



HM Revenue
& Customs



HM Treasury

Patent Box: substantial activities

Consultation document

Publication date: 22 October 2015

Closing date

for comments: 4 December 2015

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| Subject of this consultation: | Changes to the design of the UK Patent Box to comply with a new international framework for preferential tax regimes for intellectual property (IP) set out by the Organisation for Economic Co-operation and Development (OECD). |
| Scope of this consultation: | The consultation sets out the Government's preferred approach, within the new international framework, and seeks views on how this will affect businesses. Where alternative approaches may be possible the consultation document also seeks views on these. |
| Who should read this: | This will affect UK businesses which hold and exploit patents, or patent-like rights. We would like to hear from these companies, whether they are currently elected into the Patent Box or not, from those who represent and advise them and from any other interested parties. |
| Duration: | The consultation will run from 22 October 2015 to 4 December 2015 |
| Lead officials: | This is a joint HM Treasury / HMRC consultation. It is being led by Jerome Cornwall (HM Treasury) and David Harris (HMRC). |
| How to respond or enquire about this consultation: | <p>Responses should be sent by post to Patent Box Consultation Team, Area 3/63, HMRC, 100 Parliament Street, London SW1A 2BQ or by email to matthew.hopkins@hmrc.gsi.gov.uk</p> <p>Enquiries should be addressed to Matthew Hopkins either at the above email address or on 03000 530855</p> |
| Additional ways to be involved: | HM Treasury and HMRC will be attending events to explain the implications of the OECD report and the impact this will have on domestic legislation. If you would be interested in attending one of these events, please get in touch at the above address. |
| After the consultation: | Due to the OECD timescale, we plan to publish draft legislation in December informed by the consultation process (rather than publish a response document and then draft legislation). A response to the consultation will be published in Spring 2016, along with any necessary changes to be made to the draft legislation (including changes responding to comments on the December draft). |
| Getting to this stage: | As part of its wider programme of work to prevent Base Erosion and Profit Shifting (BEPS) the OECD has set out a new framework that will apply, from 1 July 2016, to tax regimes which offer preferential treatment to income from IP. This has also been adopted by the EU Code of Conduct Group. During 2014 and 2015, the Government has been negotiating with other G20 and OECD member countries over the details of the new framework. |

**Previous
engagement:**

In formulating the current operation of the Patent Box, there were three rounds of formal consultation, resulting in three publications in November 2010, June 2011, and December 2011.

During the recent negotiations, HM Treasury and HMRC held informal consultations with businesses and their representatives to ensure the UK negotiating position reflected companies' experience and priorities. The OECD Secretariat also conducted similar consultations through its Business and Industry Advisory Committee (BIAC) in this period.

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Foreword

The Government is committed to ensuring that strong and sustainable growth of the UK economy continues. To achieve this, we need to create the right environment for businesses to succeed, removing barriers to investment and ensuring returns go to businesses investing in the development of new and better products and services.

As part of this the Government is continuing to create the most competitive tax system in the G20. The main rate of corporation tax has already been cut from 28% in 2010 to the current rate of 20%, and as announced in the recent Budget it will fall further, to 19% in 2017, and then to 18% in 2020, lower rates than any country within the G20 at the present time. This builds on the substantial programme of reform set out in the 2010 Corporate Tax Road Map, and is a further demonstration of our commitment to the future competitiveness of the UK. Another significant part of this is the Patent Box.

The Patent Box is a key initiative in making the UK tax regime competitive for innovative high-tech companies, driving growth and investment in the UK, creating high-value jobs in innovative industries, and building on the UK's long and proud history of great inventions and discoveries. We have seen a positive uptake of the Patent Box, with 639 companies receiving a benefit totalling £335million to date, generating positive effects with large investments into the UK being attributed to the existence of the Patent Box.

The Government is also committed to the G20-OECD Base Erosion and Profit Shifting (BEPS) project, in order to reform international tax rules to align taxing rights over profits with the economic activities that generate these, ensuring that multinational enterprises pay their fair share of tax, and cannot artificially avoid their tax obligations. Part of this work is to ensure that preferential tax regimes, such as Patent Boxes, require sufficient economic substance that they cannot be used for profit shifting. The UK has been a driving force in creating a new international framework to ensure that substantive economic activity is required as a pre-requisite for access to all preferential IP regimes, as is currently required under the Patent Box. This is achieved by linking benefits afforded to income generated by intellectual property (IP) under such regimes to the level of R&D expenditure incurred to develop that IP.

This work means that there will be some necessary changes to the Patent Box. I am pleased to publish this consultation paper with the aim of hearing from businesses, representative bodies, and other interested parties how the UK can form a set of rules for the Patent Box building on the new international framework, and protect the availability of this benefit in order to continue to promote growth and drive investment in the UK.



David Gauke
Financial Secretary to the Treasury

1. Executive Summary

1.00 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.

1.01 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 framework¹ for preferential IP regimes (like the UK's Patent Box).

1.02 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.

1.03 The UK welcomes the introduction of this framework and this consultation sets out how the UK proposes to modify its Patent Box to operate within it, and seeks input on the design of the modified Patent Box. **Chapter 2** describes the approach and **Chapter 3** sets out how it might apply based on streaming - a method of calculating profits already used in the Patent Box. Under this method, companies would first attribute turnover and expenses to IP assets (eg patents), products or product families and calculate a profit for each, then modify this based on the nexus principle. Where, exceptionally, the principle did not give a result reflecting the true substance of the company's development activity, it would be able to challenge this (the "rebuttable presumption").

1.04 To apply the nexus principle a company would need to "track and trace" turnover, expenses and R&D to an appropriate level, which might be an IP asset, a product or a family of products. **Chapter 4** sets out proposed methodologies for achieving this covering a range of different scenarios.

1.05 **Chapter 5** describes transitional issues, including provision allowed by the OECD rules for "grandfathering" - allowing existing IP to continue to receive the benefit of the current patent Box regime for a limited time.

1.06 **Chapter 6** invites comments on an initial assessment of the impact of these changes. **Chapter 7** summarises the consultation questions and **Chapter 8** explains the overall consultation process. **Annex A** explains the current Patent Box rules.

1.07 This document is accompanied by a separate chart illustrating the Patent Box modified as proposed.

¹ http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/countering-harmful-tax-practices-more-effectively-taking-into-account-transparency-and-substance-action-5-2015-final-report_9789264241190-en#page1

2. Introduction

The UK Patent Box

2.00 The UK Patent Box was introduced in the Finance Act 2012, effective from 1 April 2013, having been announced in the 2010 Corporate Tax (CT) Roadmap. Legislation is in Part 8A of Corporation Tax Act (CTA) 2010, sections 357A – 357GE) (see Annex A for description). It applies a lower (10%) rate of corporation tax to profits attributable to patents and equivalent forms of IP. This is delivered by an additional deduction, based on the level of IP profits so that the benefit to the company is equivalent to that of a lower rate. The benefit is being phased in and companies will fully benefit from the 10% rate from 2017/18.

