Analysis

Preparing for the new patent box regime

Speed read

The UK is to introduce a new patent box regime following the OECD's recommendations on countering 'harmful' tax practices. The new regime applies a 'modified nexus approach', meaning that profits arising from qualifying IP are only available for a preferential tax rate to the extent that the claimant company itself incurs the relevant R&D expenditure that led to the creation of the underlying IP. Many domestic and multinational groups will face a significant compliance burden in calculating the nexus fraction and a number will need to restructure in order to access the new regime. Although the new regime does not come into force until 1 July 2016, many businesses will be well advised to act now.

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The UK's patent box regime allows profits from the sale of products or services and from the use of processes which have at least one patented component, and relevant royalties, to be taxed at a favourable rate. By 2017, such profits will be taxed at the reduced rate of 10%. Although the current regime (which applies to patents and similar intellectual property) requires the claimant company to own (or exclusively licence) the underlying patents, there has been no requirement for the claimant to have actually developed the patent in question.

However, following the OECD's recommendations under Action 5 (countering harmful tax practices) of its Action Plan on base erosion and profit shifting (BEPS), all preferential IP regimes must be amended by 1 July 2016 to comply with the 'modified nexus approach'. This approach means that profits arising from qualifying IP are only available for a preferential tax rate to the extent that the claimant company itself incurs the relevant R&D expenditure that led to the creation of the underlying IP.

For some time now, therefore, HMRC and HM Treasury have been working to identify how the UK's regime could be adapted to comply with the modified nexus approach, whilst remaining true to the policy intent that the regime should remain sufficiently attractive to encourage innovation in the UK. This work was facilitated through various working party meetings with business and other representatives, including myself, to understand the practical challenges associated with the proposals. This culminated in the release in late October 2015 of a formal HMRC consultation document, followed by draft legislation on 9 December (as part of the draft Finance Bill 2016 clauses) covering a number of areas of the new regime.

Not all the necessary legislation has been published yet, as HMRC and HM Treasury are still considering how best to bring the necessary changes into effect. It is also possible that changes will be made to the draft legislation released so far. However, many companies will be well advised to take action now and may not be in a position to wait for the final legislation before taking that action.

Challenges of the new regime

Under the new regime, which applies from 1 July 2016, it will in principle be necessary to split patent box profits on a patent by patent basis, and then to further restrict the amount of profit eligible to be taxed at the patent box rate by the so-called 'nexus fraction'. This fraction is based on the amount of qualifying in-house R&D expenditure incurred by the patent box company on that particular patent (or other qualifying IP right) plus third party sub-contracted R&D, relative to overall R&D expenditure and any relevant IP acquisition costs.

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It can be seen straight away that, from a compliance perspective, this is a significant change. Whereas under the current regime there is limited need to analyse R&D spend, in a matter of months all R&D expenditure will need to be tracked against the IP asset to which it relates, in some cases going back to expenditure incurred from 1 July 2013. It will be possible in some circumstances to track expenditure against products (or product families), but only where the product contains more than one eligible patent and it would not be 'reasonably practicable' to track by individual IP asset.

This raises a number of challenges, including:

- how to develop methodologies to enable ongoing R&D spend to be tracked against individual IP assets (or products/product families in some cases), especially when the relevant IP assets may not, at the time the R&D spend is incurred, be in existence!;
- categorising that R&D spend into qualifying and non-qualifying spend, which may be especially challenging when undertaken by foreign connected parties that are less familiar with the rules;
- identifying all patents used in a product or service (rather than just being comfortable that there is at least one patent, which is all that is currently required); and
- ensuring systems split profits by product/service and then, in some cases, developing methodologies to split those profits by patent.

In addition, many groups will be in a position where not all R&D activities are carried on in the patent box company itself, and hence will see a restriction of the benefits that can be claimed under the patent box without some restructuring. It should be noted that the test is whether the activities are undertaken by the same entity, not whether or not they are undertaken in the UK; therefore, restructuring may be desirable even where all R&D is already taking place in the UK.

I will consider these issues further below.

The detail

The nexus fraction

A separate nexus fraction will have to be calculated under the new regime for each stream of qualifying patent box profits, based on R&D expenditure incurred on the specific patent to which the income stream relates.

The nexus fraction is the lesser of 1 and the following:

$$\frac{(D + S1) \times 1.3}{D + S1 + S2 + A}$$

where:
D = qualifying expenditure on relevant in-house R&D;
S1 = qualifying expenditure on relevant third party sub-contracted R&D;
S2 = qualifying expenditure on relevant R&D sub-contracted to connected parties;
A = expenditure on the acquisition of qualifying IP rights.

