Changes to the UK Patent Box: an overview, October 2015

1. The current rules

The UK patent box provides a reduced corporation tax rate of 10% on profits arising from patents.

There are various provisions to prevent abuse. The patent must be owned and actively managed by the claimant. Routine and marketing profits are excluded.

2. The nexus fraction

The conditions to qualify for the UK regime will change in line with international agreement between OECD countries.

The new concept is nexus. In order to qualify for the beneficial corporate tax rate the company with income from a patent must have 'nexus' between the income and its own R&D expenditure that developed the patent.

Qualifying ('good') expenditure is expenditure on R&D, including payments for subcontracting R&D to 3rd parties

Non qualifying ('bad') expenditure are acquisition costs of patent IP, and payments for subcontracting to related parties.

The good and bad expenditure is combined in a Nexus fraction. Patent related income qualifying for the patent box is restricted by:

$$\frac{\text{Qualifying 'good' expenditure}}{\text{Total R\&D expenditure ('good' plus 'bad')}}$$

3. Implications

- Where all R&D is carried out internally or with third party subcontractors, the fraction is 1 and there is no restriction on the amount of income in the patent box.
- Where assets are acquired and / or R&D is done by (UK or non-UK) related subcontractors, typically subsidiaries or sister companies, the fraction is zero and no benefit is permitted under the patent box.
- Where the non-qualifying bad costs are 30% or less of the total expenditure there is a deemed uplift to 'good' expenditure, so there will be no restriction.
- Acquiring IP will 'taint' future patent box benefit.

4. Impact on deal structures

The table below considers the potential tax impact on various deal/exit structures relevant to biotech companies:

Deal structure	Impact on patent box benefit
IPO	• No impact provided future patent income is earned by the same company as incurred the expense.
Asset sale	• Acquisition price will be 'bad' expenditure for a UK purchaser company's nexus fraction.

Share sale	• No impact provided the acquired company retains its IP so that future patent income is earned by the same company as incurred the expense.
Intra group transfers / post acquisition reorganisation	• If IP is transferred intra-group this will be treated as an asset acquisition and will restrict future benefits.
Collaborations / cost sharing	• Cost sharing should be unaffected. Income received under a collaboration will be treated in the same way as an asset sale/licence.

5. Implementation

- Following the agreement of principles by the OECD at an international level, HM Treasury has published its consultation on implementing these changes.
- We expect the Autumn Statement on 25 November 2015 to provide a further update followed by the publication of draft legislation.
- The new legislation will be in force from 1 July 2016.
- 'Grandfathering' rules will allow income on existing patents by existing taxpayers to benefit from the current 'non-nexus' rules until 2021.

6. Points to consider

	Question	Notes
1	Given the planned fall in the headline rate of corporation tax to 18% compared to the patent box rate of 10%, will the patent box be a meaningful benefit?	The patent box only benefits companies with UK taxable profits.
2	Is your IP held in a different group company to your R&D?	This could remove all patent box benefits.
3	Would you be prepared to restructure your group in order to benefit from the patent box?	You will need all R&D spend in the same company as the patent income in order to maximise benefits.
4	How do you record R&D expenditure? Would it be possible for your current systems to identify qualifying and non-qualifying expenditure in order to calculate your nexus fraction? How easy would it be to track by patent / groups of patents product or product families?	R&D expenditure is to be defined in the same way as for R&D tax credits. Expenditure will be tracked by company from 1 July 2016.
5	What are the acquisition costs of your IP? Were they incurred upfront, or will they be triggered by later milestones? What complications could there be in determining acquisition costs? Eg bundles of assets / patents acquired in the same transaction. How easy is it to link income generating patents to earlier acquisitions?	Acquisition costs will need to be tracked in order to compute non-qualifying 'bad' expenditure.
6	Is it likely that you will seek HMRC information / agreement for your approach to logging qualifying and non-qualifying expenditure?	HMRC are not offering a formal advance assurance process but will provide informal assistance.