Executive summary

On 9 December 2015, draft legislation was published in relation to modifying the UK patent box regime in line with the agreed Organisation for Economic Co-operation and Development (OECD) minimum standards on harmful tax practices that were issued in October 2015.

The modified regime will restrict the amount of eligible patent box income by the so-called “nexus fraction.” This fraction is based broadly on the amount of expenditure incurred by the patent box company on in-house research and development (R&D) plus third party sub-contracted R&D relative to the overall R&D expenditure and acquisition costs incurred on the qualifying intellectual property (IP).

Companies that have already elected into the current patent box regime are “grandfathered” in respect of pre 1 July 2016 qualifying IP rights. For such companies, it is only from 1 July 2021 that patent box income will be restricted by the nexus fraction. Where IP rights are acquired, in some cases this acquisition must occur on or before 1 January 2016 for grandfathering to be available.

However, the current regime will be closed to companies in relation to “new” (i.e., post 1 July 2016) qualifying IP rights. Companies that do not access the current regime in time will need to apply the nexus fraction from 1 July 2016, and companies with both “new” and “old” qualifying IP rights will have to run both the new and current regimes in parallel until 2021.
For many large domestic and multinational groups calculating the nexus fraction itself will result in complex tracking and tracing of cumulative R&D spend. From 1 July 2021, such tracking and tracing will go back to 1 July 2016, but once fully within the new regime the maximum “look back” period will be 15 years. Between 1 July 2016 and 1 July 2021, companies that either did not access the current regime or are ‘grandfathered’ but also have new qualifying IP rights will need to track and trace back to 1 July 2013, although relaxation of this requirement is available where companies lack adequate data.

Detailed discussion

Initial comments
The draft legislation is much more complex than was suggested in the HM Revenue & Customs (HMRC) consultation document released in October 2015. This additional complexity is not welcome and will only add to the compliance burden already posed by the need to track and trace R&D expenditure.

Furthermore, the draft legislation is incomplete and further draft legislation is expected in areas such as the potential use of an alternative approach to the nexus fraction in exceptional circumstances (rebuttable presumption), situations where companies engage in collaborative development and the merger or acquisition of businesses. It is expected that these will be included in the final legislation but HMRC wishes to reflect on the comments received from its consultation before suggesting a preferred approach.

Comments on the draft legislation are also being welcomed so further change should be expected.

While the openness to ongoing consultation is positive, it is important that a final version of the legislation which covers all the necessary aspects is released as soon as possible in order to provide businesses with certainty.

Impact on competitiveness
The Government’s economic goal with the patent box regime remains the encouragement of investment in the UK as well as the prevention of movement of intellectual property offshore, and in this regard the fact that the nexus approach, and timing of implementation, have been agreed by the base erosion and profit shifting (BEPS) process participants should help level the playing field internationally.

However, the draft legislation only amends computational aspects of the regime and does not address broader issues. For instance, the BEPS Action 5 standard allows copyrighted software to be included in the definition of qualifying IP right. Also, we included in our representations a suggestion that US patents be included as qualifying IP rights. It remains to be seen if the UK will widen the existing definition of qualifying IP rights to encompass either of these.

The effective rate will also remain at 10% when it is fully introduced in 2017. The types of income that fall within the regime remains broad and will continue to include income attributable to product sales and licenses with adjustments solely for routine return and notional marketing royalty. Service income is also still included through the “notional royalty” calculation, the definition of which hopefully will be expanded in the final legislation.

Nexus fraction
Under the new rules it will be necessary to divide qualifying patent box income into separate sub-streams and to allocate costs to each stream on a just and reasonable basis. The draft legislation proposes that the sub-streams should be chosen by reference to the qualifying IP right itself or, where it would not be reasonably practicable to apportion income or costs between individual patents, to products or product families (provided that each product contains more than one qualifying IP right). The nexus fraction will then be applied to each sub-stream.

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

\[(D + S1) \times 1.3 \]

\[D + S1 + S2 + A\]

Where:

\(D\) = qualifying expenditure on relevant R&D undertaken in-house

\(S1\) = qualifying expenditure on relevant R&D sub-contracted to unconnected persons

\(S2\) = qualifying expenditure on relevant R&D sub-contracted to connected persons

\(A\) = qualifying expenditure on the acquisition of relevant qualifying IP rights

Qualifying in-house R&D expenditure is expenditure relating to the qualifying IP right 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 enhanced R&D tax credit apply for these purposes.

