

FINANCE ACT 2012

EXPLANATORY NOTES

INTRODUCTION

Section 19 Schedule 2: Profits Arising from the Exploitation of Patents Etc

Details of the Schedule

2. There are three parts to the Schedule. Part 1 introduces amendments to Corporation Taxes Act (CTA) 2010, whereas part 2 provides for changes to other legislation. Part 3 contains the commencement and transitional provisions.

Part 1: Amendments of CTA 2010

3. Paragraph 1 introduces a new part 8A to CTA 2010 concerning the new IP tax regime. It also explains that there are 7 chapters in part 1 covering election to the new IP treatment, qualifying companies, 2 types of determination of IP profits/losses of a trade, provisions for setting off IP losses, anti-avoidance provisions, and supplementary provisions.

Chapter 1: Reduced Corporation Tax rate for profits from patents etc

4. New section 357A(1) outlines an elective regime to provide for a reduced rate of corporation tax for profits from patents and other specified intellectual property for qualifying companies. Under new section 357G(4) the election applies to all of the company's trades.
5. Where an election is made, new section 357A(2) gives effect to that election not by applying a reduced rate of tax to eligible profits directly, but by granting a deduction from trading profits of such an amount as has the same effect as reducing the main rate of corporation tax on eligible profits to the special IP rate.
6. New section 357A(3) provides the formula for calculating the amount of the deduction.
7. New section 357A(4) sets the special IP rate of corporation tax at 10 per cent.

Chapter 2: Qualifying companies

8. New sections 357B(1) to (3) outline the requirements for a company to be a qualifying company in any accounting period for the purposes of an election under new section S357A. The company must either:
 - hold a qualifying IP right or an exclusive licence in respect of a qualifying IP right at some time during the accounting period; or
 - have previously held a qualifying IP right or an exclusive licence in respect of a qualifying IP right, and be taxable in the accounting period on income in respect of that right. That income must be attributable to events occurring wholly or partly during a period when the company was a qualifying company and had made an election under new section 357A.

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9. The second condition allows a company to apply the Patent Box rules to income received when it would not otherwise be a qualifying company. An example is damages for infringement of patent rights where compensation is received after the expiry of a patent, but where the company had made a Patent Box election at the time of the infringement.
10. In addition, for a company that is a member of a group, new section 357B(5) requires it to also satisfy the active ownership condition of new section 357BE.
11. New section 357B(4) defines a qualifying IP right. The right must be one of those listed in new section 357BB and the company must also meet the development condition of new section 357BC in respect of that IP right. New section 357GC sets out how the ownership conditions are modified where a company is party to a cost-sharing arrangement in relation to the creation and development of a qualifying IP right, or an exclusive licence.
12. New section 357BA defines the term exclusive licence.
13. New section 357BA(1) states that an exclusive licence is one granted by the proprietor, being someone who holds either the qualifying IP right or an exclusive licence over that right, which gives the person holding the licence exclusive rights over some of the IP rights held by the proprietor.
14. New section 357BA(2) specifies that the rights granted under an exclusive licence must at least:
 - confer one or more rights to the exclusion of any other person, including the proprietor, in relation to the protected item in at least a whole national territory; and
 - either include the right to take legal proceedings for any infringement of the licence-holder's rights, or receive all or the greater part of any damages that might follow from such an infringement.
15. A licence which grants more limited rights which, for example, do not extend to at least one whole country or territory, or where the licence holder can neither bring proceedings for infringement within its territory nor recover any damages, will not be a qualifying IP right.
16. New section 357BA(3) ensures that where certain rights required under new section 357BA(2) are not specifically granted by the licence, but are nonetheless granted by law to the licensee, for example under section 67 of the Patent Act 1977, these rights are treated as if they were granted by the licence.
17. New Section 357BA is subject to an anti-avoidance rule in new section 357F in chapter 6 to ensure that an exclusive licence does not include one where rights are conferred for a main purpose of securing that the licence qualifies for the regime. This is aimed at ensuring that the grant of commercially spurious exclusive rights does not constitute the grant of an exclusive licence for the purposes of this part.
18. A company can vest the rights it holds in an exclusive licence to another member of its group. Where that happens then new section 357BA(4) and (5) ensure that the other company is treated as if it holds the exclusive licence, even if the company holding the exclusive rights retains the right to enforce, assign or grant further licences in respect of the licence. This might be the case where, for example, the original licence holder is a group company whose primary role is the management of the group's intellectual property portfolio, and any exploitation or development of the rights is carried out elsewhere in the group.
19. It is quite possible for the proprietor to grant exclusive licences to several persons for use in the same country or territory, provided that their use of the rights over the protected item is in substantially distinct fields of use so that there is no effective overlap of the exclusive rights granted.

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20. New section 357BB specifies the rights to which part 8A applies. Rights specified here are the only types of right that can be qualifying IP in accordance with new section 357B(4).
21. New section 357BB(1) lists the rights currently specified. These are:
 - patents granted by the UK Patent Office, under the European Patent Convention or corresponding specified rights granted under the laws of certain specified EEA states;
 - Supplementary protection certificates;
 - Plant breeders rights granted under the Plant Varieties Act 1997; and
 - Community plant variety rights granted under Council Regulation (EC) No 2100/94.
22. New section 357BB(2) allows certain patent applications which are subject to a prohibition on publication on the grounds of national security or safety of the public to be treated as though they had been granted under that Act. This allows the invention which is the subject of such an application to be treated as protected by a right to which part 8A applies.
23. New sections 357BB(3) to (6) specify the circumstances in which a marketing authorisation granted in respect of medicinal, veterinary medicinal or plant protection products is to be regarded as a right to which part 8A applies. The marketing authorisation must benefit from marketing protection or data protection under the various EC regulations specified.
24. New section 357BB(7) gives the meaning of the terms European Patent Convention, specified and supplementary protection certificate used in new section 357BB(1), and rules used in new section 357BB(2).
25. New section 357BB(8) allows the Treasury, by order, to make further provisions in relation to marketing protection or to amend references to EU legislation in new section 357BB in consequence of EU legislation making amendments to or replacing that EU legislation.
26. New section 357BB(9) gives the Treasury power to make any additional changes that are necessary in connection with an order amending the rights to which part 8A applies.
27. New section 357BC sets out four ways (see conditions A to D below) that a company can meet the development condition in respect of an IP right it holds. Where the development condition is met, and provided that the right concerned is also of a type specified by new section 357BB, the right will be a qualifying IP right for that company.
28. New sections 357BC(2) and (3) ensure that a company meets the development condition in respect of an IP right if it carried out qualifying development in respect of the right in question (see new sections 357BD(1) below). Condition A applies where the company has not become or ceased to be a controlled member of a group since carrying out the qualifying development. Where it has, condition B applies if it continues to carry on activities of the same nature as those that amounted to the qualifying development for 12 months after becoming or ceasing to be a controlled member of the group, provided that during those 12 months it does not cease to be a member of that group or become a controlled member of any other group. These activities need not necessarily be in respect of the same protected item or right. When a company is treated as becoming or ceasing to be a controlled member of a group is defined in new sections 357BC(6) and (7).
29. New section 357BC(4) provides for condition C which allows a company within a group that holds either a qualifying IP right or an exclusive licence in respect of such rights to meet the development condition under condition C by virtue of the qualifying

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development undertaken by another group company. The company undertaking the qualifying development must have been a member of the relevant group when the qualifying development was carried out (even if the company that holds the right was not). However it is not necessary that the company holding the rights was a member of the group at the time the development occurred; it is only necessary that it is currently a member of the group.