2.01 The aim of the Patent Box is to provide additional incentives for companies to:

- increase the level of patenting of IP developed in the UK, and ensure that new and existing patents are further developed and commercialised in the UK;
- manufacture and sell those innovative products and services from the UK; and
- encourage companies to locate the high-value jobs associated with the development, manufacture, and exploitation of patents in the UK.

The BEPS process

2.02 Base Erosion and Profit Shifting (BEPS) refers to 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, resulting in little or no tax on corporate profits being paid. With the UK playing a leading role, the G20 and the Organisation for Economic Cooperation and Development (OECD) began a coordinated multinational effort in 2013 to address these issues. This is the G20-OECD BEPS project.

2.03 A key principle underlying the BEPS project is that taxing rights over profits should be aligned with the economic activity that generates them. The UK is fully supportive of this outcome and set out its priorities across the actions at Budget 2014².

Substantial Activity in IP regimes

2.04 Action 5 (of 15) in the BEPS Action Plan is “Countering harmful tax practices more effectively, taking into account transparency and substance”. This has been led by the Forum on Harmful Tax Practices (FHTP), a group comprising of G20 and OECD countries working on an equal footing, along with the OECD Secretariat and a representative from the European Commission. Its work has been primarily focussed on preferential IP regimes (“Patent Boxes”).

² <https://www.gov.uk/government/publications/tackling-aggressive-tax-planning-in-the-global-economy-uk-priorities-for-the-g20-oecd-project-for-countering-base-erosion-and-profit-shifting>

2.05 It was agreed within FHTP that in order 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 and that R&D expenditure should be used as a proxy for substantial activity in relation to preferential IP regimes. This approach therefore links benefits afforded profits from IP to the requirement to have undertaken the R&D activities to develop that IP. This is referred to as the nexus approach.

2.06 The concept of substantial activity is not new. It has been referred to in the OECD rules on harmful tax practices since the 1998 OECD report *Harmful Tax Competition: An Emerging Global Issue*, and also in the EU Code of Conduct for Business Taxation. What is new is the additional focus on this aspect of the rules, with more detail provided, consistent with the overall aim of the BEPS project.

2.07 The UK welcomes the work done to ensure that substantive economic activity is required to be undertaken as a pre-requisite for access to all preferential IP regimes, as is already required under the Patent Box. Based on the agreement reached, we also believe that this has secured the ability for these regimes to continue to act as an effective tool to stimulate investment and help to increase productivity in the UK. Significant amendments will however be required to the Patent Box to incorporate the harmonised test for substance agreed as part of Action 5.

2.08 The BEPS Action Plan has resulted in a number of new international and domestic rules and principles, and the conclusions of the Working Groups dedicated to different aspects of the BEPS project are included in reports published by the OECD in October. The FHTP have published their conclusions in *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance*³ (“the 2015 FHTP Report”) with Chapter 4 containing the new international framework agreed within the FHTP concerning preferential IP regimes.

2.09 Chapter 4 requires that only nexus compliant IP regimes operate from 1/7/16, apart from some permitted grandfathering (rules allowing IP existing before that date to continue in the current Patent Box regime for a limited time). The Government will propose legislation in the 2016 Finance Bill (FB16) to amend the current Patent Box rules (rather than replacing them completely) with effect from 1/7/16 and this consultation seeks input on the changes. References in this document to “the current rules/ Patent Box/ legislation” or to “the new rules/ Patent Box/ legislation” are therefore to the existing and the modified legislation respectively.

The Nexus Fraction

2.10 The principle set out above is implemented through a ratio, the “nexus fraction”, which is the proportion of the profit from the IP which may be included in an IP regime.

³ http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/countering-harmful-tax-practices-more-effectively-taking-into-account-transparency-and-substance-action-5-2015-final-report_9789264241190-en#page1

2.11 The numerator of the fraction comprises the taxpayer's "own" direct R&D expenditure on the IP – including any conducted through branches – plus any R&D subcontracted to an unrelated party ("qualifying expenditure"). The denominator is comprised of qualifying expenditure plus any R&D subcontracted to a related party and any acquisition or licensing costs ("non qualifying expenditure"). So if, for example, a company made profit P from an item of IP, and the company carried out 70% of the R&D itself the nexus fraction would be 0.7 and the profit to which the 10% rate would apply would be 0.7 x P.

2.12 The FHTP agreed a modification to this approach – the numerator may include an "uplift" allowing some non qualifying expenditure to be added (up to 30% of the qualifying expenditure) providing such costs have actually been incurred. It is included in recognition of the fact that companies which acquired a portion of the IP from, or outsourced R&D activity to, a related party may themselves still be responsible for much of the value creation that contributed to IP income and that the nexus fraction should not unfairly disadvantage groups that have operated in this way under existing rules.

2.13 Setting this out symbolically and calling the nexus ratio (or fraction) N , then for each item of IP

$$N = \frac{D + S + U}{D + S + A + R}$$

U is the uplift which if applicable is the lesser of $A + R$ and $30\% \times (D + S)$. The other terms represent different kinds of expenditure by the company which contribute to the IP:

D = In-house direct expenditure on R&D

S = Expenditure on R&D subcontracted to third parties

A = Expenditure on acquisition of IP

R = Expenditure on R&D subcontracted to related parties

Remainder of this document

2.14 Chapter 3 sets out the new international framework and how the Government proposes to amend the UK Patent Box to comply with it, focussing on the elements of the Nexus fraction, the determination of eligible profits and the application of Nexus in special circumstances including the "rebuttable presumption" allowing the nexus fraction to be modified. Chapter 4 addresses tracking and tracing of expenditure and IP income and Chapter 5 restructuring and transitional issues. We are interested in views from respondents on how these changes will affect relief under the UK Patent Box and whether, within the framework of the Nexus approach, there may be better ways to achieve this.

Question 1. Each chapter below sets out a number of specific questions relating to the implementation of the new international framework in the Patent Box. The Government would be grateful for any wider comments, beyond responses to these specific questions.

3. New International Framework

Income and profits

3.00 The new international framework defines what is meant by “income” that may benefit from an IP regime (see paragraphs 47 and 48 in Chapter 4 of the 2015 FHTP Report). The following principles apply;

- Income benefiting from a regime should be proportionate – it should not be defined as the gross income from the IP asset, but should instead be calculated by subtracting IP expenditures allocable to IP income and incurred in the year from gross IP income earned in the year;
- Jurisdictions should not allow the diversion of any tax losses associated with the IP income against income that is taxed at the (higher) ordinary rate;
- Income benefiting must be derived from the IP asset. It may include royalties, capital gains and other income from the sale of an IP asset, and embedded IP income from the sale of products and the use of processes directly related to the IP asset.
- Jurisdictions that choose to grant benefits to embedded IP income must implement a consistent and coherent method for separating income unrelated to IP (e.g. marketing and manufacturing returns) from income arising from IP.

