



## Should You Open The Patent Box? Tax Benefits For Innovation And Patenting

Coming into effect in April 2013, the Patent Box legislation establishes a beneficial Corporation Tax Regime for UK companies involved in the development or commercialisation of new products. To optimise the benefits of the Patent Box, companies may need to rethink their IP protection strategies now.



### What is the Patent Box?

Originally announced in the 2009 Pre-Budget Report, and passed into law on 17 July 2012 with the Finance Bill 2012, the Patent Box is a Government tax reform that will apply a reduced rate of corporation tax to worldwide profits attributable to qualifying patents and other qualifying intellectual property (IP) rights. Effective from 1 April 2013, the rate of tax payable on corporate income falling into the Patent Box will be 10%, a significant reduction from the standard rate of corporation tax of 23% due to be payable in April 2013.

### Who is the Patent Box aimed at?

According to the official documentation, "the aim of the Patent Box is to provide an additional incentive for companies to retain and commercialise existing patents and to develop new innovative patented products."

The Patent Box will therefore be relevant to any UK company paying Corporation Tax that currently owns or licences-in products or services protected by UK or European area patents, and significantly to those companies planning to develop new products or processes for which protection may be available.

### What are qualifying IP rights?

In order to benefit from the reduced rate of tax, a UK company must hold a qualifying patent or IP right. Presently, the Patent Box is confirmed as applying to products or services protected by patents granted by the UK Intellectual Property Office, the European Patent Office, and by the national offices of a number of European Area countries, including Austria, Bulgaria, The Czech Republic, Denmark, Estonia, Finland, German, Hungary, Poland, Portugal, Romania, Slovakia, and Sweden. In addition to patents, the Patent Box tax rate will apply to products protected by other qualifying IP rights, such as pharmaceutical rights afforded under Supplemental Protection Certificates, Plant Variety rights, certain regulatory data protection rights for medical products, marketing authorisations for medical products and veterinary products.

Profits generated by routine manufacturing and development, or from exploitation of branding and marketing, is deliberately excluded from the Patent Box. Thus, trademarks, which indicate the origin of a product, and design rights, which protect appearance of a product, have been excluded as qualifying rights.

### What profits benefit from the Patent Box?

The profits benefiting from the 10% rate of tax will be calculated as a proportion of the company's total gross trading profit. It will therefore be necessary to determine how much of the company's total profit is derived from qualifying IP rights and apply the tax reduction to those profits only. This profit is likely to derive from income falling into one of the following categories:

- Income from the sale of a protected item, or product incorporating a protected item (sales income).
- Income derived from licence fees and royalties (licence fees).

- Income from sale or disposal of the qualifying IP right (proceeds of sales).
- Income derived from others who are accused of infringing the IP right (e.g. damages awarded by a court).
- Income that can be determined as “a notional arms-length royalty” for use of protected processes or services. An example would be where a company uses a patented process to make a product; the Patent Box income would be the notional royalty for the use of that process.

Notably, the profits to benefit from the Patent Box will be derived from the worldwide income ascribable to a product or process protected by a qualifying IP right. Thus, if a UK company sells a newly developed product in the USA, Japan, and Australia, profits derived from those sales will qualify for the Patent Box as long as the product is protected by a qualifying IP right owned by the company, for example a UK patent. For the purposes of qualifying for the Patent Box regime it is not necessary for the new product to also be protected by patents in USA, Japan or Australia.

Once profit derived from qualifying IP rights has been determined, an assessment is made to determine what proportion of that profit is attributable to marketing and what proportion is attributable to a routine return (this is notionally calculated as 10% of certain routine expenses). When these have been removed, the remaining profit benefits from the 10% rate (and all other profit is taxed at the standard corporation tax rate).

The full benefit of the regime will be phased in from 1 April 2013. You will need to apply an appropriate percentage to the profits your company earns from its patented inventions. The appropriate percentages for each financial year are:

1 April 2013 to 31 March 2014:	60 per cent
1 April 2014 to 31 March 2015:	70 per cent
1 April 2015 to 31 March 2016:	80 per cent
1 April 2016 to 31 March 2017:	90 per cent
from 1 April 2017:	100 per cent

Some companies may have few products that are protected by a qualifying IP right. In this case, the proportion of the company’s total profit that is derived from qualifying IP may be low, and the overall reduction of the tax burden may not be great. Additionally, some companies may have a high routine return or a high level of income that is attributable to marketing. In these circumstances, the proportion of the income derived from qualifying IP rights that is eligible for the Patent Box will be reduced, or possibly eliminated. One can imagine however that many companies will be able to place a high proportion of their profits into the Patent Box, and thereby lower their overall corporation tax burden considerably.

## Are there any further conditions?

The Patent Box regime is primarily intended to encourage and reward innovation at companies that pay UK Corporation Tax. Companies must therefore meet a “Development Condition” to qualify for the Patent Box, and this means that they must carry out “qualifying development” in relation to the “qualifying IP”.

According to the legislation, a company carries out “qualifying development” in relation to a right if it creates, or significantly contributes to the creation of, an invention. Thus, the primary beneficiaries of the Patent Box will be companies that develop new products or processes and then obtain qualifying IP rights (such as UK patents) in respect of those products and processes.

Companies that buy-in or licence-in IP are not necessarily excluded from the Patent Box, however. The Patent Box legislation states that a company also carries out “qualifying development” if it performs a significant amount of activity for the purposes of developing the invention or any item or process incorporating the invention. This explicitly includes developing ways in which the invention may be used or applied.