30. New section 357BC(5) stipulates condition D to deal with the situation where a company (T), holding IP rights in respect of which it meets the development condition (as in condition B), joins a new group and then transfers the IP rights to another company in the new group. Condition D allows the company to which those rights have been transferred to satisfy the development condition where the transferee either:
 - remains a member of the group; or
 - transfers its trade to another member of the group; andtaken together (T) and/or the transferee company continue to undertake activities of the same nature as those that amounted to the qualifying development for 12 months after (T) joined the group.
31. New section 357BC(6) sets out when a company is treated as becoming a controlled member of a group. This will happen where a company that was not previously associated with the company acquires control of the company or acquires a major interest in the company.
32. New sections 357BC(7) and (8) set out when a company is treated as ceasing to be a controlled member of a group. This will happen where each company which previously controlled or held a major interest in a company ceases to do so, and the company is no longer associated with those companies. Where a company ceases to be a controlled member of the group, any company that it controls, and any company in which it holds a major interest is also treated as ceasing to be a controlled member of the original group.
33. New sections 357BC(9) and (10) define ‘associated’, control and ‘major interest’ for the purposes of this section.
34. New section 357BC(11) ensures that where a group company meets the development condition under either condition B or D of new section 357BC, it is regarded as meeting that condition from the date that either it or the other company respectively joined the group, rather than on the expiry of the 12 month period.
35. New sections 357BD(1) and (2) define qualifying development of an IP right as the creation or development (including a significant contribution to these activities) of an invention. Developing an invention includes developing ways to use or apply the item. Invention is defined by new section 357GE to mean the item or process in respect of which the right is granted.
36. New section 357BD(3) confirms that for the purpose of new section 357BC, qualifying development undertaken before the IP right was acquired, whether by the company which holds the IP right or another member of the group, is taken into account in considering whether the development condition is satisfied.
37. New section 357BE sets out when a company is regarded as satisfying the active ownership condition. Companies that are not part of a group do not need to meet the active ownership condition, by virtue of new section 357B(1).
38. New section 357BE(1) states that a company meets the active ownership condition if substantially all of its qualifying IP rights satisfy either of two conditions.
39. New sections 357BE(2) and (3) set out the first condition, which is met where the company performs significant management of its qualifying IP rights portfolio during the accounting period. In this context management activity includes the formulation

of plans and decision-making in relation to the development or exploitation of the IP rights.

40. New section 357BE(4) sets out the second condition, which is met where the company carries out development activity in relation to the particular IP rights during the accounting period, meeting either of the development conditions set out in new sections 357BC(2) or (3). These require the development activity to be carried out by the company that has the IP rights rather than by any other member of the group.

Chapter 3: Relevant IP profits

41. New section 357C sets out the Steps necessary to determine the relevant IP profits of the trade. The relevant IP profits of the trade are the profits that are used in the formula in new section 357A to calculate the appropriate amount of the deduction from the profits of the trade which gives effect to the lower rate of corporation tax.
42. New section 357C(1) outlines the six Steps involved in the computation of the relevant IP profits of a trade.
43. Step 1 specifies that the total gross income of a trade must be calculated. Total gross income of the trade is defined in new section 357CA.
44. Step 2 determines the percentage of the company's total gross income that is relevant IP income, denoted as X per cent. Relevant IP income includes not only the income identified under the various Heads in new section 357CC, but also any notional royalty identified under new section 357CD.
45. Step 3 apportions the total profit or loss of the trade between that attributed to activities of the trade involving the exploitation of qualifying IP rights and other matters. This is achieved by applying the percentage, X per cent, computed at Step 2 to the total profit or loss of the trade for corporation tax purposes adjusted as required by new section 357CG.
46. Step 4 determines any qualifying residual profit figure by deducting an amount representing a routine return, calculated under new section 357CI, from the result of Step 3. Where this is a positive figure, this is the qualifying residual profit, which represents the additional profit over and above a routine return attributed to the exploitation of the all of the company's intangible assets. If the routine return figure is greater than X per cent of the total profit, then subject to Step 7, there will be a relevant IP loss for the period. No further adjustment is necessary under Steps 5 and 6 where there is a loss at this stage in the calculation.
47. Companies with a qualifying residual profit now make a decision regarding how to calculate the amount of this qualifying residual profit that is attributed to the qualifying IP rights. Step 5 sets out that where the company has not made an election for small claims treatment, it should proceed to Step 6; alternatively if the company has made such election, it should use the simplified procedure set out in new sections 357CL and 357CM.
48. Step 6 deducts from any qualifying residual profit an amount to be attributed to marketing assets. Whilst it is possible that the result of deducting the marketing assets return figure from the qualifying residual profits creates a loss, in practice a company in that position will always be better off making a small claims election and using the alternative method set out in new sections 357CL and 357CM so long as they meet one of the conditions in new section 357CL(2) or (3).
49. Step 7 is the point at which a company includes in its relevant IP profits for the period any additional amount in respect of profits arising in the period where grant of a patent is pending when the patent is granted. The way in which this amount is calculated is set out at new section 357CQ.

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50. New sections 357C(2) and (3) specify that any positive sum determined from the Steps set out above is the relevant IP profit for the period, whilst any negative amount will be the relevant IP loss for the period.
51. New section 357CA sets out the calculation of the total gross income of the trade for Patent Box purposes.
52. New section 357CA(1) specifies that total gross income of the trade includes any amounts falling within 5 Heads each of which is further explained in new sections 357CA(3) to (8).
53. New section 357CA(2) specifies that total gross income of the trade excludes any finance income, as defined in new section 357CB.
54. New sections 357CA(3) to (4) define income within Head 1 which includes amounts that are both recognised as revenue in the company accounts, and brought into account in computing the profits of the trade for corporation tax purposes. GAAP is the standard to be used for recognition of revenue items, even where accounts are not drawn up in accordance with that standard.
55. New section 357CA(5) defines income within Head 2 as including amounts received as damages, insurance receipts or other compensation, to the extent that these have not been recognised as revenue in the accounts (and therefore included under Head 1).
56. New section 357CA(6) ensures that any adjustments that are necessary on a change of a company's accounting basis which are treated as receipts for tax purposes are included under Head 3, to the extent that these are not recognised as revenues in the accounts (and therefore included under Head 1).
57. Sections 357CA(7) and (8) set out amounts included in Heads 4 and 5 as any taxable credits from the realisation of intangible fixed assets, and any profits from the sale of pre-2002 patent rights, held for the purposes of the trade which arise during the accounting period.
58. New section 357CB defines finance income as credits arising from financial assets, any amounts treated as a receipt of the trade arising from loan relationships or derivative contracts by virtue of sections 297 and 573 of CTA 2009 respectively, and other amounts economically equivalent to interest which a company receives as a consequence of any arrangement to which it is a party. Income from financial assets includes dividends and other income from shares that forms part of the income of a financial trader.
59. New section 357CC sets out the amounts included in the total gross income of the trade which are to be regarded as relevant IP income. The aggregate of these amounts, together with any notional royalty identified under new section 357CD, will form the relevant IP income used in Step 2 of new section 357C(1). The measure of the income under the Heads of relevant IP income for any accounting period will be the amount that is brought into account for tax purposes in the period. Thus where recognition of the income from a disposal is spread over several accounting periods, then only the part recognised in the current period is treated as relevant IP income.
60. Relevant IP income must fall under one of the Heads identified in new section 357CC(1).
61. Any income which falls within Heads 1 to 5 (see new sections 357CC(2) and (6) to (9) below) will nevertheless not be relevant IP income to the extent that it is excluded income by virtue of new section 357CE.
62. New section 357CC(2) outlines income falling within Head 1. This is not limited to income from the sale of qualifying items which are items protected by a qualifying IP right. It also includes the income from the sale of items either incorporating the qualifying item, or wholly or mainly designed to be incorporated into it. Thus income

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from sales of products incorporating a patented component and from the sale of spare parts for such a product will be included under Head 1. Qualifying items are items in respect of which a qualifying IP right held by the company has been granted.

63. For these purposes an item is defined in new section 357GE in chapter 7 as including any substance.
64. New sections 357CC(3) and (4) deal with the distinction between a qualifying item and its packaging. These are treated separately unless the packaging performs an essential function relating to the use of an item. The requirement to treat packaging separately is subject to a de minimis exception in new section 357CF(6) and it should not be relevant for most companies. Companies selling qualifying items will not generally be required to separately identify the value attributable to its packaging. The principal exception, where separate treatment is necessary, is the sale of an item that is not a qualifying item but which is sold in patented packaging. The effect of the rule in such a case is to prevent the income from the sale of the item being regarded as part of the company's relevant IP income.
65. New section 357CC(5) extends the meaning of items incorporating one or more qualifying items in subsection 2(b) to include the situation where a qualifying item and an item designed to incorporate that item are sold together for a single price.
66. New section 357CC(6) provides that income falling within Head 2 is income consisting of any licence fee or royalty received by the company under an agreement which only grants to another person:
 - a right in respect of a qualifying IP right held by the company;
 - a right in respect of a qualifying item or process; and
 - a right granted for the same purposes as the right granted in respect of such qualifying IP right.