3.01 The first bullet makes clear that while Chapter 4 generally uses the term “income”, this refers to a net, not gross, figure and so for compatibility with the current Patent Box legislation this document uses the term “profit” except when quoting directly from Chapter 4.

3.02 The Government considers that the current UK rules for establishing profits within the Patent Box are consistent with these principles, including allowing the small claims election (S357CM) for the marketing assets return. The Government does not, therefore propose any changes to the fundamental definition of relevant IP profits.

Question 2. The Government would be grateful for views on whether the current approach to defining profits should be retained, including any evidence supporting the retention of a small claims election.

Applying nexus to profits: streaming

3.03 In future, where there has been related party R&D outsourcing or an IP acquisition, a company may have to apply a nexus fraction of less than 1 to its profits. It will therefore be necessary to modify the calculation of profit by introducing this fraction.

3.04 Under the current rules, the Patent Box calculations apply to the company’s IP proceeds as a whole, but the new framework requires underlying data at the level of the IP itself (e.g. a patent), at the level of a product, or at the level of product family. (The details of how these different levels of tracking and tracing might be defined are discussed in Chapter 4).

3.05 This means dividing IP profits, and corresponding expenditure, into different “parcels”, each with its own nexus fraction. To calculate the total profit to which the Patent Box applies the company will need to multiply each profit figure by the corresponding nexus fraction and add up the results.

3.06 There are currently two ways of calculating profit for the Patent Box - proportional split and streaming (see Annex A for further detail). The Government proposes that streaming will in future be the only method, as proportional split cannot easily be made to give the direct link between profit and R&D expenditure that the new international framework requires.

3.07 Companies will therefore calculate a profit for each stream, but rather than two streams (IP and non IP) there will be a separate stream for each different parcel of IP. There might be stream per item of IP, or a stream per product, or per product category – or indeed a mixture, with some streams corresponding to IP items, some to products and some to product categories. Within each stream, the calculation will be broadly as it is now. This is illustrated in the flowchart that accompanies this document.

3.08 The company will need to be able to track its expenditure on developing IP corresponding to each stream as well as the credits and debits needed to establish a profit figure. Once the streams have been established the company will need to track consistently, and would not subsequently be able to change their approach without justification. (See paragraph 4.03 for more detail of what level the tracking should be at).

3.09 There will be a nexus fraction for each stream which will be applied to the profit figure as an extra final step in the calculation before the separate profit figures are added and the Patent Box additional deduction calculated from the total. This is illustrated in the example below, and in the flowchart which accompanies this document.

3.10 It has been suggested that an exception could be made where a company has only incurred qualifying expenditure (plus, perhaps, very small amounts of non-qualifying expenditure, which would be covered by the uplift) so that the nexus fraction equals 1. It might be possible to phrase this in terms of a “gateway” test. Meeting this test would allow a company to operate the current proportional split approach. However, the company would still need to track and trace expenditure to IP assets, products or product categories since it might, in future, acquire IP or subcontract development work, and it would then need records to calculate a new nexus fraction. So there does not seem any great benefit in allowing proportional split and the Government does not propose to do this.

Example

A Ltd has turnover of 10,000 comprising 6,000 attributable to its pharmaceutical patents, and 4,000 attributable to providing contract R&D. It has total deductions of 5,000 and therefore makes profit of 5,000.

A Ltd owns three patents, A, B and C. They relate to quite different fields and are used in different products and the company is therefore able to track both R&D spend and income to the patents.

Of the 6,000 patent income, 3,000 is attributable to the product using patent A, 2,000 to the product using patent B and 1,000 to the product using patent C. There is a further stream of 4,000 corresponding to contract R&D, which is not IP income. The corresponding deductions attributable to these streams are 1,500 (patent A), 1,000 (patent B), 500 (patent C) and 2,000 (non IP income).

Assume that the nexus fractions corresponding to the three patents A, B and C are 0.7, 0.5 and 0.9. The calculation of the profit eligible for Patent Box under the new framework is therefore as follows:

| Item | A | B | C | Non IP | Total |
|--------------------|-------|-------|-------|--------|--------|
| Credits | 3,000 | 2,000 | 1,000 | 4,000 | 10,000 |
| Debits | 1,500 | 1,000 | 500 | 2,000 | 5,000 |
| Profit | 1,500 | 1,000 | 500 | 2,000 | 5,000 |
| Nexus fraction | 0.7 | 0.5 | 0.9 | - | - |
| Adjusted PB profit | 1,050 | 500 | 450 | - | 2,000 |

So the total amount of income qualifying for the new Patent Box is 2,000 rather than the 3,000 previously.

Question 3. The Government would be grateful for views on requiring streaming in all cases.

Rebuttable presumption

3.11 Chapter 4 of the 2015 FHTP Report states (at paragraph 67) that “Jurisdictions could treat the nexus ratio as a rebuttable presumption. In the absence of other information from a taxpayer, a jurisdiction would determine the income receiving tax benefits based on the calculation above. Taxpayers would, however, have the ability to prove that more income should be permitted to benefit from the IP regime in exceptional circumstances...”

3.12 This could allow taxpayers in some circumstances to challenge the outcome of the nexus fraction where it does not give a result in line with the underlying principle of nexus to link access to a preferential regime to the value added by a taxpayer in the development of an IP asset. An example given is where IP has been acquired, the value of which is subsequently written down.

3.13 This is reserved for exceptional circumstances, and the taxpayer must provide detailed supporting information. The chapter requires that:

- the taxpayer calculate the nexus ratio (excluding up-lift);
- the ratio so calculated equals or exceeds 25%;
- the taxpayer demonstrates that because of exceptional circumstances the application of the nexus ratio results in an outcome inconsistent with the principle of the nexus approach;
- the taxpayer provide evidence as to the exceptional circumstances, and;
- the application of the rebuttable presumption in any particular circumstances is reviewed yearly to determine the continued presence of the exceptional circumstances that requires an adjustment to the nexus fraction.

3.14 There are two ways in which the rebuttable presumption might be given effect in the revised Patent Box legislation. These are:

- i. to allow the result of the fraction to be modified where all the above conditions are met and where the modification restores the link between the proportion of R&D expenditure incurred and the proportion of income eligible for the IP regime; or,
- ii. to list all circumstances in which the presumption could be used and the adjustments to the fraction that would follow from them.

3.15 While an exhaustive list might give greater certainty this approach risks circumstances being unfairly excluded. The first approach therefore seems to be the best overall, with guidance on the rebuttable presumption and examples of circumstances where it might be used.

Question 4. The Government would be grateful for views on the suggested approach to the rebuttable presumption, especially on what circumstances should be considered exceptional and justify its use, and what examples should be included in guidance.