The treatment of qualifying expenditure on sub-contracted expenditure depends on whether the sub-contractor is connected with the patent box company. Where the sub-contractor is not connected, 65% of the sub-contracted expenditure (so long as it relates to the qualifying IP right or product/product family) can be included in the numerator and denominator of the nexus fraction.

Where the R&D is subcontracted to a connected person (whether in or outside the UK) the entire payment or, if less, the qualifying expenditure incurred by the subcontractor itself (defined as for in-house expenditure but also excluding costs of a capital nature), is included solely in the denominator. Sub-contracting R&D to connected parties therefore significantly reduces the benefit of the patent box.

The R&D expenditure must be incurred in the “relevant period.” This period is defined as ending with the last day of the accounting period in question. The start of the relevant period is as follows:

- 1 July 2013 if the accounting period begins before 1 July 2021 and the company has qualifying IP rights within the new regime (or such earlier day as the company may elect provided it is not more than 15 years from the last day of the accounting period in question)
- 1 July 2016 in all other circumstances

After 2031 it simply becomes the period of 15 years leading up to the end of the current accounting period. This therefore caps the period over which the cumulative data can be captured to 15 years within each sub-stream. It also effectively caps the benefit to 15 years from when the last qualifying R&D expenditure was incurred within each sub-stream, which can create potential issues if qualifying expenditure has ceased but income has yet to be fully generated.

Special provision is made where a company has insufficient data for the period 2013 to 2016 to enable it to calculate the nexus fraction for a particular sub-stream. For accounting periods beginning on or after 1 July 2019 the company can elect to calculate its nexus fraction from 1 July 2016, and for accounting periods beginning before 1 July 2019 a company may elect to consider the three year period up to the end of the relevant accounting period rather than 1 July 2013.

Furthermore relevant R&D is expanded to include any R&D which relates to the trade and any expenditure on acquiring qualifying IP rights.

The decision of whether and when to elect into the new regime for the first time can therefore be extremely complex.

**Grandfathering**

The only companies that are truly grandfathered are those which are not new entrants (i.e., they are already in the 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.

New qualifying IP rights include rights granted/issued in response to patent applications filed on or after 1 July 2016, and rights assigned or exclusive licenses granted on or after 1 July 2016. This 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. There would seem to be no requirement to actually elect into the corresponding regime. 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 until 31 December 2016.

For those companies that have elected into the existing regime but continue to innovate and either acquire or license new patents they will have to follow both the existing and new regimes. Specifically they will be required to create separate streams of their qualifying IP income as follows:

- Income properly attributable to “old”, i.e., pre 1 July 2016, qualifying IP rights
- Income properly attributable to a particular new qualifying IP right
- Income properly attributable to a product sub-stream containing new qualifying IP rights

In its simplest form this means that an individual company must apply the nexus approach to products containing new qualifying IP rights and the existing rules to products containing old IP rights. However 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. This is particularly complex as the relevant income is not linked to the value of the patent itself.
Implications

The new legislation is complex and groups should urgently review the potential impact on both existing and potential future patent box calculations and elections. This includes, in particular, considering whether it is desirable (and possible) to accelerate patent filings before 1 July 2016 as well as considering whether to elect into the patent box regime in respect of accounting periods beginning before 1 July 2016.

Groups should urgently consider moving IP prior to 2 January 2016 if this is a necessary feature of their patent box planning, but be mindful of some of the complexities in this area.

Groups may also need to consider whether they can restructure their operations where R&D spend is split between group companies. For many groups this will be particularly complex from a business perspective. There are a number of potential pitfalls from a tax perspective that will need to be carefully managed, made more uncertain by the fact that the draft legislation relevant to mergers and acquisitions of businesses has yet to published, and it is not yet known whether there will be any relief for the movement of IP assets within UK groups.

In all cases, companies need to urgently review their systems and processes to ensure they are ready by 1 July 2016 to separate out relevant income streams and to collate sufficient data on R&D spend in order to undertake the nexus fraction calculations. As noted above, for new entrants this may require retrospective review back to July 2013. Such methodologies are likely to be very fact dependent and therefore there is clear benefit from early discussions with and review by HMRC.

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EYG no. CM6074
1508-1600216 NY
ED None

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