'Qualifying process' means a process in respect of which the company holds a qualifying IP right.
67. Licence fees or royalties that exclusively relate to the qualifying IP rights, qualifying items or processes are included in Head 2 income. If a licence agreement provides for the receipt of royalties and / or fees for any other matter, then the rules for a mixed agreement in new section 357CF must be applied to determine the amount of relevant IP income.
68. New section 357CC(7) outlines income falling within Head 3. This is any income arising from the disposal of a qualifying IP right or an exclusive licence.
69. New section 357CC(8) outlines income falling within Head 4. This is any amount received by the company arising from infringement or alleged infringement of any qualifying IP right held by the company. At the time of the infringement the company must have held the qualifying IP right.
70. New section 357CC(9) outlines income falling within Head 5. This covers other amounts of damages, insurance proceeds or compensation that do not fall within Head 4 (infringement of qualifying IP rights) but which nonetheless arise in respect of the sale of qualifying items or the loss of income which would have been relevant IP income.
71. Examples of amounts that would fall within Head 5 are:
 - insurance proceeds received in respect of stocks of qualifying items lost or destroyed by fire, and
 - damages in respect of lost income from the sale of qualifying items as a result of the infringement of rights that are protected by IP rights other than qualifying rights. Such rights might relate to trademarks relating to the qualifying item, or a

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patent that protects features of protected items that are sold only outside of the EU and for which no qualifying IP rights exist in the UK or EU.

72. New sections 357CC(10) and (11) stipulate that income cannot be treated as relevant IP income under new sections 357CC(8) or (9) unless, at the time of the event in respect of which the income is received the company was a qualifying company for which an election under new section 357A in chapter 1 had effect. Where the damages etc. received for the infringement relate partly to periods when the company was a qualifying company and partly to periods when it was not, then a just and reasonable apportionment is to be made to determine the amount which is relevant IP income.
73. Income will be treated as relevant IP income within Heads 4 and 5 even where it is received at a time when the company no longer holds a qualifying IP right, provided that it relates to an infringement which occurred at a time when the company did hold the qualifying IP right and was a qualifying company to which an election under new section 357A had effect. New section 357B(3)(b)
74. New section 357CC(12) specifies that any reference in new section 357CC to a qualifying right held by the company is taken to include a reference to any qualifying IP right in respect of which the company holds an exclusive licence.
75. New section 357CD provides a mechanism for determining the amount of a company's total gross income of the trade which is not relevant IP income but which arises as a direct result of the company's exploitation of a qualifying IP right under any of the heads of new section 357CC. Such income is identified as IP-derived income. An example of this might be the sale of non-patented goods that are produced using a patented process. The aim of this section is to arrive at a further amount of the total gross income that will be treated as relevant IP income. This is achieved by establishing a notional royalty that reflects what the company would pay out of the income generated by the exploitation of the IP in the accounting period to a third party for use of those qualifying IP rights. This amount will be added to the relevant IP income of the trade for use in Step 2 of the calculation of relevant IP profits in new section 357C.
76. New sections 357CD(1) and (2) provide that relevant IP-derived income arises to a company if it holds any qualifying patent (or any exclusive licence in respect of such a patent) and the total gross income of the trade includes an amount arising from the company's exploitation of those qualifying IP rights which is neither relevant IP income under new section 357CC nor excluded income under new section 357CE.
77. New section 357CD(3) allows a company to elect to treat a notional royalty in respect of its IP-derived income as if it were relevant IP income. Where a company has negligible amounts of income that would fall within this section it may decide not to carry out a calculation of any notional royalty. Where the company wishes to calculate a notional royalty, no formal election procedure is set down, and the company may simply include the notional royalty election by way of a note to the computations in its corporation tax return (or an amended return) for the period.
78. New sections 357CD(4) and (5) set out how to determine the notional royalty. This is the appropriate amount of any IP-derived income for the accounting period that the company would pay to a third party for the right to exploit any qualifying IP rights used for that accounting period, assuming that the company were not otherwise able to exploit it.
79. New sections 357CD(6) and (7) set out the assumptions that are to be made in arriving at the appropriate percentage of the IP derived income for an accounting period. These are:
 - the royalty will be payable at arms length;
 - the company, or the company and persons authorised by it, will have the exclusive right to exploit the qualifying IP;

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- the rights deemed to be granted are only those that the company actually has in relation to the qualifying IP right. This is most likely to be relevant in cases where, for the example, the company holds a right or licence of limited duration or which is restricted to a particular country or territory;
- the rights are conferred on the later of the start of the accounting period or the date when the company acquired the IP right;
- the percentage is determined at the start of the accounting period; and
- will continue at an unchanged level for subsequent accounting periods.

These assumptions ensure that the notional royalty relates to relevant IP-derived income generated during the accounting period. The amount of the notional royalty cannot exceed the amount of the IP-derived income because it is calculated as a percentage of that income, and any amount in excess of 100 per cent would clearly not be a commercial arrangement.

80. Thus, where there is no significant change in the company's circumstances, the actual percentage used in one accounting period should also be used in the following accounting period. Only if there is a significant change in the company's circumstances would a company need to reassess the appropriate amount in accordance with the above assumptions for a subsequent accounting period.
81. New section 357CD(8) requires that the amount of the royalty must be determined in accordance with article 9 of the OECD model and the transfer pricing guidelines. Both these terms are defined in new section 357CD(9).
82. New section 357CE specifies that two types of income, which could otherwise fall within one of the Heads of relevant IP income outlined at new section 357CA, will not be relevant IP income under any circumstances.
83. New sections 357CE(1) to (3) specify that ring fence income, from UK Continental Shelf oil and gas trades as set out in part 8 of CTA 2010 (see sections 272 and 273), and income arising to a licensee that is attributable to any licence in respect of an item or process, but which is not an exclusive licence is excluded from being relevant IP income.
84. Where it is necessary to attribute an amount of income to a non-exclusive licence in respect of a qualifying IP right as set out in new section 357B(4), then this is to be done on a just and reasonable basis.
85. New section 357CE(4) ensures that where a company has been granted a mixture of exclusive and non-exclusive rights over the invention under a single licence, the licence is to be treated under Part 8A as comprising two separate licences; one an exclusive licence which confers only the exclusive right or related rights and the other a non-exclusive licence covering the non-exclusive rights. Income in respect of the deemed non-exclusive licence is excluded income by virtue of new section 357CE(3).
86. New section 357CF requires a company to make a just and reasonable apportionment of income which includes elements of both relevant IP income and other income, for the purposes of determining the company's relevant IP income.
87. New section 357CF(1) provides that the section will apply to mixed income, and income paid under a mixed agreement.
88. New section 357CF(2) defines mixed income. This is income from the sale of qualifying items together with non-qualifying items as a single unit and for a single price. A qualifying item is one whose sale would produce relevant IP income under new section 357CC(2).

