies. The Government has also chosen to define those costs which should be

included in the mark-up rather than those costs which should be excluded. Many of the terms are already defined in the R&D tax credit rules. This should create greater certainty over those costs considered to be "outsourced".

Question 13: The Government would welcome business' views on an appropriate formula to allocate residual profit to patents, and on what types of expenses should be taken into account in calculating the relative contribution made by the patent and brand to the residual profit.

Question 14: Can businesses suggest any alternative ways of effectively separating patent profits from those arising from other types of IP? If a relative contribution approach is chosen, is the proposed safe harbour set at an appropriate level to simplify smaller claims?

Summary of responses

B.25 Although a minority were content with the proposals, most responses did not accept that marketing costs constitute a reasonable proxy for brand value. Concerns over the timing of the expenses and potential volatility were also raised. Of those responses which suggested an alternative approach, most suggested that deducting a brand royalty would be more appropriate. Several suggested that brand profits should not be removed from the regime, either at all or in certain circumstances.

Government's position

B.26 The Government will implement an approach based on deducting an arm's length royalty for marketing intangibles, which will improve the fairness of this step and result in a more appropriate level of benefit in more cases. In order to mitigate the potentially increased administrative burden the Government also proposes to extend the safe harbour to cover more companies, by increasing the limit from £0.5 million to £1 million of Patent Box profit and increasing the percentage of residual profit attributed to patents from 50 per cent to 75 per cent.

Question 15: Are the proposed rules for the carry-forward of Patent Box losses appropriate? Should Patent Box losses also have to be set against Patent Box profits of other group companies in the same accounting period, in order to achieve a symmetrical treatment of Patent Box profits and losses?

Summary of responses

B.27 Most responses accepted that symmetrical treatment of profits and losses of Patent Box companies was appropriate. Many accepted that group set-off was appropriate, although some felt that this would be administratively difficult. Concerns were raised that the rules appeared to restrict loss relief for CT losses which may cause losses to become trapped in an inappropriate group company or may result in some groups being worse off in some years as a result of opting into the Patent Box.

Government's position

B.28 The Government has clarified the proposals on losses in Patent Box companies. Where a Patent Box company makes corporate tax losses overall, those losses may be used against any other profits of the group at the full normal rate of tax in accordance with the normal loss relief and group relief rules, with no additional restrictions. No groups will therefore be worse off as a result of opting into the Patent Box. The excess of Patent Box expenditure over income, now known as a Patent Box "surplus", must be deducted from Patent Box profits elsewhere in the group before calculation of the Patent Box tax deduction in that other company. Where there are insufficient Patent Box profits elsewhere in the group the surplus must be carried forward. This will achieve symmetrical treatment of Patent Box profits and losses within a group.

Question 16: Do businesses consider that taking pre-commercialisation expenses into account in these circumstances is proportionate and fair, or are there better ways of ensuring that the benefit accrues to total net patent profits?

Summary of responses

B.29 Most responses supported the use of current year R&D expenses in the Patent Box calculation and thought that taking pre-commercialisation expenses into account only where R&D has significantly decreased was fair. Clarity was requested over the exact rules, particularly for newly established companies and following reorganisation. Concerns were raised over the potential burden of calculating these expenses, particularly for small companies.

Government's position

B.30 The Government has released details of these rules in the Draft Legislation. Only R&D expenses recognised in the statutory accounts need to be tracked, which will significantly reduce the compliance burden.

Chapter 5: Computational issues

Question 17: Do respondents see any practical or technical problems with the approach of implementing the 10 per cent Patent Box rate through a computational tax deduction?

Summary of responses

B.31 Most respondents thought that the tax deduction approach was appropriate. Some concerns were raised that it may make it more difficult to explain the regime to non-tax experts. A few suggested that the Patent Box should be able to be surrendered for cash.

Government's position

B.32 The Government will implement the regime through a computational tax deduction, as it considers that the potential complexities are outweighed by practical considerations. In order to avoid technical problems with implementing the deduction for companies claiming marginal rate relief, the main rate of corporate tax will be used in all calculations. This will slightly increase benefits to companies paying tax at the small profits rate or who are eligible for marginal rate relief.

Question 18: Do respondents have any initial comments about interaction with double tax relief rules or have any views on the Government's stated aims for giving relief?

Summary of responses

B.33 Most responses welcomed the commitment to maintain double tax relief according to the current general principles. No comments were made on specific issues which needed to be resolved.

Government's position

B.34 The Government does not currently consider that changes to the double tax relief rules are required. The current rules will already take an appropriate part of the Patent Box tax deduction into account when calculating the double tax relief due. This will be kept under review.

Question 19: Would having to comply with transfer pricing rules for transactions with associated companies in cases of tax avoidance be an unreasonable burden for smaller companies?

Summary of responses

B.35 Most responses agreed that the proposals were fair, although a few suggested that transfer pricing rules would place an unnecessarily harsh burden on small companies.