Joint development

3.16 Chapter 4 of the 2015 FHTP report states (at paragraph 31) that nexus is not designed to disadvantage arrangements where different entities are engaged in activities contributing to the development of IP assets. This would cover joint/co-development arrangements including cost contribution arrangements (CCAs), as illustrated by the example in footnote 3 of the Chapter:

Company A, Company B, and Company C together develop IP Asset D in Year 1. Company A is in a jurisdiction with an IP regime. Company A contributes 30% of the R&D and 3000 of the R&D funding, Company B contributes 30% of the R&D and 3000 of the R&D funding, and Company C contributes 40% of the R&D and 4000 of the R&D funding. IP Asset D produces 100,000 of IP income in Year 2, and 30,000 of this IP income is allocated to Company A. If Company A did not pay to outsource to a related company or to acquire any IP assets, then the nexus ratio that would apply to

that 30,000 before the up-lift is 3000/3000 (or 100%). The entire 30,000 would therefore qualify for the IP regime in Company A's jurisdiction.

3.17 The Government agrees that such co-development arrangements should not be disadvantaged – as they might if, in the above example, Company A's total contribution to the overall R&D effort were treated as either acquisition costs or related party subcontracting, splitting them off from its own R&D effort. Equally, the presence of a CCA or other joint development arrangement should not result in a more favourable treatment.

3.18 Government proposes that in accordance with the aim of nexus (to ensure a direct and proportionate link between the profit eligible for inclusion in a preferential IP regime and the level of qualifying expenditure incurred in generating qualifying IP) only R&D contributions will count as qualifying expenditure in the nexus fraction. Where funding or other non R&D contributions are provided by a taxpayer as part of their obligations under the co-development arrangement, these will be treated as acquisition costs or related party subcontracting according to their underlying substance⁴. For example, a balancing/ top-up payment made by a taxpayer to reflect that its direct contribution to the co-development was not commensurate with the share of rights it received in the exploitation of the IP ultimately generated, will be treated as an acquisition of the rights, which if split on the basis of relative R&D contribution value would otherwise have accrued to the other participants.

Question 5. The Government would be grateful for comments on the suggested approach to co-development.

Expenditure

3.19 Chapter 4 of the 2015 FHTP report states (paragraph 39) that R&D expenditure, for the purposes of calculating the nexus fraction, includes the type of cost that would qualify for a country's R&D tax credits. It also says that expenditure must be essential and directly connected to the IP asset (though general R&D costs which are relevant to more than one asset may be apportioned) and that "unsuccessful" R&D should not be included. (It is though in the nature of R&D that success or failure can be hard to judge and that negative results can still advance the state of science or technology by resolving uncertainties.)

3.20 With all this in mind, the Government proposes that the definitions of direct and subcontracted R&D expenditure should be aligned as closely as possible with those used for the R&D tax credits, but not based on the actual amount of the company's claim to R&D relief. This is because other considerations could affect this which are unrelated to Patent Box (e.g. differences in the tax credit rules depending whether the business is large or is a small or medium enterprise (SME)).

⁴ This will not affect any determination of the income attributable to a participant in the joint arrangement which will be determined under normal transfer pricing principles.

3.21 The main R&D tax credit provisions are in Chapter 6A of Part 3 of the Corporation Tax Act 2009 (CTA2009) at sections 104A-Y (the Research and Development Expenditure Credit (RDEC)) and in Chapters 1-4 of Part 13 of that Act (Relief for companies that are small or medium enterprises (SMEs)). In either case, relief is available for expenditure in certain defined categories where this is incurred on qualifying R&D.

3.22 The Government proposes that;

- direct or subcontracted expenditure for the nexus fraction must be expenditure on R&D. R&D is defined for tax purposes at s1138 CTA2010 and in guidelines issued by BIS⁵ and the Government proposes to use the same definition for nexus.
- direct or subcontracted expenditure for the nexus fraction must also be relevant R&D of the company (i.e. related to the company's trade or from which a trade will be derived: see s1042 CTA2009). This ensures a link between eventual IP income, which arises from the trade, and R&D expenditure, which underpins it.
- company in-house direct expenditure on R&D (D in the equation above) will be defined as expenditure on staffing costs, software or consumable items, externally provided workers or payments to subjects of a clinical trial.
- expenditure on related party and third party subcontracting will be defined following the rules for subcontracting in the current SME R&D scheme (see ss1122 and 1123 CTA2009). This means that for third parties, the amount used in the nexus fraction will be 65% of the amount actually paid. For related parties the amount used will be the lesser of the amount paid and the actual amount spent on R&D by the subcontractor. This means that where a related party subcontract payment covers work that is not R&D, the non R&D aspect will not inflate the denominator of the nexus fraction.
- Total expenditure will be the above, plus payments for acquired IP (see below) and will include contributions to co-development exceeding the company's direct R&D input (see paragraph 3.18 above).

3.23 R&D Expenditure can be incurred before or after a patent is granted – so continuing expenditure on creating a saleable product based on a piece of existing IP will count, so long as R&D (within the BIS definition) is still taking place.

3.24 Chapter 4 of the 2015 FHTP report allows “pass through” payments to a third party for work subcontracted to it to be made via a group company (paragraph 50). The Government therefore proposes that where a company makes payments in this way to a third party subcontractor, amounts actually paid to the third party will qualify in the same way as if they were paid directly. However this will only be the case where the second company is a true intermediary – not if for example it is itself managing the work and simply recharging the first company.

⁵ https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/71260/bis-10-1393-rd-tax-purposes.pdf

3.25 The Government proposes that “acquisition costs” should include any amounts paid, whether to purchase an IP asset outright or to purchase a right to use IP. In line with the approach required by the new international framework, payments will be included in the nexus fraction as they are made, so staged payments, for example, would be included as they arise while upfront payments will be included from the start (see below).

3.26 However this only includes payments relating to IP with income which could eventually itself be within the Patent Box regime. If, for example, a bundle of IP is purchased – say, a patent and associated know-how, trademarks, and copyright in computer software – then only the element of the payment relating to the patent would count towards total expenditure.

Question 6. Do respondents agree that

- **the same definition of R&D should be used for nexus as for R&D tax credits?**
- **expenditure for the nexus fraction should be relevant R&D of the company?**
- **the definitions of and rules for calculating direct and subcontracted expenditure should be aligned with the R&D tax credits, as set out above?**

Timing of expenditure

3.27 Chapter 4 requires expenditure to be included in the nexus fraction when it is incurred (paragraph 46). While this term is not defined the context makes it clear that this is intended to prevent capitalised expenditure, for example, from being kept out of the nexus fraction simply because it does not lead to a deduction. The Government proposes to follow the rules currently used for the R&D tax credits. This does not directly define when expenditure is incurred but relies on its being deductible in a period (though allowing such capitalised expenditure to qualify through S1308 CTA2009).

3.30 It is possible that the composition of the nexus fraction could be manipulated, for example by delaying acquisition costs so that a more favourable nexus fraction was available when income arose. This would of course mean that the expenditure was not deductible and so R&D tax credits would not be available.