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89. New sections 357CF(3) and (4) define a mixed agreement. This is any agreement that provides for any of:
- the sale of a qualifying item, as set out in new section 357CC(2);
 - the granting of rights in respect of a qualifying IP rights held by the company under new sections 357CC(6)(a) or (b); or
 - a sale or disposal falling within new section 357CC(7);
- and also
- the sale of any non-qualifying item, the granting of any rights other than in respect of a qualifying IP right or the supply of any service.
90. New section 357CF(5) requires the amount of relevant IP income to be determined using a just and reasonable apportionment of the mixed income or the income received under mixed agreement. This is subject to a de minimis rule in new section 357CF(6). A company may need to determine appropriate apportionments where none are provided within the agreement, or override the terms of an agreement for tax purposes where it is necessary to do so to arrive at a just and reasonable result.
91. For example, an agreement provides a single price for the sale of a single unit, where the sale includes 50 hairdryers with a patented motor (with the protected IP item (see new section 357CC) owned by the vendor), and 70 curling tongs where the vendor has no interest in any protected IP rights. The vendor's basic wholesale price of the hairdryer is £10 per unit, and the curling tongs £6 per unit. Income from the sale which relates to the hairdryers falls within new section 357CC(2)(b), whereas that relating to the curling tongs does not fall within new section 357CC. A just and reasonable amount of relevant IP income from the sale of the hairdryers could be calculated as:
- $$£ 750 \times (50 \times 10) (70 \times 6) + (50 \times 10) = £ 407.61$$
92. New section 357CF(6) allows a company to disregard trivial amounts of income that can be attributed to the sale of non-qualifying items, the grant of other rights or the supply of services arising from a sale that generates mixed income, or under a mixed agreement, when calculating relevant IP income. Where there are several non-qualifying amounts it is the aggregate amount which must be considered to determine whether the income is trivial.
93. New section 357CG sets out the adjustments that a company needs to make to its taxable profits from a trade in order to determine its relevant IP profits from that trade.
94. New sections 357CG(2) to (4) provide for the profits of the trade to be adjusted for two amounts, relating to research and development (R&D) tax relief, and financial income or expenses as follows.
95. Adding back any additional deduction for R&D expenditure obtained under part 13 of the CTA 2009 ensures that the company retains the full benefit of this tax relief even though its IP profits are taxed at a lower rate.
96. Removing any debits in respect of the trading loan relationships or derivative contracts, and any credits in respect of finance income ensures that the method of financing the company's trade will not affect its relevant IP profits, and therefore the amount of tax relief it receives from the reduced rate of tax on those profits. Finance income is defined in new section 357CB.
97. New section 357CG(5) requires a company to use a greater amount of R&D expenditure in computing the profits of its trade in a relevant accounting period where there is a shortfall in R&D expenditure in relation to the trade of the company. The provision operates in situations where a company's R&D expenditure has predominantly been incurred in earlier periods while it was not within the Patent Box regime, and income from the results of that expenditure is mainly received in later periods at a time when it

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is within the regime, but its R&D expenditure has significantly reduced. It only applies in the four years after a company makes an election under new section 357A.

98. Where there is a shortfall in R&D expenditure in relation to the trade of the company for a relevant accounting period, the provision requires a company to increase the amount of R&D expenditure taken into account in calculating relevant IP profits for that accounting period by the amount mentioned in new section 357CH(2).
99. New section 357CG(6) defines terms used in new section 357CG(5).
100. New section 357CH describes when and how the calculation of a company's relevant IP profits for a relevant accounting period must take account of a greater amount of expenditure on R&D than that which has been incurred in the accounting period. A relevant accounting period is defined in new section 357CG(5) and covers any accounting period beginning within four years of the date that an election into the Patent Box has effect for a qualifying company.
101. New section 357CH(1) specifies that there is a shortfall in R&D expenditure for a relevant accounting period where the actual R&D expenditure in the accounting period is less than 75 per cent of the average amount of R&D expenditure. The actual R&D expenditure for an accounting period is defined in new section 357CH(3), although this is subject to any adjustment through a 'smoothing' procedure described in new sections 357CH(8) to (11).
102. New section 357CH(2) sets out the amount of the adjustment required when there is a shortfall in R&D expenditure for a relevant accounting period. It is to be increased by the difference between 75 per cent of the average R&D expenditure in the relevant period before the company started to use the Patent Box and the actual R&D expenditure for that accounting period.
103. New section 357CH(3) defines the actual R&D expenditure, and specifies that R&D expenditure and relevant accounting period have the meanings given by new section 357CG(6).
104. New section 357CH(4) sets out how to calculate the average amount of R&D expenditure. This is the total amount of R&D expenditure incurred by the company for the relevant period (as defined in new section 357CH(4)) divided by the number of days in that period. This daily figure is then multiplied by 365 to give an annual amount.
105. New section 357CH(5) defines the relevant period for the purposes of new section 357CH. This will generally be the four years prior to the accounting period in which an election under new section 357A by a qualifying company first had effect (or the time since the trade commenced if this is less than four years).
106. New section 357CH(6) directs that where a relevant accounting period is less than 12 months, the average amount of R&D expenditure used to compare with the actual expenditure is proportionately reduced.
107. New sections 357CH(7) to (11) address the circumstance where a company has fluctuating levels of R&D expenditure for different relevant accounting periods. They allow a degree of 'smoothing' which will reduce the frequency and amount of any adjustments required under new section 357CH(2).
108. New section 357CH(8) provides that where, for any relevant accounting period, actual R&D expenditure is greater than the average calculated under new section 357CH(4) the excess can be added to the actual amount of R&D expenditure for the next relevant accounting period. That augmented amount of R&D expenditure is then compared with the average amount to determine whether there is a shortfall in R&D expenditure.
109. New sections 357CH(9) and (10) apply where it is the only additional amount of R&D expenditure included for an accounting period by virtue of new section 357CH(5) that causes there not to be a shortfall for that period. In such a case, any remaining part of the

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additional amount over and above that which is necessary to increase the actual R&D expenditure for an accounting period to 75 per cent of the average R&D expenditure may be carried forward for use in the next period.

110. New section 357CH(11) specifies that where an additional amount of R&D expenditure is included for an accounting period by virtue of subsection (8), but it is needed to make up for a shortfall in R&D expenditure for that period then it may be carried forward to the next period, in addition to any excess of R&D expenditure over the average that arises in that period.
111. New section 357CI sets out how to compute a routine return figure for the purposes of Step 4 of the calculation of relevant IP profits. Step 4 aims to exclude an amount of profit which represents a routine return. A routine return is the return which could be expected from the business if the company was not able to exploit its qualifying IP rights and other intangible assets.
112. New sections 357CI(1) outlines the three Steps for calculating the routine return figure.
113. Step 1 identifies the total of the routine deductions made by the company in computing the profits of the trade. Routine deductions are those identified in new section 357CJ, and not excluded by new section 357CK.
114. Step 2 applies a mark-up of 10 per cent to the amount identified in Step 1. A cost-plus methodology is used to determine the arms-length return expected from a trader that does not use unique intangible assets in its trade. The 10 per cent rate reflects the fact that only a proportion of the actual expenses of the trade are used when estimating a routine return figure.
115. Step 3 determines how much of that routine return is to be attributed to profits from the company's relevant IP income. This is achieved on a pro-rata basis using the ratio of relevant IP income to the total gross income figure, as in Steps 1 and 2 of the computation under new section 357C, denoted as X per cent.
116. New sections 357CI(2) and (3) ensure that the deductions taken into account for the purposes of determining a routine return also include any expenses incurred on a Patent Box company's behalf by other members of the group, irrespective of whether or not these have been reimbursed, for example by way of a service fee or adjustment to intercompany balances. Where necessary, a just and reasonable apportionment of expenses incurred by the other company should be made to determine the amount to be included in calculating the Patent Box company's routine return.
117. New section 357CJ sets out the meaning of routine deductions for the purposes of new section 357CI. These are the deductions to which a mark-up is applied to determine the routine return from the trade. A number of costs related to financing and the development of IP rights are specifically excluded by virtue of new section 357CK.
118. New section 357CJ(1) sets out six general heads of expenditure, each of which is further explained in new sections 357CJ(2) to (7).
119. New section 357CJ(8) defines various terms used in the descriptions under the six Heads.
120. New section 357CJ(9) permits the Treasury to amend the list of items included in relevant deductions and their descriptions by way of an Order.
121. New sections 357CK(1) to (7) define deductions which are not to be marked up as routine deductions. Any loan relationship or derivative contract amounts are excluded from the routine deductions, as well as certain costs associated with the development of the company's qualifying IP rights. The exclusion of any amounts that have qualified for R&D tax relief, including any additional deduction under part 13 of CTA 2009 at this stage ensures that there is no incentive for Patent Box companies to outsource their R&D activities to other group companies. Capital allowances related to R&D

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expenditure and patent allowances are excluded, as are certain tax deductions for employee share schemes.