To allow some relief for outsourced expenditure and acquisition costs, the fraction includes a maximum 30% uplift, as explained further below.

This fraction uses total R&D spend to date, rather than annual spend, going back in the first instance to 1 July 2013 (or earlier if the company so elects). There is some relaxation in this because, until 1 July 2019, the nexus fraction for the period from 1 July 2013 to 1 July 2016 can be calculated across all IP rather than on a patent by patent basis; and after 1 July 2019, companies need only use data going back to 1 July 2016. However, this relaxation is only available where the company has insufficient information in the period up to 1 July 2016 to be able to calculate the fraction on a patent by patent basis. This will create a number of challenges, as companies will need to assess this historical data in calculating the fraction. It also leads to an element of retrospection in the rules.

For all companies, only R&D spend from 1 July 2016 is taken into account for accounting periods beginning on or after 1 July 2021. After 2031, the fraction is based on cumulative data for the period of 15 years to the end of the accounting period in question. Whilst this limits the data gathering exercise, it also effectively caps the benefit to 15 years from when the last qualifying R&D expenditure was incurred, which can create potential issues if qualifying expenditure has ceased but income has yet to be fully generated.

What expenditure is included?

Qualifying in-house R&D expenditure is expenditure relating to the patent or product/product family (as appropriate) that is incurred on staffing costs, software or consumable items, externally provided workers and on relevant payments to the subjects of clinical trials.

The definitions used for the purposes of the R&D tax credit rules apply for these purposes. Accordingly, only expenditure that relates to directors, employees and externally provided workers that are 'directly and actively engaged' in relevant R&D will count, and costs relating to support services, such as secretarial or administrative staff, are specifically excluded.

The treatment of expenditure on sub-contracted R&D depends on whether the sub-contractor is connected with the patent box company. Where the sub-contractor is a third party, as the group is unlikely to have the information to calculate the actual qualifying element, 65% of the sub-contracted expenditure (so long again as it relates to the patent or product/product family) is assumed to be qualifying. Where the R&D is sub-contracted to a connected party (whether in or outside the UK), the group is required to work out the qualifying element.

Grandfathering

The only companies that are truly grandfathered within the existing patent box regime are those which are not new entrants, i.e. they are in the existing regime by 30 June 2016 (or 2 January 2016 in certain situations – see below), and which have no income attributable to 'new qualifying IP rights'. For such companies, it is only from 1 July 2021 that patent box income will be restricted by the nexus fraction.

Subcontracting R&D to connected parties and acquiring, rather than developing, patents can potentially reduce the benefit of the patent box

However, companies that do not access the existing regime in time will need to apply the nexus fraction from 1 July 2016. Furthermore, companies with both 'new' and 'old' qualifying IP rights will have to run both the new and current regimes in parallel until 2021. This will mean applying the nexus approach to products containing new qualifying IP rights and the existing rules to products containing old IP rights. This is likely to lead to considerable complexity where a single product contains both a new and old IP right, as total income will have to be subdivided between the old and new regimes, which is an odd approach given that relevant income is not generally linked to the value of the patent itself.

New qualifying IP rights include rights that are granted or issued in response to patent applications filed on or after 1 July 2016, and rights assigned or exclusive licences granted on or after 1 July 2016. As an anti-forestalling measure, this date is brought forward to 2 January 2016, where the assignment or grant is from a connected company that does not qualify under the UK patent box regime or an equivalent regime in another territory.

Companies acquiring IP rights on or after 2 January 2016, but before 1 July 2016, which fall foul of this anti-forestalling measure can continue to apply the existing patent box regime, but only until 31 December 2016.

What are the implications of this?

It can be seen that subcontracting R&D to connected parties and acquiring, rather than developing, patents can potentially reduce the benefit of the patent box. To allow some relief for this, the fraction includes a maximum 30% uplift, which has the effect of allowing patent acquisition costs and connected party sub-contracted R&D spend to qualify, so long as, in total, they amount to no more than 30% of the sum of in-house and third party qualifying sub-contracted R&D spend. However, this only offers limited relief, and so claimant companies may wish to minimise sub-contracted connected party R&D or IP acquisition spend in order not to fall foul of this 30% cap.