3.31 Equally, payments might be brought forward. One option to prevent this would be to define when expenditure is “incurred” in more detail (as, for example, with film tax relief, which has specific rules dealing with pre-payments and deferred payments). The Government does not propose to include similar rules as these seem to move away from the text of Chapter 4, but would instead consider using the existing Patent Box anti-avoidance rules at S357FB CTA2010, should this situation arise.

Question 7. Do respondents agree with the suggested approach to the timing of expenditure for the nexus fraction?

4. Establishing the R&D base for nexus

Tracking and Tracing

4.00 The new framework was designed to require a link between expenditure, IP assets and IP income. This leads to a requirement on groups to track expenditure to the lowest possible level, defined as the level of individual IP assets such as patents. However, Chapter 4 of the 2015 FHTP report recognises this may not always be possible or an accurate reflection of the way the IP asset was developed, and so allows for tracking at the level of products (including product families). However Chapter 4 requires jurisdictions to “apply a purposive definition of products... which cannot be so large as to include all the IP income or expenditures of a taxpayer engaged in a complex, IP-based business with multiple products and R&D projects...” (paragraph 57).

Overall approach

4.01 The Government therefore proposes that the revised Patent Box rules should offer companies a choice of whether to track to IP asset or product (including product family).

4.02 The legislation would set out broad principles governing this choice (for example, companies would be prohibited from simply tracking total income or expenditure except where they had a very narrow range of products such as a single item of IP or a single product and only invested in R&D linked to this) and HMRC would issue supporting guidance. However the legislation would not seek to tightly constrain the choice.

4.03 As tracking to the lowest level is defined as directly to patents, or patent equivalents, the Government proposes that the company must track its expenditure and corresponding profits to the level of individual IP assets, unless this:

- would be unrealistic;
- would require arbitrary judgements; or
- would entail tracking and tracing to a category entirely unrelated to innovation or business practice.

(See also paragraph 3.08 on establishing profits at the same level).

4.04 If such factors existed the company would be able to choose to track to a higher level, though it would still be required to track to the lowest level that did not entail the factors listed above and in any case not to one so high as to include all or most of the IP income and related expenditure for a complex IP-based business with multiple products and R&D projects.

4.05 The company would be required to provide evidence to show why the level chosen was appropriate, and HMRC would be able to challenge the company’s approach by enquiring into the self-assessment the company had made based on it.

4.06 Whether this alternative level amounted to tracking by “product” or “product family” or something in between would not appear to affect the outcome and the Government does not therefore propose to define those terms, relying instead on the approach suggested above.

4.07 A company will be able to track different aspects of its business to different levels where this is appropriate.

Question 8. The Government would be grateful for

- **views on the merits of the suggested approach to tracking and tracing, in contrast to defining “product” and “product family” more precisely; and,**
- **suggestions as to what factors might be relevant in judging the conditions set out in paragraph 4.03.**

Company history

4.08 There are, however, many different circumstances in which a company may come to “own” IP. For example, a company may acquire or merge with another business. Many companies have complicated histories and structures. Not all of these should necessarily be treated as “acquisitions”. They do however raise the question of how such previous expenditure is to be treated.

4.09 If, for example, two companies merged, each owning IP with an established spending history, it seems right to recognise this as “own spending” when calculating future nexus ratios. But it is important not to create an incentive for larger companies to merge with smaller ones as an alternative to simply acquiring IP.

4.10 The Government proposes to adopt one of the following options

- i. Rules analogous to those for loss streaming so that when a company acquires a trade which includes IP with an R&D expenditure history, that history, and the corresponding income, is kept separate, with its own nexus fraction; or,
- ii. Include a purpose test so that where a merger or other transaction is a contrived alternative to an acquisition of IP, its effect could be disallowed for Patent Box purposes; or,
- iii. Rules analogous to loss buying, where the nexus fraction of the acquired business would be retained unless it was subsequently restructured such that, on a notional basis, the income to which the nexus fraction applies would have been attributable to the acquiring company if the merger had not taken place

Question 9. The Government would be grateful for views on the alternative approaches suggested for dealing with pre-merger costs, including, under option (i), how long this treatment ought to last. The Government would also welcome suggestions for any alternative options which respondents feel may better address the issue raised at 4.09.

Question 10. The Government would also welcome information about any other circumstances in which a company may come to own IP and which may not be clearly addressed by the proposed rules.

Composition of the nexus fraction

4.11 As explained above, in future, to benefit from an IP regime, it will be necessary to track expenditure on developing IP. Costs, for the purpose of the nexus fraction, should be cumulative (i.e. cover all expenditure to date).

4.12 Chapter 4 of the 2015 Report (paragraph 55) then requires expenditure to be removed from the nexus fraction when it no longer contributes to income. If this were not done, then the fraction might over time come to not fairly represent the development activity from which the profit comes.

4.13 Assessing which expenditure still contributes, and to what degree, could be a complicated matter. The Government proposes a simple rule, that expenditure should be removed from the nexus fraction 15 years after being included, this number being the potential 20 year life of a patent, assuming annual fees are paid, less 5 years to allow for the fact that a patent may have a priority date earlier than the filing date. However the Government appreciates that protection can vary if, for example, a supplementary protection certificate extends the lifetime of a patent, that different sectors may have different characteristic development timescales, and that a single rule might not fit all circumstances.

Question 11. The Government would be grateful for views on the suggested approach to retiring expenditure from the nexus fraction, including other suggestions for addressing the issue without introducing undue complexity.

Rules for calculating the nexus fraction in particular circumstances

4.14 Chapter 4 of the 2015 FHTP report allows IP regimes to take account of the fact that companies may not have adequate records (to the level of detail required by the Chapter) going back to the start of work on all their IP. (This is a separate matter from “grandfathered” IP – which is allowed to continue within the current regime for a limited period of time, as discussed in the next chapter). There are several different cases to consider and the Government proposes the following treatment.

Case 1: Company begins activity on IP after 1/7/16

4.15 In this case, companies should immediately begin tracking expenditure at the appropriate level, and any nexus ratio will then be able to take account of all expenditure to date. No special rules need to apply.

Case 2: Company has been incurring expenditure pre 1/7/16 but IP is not grandfathered

4.16 This could be the case if, for example, expenditure were under way pre 1/7/16 but no patent has yet been applied for – so that the IP, once it emerges, is “new” post 1/7/16. Companies in this situation may not, immediately post 1/7/16, have adequate records as they would not have known that this would be necessary. Chapter 4 of the 2015 FHTP report therefore allows transitional arrangements. There are two aspects to these.

- Companies may track expenditure and profits at a higher level (e.g. global expenditure rather than by IP asset, product or product family), if they lack sufficient detail; and,
- Companies may use a limited number of years’ recent expenditure data (3 or 5 is suggested), rather than full cumulative data reaching back to the start of expenditure on the asset.

4.17 Moreover, once companies do have full detailed data and begin using it, they will be tracking from the start of that data, and not using any earlier data.

4.18 The aim is that the company must, as soon as possible, begin gathering information at a sufficient level of detail that it can use its post 30/6/16 data to calculate a nexus fraction at the lowest level feasible (see paragraphs 4.01 – 4.07 above). Once it can do so it must do so cumulatively.