122. New section 357CK(8) permits the Treasury to amend the list of items excluded from being relevant deductions and their descriptions by way of an Order.
123. New sections 357CL and 357CM provide a simpler method for calculating the relevant IP profits of a company where its profits are small. In this circumstance, the company may make an election under new section 357CL(1) and use a formulaic approach in the computation of their relevant IP profits instead of Step 6 as set out in new section 357C. No formal election procedure is set down, and a company may simply include the election for small claims treatment by way of a note to the computations in its corporation tax return (or an amended return) for the period. The rule is intended to relieve companies with smaller profits from the administrative burden of carrying out a full analysis of its marketing assets return as is required under Step 6.
124. New section 357CL(1) sets out that a company can elect for small claims treatment where either of conditions A or B are met. Condition A is the basic rule which will apply to most companies including all those with small profits. Condition B will apply to companies that have larger amounts of profits in some years, and is intended to ensure that such a company does not only use the small claims treatment for years when it provides a beneficial result compared to calculating a marketing assets return in accordance with Step 6 of Condition A is the basic rule which will apply to most companies including all those with small profits. Condition B will apply to companies that have larger amounts of profits in some years, and is intended to ensure that such a company does not only use the small claims treatment for years when it provides a beneficial result compared to calculating a marketing assets return in accordance with Step 6 of Condition A is the basic rule which will apply to most companies including all those with small profits. Condition B will apply to companies that have larger amounts of profits in some years, and is intended to ensure that such a company does not only use the small claims treatment for years when it provides a beneficial result compared to calculating a marketing assets return in accordance with Step 6 of
125. New section 357CL(2) specifies condition A. This is that the total amount of qualifying residual profit of all of the company's trades taken together does not exceed £1,000,000. In determining this total amount any negative amount of QRP in respect of any of the company's trades is disregarded by virtue of new section 357CL(7).
126. New section 357CL(3) specifies condition B. This is that the total amount of qualifying residual profit of all of the company's trades taken together does not exceed the relevant maximum, and that the total company has not followed Step 6 of new section 357C(1) for the purpose of calculating RIPI (deducting a marketing assets return figure under new section 357CN) for any accounting period commencing within the previous 4 years.
127. New section 357CL(4) gives the relevant maximum amount for a company with no associated companies. This is £3,000,000.
128. New sections 357CL(5) and (6) specify that the relevant maximum is to reduced proportionately where a company has one or more associated companies in relation to which an election under new section 357A has effect and where its accounting period is less than 12 months long.
129. New section 357CL(8) specifies that when determining whether two companies are associated for the purposes of the small claims threshold the rules used for claims to the small profits rate of corporation tax are to be followed.
130. New section 357CM(2)(a) provides that where an election for small claims treatment is made by a company with just one trade, the amount of relevant IP profits is the lower of 75 per cent of the qualifying residual profit of the trade or the small claims threshold.

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131. Where a company has more than one trade, the qualifying residual profit of each of the trades is aggregated to determine whether the small claims limit has been exceeded. Any negative amounts of qualifying residual profit in a trade are ignored, by virtue of new section 357CM(4).
132. Where the total does not exceed £1,333,333, the relevant IP profits are 75 per cent of the qualifying residual profit in each trade. Otherwise the relevant IP profit figure is the small claims threshold – this is a total figure rather than an amount per trade.
133. New section 357CM(5) sets the small claims threshold for a company which has no associated companies that have made an election under new section 357A at £1 million for an accounting period of twelve months.
134. New sections 357CM(6) and (7) reduce the small claims threshold proportionately where a company has one or more associated companies that have made an election under new section 357A, or where the accounting period is less than twelve months respectively.
135. New section 357CM(8) specifies that when determining whether two companies are associated for the purposes of the small claims threshold the rules used for claims to the small profits rate of corporation tax are to be followed.
136. New section 357CN details the method that is to be used to arrive at the marketing assets return figure required for a deduction from qualifying residual profit at Step 6 of new section 357C(1).
137. New section 357CN(1) specifies that the marketing assets return figure is the difference between notional marketing royalty in respect of the trade (NMR) for the accounting period and the actual marketing royalty in respect of the trade (AMR) for the accounting period. The NMR and the AMR are defined by new sections 357CN and 357M.
138. New section 357CN(2) states that the marketing assets return figure is taken to be nil where:
 - AMR is greater than the NMR; or
 - NMR is less than 10 per cent of qualifying residual profit (see new section 357GE(2) in Chapter 7).
139. New section 357CO outlines the principles to be used in determining the notional marketing royalty figure to be used in new section 357CN.
140. New sections 357CO(1) and (2) specify that the notional marketing royalty is to be determined as the amount of its relevant IP income for the accounting period that the company would pay to a third party for the right to exploit its relevant marketing assets, assuming that otherwise it would have no such right. This is the appropriate amount of the relevant IP income.
141. New section 357CO(3) provides that relevant marketing assets are those marketing assets that are used to generate relevant IP income of the trade in the accounting period.
142. New section 357CO(4) details the assumptions used for deriving the amount of the notional marketing royalty. These are:
 - the royalty will be payable at arms length;
 - the company, or the company and persons authorised by it, will have the exclusive right to exploit the relevant marketing assets;
 - the royalty will be paid only in respect of rights that the company actually holds;
 - the right will be granted on the relevant day;
 - the appropriate percentage is calculated at the start of an accounting period;

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- the same percentage will apply for succeeding accounting periods; and
- the only benefits the company will derive from the exploitation of the rights will be in respect of relevant IP income during the accounting period.

These assumptions ensure that the notional marketing royalty relates only to relevant IP income generated during the accounting period. They will exclude the use of assumptions based on other market practices such as front- or rear-loaded payments, lump sums covering longer periods, etc.

143. New section 357CO(5) defines the relevant day for the purposes of the assumptions made about the appropriate amount.
144. New section 357CO(6) requires that the amount of the royalty must be determined in accordance with article 9 of the OECD model and the transfer pricing guidelines.
145. New section 357CO(7) defines the term marketing asset.
146. New section 357CP sets out how to determine the actual marketing royalty of a trade for an accounting period.
147. New section 357CP(1) states that the actual marketing royalty is X per cent of the total amount paid by the company for the acquisition of, or the right to exploit, any relevant marketing assets, and which are debited in the calculation of the corporation tax profits of the company's trade for the accounting period.
148. New section 357CP(2) provides that in new section 357CP(1) relevant marketing assets has the same meaning as that given in new section 357CO, and X per cent is the proportion of total gross income of the trade that is relevant IP income, as computed under Step 2 of new section 357C(1).
149. New section 357CQ provides that an amount of profits arising between the date of application to register a patent and the date of grant may be included in the calculation of relevant IP income in the period in which that right is granted. This provision does not apply to qualifying IP rights other than patents. Registration of a patent may take a number of years; the intervening period is generally known as the patent pending period. A maximum of six years' additional profits may be brought in for the period when the right is granted. New section 357BB defines relevant IP rights, and, other than in a case where the exception for patents that affect national security or public safety in new section 357BB(2) applies, requires the right to have been granted. Without this section any income received from the innovation which is the subject of the application, prior to grant, would not be relevant IP income.
150. New section 357CQ (2) provides for a company to elect to include an additional amount in its calculation of the relevant IP profits of the accounting period in which a patent is granted. No formal election procedure is set down, and a company may simply include the election by way of a note to the computations in its corporation tax return (or an amended return) for the period.
151. New section 357CQ(3) sets out how the additional amount is calculated. It includes IP profits arising after the relevant day, in any relevant accounting period, that have not otherwise been included in relevant IP profits of the period. Relevant day and relevant period are defined in new sections 357CP(6) and (4) respectively.
152. New section 357CQ(4) ensures that any relevant IP profits that have been the subject of a set-off of relevant IP losses are disregarded for the purposes of calculating the additional amount.
153. New sections 357CQ(5) and (6) give the conditions which determine which accounting periods will be a relevant accounting periods. A relevant accounting period is any accounting period in which the right is granted, and any earlier accounting period,

ending on or after the relevant day, for which the company is a qualifying company and has made an election under new section 357A.

154. New section 357CQ(7) defines the relevant day for the purposes of the section. This will be the later of:
- 6 years prior to the date of grant; and
 - either the date of application for the qualifying IP; or
 - where a company holds an exclusive licence, the date the licence was granted.
155. New section 357CQ(8) allows a company to be treated as if it was a qualifying company for the purposes of new section 357CQ if the only reason it would not be a qualifying company is that the right had not yet been granted.
156. New section 357CQ(9) allows a company to be treated for the purposes of new section 357A as if it was a qualifying company for the accounting period in which the right is granted if the only reason that it would not qualify is that the company disposed of the right, or the licence to that right before it was granted. This allows a deduction under new section 357A to be made by a company that would not otherwise be a qualifying company for that accounting period.

