The United Kingdom's Patent Box Regime

BY GARY MOSS[1]

One of the stated policy aims of the current UK Government is to move the UK economy away from its over reliance on financial services to a more balanced position in which research, development and manufacturing play a much greater role. A "complaint" frequently made about the UK is that while the country boasts world class capabilities in basic scientific research, commercial developments of its discoveries often ends up in the hands of overseas companies to the detriment of employment and wealth generation in the UK itself[2]. The current Coalition Government has vowed to try and reduce this, with a view to retaining more high value jobs for the UK economy.

One element of this strategy involves making the UK more attractive from a corporation tax point of view.[3] But as another part of that overall effort the Government has decided to bring in favourable tax treatment for profits which derive from inventions and their exploitation. This has led to the implementation of the so called Patent Box regime. The legislation for this has been included in the Finance Bill for 2012, which is making its way through Parliament. Since the Patent Box was originally proposed by the former Labour Government, and the proposals received a large measure of approval from industry, it can be anticipated that this aspect of the Bill will pass through the legislative process largely unscathed. It is expected that the new regime will be brought into effect in tax year 2013/4.

In broad outline, corporations which elect to be within the Patent Box will be taxed in the UK on profits arising from the exploitation of the patents and other qualifying rights at the rate of 10% instead of the normal Corporation Tax rate, which is currently 20% to 24% depending on the size of profits. Thus the rate of tax is reduced by at least 50%.

The new regime will apply not only to UK Corporations, but to any Corporation which trades in the UK and is liable to UK Corporation Tax. The existence of this relief is an additional factor which International Corporations will now need to take into account when deciding where to locate their research and manufacturing facilities and how to structure their holdings of IP Rights.

HOW SIGNIFICANT IS THIS NEW REGIME?

This new regime needs to be seen in context. In recent years a number of European jurisdictions have introduced specific reliefs for revenues arising from intellectual property as part of their efforts to persuade high value international companies to locate in their jurisdictions. Ireland has had longstanding favourable treatment for such revenues although that may be falling victim to that country's austerity measures taken in the light of the current Euro crisis. The Netherlands taxes net income from self-developed patents and software at 5%. Belgium provides an 80% exemption from net income for self-developed patents resulting in an effective tax rate of just below 7%. Luxembourg has a similar approach under which such income is taxed at approximately 6%. Spain takes a different approach in that it exempts 50% of revenues from tax but allows expenses to be deducted in full resulting in an effective tax rate much below its headline corporation tax rate.

Against that background the UK Government's proposals for an effective tax rate of around 10% may not seem overly generous and it may be questioned as to whether it is sufficient to persuade companies to alter their existing arrangements in order to relocate to the UK? Nevertheless, the Government appears to be banking on the fact that, when coupled with the other attractions of locating in the UK (e.g. strong research base, lowering of corporation tax generally), this relief will be enough to persuade those companies which are already located in the UK not to transfer their holdings elsewhere and those companies which are on the point of setting up in Europe for the first time or whose tax arrangements are not that mature consider the UK as a place in which to locate.

These proposals also need to be seen as part of a bigger picture. In the current economic climate in Europe, with its emphasis on austerity, all countries are seeking to maximise revenue while at the same time looking at anti avoidance measures aiming to reduce the scope for companies to use off shore jurisdictions in which to shelter their IP assets and the income arising from it. There has been considerable backlash recently in all sections of the British Press against international organisations who carry on large amounts of trade in the UK but pay virtually no tax in that country. Apple, Google and Amazon are just three of the entities against whom such charges have been levelled. Thus to some extent this represents a carrot and stick approach.

THE NEW REGIME IN OUTLINE

The new regime is complex and of necessity what follows is simply an overview. Those readers who would like more detail are referred to our guidance note which can be found at http://www.eip.com/#/strategy/patent_box.

What rights are within the Patent Box?

The first point to note is that the benefit of the regime is limited to:-

- Patents;
- Supplementary certificates;
- UK and European plant breeders rights;
- UK and European data exclusivity rights such as those granted in respect of medical, veterinary and plant breeders' rights.