4.19 The Government therefore proposes the following rules

- a company must track all future expenditure (i.e. incurred after 1/7/16) either to IP, product or product family and this must be included in a nexus ratio on that basis, updating it year by year;
- once that ratio is based on 3 years of data, the company must begin using the ratio in its PB calculation, adding future years’ data into the fraction as they are available;
- until then, the company’s nexus ratio may be based on global data for the last 3 years, ‘global’ referring to the total R&D spend of the company rather than spend linked to IP asset or product. (If the company had adequate data to calculate on the basis of eg IP asset it would be able to do so);
- if the company has no expenditure post 1/7/16 (say, development was complete at 30/6/16 but the patent had not yet been applied for) then the company must make the best estimate it can on the basis of pre 2016 expenditure.

4.20 It follows that

- initially, the transitional ratio will be based on some pre 1/7/16 data;
- the company will at the same time be collecting detailed data for the future cumulative nexus ratio and global data for the transitional ratio, but;
- the company will, at the end of the transitional period switch over to a nexus fraction based entirely on new, detailed data.

4.21 If, though this seems unlikely, the company did have the detailed information to track to IP asset, product or product family before 2016, it would not be prevented from doing so immediately. However in the spirit of the nexus approach it would have to do so cumulatively ie pre 2016 data would not drop out after 3 or 5 years.

Case 3: Company has IP in grandfathered regime

4.22 Companies in the existing Patent Box at 1/7/16 may be able to continue in it under the grandfathering rules (see Chapter 5 below) in which case they will not have to apply a nexus fraction immediately after that date.

4.23 However, once the grandfathered regime ceases, by 1/7/21 at the latest, they will need to apply a ratio based on cumulative spending since 1/7/16. So even companies not immediately operating the new regime will need to ensure that they keep adequate records for the future. In this sense even those with grandfathered IP will need to operate nexus from 1/7/16.

4.24 Where there is no development spend post 1/7/16 and therefore nothing on which to base a ratio from 2021, the company must make the best estimate it can on the basis of pre 2016 expenditure and use this until it can be replaced by new data.

Case 4: Company tracks by product or product family and has product containing both old and new IP

4.25 An example of this might be a mobile phone, where a new product is launched each year which reflects additional development expenditure but retains some from the previous model. The price is constant, reflecting the need to innovate in order to retain market share, so over time, the profit attributable to the older IP declines.

4.26 In a case like this the income stream from the product needs to be split between the “old” and “new” IP. The old IP will, presumably, be grandfathered, while the new IP (ie that appearing post 1/7/16) will be within the new Patent Box rules. The current Patent Box legislation will be modified to exclude the new IP.

Question 12. The Government would be grateful for views on the suggested rules for calculating the nexus fraction, including the lengths of the time periods to be used (with evidence if possible showing why these are appropriate).

5. Transitional Issues

Grandfathering

5.00 Chapter 4 of the 2015 FHTP report requires that the current regime be withdrawn completely by 30 June 2021 at the latest, but companies – and IP – already in the current regime can continue to receive the benefit of the current rules until the regime is withdrawn.

5.01 This maximum five year period is intended to give companies time to adapt systems, reorganise their affairs, and begin collecting the information they will need to calculate the nexus fraction.

5.02 The Government's view is that the greatest possible flexibility should be provided and it therefore proposes to use the full five year period ie to allow those who enter the current Patent Box regime before 1 July 2016 continue to be taxed under those rules until 30 June 2021. This is subject to a specific anti-abuse rule noted below.

5.03 It may however be that this is not necessary and that companies could adjust within, say, three years.

Question 13. The Government would be grateful for evidence about the length of time likely to be needed for companies to adapt systems, reorganise their affairs, and begin collecting the information they will need to calculate the nexus fraction to inform the length of the grandfathering period.

Transitional Rules

5.04 Currently, companies may elect into the Patent Box at any time, whether or not they have qualifying income. If, having elected in, they have qualifying income for any period after 1 April 2013, then the Patent Box rules apply to that income and they will have a corresponding Patent Box loss or Patent Box profit. Any Patent Box profit gives rise to an additional deduction; and Patent Box loss is carried forward to reduce a future Patent Box profit before a deduction is generated.

5.05 The process of granting a patent can be a lengthy one in some cases and there are specific provisions to ensure that once a patent is granted, the company may receive the benefit of the patent box backdated to the effective date from which the patent applies.

5.06 Chapter 4 of the 2015 FHTP report requires current Patent Box regimes (i.e. those not compliant with nexus) to be closed to “new entrants” (new IP, or companies not previously opting in) from 1 July 2016 (paragraph 63). The Government proposes to modify the current regime, with the new, modified regime applying to any “new entrants” from that date, as follows

- Any company already elected into the existing Patent Box regime at 30/6/16 will
 - continue to benefit from the existing Patent Box rules for profits arising before 30/6/2021 from any IP that already exists at 30/6/16
 - For this purpose, “exists” refers to the priority date for the patent (the effective filing date) from which it will have legal force, not the date that the patent is granted. This date must be before 1/7/16
 - This would apply whether or not the patent is granted before 2021
 - be subject to the new Patent Box rules for profits arising at any time from IP that does not exist at 30/6/16;
- Any company not elected into the existing Patent Box at 30/6/16
 - but which wishes to make an election, within normal time limits, relating to pre 1/7/16 profits may do so, provided that it would satisfy the conditions to do so at 30/6/16;
 - but if it does not elect in within normal time limits, it will be subject to the new Patent Box rules for profits arising at any time, whether or not the IP existed at 30/6/16.
- A company which had previously elected out of the Patent Box will be able to elect back in despite the current rule that prevent it doing so within 5 years.

5.07 It is likely that some companies will have different IP subject to both the old and new rules, and income from some products may even be split if the company tracks to the level of products or product categories and, post 30/6/16, new products combine IP subject to the two sets of rules.

5.08 In these circumstances the company will be required to apportion profits and, where necessary, R&D costs from the product between the two regimes and to operate the appropriate rules for the two categories. Clearly this will not be necessary where the company is able to track at the level of IP.

Question 14. The Government would be grateful for views on the suggested transitional rules.

Acquisitions after 1/1/16

5.09 There is an additional safeguard in Chapter 4 of the 2015 FHTP report (paragraph 66). In order to prevent IP being moved between related companies to take advantage of grandfathering, any IP acquired from a related party after 1/1/16 must be excluded from a grandfathered regime unless that IP already qualifies for benefits under an existing IP regime.

5.10 IP that is so excluded will continue to get the benefit of the UK Patent Box until 31/12/16, but after then, it will not be grandfathered and can only be within the new Patent Box regime.

