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HMRC internal manual

Corporate Intangibles Research and Development Manual

From: **HM Revenue & Customs (/government/organisations/hm-revenue-customs)**

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CIRD273100 - Patent Box: small claims treatment for notional royalty appropriate percentage CTA10/s357BNA

What a notional royalty is, when it should be used and how to calculate it is described at CIRD220250 (https://www.gov.uk/hmrc-internal-manuals/corporate-intangibles-research-and-development-manual/cird220250).

A company which qualifies for Small Claims Treatment CIRD220470 (https://www.gov.uk/hmrc-internal-manuals/corporate-intangibles-research-and-development-manual/cird220470) may choose to elect for a simpler formulaic method of arriving at an 'appropriate percentage' of IP derived profit instead of using transfer pricing methodology, due to the small amounts involved in the computations.

The legislation at CTA10/s357BN(3) requires the qualifying company to make this election in the first year of using the new rules if the Qualifying Relevant Profits (QRP) are above £1,000,000 for it to apply in a subsequent period. In effect, a protective election is required if it is anticipated that this section may be relevant in the following year.

A company will still need to identify how the IP derived income is calculated. The company will need to describe the methodology in calculating the IP derived income as a proportion of the total profits, if not evident from the calculations. This is not the notional royalty, but it is the first stage in identifying the relevant income to be included in the patent box when that income does not fit into one of the Heads of Income described in CIRD220160 (https://www.gov.uk/hmrc-internal-manuals/corporate-intangibles-research-and-development-manual/cird220160).

The notional royalty is an 'appropriate percentage' of that IP derived income. This is the relevant income to be included in the patent box. Companies qualifying for small claims treatment may take that 'appropriate percentage' to be 75% instead of using transfer pricing principles to identify the notional appropriate percentage.

A company will need to calculate its QRP to know whether it can qualify for Small Claims Treatment (CIRD220470 (https://www.gov.uk/hmrc-internal-manuals/corporate-intangibles-research-and-development-manual/cird220470)), but the notional royalty will form part of the QRP. It is not the intention to ask companies to calculate the notional royalty before being able to identify whether they qualify for Small Claims Treatment. The way to calculate whether the company qualifies for small claims treatment is as follows:

- identify 75% of the IP derived income (CIRD220250 (https://www.gov.uk/hmrc-internal-manuals/corporate-intangibles-research-and-development-manual/cird220250)) and add this to any other QRP. If this falls within the criteria for Small Claims Treatment then the election may be made.
- If 75% of the IP derived income plus other QRP exceeds the criteria, then the company does not qualify for small claims treatment.

Example:

Company X manufactures widgets. It holds a patent over a new machine that makes the widget but the patent does not cover the widget itself. The sale of the widgets does not fall within Head 1 and so the income is not relevant IP income. However it is early days and the company has qualifying profits of only £500,000. The notional royalty cannot exceed the qualifying profits and so it falls within the Small Claims Treatment criteria, as the company has not previously used Transfer Pricing methodology to compute this.

The company still has to calculate the profit derived from the exploitation of the patent, maybe by comparing profits before and after the arrival of the patented technology, or by using cost savings or mark up increases as a result of the patented technology, to arrive at income which for the purposes of the notional royalty provision will be ‘IP-derived income’, to the extent that it is reflected in the company’s trading income. The company knows that this new machinery improved production through cost savings of £100,000 from their cost benefit analysis created when they invested in the patent. That will form the IP derived income.

However the company does not then have to use Transfer Pricing methodology to identify the notional royalty element of that IP derived income which will go into the Patent Box. It can simply take 75% of the IP derived income. So £75,000 will fall into the Patent Box.

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