

# Are you thinking inside the box?

## Part 2 - Draft legislation published



### The revised Patent Box

In our last update, 'Are you thinking inside the box?' we discussed Government proposals for a new UK Patent Box scheme. The Patent Box will provide a reduced corporation tax rate for profits generated from qualifying patents, and certain other IP related to R&D and high-tech activity, held by UK businesses. The proposals were set out in the June 2011 consultation document.

In response to the consultation the proposals have been revised and draft legislation published. This briefing considers the main changes to, and likely implications of, the scheme.

### What IP is covered?

#### The patents

It was originally proposed that the Patent Box would apply to income generated from patents granted by the UK Intellectual Property Office or the European Patent Office, as well as supplementary protection certificates, regulatory data protection and plant variety rights. The limited scope of this proposal has been criticised. The Government has now extended the regime to include patents granted by other EU national patent authorities with comparable patentability criteria and search and examination practices to the UK. The draft list of approved schemes in other Member States is expected to be published in spring 2012.

**Impact:** Whilst this does not go as far as some may have liked (not as far as the qualifying IP position in, say, the Netherlands) it is an improvement on the original proposals.

#### Owned and licensed IP

A company can qualify for the Patent Box if they own or hold an exclusive licence for the IP. The original proposals have been amended to make it easier for groups to qualify for the Patent Box where IP is held centrally but actively owned and managed by a UK group company. In this situation a UK company will fall within the Patent Box if it has the rights to use, sell or licence the invention and to receive the profits related to that IP under a group agreement.

**Impact:** This modification will be welcomed by group companies whose activities may not have qualified for Patent Box treatment under the original proposals. Groups may avoid the need to restructure activities in order to qualify for the Patent Box.

### Old, new and acquired IP

The Patent Box will now apply to existing, new and acquired IP, provided that the group has created or developed that IP or, in the case of acquired IP, it has further developed that IP or the product which incorporates that IP.

**Impact:** This is good news for companies holding existing IP as well as those looking to develop or acquire IP in the future.

### Development criteria

The Patent Box is aimed at innovative companies properly involved in innovation and creating or developing IP. Therefore, to qualify for the regime, development criteria must be satisfied. The original proposals explained that companies claiming the Patent Box cannot be passive recipients of income from merely holding the IP; they must be actively involved in the development cycle. The Government has clarified what this means.

The draft legislation defines development as creating or significantly contributing to the creation of a patented invention or performing a significant amount of activity to develop a patented invention, any product with a patented invention in it or the way a patented invention can be applied.

Acquiring rights to and marketing a fully developed patented invention is not enough. The Treasury's technical note discusses what may be regarded as 'significant' for these purposes and gives examples such as coming up with a breakthrough idea or dedicating significant time, costs and effort.

**Impact:** As highlighted above, this is good news for those companies holding existing IP, as well as those looking to develop or acquire IP in the future.

### Active ownership criteria

The active ownership criteria require a Patent Box company to be actively involved in the development or management of the qualifying IP.

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**Impact:** This test will only really affect group companies, as single companies who have already met the development criteria will automatically meet this test as well.

The key for groups is what is meant by the management of IP. The current guidance suggests that planning and decision making activities associated with the development or exploitation of that IP, such as deciding whether to maintain protection in particular jurisdictions and whether to grant licences, will meet the active ownership criteria. It is hoped that in practice it will usually be clear whether the managing of IP is significant and sufficient to be deemed active ownership.

### What income is covered?

The Patent Box will apply a reduced rate of corporation tax to 'qualifying income' produced by qualifying IP. The Government has confirmed that the following will be qualifying income, as originally proposed:

- licence and royalty income from qualifying IP;
- income from the sale of products incorporating a patented invention;
- income arising from infringement of IP rights; and
- notional arm's length royalty income for using qualifying IP in a process or services.

Financial income is to be excluded. However, the Government has proposed that any income from leasing transactions will be qualifying income to the extent it relates to the provision of a patented product, rather than the provision of finance or services. The Government is looking to explore with businesses over the coming months how this will work in practice.

The draft legislation has extended the period for which a company can claim profits before a patent is granted. This has been extended from 4 to 6 years prior to grant. These profits will be aggregated and brought into the Patent Box once a patent has been granted.

### Patent Box profits – the calculation

Whilst there has been overall support for the formulaic approach put forward by the Government, serious concerns were raised over some of the detail. This has prompted the Government to make changes to the calculation of the Patent Box profits in the draft legislation.

The main changes are as follows:

- Income derived from qualifying IP can now be divided between qualifying and non-qualifying IP in one of two ways - either profit apportionment or (new to the draft legislation) income streaming on a just and reasonable basis.
- As part of the calculation, it is necessary to exclude profit attributable to 'routine activities' of the company. The original proposals calculated routine profits as a 15% mark up on internal costs, but following responses to the consultation this has now been reduced to a 10% mark-up. In addition the costs to be marked up will now exclude any R&D costs that qualify for R&D relief. These are welcome changes that will increase the profits eligible for the Patent Box.
- The final step of the calculation (as originally proposed) required the allocation of residual profits between qualifying IP and brands. This was not popular with respondents to the consultation and has now been revised. The draft legislation proposes a new approach; those companies whose marketing intangibles contribute 10% or more of residual profit must calculate an arm's length royalty for the use of those intangibles which will be taxed at the full rate of corporation tax. However, those companies that do not have a commercial brand or do not licence out IP to other businesses with the right to market intangibles will not be required to make this royalty calculation.

The Government has confirmed that the benefit of the Patent Box will now be given as a tax deduction.

### When will the Patent Box rules apply?

It is proposed that the rules will be effective for qualifying income earned on or after 1 April 2013 and they will be phased in over a 5 year period.

Full guidance on the operation of these new rules is to be published in summer 2012.

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### What next?

Whilst draft legislation has been published, the changes highlighted above are still open to comment until 10 February 2012 and therefore the legislation may be further amended. We will keep you updated with changes as and when they happen.

### Need advice?

If you would like any further information or advice on any of the issues raised in this note please contact your usual Osborne Clarke contact or a member of our team below.



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