6. Assessment of Impacts

Summary of Impacts

6.00 The Government will publish a full impact assessment when final decisions have been taken on the changes to the Patent Box. The table below gives the current assessment of impacts.

| | |
|---|---|
| Exchequer impact | <p>The Exchequer impact of the changes proposed will depend on the final policy design, which will be influenced by responses to this consultation, and any behavioural responses by affected businesses.</p> <p>The overall impact is expected to be relatively small particularly in the early years as a result of the proposed transitional arrangements described in Chapter 5. The changes to the substantial activity requirement may result in less tax benefit in cases where a company's nexus fraction is less than 1 and it does not make changes to undertake more R&D in house.</p> <p>The final costing will be subject to scrutiny by the Office for Budget Responsibility, and will be set out at a future fiscal event.</p> |
| Economic impact | <p>The introduction of the Patent Box has encouraged investment and economic growth in the UK as well as limiting the movement of intellectual property offshore by innovative businesses that might otherwise have invested elsewhere.</p> <p>The changes proposed to ensure compliance with the new international framework are not expected to have any significant additional economic impacts, and the Patent Box will continue to promote investment and growth in the UK.</p> |
| Impact on individuals and households | <p>No direct impacts are expected on individuals and households as the Patent Box relief only applies to companies</p> |
| Equalities impacts | <p>Patent Box is a corporate tax relief claimed by businesses holding and exploiting intellectual property. As such, the Government does not expect that the changes proposed will have any equalities impacts.</p> |
| Impact on businesses and Civil Society Organisations | <p>Companies electing into the Patent Box will have to comply with additional income and expenditure tracking rules and may face additional costs and record keeping requirements. There could also be upfront familiarisation and other costs arising from the new regime (e.g. systems changes). Companies with grandfathered and "new" IP will potentially be operating both sets of rules at the same time.</p> <p>Estimates of these costs have not yet been quantified. The responses to this consultation will help inform the Tax</p> |

| | |
|---|--|
| | Information and Impact Note which will be published alongside the draft legislation. |
| Impact on HMRC or other public sector delivery organisations | HMRC will have to issue revised guidance and modify systems to operate the new rules at the same time as the grandfathered ones. |
| Other impacts | The new rules are part of the wider G20-OECD BEPS project, which is intended to apply consistent principles across different countries, counteracting base erosion and profit shifting. This should lead to a fairer international tax system. |

Question 15. The Government would be grateful for views from business as to the likely impact on amounts of relief they may claim under the new rules.

Question 16. The Government would be grateful for views from business as to the likely impacts on administration and compliance costs, and how these can be kept to a minimum.

Question 17. The Government would welcome views on other possible impacts arising from these changes, including the equalities impact, impacts on additional administrative burdens and compliance costs and on small businesses.

7. Summary of Consultation Questions

Question 1. The Government would be grateful for any wider comments, beyond responses to the specific questions below.

Question 2. The Government would be grateful for views on whether the current approach to defining profits should be retained, including any evidence supporting the retention of a small claims election.

Question 3. The Government would be grateful for views on requiring streaming in all cases.

Question 4. The Government would be grateful for views on the suggested approach to the rebuttable presumption, especially on what circumstances should be considered exceptional and justify its use, and what examples should be included in guidance.

Question 5. The Government would be grateful for comments on the suggested approach to co-development.

Question 6. Do respondents agree that

- the same definition of R&D should be used for nexus as for R&D tax credits?
- expenditure for the nexus fraction should be relevant R&D of the company?
- the definitions of and rules for calculating direct and subcontracted expenditure should be aligned with the R&D tax credits, as set out above?

Question 7. Do respondents agree with the suggested approach to the timing of expenditure for the nexus fraction?

Question 8. The Government would be grateful for

- views on the merits of the suggested approach to tracking and tracing, in contrast to defining “product” and “product family” more precisely; and,
- suggestions as to what factors might be relevant in judging the conditions set out in paragraph 4.03.

Question 9. The Government would be grateful for views on the alternative approaches suggested for dealing with pre-merger costs, including, under option (i), how long this treatment ought to last. The Government would also welcome suggestions for any alternative options which respondents feel may better address the issue raised at 4.09.

Question 10. The Government would also welcome information about any other circumstances in which a company may come to own IP and which may not be clearly addressed by the proposed rules.

Question 11. The Government would be grateful for views on the suggested approach to retiring expenditure from the nexus fraction, including other suggestions for addressing the issue without introducing undue complexity.

Question 12. The Government would be grateful for views on the suggested rules for calculating the nexus fraction, including the lengths of the time periods to be used (with evidence if possible showing why these are appropriate).

Question 13. The Government would be grateful for evidence about the length of time likely to be needed for companies to adapt systems, reorganise their affairs, and begin collecting the information they will need to calculate the nexus fraction to inform the length of the grandfathering period.

Question 14. The Government would be grateful for views on the suggested transitional rules.

Question 15. The Government would be grateful for views from business as to the likely impact on amounts of relief they may claim under the new rules.

Question 16. The Government would be grateful for views from business as to the likely impacts on administration and compliance costs, and how these can be kept to a minimum.

Question 17. The Government would welcome views on other possible impacts arising from these changes, including the equalities impact, impacts on additional administrative burdens and compliance costs and on small businesses.

8. The Consultation Process

This consultation is being conducted in line with the Tax Consultation Framework. There are 5 stages to tax policy development:

- Stage 1 Setting out objectives and identifying options.
- Stage 2 Determining the best option and developing a framework for implementation including detailed policy design.
- Stage 3 Drafting legislation to effect the proposed change.
- Stage 4 Implementing and monitoring the change.
- Stage 5 Reviewing and evaluating the change.

This consultation is taking place during stages 2 and 3 of the process. The purpose of the consultation is to seek views on the detailed policy design and a framework for implementation of a specific proposal, rather than to seek views on alternative proposals.

How to respond

Responses should be sent by 4 December either in writing to

Patent Box Consultation Team
Area 3/63
HMRC
100 Parliament Street
London SW1A 2BQ

Or by email to:

matthew.hopkins@hmrc.gsi.gov.uk

Enquiries about the consultation should be addressed to Matthew Hopkins either at the above email address or on 03000 530855 (from a text phone prefix this number with 18001)

Paper copies of this document or copies in Welsh and alternative formats (large print, audio and Braille) may be obtained free of charge from the above address. This document can also be accessed from [HMRC's GOV.UK pages](#). All responses will be acknowledged, but it will not be possible to give substantive replies to individual representations.

When responding please say if you are a business, individual or representative body. In the case of representative bodies please provide information on the number and nature of people you represent.

Confidentiality

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 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004.

If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, 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 Revenue and Customs (HMRC).

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.

Consultation Principles

This consultation is being run in accordance with the Government's Consultation Principles. The timescale has been constrained by the publication and final approval date of the new international rules and by the need to introduce changes from July 2016.

The Consultation Principles are available on the Cabinet Office website: <http://www.cabinetoffice.gov.uk/resource-library/consultation-principles-guidance>

If you have any comments or complaints about the consultation process please contact:

Oliver Toop, Consultation Coordinator, Budget Team, HM Revenue & Customs, 100 Parliament Street, London, SW1A 2BQ.