Chapter 4: Streaming

157. In certain circumstances apportioning the profits of a trade by using the overall ratio of relevant IP income to total gross income, as required at Step 3 of new section 357C, may give rise to a distorted result. This may occur where the relative proportions of income from the exploitation of IP rights and other income differs markedly from the relative proportions of profits derived from such income.
158. New section 357D therefore provides for a company to elect for the provisions of new section 357C to be set aside, and for the relevant IP profits of the trade to be ascertained using the streaming provisions of new section 357DA. It also provides that the provisions of new section 357DA will replace new section 357C where any of the mandatory streaming conditions of new section 357DC is met.
159. New section 357D(1) allows a company to elect to apply new section 357DA. This is a streaming election. No formal election procedure is set down, and a company may simply include the streaming election by way of a note to the computations in its corporation tax return (or an amended return) for the period.
160. New section 357D(2) ensures that where a streaming election is made, it can to be applied to any or all of the company's trades. This allows a company to pick and choose which of its trades would benefit from a streaming election.
161. New section 357D(3) states that a streaming election has effect for the accounting period in which it is made and each following period, unless the company ceases to use streaming where there has been a change of circumstances as set out in new section 357DB(3).
162. New section 357D(4) stipulates that where a company is required to use streaming because one or more of the conditions in new section 357DC is met, it must apply the provisions of new section 357DA to calculate its relevant IP profits rather than new section 357C.
163. New section 357DA(1) outlines the steps used to determine the relevant IP profits of the trade where either, the company has made a streaming election, or the company meets one or more of the mandatory streaming conditions.
164. Step 1 directs that any credits taken into account in computing the corporation tax profits of the trade other than finance income are to be split in to two streams;

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a relevant IP income stream (including any notional royalty computed under new section 357CD) and income that is not relevant IP income. Finance income is defined in new section 357CB.

165. Step 2 requires that, having separated the income of the trade into separate streams, all of the amounts deducted in calculating the corporation tax profits of the trade, should now be allocated on a just and reasonable basis against one or other of the streams of income. There is an exception for amounts identified under new section 357CG(3), that is any additional deductions for expenditure on research and development under part 13 of CTA 2009, and any trading loan relationship or derivative contract debits. The effect of not allocating these amounts is that they do not reduce relevant IP profits so that they attract relief at the full corporation tax rate.
166. Step 3 requires that the amounts allocated to the relevant IP income stream under Step 2 above are deducted from that income stream.
167. Step 4 determines any qualifying residual profit figure by deducting an amount representing a routine return, calculated under new section 357CI, from the result of Step 3. Where this is a positive figure, this is the qualifying residual profit, which represents the additional profit over and above a routine return attributed to the exploitation of the all of the company's intangible assets. If the routine return figure is greater than the figure at Step 3, then subject to Step 7, there will be a relevant IP loss for the period. No further adjustment is necessary under Steps 5 and 6 where there is a loss at this stage in the calculation.
168. Companies with a qualifying residual profit now make a decision regarding how to calculate the amount of this qualifying residual profit that is attributed to the qualifying IP rights. Step 5 sets out that companies that cannot or have not made an election for small claims treatment proceed to Step 6; those that have made an election use the simplified procedure set out in new sections 357CL and 357CM.
169. Step 6 deducts from any qualifying residual profit an amount to be attributed to marketing assets. Whilst it is possible that the result of deducting the marketing assets return figure from the qualifying residual profits creates a loss, in practice a company in that position will always be better off making a small claims election and using the alternative method set out in new sections 357CL and 357CM so long as they meet one of the conditions in new section 357CL(2) or (3).
170. Step 7 is the point at which a company includes in its relevant IP profits for the period any additional amount in respect of profits arising in period where grant of a patent is pending that are allowed under new section 357CQ.
171. New sections 357DA(2) and (3) specify that any positive sum determined from the Steps set out above is the relevant IP profit for the period, whilst any negative amount will be the relevant IP loss for the period.
172. New section 357DA(4) specifies that the routine return figure referred to in Step 4 is 10 per cent of the aggregate of routine deductions allocated against the relevant IP income stream at Step 2. Routine deductions for this purpose are those identified in new section 357CJ and not excluded by virtue of new section 357CK.
173. New section 357DA(5) applies the rule at new section 357CI(2) and (3) where a routine return is computed in cases where there is a streaming election. The effect of that rule is to ensure that the deductions taken into account also include any deductions incurred on a company's behalf by other members of the group, irrespective of whether or not these have been reimbursed, for example by way of a service fee or adjustment to intercompany balances. Where necessary, a just and reasonable apportionment of amounts incurred by the other company should be made to determine the amount relating to the company's routine deductions.

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174. New section 357DA(6) adapts the rule for calculating a marketing assets return figure at Step 6 where the streaming provisions apply.
175. New section 357DB requires that where a company has made a streaming election, the method it uses to allocate deductions between income streams, at Step 2 of new section 357DA, should not change from accounting period to accounting period, unless there is a change of circumstances.
176. New section 357DB(1) states that the phrase method of allocation refers to the method applied at Step 2 of new section 357DA.
177. New section 357DB(2) requires that where a company applies the streaming rules it must use the same method of allocation in each accounting period for which the streaming election has effect. This applies irrespective of whether the rules are applied by election or are mandated.
178. However, new sections 357DB(3) and (4) provide that where there is a change of circumstances in respect of any of the company's trades, which makes the method of allocation inappropriate for an accounting period, the company can choose a different method of allocation, or elect not to apply the streaming election, for that accounting period. If the company chooses a different method then new section 357DB(2) will apply to require that that new method is applied for each subsequent accounting period. No formal procedure is set down, and a company may simply include an election not to apply streaming for the accounting period by way of a note to the computations in its corporation tax return (or an amended return) for the period.
179. New section 357DB(5) provides that where a company elects not to apply streaming for an accounting period under new section 357DB(4)(b), this does not prevent it from making fresh streaming elections in subsequent accounting periods.
180. New section 357DC details the circumstances under which a company is required to apply the streaming provisions of new section 357DA in determining relevant IP profits rather than those of new section 357C, other than where it has made an election to do so. Streaming is mandatory where any one or more of the conditions A to C is met in relation to a trade of the company for an accounting period. If, exceptionally, a company operates more than one trade within the Patent Box, and a mandatory streaming condition is met in respect of only one of the trades, then the company is required to apply streaming only to that trade. As with optional streaming elections, it may continue to apply the provisions of new section 357C to calculate relevant IP profits of the rest of its trades.
181. New section 357DC(1) sets out mandatory streaming condition A. This is met for an accounting period where the accounts of the company for the period do not recognise a substantial amount of revenue from the trade that is taken into account in computing the profits of the period for corporation tax purposes.
182. This may happen when, for example there are accounting adjustments affecting prior years' statements of income, or where additional income is recognised for tax purposes on the basis of a transfer pricing adjustment covering several periods. The latter position is specifically catered for in new section 357DC(4). In these circumstances the general presumption that there is an indirect link between the ratio of relevant IP income to other income and the relevant IP profits to other profits does not apply, so using the rules of apportionment in new section 357C is inappropriate.
183. New sections 357DC(2) and (3) specify that an amount is substantial if it exceeds the lower of £2 million or 20 per cent of the aggregate of the relevant IP income and such licensing income, subject to a de minimis figure of £50,000.
184. New section 357DC(5) sets out mandatory streaming condition B. A company meets this condition for an accounting period if its total gross income from the trade includes

relevant IP income, and a substantial amount of licensing income that is not relevant IP income. Licensing income is defined in new section 357DC(6).

185. New sections 357DC(7) and (8) set out mandatory streaming condition C. A company meets this condition for an accounting period if its total gross income from the trade includes income that is not relevant IP income, and a substantial amount of relevant IP income in the form of licence fees or royalties received under an agreement granting rights to another person over IP rights, where the company itself only holds an exclusive license in respect those IP rights. The reason for this is that the licence income received and the royalties paid would result in very little profit. An apportionment process to determine relevant IP profits would not be appropriate in these circumstances.
186. New section 257DC(9) requires a company to make an apportionment of relevant IP income from such licenses if not all of the company's qualifying IP rights meet the conditions of relevant Head 2 income in new section 357DC(8).