During consultations there was a push by organisations which rely for protection on other forms of intellectual property (particular entertainment entities) to provide similar beneficial treatment for profits arising from the exploitation of copyright and trade marks. However, the Government held out against this and pointed out that this regime was specifically targeted at research and development leading to "industrial" exploitation and the employment opportunities which that brings.

In the interests of simplicity for the rest of this article the author will focus on patents since these are likely to form the bulk of rights falling within the Patent Box.

Which patents are relevant?

In order to qualify for Patent Box the products or process from which profits are derived must fall within the scope of

a patent granted by an "approved" Patent Office. Originally the only offices proposed were the UK and European Patent Offices but the UK Government has subsequently published a list of other "approved" patent offices. The offices in question must subject the application to substantive examination prior to grant and the criteria for patentability applied by that office must be the same as those which prevail in the UK. Since most European countries are signatories to the European Patent Convention and have aligned their substantive laws to be in compliance with that convention, the latter condition is not something which the majority of national patent offices will encounter any difficulty in fulfilling. But it is worth noting that this requirement means that patents granted by the USPTO will NOT be included; the Government has cited the different criteria for patentability in that jurisdiction as a reason for not including US granted patents.

But that does not mean that profits arising from exploitation of patented inventions in the US are excluded from the ambit of the Patent Box. One of the more interesting aspects of the Patent Box (and one which was pushed for very hard by industry and practitioners) is that there does not have to be a patent in the country in which the product is actually manufactured or sold in order for income arising from those products being regarded as "qualifying income". Instead there only needs to be a single qualifying patent granted by an approved office, but once such a patent has been granted then all products or processes which fall within the scope of that patent count as qualifying income even if the actual manufacture or sale is in a different territory. Thus, for example, if a Corporation secures a patent in the United Kingdom, its worldwide sales of products which fall within the scope of that patent will qualify for favourable treatment even if no other patents are secured.

The reason for this is that the regime seems to regard the grant of a patent following substantive examination as constituting some form of "certification" that the invention is "worthy" of favourable treatment for the purposes of the Patent Box. Given the ease with which some offices seem to grant patents even after apparent substantive examination, one might question whether this is a realistic view but it is difficult to see how else this could be approached without imposing significant administrative burdens on the tax payers.

The right to relief only arises once the patent is granted. However, tax on profits arising prior to grant can be clawed back once grant has been obtained.

Qualifying entities

In order to qualify for Patent Box treatment the Corporation in question must play some active role in the origination, development and / or management of the rights in question of the product incorporating that right – passive ownership will not count. This is to avoid international corporations simply "parking" their intellectual property in the UK and seeking to benefit from the more favourable tax treatment. It has to be borne in mind that the regime is intended to promote employment in the UK and that purpose is not going to be achieved if corporations simply have "post box" companies holding assets in a manner similar to how they are held in tax havens. Special rules apply where the UK entity is part of an international group but for the purposes of the group the IP is held outside of the UK but managed from the UK.

The other point to note is that the rights do not have to be owned by the Corporation Tax paying entity. Relief will also be available if that entity has the benefit of an exclusive licence under the right in question.

How are qualifying profits calculated?

Not all profits arising from the sale of a "qualifying product" will qualify for inclusion in the Patent Box. The new regime is intended to "reward" the innovative effort from which profit derives but not other "standard" elements of profits. Thus it is necessary to deduct from overall profits the proportion of profit attributable to the "normal" return on investment inherent in all entrepreneurial activity and that element of profit which can be attributed to marketing assets such as trade marks. One can demonstrate this by considering the well-known Apple iPad. No doubt many features of that successful product are the subject of very many patents. But at the same time much of the success of this product is due to the Apple brand which has been established over very many years. As stated, trade marks do not qualify, patents do.