Email: hmrc-consultation.co-ordinator@hmrc.gsi.gov.uk

Please do not send responses to the consultation to this address.

Annex A: Current Legislation – Design of UK Patent Box

A1 The Patent Box legislation is in Part 8A of Corporation Tax Act (CTA) 2010, in sections 357A – 357GE.

A2 The essence of the design is identifying IP profits to which a lower 10% CT rate is applied. This is the aspect that will change the most, due to the need to introduce the “nexus fraction” required by Chapter 4 of the 2015 report. The process is illustrated in Flowchart A1

A3 The current legislation allows the IP profits to be identified in one of two ways. These are the “proportional profit split” and the “streaming” methods.

Proportional profit split

A4 The company’s taxable trading profits are split into IP and non IP parts based on the ratio of qualifying income (“QI”) to total income (“TI”) ($QI/TI \times \text{Trading Profit}$). Qualifying income is, essentially, income from IP. The method therefore assumes that the ratio of IP to total income is a good measure of the ratio of IP to total profit.

Streaming

A5 Under this method, which the Government proposes to build on in revising the Patent Box rules, the company identifies qualifying and non-qualifying streams of income and then splits its allowable deductions between those income streams on a just and reasonable basis. IP profit is then IP income less attributable deductions.

Streaming

A Ltd has turnover of 10,000 comprising 6,000 income from pharmaceutical patents and 4,000 from carrying on contract R&D. It has deductions of 3,000 for exploiting patents and 2,000 for contract R&D, so the calculation of the profit eligible for Patent Box is as follows:

| | IP | Non IP | Total |
|---------|-------|--------|--------|
| Credits | 6,000 | 4,000 | 10,000 |
| Debits | 3,000 | 2,000 | 5,000 |
| Profit | 3,000 | 2,000 | 5,000 |

The income qualifying for the Patent Box is 3,000

A6 For either method, the next step is then to reduce the profit to take account of returns attributable to

- “routine” profit from the assets the business employs in its trade, taken to be 10% of the deductions claimed against qualifying income that are attributable to capital

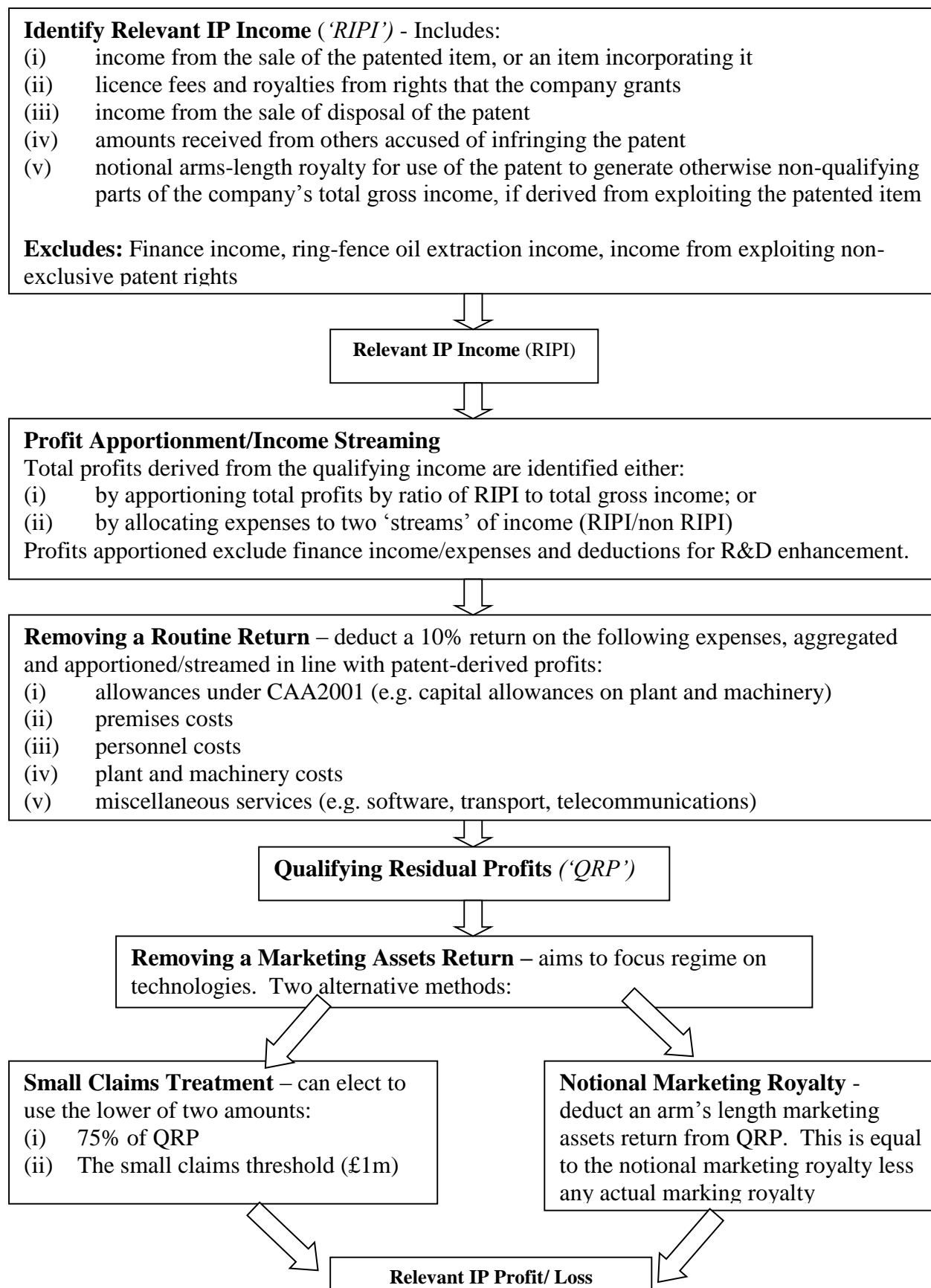
allowances, premises, personnel, plant & machinery, professional services or other services such as heat light & power, telecommunications, transportation etc.

- marketing assets – the amount the company would pay to a third party to access these if it did not own them. (A safe harbour is available for small claims).

A7 What is left is then taken to be attributable to the company's qualifying IP and will be either relevant IP profit or relevant IP loss. Any relevant IP profit is taxed at 10% (from 2017/18 as noted above). The 10% rate is given effect by calculating an amount to be deducted from taxable trading profits. Taxing the reduced amount of taxable trading profits at the full CT rate results in a tax rate of 10% on the relevant IP profits.

A8 Any relevant IP loss is set against relevant IP profits of the accounting period for any associated companies who have also elected into the regime, or carried forward and set against relevant IP profits of later periods. For full detail on how the current Patent Box works see the HMRC guidance at

<http://www.hmrc.gov.uk/manuals/cirdmanual/CIRD200000.htm>



Flowchart A1