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Corporate Intangibles Research and Development Manual

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CIRD220270 - Patent Box: relevant IP profits: relevant IP income: notional royalties: transfer pricing principles: assumptions

CTA10/ s357BHA(4) (previously s357CD(6) but unchanged)

Patent Box: notional royalties: transfer pricing principles: assumptions

Some assumptions must be made in calculating the notional royalty to specify certain

circumstances which would affect the proportion of the IP derived income which the company would pay at arm's length:

- The company and the other person ('P') are dealing at arm's length.

- The company and persons it authorises will have exploitation rights to the exclusion of all others (including to the exclusion of 'P').

- The characteristics of the hypothetical transacting party (termed "P" in the legislation) are not explicitly prescribed. However, the legislation refers to the amount "…which the company would pay another person ("P") for the right to exploit the relevant [assets]…"

- The company will have all the same rights as it actually has.

- The notional royalty takes into account all the actual IP rights held by the company. So if the company holds a package of patents, each of which individually has little value but the portfolio as a whole is essential for the business, then the appropriate percentage is that for the whole package, this approach prevents the following incorrect outcomes:

- Aggregate notional royalty nil because no individual patent has value.

- Aggregate notional royalty exceeds actual income because each individual patent is very valuable.

- The licence is to be entered into on the later of the first day of the accounting period and the day the company obtained the IP right. This is so that in each accounting period the royalty corresponds closely to the current value of the rights, without requiring recalculation on a more frequent basis if the value changes during the accounting period. In practice it should not normally be necessary to determine a new royalty rate for each new accounting period if none of the relevant facts and circumstances has changed from the previous accounting

period. However, this would need to be considered if the facts change.

- The notional licence is assumed to be granted for a period matching the period for which the company actually holds rights. This allows the amount of the royalty to properly reflect the actual value of the patent rights. A longer term licence tends to be more valuable, on an annual basis, than a shorter term but otherwise equivalent licence.

- The notional royalty must take the form of a fixed-rate periodic royalty in order to unambiguously match payments under the licence to the accounting periods in which the IP-derived income is generated. The royalty must be calculated as a percentage of the IP-derived income from the patent rights for their remaining life. This precludes any lump-sum upfront or milestone payments and tiered or front-loaded or back-loaded royalties which could distort the Patent Box calculation in particular years.

- The notional royalty is only calculated based on income that is not itself relevant IP income, to prevent double-counting.

- It is not calculated on 'excluded income' because no part of this income can qualify for the Patent Box.

- The notional royalty can never be greater than the IP-derived income from which it is calculated.A useful check when considering the appropriate percentage for the qualifying IP right(s) is whether it can be supported over time by the company given its other obligations and the risks that it retains.

Any enquiries by HMRC into the computation and determination of the notional royalty will be subject to the transfer pricing governance process detailed in the International Manual at /manual/international-manual/intm480000 (https://www.gov.uk/hmrc-internal-manuals/international-manual/intm480000)

- HMRC will normally seek to reach agreement on the amount of a notional royalty on the basis that the agreement can remain in force for a period of years.

- Cases where a notional royalty is claimed in respect of a patent that has not been disclosed on the grounds of national security or public safety should be dealt with as set out in CIRD210150 (https://www.gov.uk/hmrc-internal-manuals/corporate-intangibles-research-and-development-manual/cird210150).

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