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Inside the (Patent) Box: UK Government introduces beneficial tax regime on patent income

By Alistair Maughan and Trevor James

Beginning on 1 April 2013, the UK Government will reduce the rate of corporation tax payable in the UK on profits arising from patents and some other forms of intellectual property ("IP"). The reduced tax rate implemented by this so-called "patent box" scheme will be 10%. This Alert looks at the implications of the patent box regime and also what organisations that derive material income from patent rights can do in order to position themselves to take the benefit of the reduced UK tax regime.

The patent box regime to be implemented by the UK Government has been in the works for some time, having been trailed in a consultation exercise as far back as 2010. It mirrors the reduced tax regime that exists in some other countries (*e.g.*, various Swiss cantons have a similar regime) and is designed to encourage the development of the technology sector as a net contributor to the overall UK economy.

The regime is not just available to UK companies that were involved in the initial development of a patent or other qualifying IP: IP holding companies based in the UK can, in some circumstances, also apply the reduced rate of tax to their worldwide income from patents transferred to them and which they actively manage.

At the same time, the UK Government confirmed in March 2012 that it will introduce an "above the line" R&D tax credit with a minimum rate of 9.1% before tax. This will mean that loss-making companies involved in R&D will be able to claim a payable credit. This new rule will also apply from April 2013. As with the patent box scheme, the aim is to incentivize R&D activity in the UK and is part of a long-term government plan to make the UK a more attractive place to do business.

The details of the new regime are slowly being released and the UK Government has published a series of draft clauses on the patent box for inclusion in the Finance Bill 2012 along with a technical explanation note. The main aspects of the new regime are as follows:

WHO MAY BENEFIT?

The patent box scheme will be available to any business paying UK corporation tax as long as it

(a) actively holds a qualifying IP right or an exclusive licence in respect of qualifying IP rights, and

(b) receives income related to those qualifying IP rights.

It is important that the assets within a patent box are held by a company because the legislation specifies that the benefits of a patent box are available only to "qualifying companies".

WHAT INTELLECTUAL PROPERTY IS COVERED?

The regime applies to patents granted by the UK Intellectual Property Office under the Patents Act 1977 or patents granted by the European Patent Office.

As a result of comments received during the consultation period, by way of concession, the regime will also apply to other areas of high-tech innovation in which patenting is not permitted, such as UK and European Community plant variety rights, and patents that the UKIPO would have granted but for a prohibition on publication on the grounds of national security or public safety (*e.g.*, nuclear technology).

The UK Government also intends to extend the patent box scheme to patents issued by other EU member states that have similar examination and patentability criteria as the UK. The government will publish a list of other qualifying jurisdictions later in 2012.

WHEN DOES THE PATENT BOX SCHEME START?

The patent box regime begins with effect from 1 April 2013. Companies can elect to apply the reduced rate to patent-derived profits from that date – although it will not be mandatory to do so. A company may opt out of the regime but, once such an election has been made, the company will not be able to opt back in for 5 years.

The benefits of the regime will be phased in over 5 years from that initial date, with 60% of the benefit being available in the financial year 2013/14 and then rising by 10% per annum over the next 5 years. So, the full benefit of the patent box regime will only be available from 1 April 2017.

WHAT RATE OF TAX APPLIES?

The reduced rate of corporation tax is set at 10% and will apply to all profits attributable to patents and other qualifying IPRs. The regime applies to worldwide income from qualifying IP, whether that income is received by way of a discrete royalty or embedded in the sale price of a product or service. The latter has already been identified as a problem area and will result in an increased compliance burden on the taxpayer.

THE REQUIREMENT FOR “DEVELOPMENT”

Importantly, companies seeking to claim the protection of a patent box must also fulfill a “development condition” *i.e.*, they must have been involved in a particular way in the creation of the qualifying IP right. The point of the development condition is to make sure that the beneficial patent box regime only applies to companies that have been genuinely involved in the research or development that led to the creation of the patented invention.

To comply with the development condition, a rights holder must either (a) create, or significantly contribute to the creation of, the invention; or (b) perform a significant amount of activity that led to the invention or any item incorporating the patented technology.

The legislation explains that it is sufficient both to develop patented technology and to develop ways in which the technology may be used or applied. It may be an issue as to whether activity is sufficiently “significant”, although that needs to be determined in the light of all of the relevant circumstances. So, for example, coming up with a breakthrough idea or testing or enhancing the viability or usefulness of the idea are significant activities. A contribution could also be significant in terms of the cost, time or effort incurred.

It is clear, however, that it is not sufficient merely to acquire rights to an already developed patent, or a product incorporating patented technology invention, and then market it.

WHAT INCOME IS COVERED?

The regime will apply to worldwide income earned by UK businesses from the inventions covered by such patents and also will cover profits arising from the sale of a patent. There are some very detailed rules describing the manner of calculation of relevant income. Broadly, there are 4 types of qualifying income which consist of income arising from the sale of any of the following:

- items protected by a qualifying IP right held by the company ("qualifying items") and items incorporating one or more qualifying items. HMRC's view is that, to be incorporated, an item must be physically part of the larger item and intended to be so for its operating life, so a peripheral or consumable would be excluded. However, income from sales of spare parts is included as long as the tax-paying company holds the qualifying intellectual property rights in the item for which the spare parts are designed. Income associated with packaging is presumed to be excluded from the patent box regime;
- licence fees or royalty income received under a licence agreement applying to a qualifying IP right and also associated non-patented items if the purpose of granting those rights is the same as for the rights over the qualifying IP;
- income from the sale or other disposal of a qualifying IP right;
- amounts that the company receives in respect of an infringement (or alleged infringement) of a qualifying IP right.