This is a particular issue for groups which have traditionally carried on their R&D in a separate company to the patent box claimant company, as the claimant company may have either incurred no R&D expenditure in the past or it would have been sub-contracting to the R&D company – either way, under the new regime, the claimant would potentially have a nexus fraction of zero.

Such groups may therefore need to restructure their operations, if they wish to continue to claim the benefits of the patent box. However, this raises its own complications.

A transfer of R&D activities to the patent box claimant company may improve matters following the transfer, but historical R&D spend (absent any specific relief – see below) would remain in the R&D company (or, at most, any historical recharged expense would remain in the nexus fraction as connected party sub-contracted R&D spend). Also, the transfer of IP to the patent box company will potentially give rise to IP acquisition costs. Absent any specific reliefs, these may have to be included in the nexus fraction at market value, which may be significantly above the actual R&D spend, thereby exacerbating the negative impact of the transfer.

However, within these constraints, it may still be possible to improve the position.

Transferring IP before 1 July 2016

If IP is in the wrong place, transferring it before 1 July 2016 is likely to be beneficial, whether it falls within the existing regime or is new IP. This is because, although the acquisition cost may initially have to be included in the nexus fraction, it will fall out of account by 1 July 2021 at the latest, whereas a transfer on or after 1 July 2016 will mean the acquisition cost remaining within the nexus fraction until 2031. A pre-1 July 2016 transfer of IP may even fall out of account from the nexus fraction before 2021, or possibly not be recognised at all, as is explained further below.

> The new regime will create a significant compliance burden for many domestic and multinational groups in calculating the nexus fraction

Where a company has IP within the existing regime (grandfathered IP) and is not expected to have any new qualifying IP, but is continuing to undertake R&D in respect of its existing patents, then a transfer of that IP into a single company before 1 July 2016 is likely to be beneficial. This is because grandfathered IP will only come within the new regime for accounting periods beginning on or after 1 July 2021; and, as explained above, the calculation of the nexus fraction from that date will only take into account post-1 July 2016 expenditure. There is a challenge here, though, if no further R&D is expected to be incurred in respect of the grandfathered IP.

However, if new patents are still to be created, then under the draft legislation so far released, the transfer of IP before 1 July 2016 (even if from another UK company) could, in the early years, have a negative impact on the nexus fraction for new patents granted. This is because if the company cannot track data at patent/product level and so uses total expenditure between 2013 and 2016, this means that *all* the company's IP acquisition expenditure is taken into account in the nexus fraction. HMRC is aware of this point and is considering what, if anything, can be done to address this issue.

The consultation document published on 22 October suggested that relief might be available for mergers. We suggested in our representations that a 'merger' should be widely interpreted; and, in addition, that there should be a specific relief for transfers of IP between UK entities which is not part of a business transfer or does not otherwise qualify for the merger relief. HMRC is still considering these aspects and it is hoped that some form of relief, at least for business transfers, will be available. However, we may not see the draft legislation for this before the Finance Bill is published in March.

Transferring R&D activities before 1 July 2016

There are similar issues associated with transferring R&D activities into an existing or new patent box claimant company. In some cases, it is necessary to look back as far as 1 July 2013 in determining the nexus fraction and the R&D history will be in the wrong company. However, if the transaction takes place before 1 July 2016, then from 1 July 2019 it may be possible to use data only from 1 July 2016. Groups may therefore have a choice of potentially reducing the benefits in the short term but improving the position in the longer term. As set out above, HMRC is in any case considering a relief that would enable the R&D history to be carried over to the acquiring company; as of the date of writing, though, no details are yet available as to how such a relief will operate.

Other reorganisations

The best course of action is going to be very fact dependent and will vary from group to group. However, it is likely that, where R&D is not currently in the patent box company, then some form of reorganisation is likely to be beneficial.

Given the historical position, this might not be as simple as uniting all R&D and IP in one entity but might involve multiple entities going forward; for example, with grandfathered and non-grandfathered IP held in separate companies and intra-group licenses. It might also involve changes to the way the R&D is carried out, without necessarily a change in the entities involved.

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It should also be noted that the rules apply by reference to the entity undertaking the work, but not by reference to the territory in which the work is undertaken. Whilst this may create seemingly unfair outcomes where activities are split between a number of UK entities, it may also enable work undertaken in overseas branches to qualify. A careful review of facts is therefore required to determine how best to structure innovation activities going forward.

