



BOXING CLEVER

The government's patent box policy could mean big tax breaks for companies with significant income from intellectual property, says **Gary Moss**

One of the stated policy aims of the current government is to move the UK economy away from its over-reliance on financial services to a more balanced position in which research and manufacturing play a greater role. One element of this strategy involves making the UK more competitive from a corporation tax point of view. The government has decided that it needs to provide favourable tax treatment for profits which derive from inventions and their exploitation, hence the proposed patent box, the draft legislation for which was published by the Treasury on 6 December 2011. It is currently envisaged that this legislation will be incorporated into the Finance Bill for 2012 and that the scheme will come into effect in 2013/14.

If a company elects to be within the patent box it will be taxed on profits arising from

the exploitation of the patents and other qualifying rights at 10% instead of the normal corporation tax rate. The patent box will not only apply to qualifying IP rights that are owned by the entity in question; it will also apply where rights are held by the tax paying entity under an exclusive licence.

NEW REGIME

In recent years, a number of European jurisdictions have introduced specific reliefs for revenues arising from intellectual property. 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.

CASE STUDY A



Tax payable before patent box



Tax payable after patent box

Against this background, the government's proposals for an effective tax rate of around 10% may seem ungenerous and it may not be sufficient to persuade companies to alter their existing arrangements in order to relocate to the UK. The government appears to be banking on the fact that, when coupled with the other attractions of locating in the UK (eg, 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, to consider moving to the UK.

In the current economic climate, all countries are seeking to raise revenue and looking at anti-avoidance measures to reduce the scope for companies to use offshore jurisdictions to shelter their IP assets and the income arising from it. Thus to some extent this represents a carrot and stick approach.

How useful the patent box is to a company will depend on the amount of income which is patent-related. Where patent-related income is only a small proportion of a company's total income, the overall reduction in tax liability is relatively small but if patent-related income represents a large proportion of overall income then the savings in corporation tax could be significant.

Each company will need to make an individual assessment. But there are many companies in the high tech and life sciences fields that 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, the 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.

CASE STUDY A

BASED ON A COMPANY IN LOWER CORPORATION TAX BAND

	Trading without patent box	% for qualifying profit on a ratio of 90:10	Qualifying patent box profit
Sales	1,400,000	90%	1,260,000
Expenses:			
R&D	150,000	90%	135,000
Marketing	50,000	90%	45,000
All other trading costs	900,000	90%	810,000
	1,100,000		990,000
Profit before tax	300,000		270,000
Mark up on trading expenses proposed at the rate of 10%			85,500
Profit on qualifying income			184,500
Adjust for notional marketing asset return (std 25%)			75%
Final patent box profit			138,375

Basic corporation tax calculation

Small business rate at 20%	60,000	
Tax on patent box profit at 10%		13,838
Tax on residual profit at 20%		32,325
Comparable corporation tax changes	60,000	46,163

Source: EIP (figures calculated at third stage of legislative process)

TAX PLANNING

This raises an important question about whether it is necessary to change the way your organisation currently holds its IP. This is a complex question which will require detailed consideration with the organisation's tax specialists. It is likely that many organisations, in particular multinational operations, are already holding their patents in tax efficient ways; they will need to determine whether the patent box is likely to yield significant additional benefit.

By contrast, there are likely to be many national corporations and small to medium enterprises (SMEs) who currently do not have the benefit of complex international tax



Against the European background, UK proposals for an effective tax rate of around 10% may seem ungenerous. It represents a carrot and stick approach

CASE STUDY B

BASED ON A COMPANY IN HIGHER CORPORATION TAX BAND

	Trading without patent box	% for qualifying profit on a ratio of 80:20	Qualifying patent box profit
Sales	10,000,000	80%	8,000,000
Expenses:			
Raw materials	3,000,000	80%	2,400,000
R&D	1,500,000	80%	1,200,000
Minus R&D tax credit enhancement	-450,000		
Marketing	1,500,000	80%	1,200,000
All other trading costs	2,550,000	80%	2,040,000
	8,100,000		6,840,000
Profit before tax	1,900,000		1,160,000
Mark up on trading expenses proposed at the rate of 10%			324,000
Profit on qualifying income			836,000
Adjust for notional marketing (eg 11%)			89%
Final patent box profit			744,040

Basic corporation tax calculation

Large business rate at 26%	494,000	
Tax on patent box profit at 10%		74,404
Tax on residual profit at 26%		300,550
Comparable corporation tax changes	494,000	374,954

planning and for whom this regime could represent significant extra relief from their corporation tax liabilities and for whom 'patent tax planning' could prove useful. Also, as stated, international companies who are considering setting up in Europe for the first time, or who have only recently set up in Europe, would do well to consider the potential tax advantages which might now be available from locating in the UK.

PATENT PLAN

First, as a basic point, the patent box is a corporation tax relief. It is only available to those entities that pay corporation tax, namely companies. Thus sole traders, partnerships and limited liability partnerships who wish to take advantage of this regime will need to incorporate and will obviously need to calculate whether the potential savings will make that worthwhile.

Secondly, there may be advantages in securing the speedy grant of a patent since this brings forward the availability of the tax relief. At present, most organisations tend to seek

CASE STUDY B



Tax payable before patent box



Tax payable after patent box

protection through the European Patent Office and obtain protection in the UK as one of the designated states. But the EPO is not that fast – a period of five years from application to grant is not uncommon.

By contrast it is possible to obtain a patent from the UK Intellectual Property Office in 12 to 18 months. It is true that the proposed rules allow companies, once a patent has been granted, to claw back qualifying profits earned up to six years prior to the date of the grant but many companies will not want to wait that long before securing the relief. Organisations should consider whether there is merit in seeking to protect their inventions in the UK via the UKIPO rather than the EPO. This may involve additional patenting costs initially but these could prove to be relatively minor, compared with the level of relief available and the benefits of securing this relief speedily.

Thirdly, patentees will need to ensure that their own products fall within the claims of the patents which they are filing.

Fourthly, for many industries patents do not form a significant part of their IP protection strategies. The IT and software industries » 48



CHECKLIST

WHAT YOU NEED TO KNOW: PATENT BOX

- 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?

are examples that immediately spring to mind, primarily because of the uncertainties over whether their products qualify for patent protection but also with perceived difficulties in enforcement. These industries will need to revisit this issue if they wish to take advantage of the relief which is now available.

Finally, many groups of companies hold their IP centrally, often in entities which are not themselves responsible for the exploitation. The patent box rules allow the operating company to claim the relief even though the patent is held by another entity within the group but it would appear that there needs to be some formal record of the rights granted to the operating entity. This will require groups to review their existing arrangements since in many instances these are entirely informal and thus may not qualify.

**ACTION PLAN**

It is important that organisations review their IP protection strategies in light of the patent box proposals. Whilst the final legislation may differ from the current draft, the content of the draft legislation is sufficiently final for organisations to start considering now whether they need to modify their structures and procedures so as to take maximum benefit.

The patent box is an important new regime which in many instances will enable companies to achieve substantial savings in their corporation tax liability. But the rules regarding which elements of profits qualify, and in which circumstances, are complex and require a good understanding of IP law, particularly patent law and the procedures for obtaining patent protection.

It is important that companies start reviewing now whether they qualify for the new regime and if there are practical steps they can take in order to either enhance the level of qualification or, alternatively, to ensure that they do qualify where previously they may not have done so.

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