Chapter 5: Companies with relevant IP losses: set-off amount

187. New section 357E identifies a set-off amount where a company has a relevant IP loss for an accounting period that is equal to those losses. This is subject to the transitional rules for the Financial Years 2013 to 2016 whereby the relevant IP profits or losses for the period are reduced to a specified proportion, as set out in paragraph 8(3) of the Schedule.
188. New sections 357EA to EE describe how this set-off amount is to be dealt with in the computations. The principle underlying these rules is that the set-off amount should be matched with an amount of relevant IP profits either in another trade of the company, in other group members who have made an election under new section 357A, or in a later accounting period, to reduce an amount of relevant IP profits in respect of which new section 357A can apply to give a deduction from the corporation profits of the trade.
189. New section 357EA provides that the set-off amount is first allocated against any relevant IP profits arising in the same accounting period in respect of another trade of the company.
190. New section 357EB(1) sets out the rules for allocating a set-off amount where a company is a member of a group in which more than one company has made an election under new section 357A. The effect of the allocation is to reduce both the set-off amount and the relevant IP profits of the other trade to which an election under new section 357A has effect by the lesser of those two amounts.
191. New sections 357EB(2) to (4) provide that where there is another company in the same group that has relevant IP profits for a relevant accounting period, any set-off amount not allocated against another trade of the company is to be allocated against the relevant IP profits of that other company. The effect of the allocation rule is to reduce both the set-off amount, and the relevant IP profits of the trade of other company to which new section 357A can apply, by the lesser of the remaining set-off amount and the relevant IP profits.
192. New section 357EB(5) allows the group companies to jointly determine in which order the set-off amount is to be applied to them where there is more than one company in the group with relevant IP profits against which the set-off amount can be allocated.
193. New section 357EB(6) sets out the order in which the allocation is to be made in the absence of any joint determination by companies in the group. This is firstly to the trade of the company with the highest amount of relevant IP profits, then that with the next highest profits, and so on until the either all of the set-amount has been allocated or there are no relevant IP profits remaining against which to allocate the remainder.
194. New section 357EC sets out the rules for carrying forward a set-off amount.

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195. New section 357EC(1) specifies that the rule applies where some of a set-off amount remains after any allocation has been made against relevant IP profits in other trades in the company, or other relevant group members.
196. New sections 357EC(2) and (3) provide that any set-off amount which remains unallocated from an earlier accounting period is first allocated against relevant IP profits of the company in which the set-off amount arose for the following accounting period. New section 357A does not apply to a matching amount of relevant IP profits.
197. New section 357EC(4) sets out that where any of the set-off amount remains after any allocation has been made against relevant IP profits of the company in the following accounting period, it is treated as a set-off amount for this subsequent accounting period. The allocation rules in the chapter, for instance the group rules in new section 357EB, may then apply to that remaining amount.
198. New section 357EC(5) specifies that where a company has carried forward all or part of a set-off amount, this is to be added to any relevant IP losses in the later period, such that the set-off amount for that period is the sum of the two figures, and the allocation rules in the chapter may then apply to that amount.
199. New section 357ED ensures that where a company in a group ceases to carry on a trade, any set-off amount incurred in the trade which has not been reduced to nil by the operation of new sections 357EA or 357EB continues to be carried forward until such time as it has been fully allocated against relevant IP profits of other members of the group.
200. New sections 357ED (1) to (3) set out how any unallocated set-off amount is dealt with where a company in a group ceases to carry on a trade, no longer falls within the charge to corporation tax, or where an election under new section 357A otherwise ceases to have effect for any reason.
201. New section 357ED(3) specifies that new sections 357EA to 357EC will apply with some modifications to any set-off amount incurred in the company's trade, or trades, which has yet to be allocated against relevant IP profits.
202. New section 357ED(4) modifies the wording of new section 357EB so that it applies in situations where a company ceases to trade, no longer falls within the corporation tax charge or an election under new section 375A ceases to have effect. The modifications act to transfer the unallocated set-off amount to a relevant group member. In the absence of a joint determination to the contrary, this will be the relevant group member with the highest amount of relevant IP profits in that accounting period. However if there are no relevant group members with relevant IP profits for the accounting period, the unallocated set-off amount is to be added to the set-off amount of the company with the largest set-off amount in that accounting period.
203. New sections 357ED(5) to (6) determine when any unallocated set-off amount will finally be extinguished. Where a company is not a member of a group, the amount is extinguished only when the company ceases to carry on any trade. Where a company is a member of a group, the set-off amount will remain to be allocated amongst other members of the group until such time as there is no company in the group that has made an election under new section 357A and is a qualifying company for the accounting period.
204. New section 357EE provides for the transfer of any unallocated set-off amount where the trade of a company is transferred to another group company.
205. New section 357EE(2) directs that in such cases the set-off amount is to become the unallocated set-off amount of the other group company for the accounting period in which it begins to carry on the transferred trade. Where the group company which acquires the trade already has an unallocated set-off amount, the unallocated set-off

amount of the transferor company is added to the set-off amount of the transferee company.

206. New section 357EF sets out the tax treatment of payments made between members of a group of companies as compensation for the transfer of relevant IP losses. So long as the payment does not exceed the amount of the relevant IP losses transferred, it will be ignored for the purposes of calculating the corporation tax profits or losses of the company that makes or receives the payment, and neither will it fall to be treated as a distribution.

Chapter 6: Anti-avoidance

207. New sections 357F to 357FB are anti avoidance provisions.
208. New section 357F applies in situations where licences may be entered into for non commercial reasons. This will be where the main purpose or one of the main purposes of conferring any right in respect of a protected item is to ensure that the licence meets the definition of exclusive licence for the purposes of the new regime. Thus it may apply for example in cases where the exclusivity provided by the agreement was in respect of a spurious commercial right. In such cases, even though the licence may confer the right to the exclusion of all other persons, it will not be regarded as an exclusive licence for the purposes of part 8A.
209. New section 357FA applies in situations where a qualifying item is incorporated into a larger item to ensure that income from the sale of that larger item will be relevant IP income. Where the main purpose or one of the main purposes of the inclusion of the item is to make income from the sale of the larger item relevant IP income, then such income will not be relevant IP income.
210. New section 357FB is a targeted anti-avoidance provision which limits or denies a Patent Box deduction to a company that is party to a scheme entered into in order to secure a tax advantage.
211. New section 357FB(1) applies the section where a company that is entitled to make a deduction under new section 357A is party to a scheme, one of the main purposes of which is to obtain a relevant tax advantage. A scheme is defined in new section 357FB(6).
212. New section 357FB(2) identifies a relevant tax advantage for the purposes of the section where there is an increase in the amount of any deduction due to the company, or another member of that company's group, under new section 357A. This increase must be attributable to:
- avoiding the operation of any provision of the regime, such as the R&D expenditure condition of new section 357CH, or the relevant IP loss provisions of chapter 5, or
 - artificially inflating the amount of relevant IP income which is brought into accounts in determining trade profits, or
 - a mismatch between relevant IP income and the expenditure incurred in generating that relevant IP income.
213. New section 357FB(3) explains that a company will be regarded as having artificially inflated the amount of its relevant IP income where it is party to a scheme that does either of two things affecting the proportion of relevant IP income and other income used in calculating its relevant IP profits. The first is to include matching amounts of additional income that would be relevant IP income and additional expenses that would be debited in the computation of profits. The second is to include an additional amount of income that would be relevant IP income where there is a corresponding decrease in other income that is not relevant IP income.

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214. New section 357FB(4) sets out when there is a mismatch between relevant IP income and expenditure for the purposes of the rule. This will be where:
- relevant IP income is brought in to account in calculating a deduction under new section 357A for a company, and
 - expenditure in relation to that right is brought to account in a different accounting period of that company, or in a different company, where no election under new section 357A was in effect.
215. New section 357FB(5) provides that where the section applies, the deduction to be made by the company is to be limited an amount that ensures that no relevant tax advantage arises.