Tracking and tracing R&D spend

Much of the compliance requirements of the new regime will centre around a company's ability to trace all its R&D spend, and track it against individual IP assets. Whilst this may be possible to achieve retrospectively once a product is developed, a tracking system is only likely to be feasible if it tracks expenditure as it occurs on a real time basis. However, this may be easier said than done – in particular, how many R&D departments can specify in advance exactly what IP assets will arise from R&D work that may, at the time, represent 'blue sky' thinking?

Some R&D departments are organised on a product basis, and the draft legislation does allow tracking and tracing to take place on a product, or product family, basis. However, this is only possible in cases where more than one IP asset within the new regime is incorporated within the product, and only where it would not be 'reasonably practicable' to track by IP asset. It is hoped that there will be some relaxation of this but there is no indication of that so far.

> At 10%, the UK rate may not be the lowest but the breadth of income that can be included in the regime makes it particularly attractive

It is clear that the new regime raises a number of compliance challenges. The methodologies required to track expenditure and patent box income to the requisite level of detail are likely to be complex and fact dependent, requiring an understanding of R&D processes, IT systems and the use of data interrogation techniques, patent law and tax expertise.

Other outstanding matters

There are a number of aspects of the new regime for which draft legislation is still awaited, following on from the end of the consultation period, covering key areas such as:

- the alternative approach to the nexus fraction that is intended to be available in exceptional circumstances (otherwise known as 'rebuttable presumption');
- the much needed reliefs necessary to deal with mergers and acquisitions of businesses; and
- how to deal with companies that engage in collaborative R&D development.

In addition, a number of issues relating to the broader aspects of the regime are not currently addressed in the draft legislation. For instance, the BEPS Action 5 report allows the inclusion of copyrighted software in the definition of qualifying IP rights and we included in our representations a suggestion that US patents also be included as qualifying IP rights. It remains to be seen whether the UK will widen the existing definition of qualifying IP rights to encompass either of these.

Other territories

All regimes must be compliant with the modified nexus approach and we have already seen a number of territories take steps to amend their regimes. For some territories, this means a significant reduction in the scope of their regime; in particular, brands cannot from 1 July 2016 be included in preferential IP regimes. At 10%, the UK rate may not be the lowest but the breadth of the income that can be included in the regime makes it particularly attractive.

Action required

It is clear that the new regime will create a significant compliance burden for many domestic and multinational groups in calculating the nexus fraction, as it requires complex tracking and tracing of cumulative R&D spend going back many years, and in streaming qualifying profits on a patent by patent basis.

Groups should therefore urgently review the potential impact of the new regime on their patent box claims. This includes, in particular, considering whether it is desirable (and possible) to accelerate patent filings before 1 July 2016, and whether to elect into the existing regime in respect of accounting periods beginning before 1 July 2016, in order to grandfather IP within the existing regime.

Groups may also need to consider whether they can restructure their operations where R&D spend is not in the patent box company. For many groups, this will be particularly complex from a business perspective, and creates a number of potential pitfalls from a tax perspective that will need to be carefully managed. These are made more uncertain by the lack of any draft legislation yet in relation to the proposed mergers and acquisitions relief.

Outside the patent box, there are a number of other changes impacting groups' IP strategies, including changes in approach to tax planning, the UK's diverted profits tax, and the other outcomes of the BEPS review, including country by country reporting, master file requirements, changes to treaties and transfer pricing. These and other factors mean a review of the overall IP strategy of a group would be appropriate in many cases.

> Companies need to review their systems and processes to ensure they are ready for the new regime .... For new entrants, this may require a retrospective review back to July 2013

In all cases, companies need to urgently review their systems and processes, and the way their R&D activities and IP ownership are structured, to ensure they are fully ready for the new regime by 1 July 2016. As noted above, for new entrants this may require a retrospective review back to July 2013. The methodologies required to undertake the required analysis of income streams and R&D spend are likely to be complex but much can be learnt from work done on R&D claims. ■

For the draft legislation and accompanying explanatory notes, see www.bit.ly/1RnfSc8.

For related reading visit www.taxjournal.com

- Highlights of draft Finance Bill 2016 (14.12.15)
- Q&A: The UK patent box consultation (Jonathan Bridges & Carol Johnson, 5.11.15)
- 30 questions on BEPS (Jill Gatehouse & Susanna Brain, 29.10.15)
- The UK/German proposal for preferential IP regimes (Jonathan Bridges, 21.11.14)
- Is the UK's patent box 'harmful'? (Carmen Aquerreta, 31.10.13)
- FA 2012 analysis: Patent box (Pete Miller, 6.9.12)