Again the detailed calculations are complex and beyond the scope of this article. Stripped down to the essentials the way in which the proportion of profit which qualify for Patent Box relief is calculated is as follows:-

- Calculate total profits – this is generally a fairly straightforward accounting exercise. Certain categories of expenditure are excluded but these are not significant;
- Deduct from the total profits an element for routine return. This is a fix percentage of certain items of expenditure. Originally the Government proposed a flat rate of 15% but has subsequently reduced this to 10% following representations;
- Deduct the element of profits attributable to marketing assets. This can be done in one of two ways:-
- The patentee can opt for an actual calculation based on the assets in question. This involves consideration of what a willing licensee would pay for the use of the marketing assets;
- Small companies (i.e. those for whom profit is less than £1 million) can opt for a notional, flat rate deduction of 25% - this is to avoid such companies having to undertake relatively complex calculations and negotiations with the Revenue Authorities.

The balance left after making the above deductions is the element which is then taxed at the more favourable rate. The rest of the profit is taxed at the normal corporation tax rate.

What other income qualifies for favourable treatment?

The Patent Box regime does not just apply to the profits arising from the manufacture and sale of products – it includes other forms of patent related income. In particular:-

- Where a company exploits a patented process in the course of its own manufacture it may allocate a notional royalty to that patent;
- Income arising from the sale or licensing of qualifying rights qualify for favourable treatment;
- Sums received by way of compensation for infringements committed.

HOW USEFUL IS THE PATENT BOX LIKELY TO BE?

The answer to this will depend on the amount of a Corporation's income which is patent related. Where patent related income is only a small proportion of a company's total income, then, not surprisingly, the overall reduction in tax liability will be relatively small. Conversely, however, if patent related income represents a large proportion of overall income then the savings in corporation tax could be significant. Every corporation doing business in the UK will need to make an assessment. Nevertheless, it goes without saying that there are many companies in the high tech and life sciences fields which can properly claim that virtually all their products are protected by qualifying IP and for whom patent related income will be a large proportion of their overall income. For those companies this new regime is likely to prove of significant value. Also, even if patent related income is only a small proportion of the income overall, if the sums are large enough the savings in tax will still be sufficient to make the Patent Box election worthwhile.[4]

WHAT SHOULD COMPANIES BE DOING NOW?

It is important that organisations doing business in the UK review their IP protection strategies in light of these proposals. The following are some of the questions which such corporations need to be asking themselves:-

- When balanced against other commercial determining factors, is our present patent filing strategy optimised to obtain maximum benefit from the Patent Box?
- Are the criteria to determine whether or not to seek patent protection for an invention, which are typically cost-driven, set at such a high level that opportunities to qualify for the Patent Box, thereby potentially offsetting much of the cost, are being missed?
- Which current and future products are covered by a relevant patent and qualify for the Patent Box?
- Do the claims of our patents cover the products actually being sold? For example, did the design of the product change after the patent application was drafted?
- Would filing new patent applications qualify a greater proportion of profit for the Patent Box?
- Could additional patent applications be filed to bolster existing protection, and strengthen the Patent Box case, in instances where protection is perceived to be weak?
- Are any amendments to existing applications advisable to improve qualification for the Patent Box?;
- Are any patents due to expire soon? If so, what can be done to extend or maintain their lifetime to continue qualification under the Patent Box?
- Can any steps be taken to accelerate examination of a patent application, to obtain a granted patent sooner, so as to qualify for the Patent Box sooner?
- Do we need to put in place formal licensing arrangements between members of our corporate group?

CONCLUSION

The UK Patent Box is an important new regime which in many instances will enable corporations doing business in the UK to achieve substantial savings in their tax liability. The rules regarding which elements of profits qualify, and in which circumstances, are extremely complex and will require detailed consideration on a case by case basis. But what is clear is that those entities which are currently doing business in Europe, and those which are planning to do so in the future, need to consider how they currently hold their international IP assets and whether the attractions of this new regime tip the balance in favour of locating their businesses in the UK. IPT

ENDNOTES

1 The author is a UK solicitor and a partner with EIP Partnership LLP, London and is Head of EIP Legal.

2 The UK is second in the list of nobel laureates, behind the US but ahead of France and Germany. Yet those two countries have much stronger domestic industries. According to figures published by WIPO German companies secure roughly four times and French companies roughly two times the number of patents obtained by UK based companies.

3 The Coalition is currently in the process of reducing the top rate of corporation tax from 28% in 2010 to 23% in 2013

4 For some worked examples showing what this might mean in practice please visit http://www.eip.com/#/strategy/patent_box