BIA members' guide to the Patent Box

February 2018

Developed by FTI Consulting and Confluence Tax with input from other members of the BIA Finance and Tax Advisory Committee

What is the Patent Box?

The Patent Box election provides a reduced rate of corporation tax of 10% for profits attributable to patents. These can be profits that arise on selling patented products and licensing (including milestones and royalties) or selling qualifying IP rights.

A company can also claim a benefit if it uses patented technology that it has developed to manufacture products or provide services.

> If you meet the following criteria you may qualify for the Patent Box:
>
> - you own or have an exclusive license in respect of a UK or EU patent; and
> - you have contributed to its development before or after the grant of the patent.

Who can elect in?

Only qualifying companies can benefit from the regime. This requires companies to hold a qualifying IP right (or an exclusive license to such a right) and, if part of a group, to satisfy the active ownership condition (covered below).

Qualifying IP Right

A company can benefit from the Patent Box if it owns or has an exclusive license in respect of "qualifying IP rights" which is a patent granted by:

- The UK Intellectual Property Office
- The European Patent Office
- Certain specified EEA states

The regime is also extended to other rights that grant additional market or data protection. This includes

> Consider groups of companies, including entirely UK group companies, carefully. The IP income needs to be received by the company that did the R&D.

supplementary protection certificates, data protection rights, and orphan drug and paediatric extensions.

For an exclusive license to qualify, the licensee must have rights over the patent to the exclusion of all other persons, including the patent licensor. The rights must extend throughout at least an entire national territory.

There are catch up provisions for profits earned prior to patents being granted.

R&D Fraction

Rules were introduced in 2016 as a consequence of international actions to combat potentially harmful regimes which include innovation incentives such as the UK Patent Box. The objective of this new measure is to ensure that the company that benefits carried out the R&D on its own or with third parties (not group companies) and did not buy the IP in.

The principle will be applied through the calculation of the 'R&D fraction'. The fraction is calculated as:

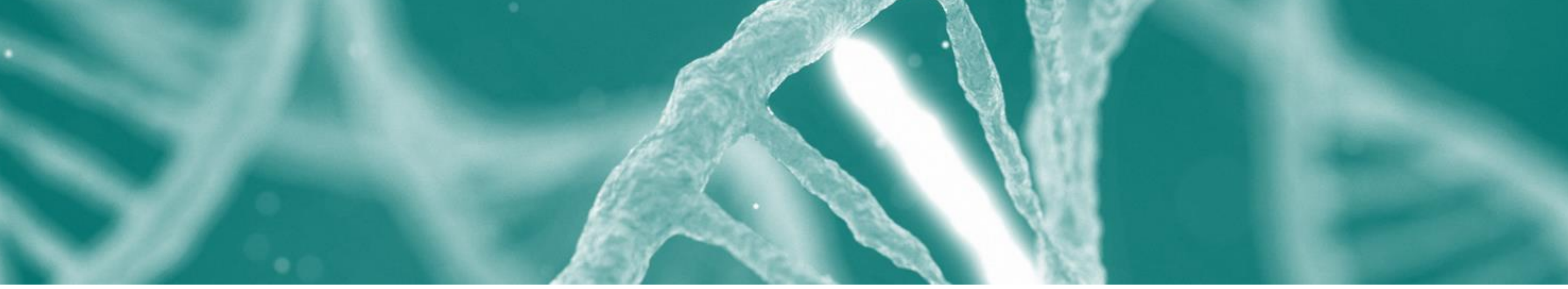
$$\frac{Qualifying\ Expenditure\ to\ Develop\ the\ IP\ Asset}{Overall\ Expenditure\ to\ Develop\ the\ IP\ Asset} = \frac{(D + S1) * 130\%}{D + S1 + S2 + A}$$

D = R&D undertaken by the entity

S1 = R&D sub-contracted to 3rd parties

S2 = R&D sub-contracted to connected parties

A = Acquisition costs (including licenced IP)



Track historic R&D spend and IP acquisition costs since June 2013, irrespective of if and when you plan to elect in. R&D tax credit records will help.

This is calculated on a cumulative basis covering a 15-year period (going back to June 2013) over which the technology has been developed. The starting point is to track expenditure by specific patents. Only if this is demonstrably not 'practicable' to identify either expenditure or profits at this level, can the expenditure be tracked at a higher level by reference to a product or product family (or programme).

Development Condition

The aim of this condition is to limit the regime to companies that have been involved in the creation of IP. Qualifying development requires a significant contribution to the creation of the patented invention or any product of a process incorporating the invention.

If the company is a member of a group, it must also actively own the patented inventions. This requires the Patent Box company to either have developed the IP itself or to take a significant role in managing its eligible patents ('the active ownership condition').

When should you elect in?

The reduced rate of tax of 10% is achieved by way of creating an additional tax deduction. This deduction is based on IP profits i.e. profits derived from a patent using the Patent Box calculation.

