

## **R&D Credits and Patent Box**

There is a direct link between business investment in R&D and innovation and international competitiveness, so it's not surprising in the current climate that, as part of wider tax reforms, the regime for research and development (R&D) tax reliefs in the UK is under review. Businesses and Government want to ensure we have R&D incentives that make the UK an attractive investment location for both overseas investors and UK companies. The Government is also engaged in a consultation process regarding the introduction of a 10 per cent 'Patent Box' which could be worth as much as £1 billion in savings for UK companies annually.

PwC is heavily involved in both consultations and in advising HM Treasury on a range of issues related to any reforms to the R&D regime. We would encourage local businesses to get involved relevant consultations and have a role in shaping these changes.

So what is this Patent Box and why should I be interested?

### **RESEARCH AND DEVELOPMENT TAX RELIEF**

More companies now qualify for higher R&D relief with the limits to qualify as a small or medium-sized enterprise (SME) doubling and the rates of R&D relief increasing for all companies in 2008. At the same time, companies are carrying out a wider range of activities to develop their product range, with environmental concerns being high on the list of drivers. HM Revenue & Customs (HMRC) reviews of claims are becoming more sophisticated and more claims are likely to be challenged. All these factors coupled with the fact that R&D tax relief is still a huge cash saving opportunity contribute to the reasons why R&D should still be high on the agenda.

The type of activity that qualifies for R&D tax relief is wide-ranging and sometimes challenging to apply in practice, e.g. qualifying indirect activities can now be added to claims.

#### **There are three key areas of proposed reform to R&D tax credits.**

Firstly, a fundamental change to the structure of the relief which will allow the relief to become a genuine credit accounted for 'above the line'. This would enable the income to be recorded in operating costs, reducing the cost of doing the R&D rather than tax. However, the government has some reservations on this and therefore it is important for businesses to contribute their views.

Secondly, there are proposal to extend the large company relief to sub-contractors who provide routine services as part of a customer's project. Currently, neither the customer nor sub-contractor is able to claim on this routine activity. This will be of particular benefit to contract research organisations, but many other organisations could also benefit from this change.

Lastly, the SME rates for enhanced R&D deductions increased from 175% to 200% from 1 April 2011 and will increase further to 225% from 1 April 2012 (these increases have now received EU State aid approval).

The rise in the rate relief for SMEs means that the cash tax value of claims for tax paying companies will go up from £21 for every £100 of R&D spend to £26 from April 2011, and to £31 from April 2012. The changes to R&D tax relief have made claiming for this relief more valuable to SMEs.

Alternatively, companies not in profit claiming under the SME scheme may be entitled to a cash payment worth 25 per cent of qualifying expenditure from April 2011, and 24.75 per cent of qualifying expenditure from April 2012 – an increase on the previous rate of 24.5 per cent cash payment for every pound of expenditure on qualifying R&D.

In Budget 2011, in addition to announcing changes in the rate of relief under the SME scheme, the Chancellor also announced the removal of the PAYE/NIC cap on the amount of payable credit that can be claimed, and the removal of the minimum (£10,000) expenditure rule before the credit can be claimed. These changes will be introduced in the Finance Bill 2012.

## **Potential issues you may face when making future claims**

- Interpreting qualification criteria can be complex with many companies incorrectly ruling themselves out by failing to recognise some qualifying activities and costs
- The six year time limit for R&D tax relief claims has been cut to two years. Companies, therefore, will need to act faster to file their claims
- Changing legislation means that companies may file their claims incorrectly
- Robust documentation to support a claim is essential
- Determining whether a company is an SME is not always easy, and some claimants may confuse the rules relating to SMEs and large companies. Specialist advice should be sought in determining whether a company meets the SME criteria.
- How to include indirect qualifying activities in your claims

## **Interaction with R&D Grants**

If your company receives a grant for a particular R&D project this may affect the amount of tax relief you can claim. Your company may be an SME under the guidelines, but if the grant received is a 'State aid' recognised by the European Commission, then you won't be able to make a claim under the SME regime.

You can appreciate there is a considerable amount of difference in the relief available under the two schemes. The benefit of receiving the grant may be very small in comparison to the amount of relief available under the SME scheme.

It is always better to have a discussion to weigh up the pros and cons of taking a grant or not.

## **PATENT BOX**

A key question for companies is how to protect their innovations, in particular that bit of knowledge that only they know which differentiates them from all their competitors. For companies associated with innovative products a Patent is an obvious consideration and until now the prevailing tax rate would never have entered into anyone's thoughts. All this is about to change.

The government has made a number of commitments for companies involved in the development, manufacture and exploitation of patents and are introducing from April 2013 the PATENT BOX. It is estimated that the UK Patent Box will save UK companies around £1 billion a year.

On a first read of the government's announcement, one would be forgiven for assuming that the box would have only limited effect to most Northern Ireland companies. If you dive behind some of the background you will in fact find that many Northern Ireland companies should receive significant benefits from the box.

### **So what is this box? What will it look like?**

Companies that either own a patent or have an explicit right under a license to exploit a patent and who have a profit stream arising from the development and exploitation associated with that patent should get into the box.

All profit streams that fit into the box will benefit from an enhanced tax deduction and suffer tax of only 10% rather than the 24% corporate tax rate that will then be in force.

### **Sounds great but I only have one patent?**

Provided a company has one patented and UK managed invention underpinning a product or service the entire turnover and ultimately profits could fall within the Patent Box scheme.

The final product does not need to be the patented product in its own right it could be part of a much larger product that has an embedded patent within it.

In some cases, the benefit may also apply to income from patent licensing and profits made through the use of a patented process.

### **Does my patent qualify?**

As the legislation stands now, the patent must be **granted** by either the UK or European Patent office however when the full legislation is released other jurisdictions may also qualify. Note that the intellectual property associated with the Patent does not necessarily need to rest within the UK.

### **So how does the 10% work?**

A formulaic approach is proposed to calculate the net profit attributable to patents. Essentially there are three profit streams that can avail of the 10% rate: licensing income and royalties, outright sale of patent rights & income embedded in the sale of patent products.

Taking each profit stream in turn the formulaic approach will split profits based on the proportion of the total turnover from patented products compared to non patented product turnover. An adjustment will be made for a predetermined profit element likely to be around 15% with the final step being the elimination of any value associated with other forms of intellectual property such as brands.

### **So what should I do now?**

An effective rate of tax as low as 10% should certainly get the Board's attention and with the possibility of a reduced rate of corporation tax in Northern Ireland the combined effective rate could even be as low as 5%, although we would need to see what restrictions the final legislation contained.

The regime does not kick in until 2013 but companies should prepare now if they are to maximise the box's full potential. Areas where companies may need to look at include:

- looking at whether any existing unpatented technology can be updated so that any improvements can be patented and the net profits from the product included within the Patent Box scheme.
- Companies should consider what processes they have in order to quantify the associated profits arising from patented technology.
- Companies should consider what intra group arrangements they have and if those arrangements could be made more formal i.e. by license agreements.