A company using licensed-in IP can only benefit from the Patent Box if they hold a country-wide exclusive licence to a qualifying IP right. The exclusive licence must include the right to bring proceedings for infringement of the right without the consent of the proprietor of the right, or any other person, and the right to receive the whole or greater part of any damages awarded in respect of infringement.

In addition to the “Development Condition” there is also an “Active Ownership Condition”. This only applies, however, where the company is a member of a group of companies and another member of the group has undertaken the “qualifying development” referred to above.

## What will the Patent Box cost to implement?

There are likely to be some accountancy costs, at least initially, in preparing tax returns claiming Patent Box income. For example, advice is likely to be required to calculate an appropriate routine return, and where arms-length royalties need to be applied there may be some expense in determining what a reasonable rate should be. Companies may also wish to take advice from a tax advisor as to whether the scheme would benefit them at all.

The Government has listened to concerns regarding the potential accountancy costs of the Patent Box and has proposed that the profits that go into the Patent Box should be determined, in most cases, by a standard formulaic approach. If this is not desirable, companies can opt to provide a detailed bespoke calculation of their Patent Box profits.

Should a company not wish to partake in the Patent Box they do not have to. Companies need to elect into the Patent Box should they wish to benefit from the scheme.

### Does the scope of my patent influence the Patent Box?

The scope of protection of the qualifying right does not appear to have any bearing on eligibility for the Patent Box, as long as profits can be attributed to a product protected by that right (or a licence, sale etc... of the right).

There are a number of specific “anti-avoidance” measures however set out in the legislation. These measures include a prohibition on awarding an exclusive licence where the main purpose is to gain qualification for the Patent Box, and a prohibition of incorporating a protected component into an item for the sole purpose of qualifying for the Patent Box. Notes issued by the Government indicate that they will not object to any practical and commercially appropriate transaction, even if they enhance Patent Box benefits.

The legislation does not appear to prohibit the gaining of patents for new products with the sole aim of qualifying profits from those new products for the Patent Box. Indeed, the purpose of the legislation is to encourage development and protection of new IP.

### Do pending patent applications count towards the Patent Box?

Only profits attributable to granted rights will be eligible for the Patent Box. However, a retrospective benefit can be calculated for pending patent applications for up to six years before grant and redeemed in the year that the patent is granted.

### What should you be doing now?

The Patent Box regime starts on 1 April 2013. Thus, it is time to consider whether the Patent Box is applicable to your business and whether any steps need to be taken to procure qualifying IP rights. The following are suggested steps that should be considered. Although these suggested steps are set out with reference to patents, they are equally applicable to other qualifying IP rights.

- **Seek UK patent protection for new products**

Companies with a regular stream of new products should be attempting to obtain a qualifying IP right that protects each new product launched. In this way an increasing proportion of the company’s profits will fall within the Patent Box over time and become eligible for the 10% rate of corporation tax. While attempting to obtain global patent protection for a product can be an expensive undertaking, it is relatively inexpensive to pursue patent protection in the UK. Further, a UK patent can remain in force for up to 20 years (on payment of relatively low annual renewal fees). In some cases it may be

economically attractive to continue holding UK patents covering a product purely for the potential tax benefit.

Many companies understand the advantages that patent protection can bring and the value of patents and patent applications as assets of the company. However, the cost of pursuing global patent protection means that commercial decisions need to be taken at an early stage, and there may be a tendency to only pursue protection for products or processes that are deemed to be of significant commercial importance. With the initiation of the Patent Box, it may now be attractive to file a greater number of applications in a low cost jurisdiction such as the UK.

- **Pursue swift grant of rights**

Many companies seek UK patent protection via the European Patent Office (EPO). As a Patent granted by the EPO can be brought into force in many European countries, there is often no need to pursue a separate UK national patent. However, patents granted by the EPO frequently take 6 or 7 years from filing to grant, while patents granted by the UK IPO directly tend to be granted in less than 4 years from filing, and can be granted sooner if the applicant takes appropriate steps, such as requesting a search and examination on filing. Thus, there may be a case for pursuing both UK and European rights in order to qualify for the patent box more swiftly. For complex products or services, it may also be desirable to pursue a UK national application that has a narrow scope of protection (in order to obtain a swift grant of a Patent Box qualifying patent). A more commercially relevant scope of protection can still simultaneously be pursued via a European patent application.

- **Identify relevant third party IP portfolios and purchase rights or negotiate exclusive licences**

As an example, your company may have developed products falling within a patent portfolio owned by a third party. You may have a non-exclusive licence to use the technology, you may not. As long as you meet the “Development Condition” discussed above, rights in the IP portfolio may allow you to qualify for the Patent Box regime. Consideration should be made as to whether to purchase the IP or obtain an exclusive licence to the IP.

### Act Now!

As the Patent Box will enter into force on 1 April 2013, now is the time to consider protecting new products so that income generated from those products can qualify for the Patent Box.

### Detailed Information

Further information is available from HM Revenue & Customs at: <http://www.hmrc.gov.uk/ct/forms-rates/claims/patent-box.htm>

*Please note, this general briefing note is not intended to constitute advice on legal or tax matters. For more information on the details of the tax measures contact a tax accountant or advisor. For more information regarding IP strategy please contact your usual Reddie & Grose attorney.*