A company may have a relevant IP loss if it has income from its qualifying IP rights but is not sufficiently profitable. As a result, the company will not be able to benefit from the regime for that period as it has no amount of relevant IP profit. Any IP losses generated must be carried forward and offset against subsequent IP profits before a deduction is calculated. All IP losses must be utilised before the additional Patent Box deduction can be taken.

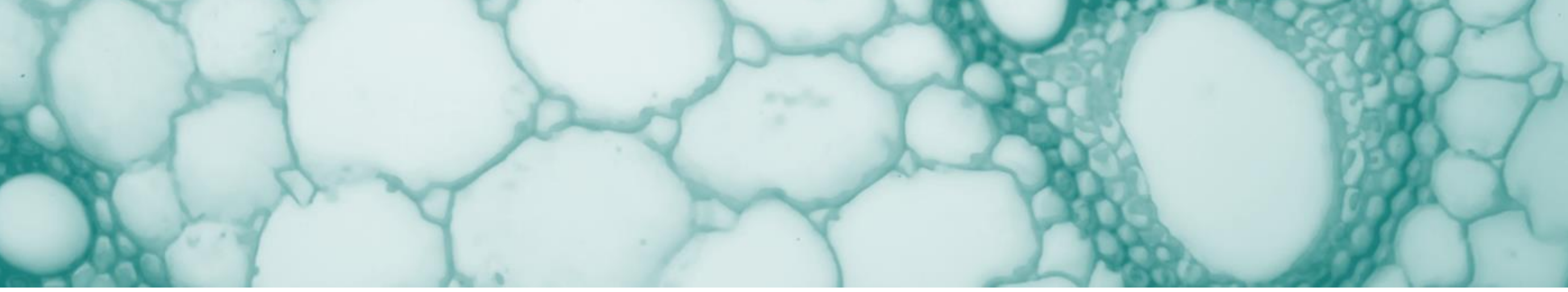
Accordingly, a company with a relevant IP loss will probably not elect into the regime in that period (if it has not previously done so) as it will delay when a Patent Box deduction can be taken.

Example

If a company elects in for period one and the Patent Box calculation results in £1M of IP losses no additional deduction can be taken in that period. If in period two the Patent Box calculation results in IP profits of £500K there will still be no additional deduction as the IP losses carried forward from the previous period will offset the IP profits. If in the third period IP profits of £700K are made, the remaining IP losses from the first period will reduce the IP profits to £200K. This is the amount on which the 10% deduction will be calculated on.

However, if the company had not elected in to the Patent Box until period two where £500K of IP profits were made they would have been eligible for a deduction in the second period based on the full £500K and a deduction in period three based on the full £700K. Clearly the second scenario is more beneficial as a larger deduction for earlier accounting periods.

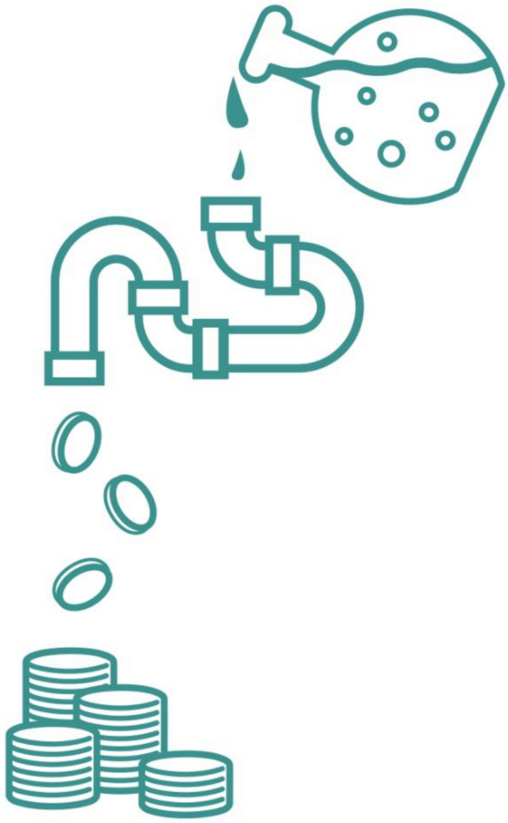
Once a company has exited the regime it cannot re-join for a period of five years. As a result, it is important to consider the election where the company makes losses or losses on patented items.



How do you elect in to the Patent Box?

The election is made on the Company's self-assessment corporation tax return. There is a two-year time limit from the end of the accounting period. Therefore, the company will know before they make the election if they have IP profits or losses for that period. Careful consideration may be needed at the outset for groups of companies where the R&D is undertaken by a different company which may ultimately exploit the rights.

Understanding a company's potential ability to qualify for the regime and the potential benefit could be valuable in understanding the company's long term effective tax rate and its impact of valuation.



> Don't elect in too early to the Patent Box, if you cannot use the Patent Box deduction. Use the two-year tax filing time limit as thinking time, to do calculations and work out if and when you should elect in.

www.bioindustry.org