Chapter 7: Supplementary

216. New section 357G sets out the procedure for making an election under new section 357A.
217. New sections 357G(1) and (2) require a company to provide a notice of election that specifies the first accounting period for which the rules are to apply.
218. New section 357G(3) sets out the latest date by which an election can be made for any particular accounting period. This is the date by which an amended corporation tax return for that period must have been submitted in accordance with paragraph 15 of Schedule 18 to Finance Act 1998.
219. New section 357G(4) ensures that the election applies to all the trades carried on by the company, so that it is not possible to make an election in respect of only some of a company's trades.
220. New subsection 357G(5) ensures that an election made under new section 357A need only be made once, and that the election will continue to have effect until it is revoked.
221. New section 357GA sets out the terms under which a company may revoke an election it has made under new section 357A.
222. New sections 357GA(1) and (2) require a company to give a notice revoking the election, which specifies the first accounting period for which the rules are to cease to apply.
223. New section 357GA(3) sets out the latest date by which an election can be revoked for any particular accounting period. This is the date by which an amended corporation tax return for that period must have been submitted in accordance with paragraph 15 of Schedule 18 to Finance Act 1998.
224. New section 357GA(4) specifies that the revoking of an election has effect for all future accounting periods of the company, until and unless the company makes a new valid election under new section 357A.
225. New section 357GA(5) specifies that a new election under new section 357A can only have effect after five years have elapsed since the company revoked a previous election.
226. New sections 357GB(1) and (2) introduce the amendments that are made to the rules in order for them to apply to a company that carries on a trade in partnership with other persons. In brief, the provisions of the regime are to be applied to the firm as a whole in similar way as they apply to a single company carrying on a trade, subject to the modifications set out in new sections 357GB(3) to (9). A partnership may include both corporate and non-corporate partners, and any deduction to be made in consequence of an election under new section 357A is made only for the purposes of determining the share of a member who is liable to corporation tax.

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227. New section 357GB(3) sets out the procedure for a corporate partner to make or revoke an election for the Patent Box, and the effect of its doing so. Any corporate partner in a firm may choose to make or revoke an election under new section 357A. The effect of the election is that the partner's share in the profits (or losses) of the firm is computed as if the election had been made or revoked by the firm. An election made or revoked by one partner has no effect on the shares of any other partner.
228. New section 357GB(4) ensures that references to the time limits applying to the making or revoking of an election are those relevant to the corporate partner rather than the firm.
229. New section 357GB(5) applies the rules in section 1261 of the CTA 2009 for determining accounting periods of the firm where there is a corporate partner.
230. New section 357GB(6) ensures the firm must meet the active ownership condition, even though it is not a member of a group.
231. New sections 357GB(7) and (8) sets out that a firm meets the development condition in respect of an IP right where either the partnership itself, or a corporate partner with at least a 40 per cent share in the partnership has carried out qualifying development in relation to that right.
232. New section 357GB(9) applies the rules in new section 357BD that determine whether the development condition is met by a company that is at some time a member of a group to a firm.
233. New sections 357GB (10) amends condition B of the active ownership condition where it is to be applied to a corporate partner.
234. New section 357GB(11) modifies the provision for a small claims election, so that it is appropriate to claims made by a corporate partner.
235. New sections 357GB(12) & (13) ensure that any corporate partner who is party to an arrangement designed to secure a return from the firm that is economically equivalent to the receipt of interest is treated as if they had not made an election under new section 357A.
236. New section 357GC sets out how the Patent Box regime is to be applied to a company that is a member of a cost-sharing arrangement.
237. New section 357GC(1) defines a cost-sharing arrangement. This is an arrangement between several parties where one party holds a qualifying IP right, or an exclusive licence over such a right. The arrangement leads to the creation or development of an invention to which each party makes a contribution in terms of funding or other activity. All the parties are entitled to a share of the income attributable to that right proportionate to their participation in the arrangement, or have rights in respect of the invention.
238. New section 357GC(2) treats a company, which is party to the cost-sharing arrangement but which does not hold the qualifying IP rights created or developed under the arrangement, as if it did hold those qualifying IP rights.
239. However, new section 357GC(3) prevents this treatment where the income received by the company in respect of its contributions to the arrangement is economically equivalent to interest.
240. New section 357GC(4) ensures that cost-sharing arrangements which lead to the development of new ways to use or apply an invention are included in the same way as those which seek to develop the invention itself.
241. New section 357GD defines a group for the purposes of the Patent Box regime. This is a company, A, and any other company that is associated with company A. For this

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purpose, a company (company B) is associated with company A at any time during an accounting period of company A if any one of following five conditions is met.

242. The first condition is that the financial results of company A and company B meet the consolidation condition. The consolidation condition is defined in new section 357GD(9).
243. The second condition is that company A and company B are connected. Sections 466 to 471 of CTA 2009 apply for the purposes of establishing connection.
244. The third condition is that company A has a major interest in company B or vice-versa. Major interest has the same meaning as in sections 473 and 474 of CTA 2009.
245. The fourth condition is that company A and a third company meet the consolidation condition and that third company has a major interest in company B.
246. The fifth condition is that company A and a third company are connected and that that third company has a major interest in company B.
247. New section 357GD(9) defines the consolidation condition in terms of the financial results of any two companies which :
 - Are required to be fully consolidated into group accounts;
 - if they are not required to be fully consolidated in such accounts, then this is due to a specific exemption; or
 - whether or not there is a requirement for them to be fully consolidated, are actually fully comprised in group accounts.
248. New section 357GD(10) specifies that group accounts means accounts prepared under section 399 of the Companies Act 2006 or any corresponding provision of the law of a territory outside of the UK.
249. New section 357GE provides information on the interpretation of Part 8A.
250. New section 357GE(1) defines ‘invention’, ‘item’, ‘the OECD Model Tax Convention’, ‘the OECD Transfer Pricing Guidelines’ and ‘qualifying residual profit’.
251. New section 357GE(2) ensures that references to the calculations of the profits (or losses) of the trade for a company are to be read as calculations of profit or loss for corporation tax purposes.
252. New section 357GE(4) amends the index of defined expressions in Schedule 4 to the Corporation Tax Act 2010 to include expressions that are defined in part 8A.

Part 2: Amendments of TIOPA 2010

253. Paragraphs 2 to 6 make changes to the transfer pricing rules contained in the Taxation (International and Other Provisions) Act (TIOPA) 2010 including changes to the exemption from the requirement to calculate profits and losses of a potentially advantaged person in accordance with arm’s length principles where that person is a small or medium sized enterprise for a chargeable period.
254. Paragraph 4 inserts a new section 167A to TIOPA 2010.
255. New section 167A provides an exception to the general exemption from transfer pricing requirements for a company that is a small enterprise in the chargeable period. This exception applies where the Commissioners for Her Majesty’s Revenue and Customs have issued a transfer pricing notice to the company. Such a notice may relate only to provisions affecting the calculation of relevant IP profits under part 8A of CTA 2010. A medium sized enterprise can already be required to use arm’s length principles

in respect of any provision where a notice to that effect is issued under section 168 TIOPA.

Part 3: Commencement and transitional provisions

- 256. Paragraphs 7 and 8 set out the commencement and transitional provisions.
- 257. Paragraph 7 applies the changes made by the Schedule to income arising on or after 1 April 2013. Where the first accounting period to which an election under new section 357A relates straddles the commencement date, only income and expenses arising after commencement is to be taken into account for the purposes of computing its relevant IP profits. Where it is necessary to apportion income or expenses between pre- and post-commencement periods, then this may be done on any basis that provides a just and reasonable result.
- 258. Paragraph 8(1) provides for the benefits of an election under new section 357A to be progressively increased in relation to relevant IP profits arising in each of the Financial Years 2013 to 2017. For 2013, relevant IP profits to be included in the calculation set out in new section 357A(3) are 60 percent of the amount otherwise calculated in accordance with the Schedule. This rises by 10 percent in each succeeding Financial Year up to and including Financial Year 2017.
- 259. Paragraphs 8(2) to (4) set out how to determine the set-off amount in respect of an accounting period in the Financial Years affected by the phasing in rule in paragraph 8(1). Where a set-off amount is carried forward to a later accounting period under new section 357EB or 357EC, the amount brought forward is reduced incrementally by 10 per cent per annum, the rate at which benefits are phased in under paragraph 8(1), to give the actual set-off amount.
- 260. Paragraph 8(5) provides for an apportionment to be made of the profits of an accounting period that falls within more than one Financial Year.