Government's position

B.36 The Government considers that the proposed rules are proportionate. Small and Medium companies claiming the Patent Box will only have to apply transfer pricing rules if HMRC issues a notice instructing them to do so, and then only for the specific provision(s) covered by the notice. Any additional burden will therefore be restricted to those cases where artificial tax avoidance is suspected.

Question 20: Can respondents suggest any alternative ways to prevent artificial tax avoidance abuse of the Patent Box?

Summary of responses

B.37 Most responses emphasised the need to avoid creating uncertainty for genuine claimants. Flexibility to allow groups to restructure to take full but appropriate advantage of the regime was also emphasised as important. Suggestions made included use of an arm's length override where the Box is abused and a motive test.

Government's position

B.38 The Government considers that effective anti-avoidance rules are critical to the long term success and stability of the regime. The targeted anti-avoidance provision is aimed at preventing companies from artificially inflating their Patent Box deductions. The Government would welcome further engagement on this issue.

Question 21: Do respondents consider that other aspects of the formula apart from divisionalisation and step 3 will give rise to clearance applications? Will the current non-statutory clearance system be sufficient to respond to the range of enquiries that the Patent Box is likely to generate?

Summary of responses

B.39 Most responses felt that clearances, or the ability to agree an approach in real time with HMRC, would be essential to the smooth running and attractiveness of the regime. Specific areas mentioned were the nature of qualifying income; active ownership; divisionalisation; removal of brand profit; anti-avoidance provisions and restructurings. Concerns were raised over capacity in the current regime.

Government's position

B.40 HMRC intends to publish comprehensive guidance on the new regime in summer 2012 and will embark on a programme to educate taxpayers and explain the Patent Box to both large and small businesses. The aim of this programme will be to enable the majority of customers with simple claims to confidently self-assess their Patent Box relief. The largest and most complex claims are likely to require real-time engagement and dialogue with HMRC in order to provide certainty for businesses and avoid later disputes between HMRC and business wherever possible. The exact clearance process will be considered carefully over the next few months alongside drafting of guidance on implementation of the regime.

Chapter 6: Commencement of the Patent Box

Question 22: The replacement of a cut-off date with a phase-in approach will have different effects for each company. The Government would welcome comments on the impact of this proposal on different sectors as well as views on whether businesses prefer a cut-off date as originally announced or would favour the proposed phase-in approach.

Summary of responses

B.41 Almost all responses supported the change to a phase-in approach, as being simpler and allowing greater flexibility over location of existing patent portfolios.

Government's position

B.42 The Government will implement the phase-in approach.

Chapter 7: Tax impact assessment

Question 23: The Government would welcome comments or evidence to support the assessment of the impacts of the regime.

Summary of responses

B.43 Most responses said that the introduction of the regime would have a positive impact on investment in the UK and would be likely to make groups reconsider the UK more favourably as a location for holding and exploiting their IP. A few responses gave specific examples of possible new investment which is contingent on the Patent Box. Some concerns were raised that the regime was insufficiently generous in comparison with other international regimes to have a significant effect on behaviour.

Government's position

B.44 The updated impact assessment has been published separately.

Question 24: The Government would welcome comments on the best forum for dealing with emerging issues once the Patent Box is introduced.

Summary of responses

B.45 Most responses suggested that a forum of business and Government representatives would be the most appropriate approach to dealing with ongoing issues, alongside the Government's usual internal monitoring of tax receipts. Dedicated HMRC resource was also suggested as a way to improve consistency and reduce the time taken to resolve initial disputes. The R&D tax credits centres and the R&D Consultative Committee were suggested as good models for implementation and discussion.

Government's position

B.46 The current Working Group will be retained until the final legislation has been included in the Finance Bill, after which the Government will consider setting up a Patent Box Consultative Committee to monitor implementation and to continue to discuss any changes required to the rules in the initial years. The appropriate membership of this Committee will be considered in spring 2012.

C Code of conduct on consultation

C.1 This consultation is being conducted in accordance with the Code of Practice on Consultation that sets out the following criteria:

- When to consult – formal consultation should take place at a stage when there is scope to influence the policy outcome.
- Duration of consultation exercises – consultations should normally last for at least 12 weeks with consideration given to longer timescales where feasible and sensible.
- Clarity of scope and impact – consultation documents should be clear about the consultation process, what is being proposed, the scope to influence and the expected costs and benefits of the proposals.
- Accessibility of consultation exercise – consultation exercises should be designed to be accessible to, and clearly targeted at, those people the exercise is intended to reach.
- The burden of consultation – keeping the burden of consultation to a minimum is essential if consultations are to be effective and if consultees' buy-in to the process is to be obtained.
- Responsiveness of consultation exercises – consultation responses should be analysed carefully and clear feedback should be provided to participants following the consultation.
- Capacity to consult – officials running consultations should seek guidance in how to run an effective consultation exercise and share what they have learned from the experience.

C.2 If you feel that this consultation does not satisfy these criteria, or if you have any complaints or comments about the process, please contact

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