There will be special anti-avoidance rules dealing with mixed sources of income and also "notional royalty rules" which will apply where a company is using a patented invention in a way that does not generate relevant IP income but that does result in its deriving income and profits (*e.g.*, if it uses a patented process to provide a service).

The reduced tax regime will apply to net patent income, meaning that any expenses associated with developing and implementing the patent will be deducted from profits subject to tax at the lower 10% rate.

When the patent box regime was originally proposed, there were fears that the regime would only apply to recent patents. That fear has now been dispelled and the regime will apply to all active patents rather than just patented products that have been commercialised after November 2010 as was originally proposed.

The type of income to which the regime will apply includes both royalty income and so-called "embedded income" which means income arising from the sale of the product for which the patent forms only part of the overall value. The means of calculation of the embedded income will be determined by a formula-based approach. Companies can, however, opt to identify profits via a more bespoke calculation.

OWNERS AND LICENCEES

The regime is not limited only to patent owners. It will also apply to exclusive licences and assets created under partnership, joint venture and other similar cost sharing arrangements. This could be particularly helpful to UK subsidiaries of non-UK-based multinational groups.

There are some specific criteria that an exclusive licence must fulfill in order to qualify for patent box treatment, including that the licence must be genuinely exclusive (for example, in terms of the ability to sue infringers without the consent of the patent proprietor) and must extend at least over the whole of a national territory (so a licence doesn't need to be exclusive over the whole of the world, for example, but it does at least need to cover the whole of the UK and not just, say, the Greater London area). Concurrent exclusive licences – for different fields of application, for example – are expressly permitted.

In some circumstances, patents that have been acquired after issue may potentially fall within the beneficial tax regime. However, in those cases it will be important that the relevant company remains actively involved in the exploitation of the patent and that it, or another group company, was involved in expending significant development activity in relation to the patent.

THE NEED TO BE "ACTIVE"

The patent box regime is intended to encourage companies to be actively involved in the patent development process. Passive recipients of patent income will not qualify for the beneficial rate of tax. Where a single company both develops and exploits the patent, there ought to be no issues.

Problems may arise, however, in the relatively common situation in which patents and other technology are developed in one part of a corporate group structure but then assigned to a different company – often a specialist group IP holding company – for the purposes of exploitation.

Accordingly, an extra condition applies to members of a corporate group seeking to claim patent box protection. The aim of this extra condition is to ensure that a passive IP holding company does not qualify for the regime. Under this rule, a company must either have developed the intellectual property itself or be actively managing it.

If a company only satisfies the "development condition" because of the activity of an associated group company, it will also need to show that it plays an active role in managing the qualifying patent rights. For example, the holding company must be involved in planning and decision-making activities associated with developing and exploiting a qualifying patent portfolio. The activities that the patent box rules contemplate include deciding on whether to maintain protection in particular jurisdictions, grant licences, research alternative applications for the innovation or licensing others to do so.

There are two ways for a group holding company to meet the active ownership condition:

A. Firstly, a company may qualify if all (or almost all) of the qualifying IP rights that it holds are rights in relation to which it performs a "significant amount" of "management activity". Management activity" means formulating plans and making decisions in relation to the development or exploitation of the rights. Obviously, for practical purposes it will be important to document both the plans and the decision-making process as evidence of this "management activity".

B. Alternatively, a company may qualify if all (or almost all) of the qualifying IP rights that it holds are rights in relation to which the company meets a so-called "development condition".

ANTI-AVOIDANCE RULES

A lot of the technical detail behind the regime relates to implementation of anti-avoidance rules. The main targets for the anti-avoidance rules are situations in which companies artificially inflate their patent box tax deduction by:

- granting non-commercial exclusive licences in situations where the purpose is purely to ensure that income from the licence qualifies for the patent box;
- incorporating a qualifying item into another item to make income from the latter qualify;
- entering into certain other specified schemes.

COMPUTING PATENT BOX INCOME

Among the more difficult issues to deal with is the computational issues and the formulaic approach to determining embedded income. Essentially, there is a 3-stage approach to calculating patent box profits:

a. an entity's total taxable profits must be apportioned to determine the amount attributable to qualifying income;

b. the proportion of those profits that are "residual profits" needs to be identified – *i.e.*, profits that would not have been recognised without the existence of valuable IP; and

c. the residual profits are then attributed between patent and non-patent IP to determine the total patent box profits.

STEPS TO TAKE

All in all, the UK's patent box regime is welcome and is likely to encourage both development of patented technology in the UK and the re-location of IP holding companies to the UK as long as companies can fulfill the criteria needed to qualify for the reduced tax rate.

While the regime may seem narrow in scope because it only really covers patents and not the other primary forms of IPR, many aspects of the patent box are quite broad-based, such as the wide definition of "group" for the purposes of the regime; the eligibility of spare part income; and the notional royalties rules, which allow income from patents used in processes or services to qualify for the regime;

Some organisations may need to consider whether to incorporate into limited liability companies in order to benefit from the regime – although in practice most entities involved in R&D and innovation are likely to be incorporated already.

The existence of the patent box regime will, of course, increase the incentive to apply for patents. Many factors are relevant to this decision, including the trade-off between cost, time, disclosure and the value of the monopoly right conferred by a patent. Going forward, tax considerations will enter the equation as a factor in patent portfolio management decision-making.

Companies considering electing into the regime for accounting periods beginning on or after 1 April 2013 ought to start preparing themselves now to meet the patent box requirements. So, for example, companies ought to structure themselves so that their patent licences are exclusive within the terms defined by the patent box regime because only such exclusive licences will qualify. This may be easier said than done because the anti-avoidance rules are designed to stop commercially relevant exclusivity being conferred solely for the purposes of ensuring that income from the licence qualifies for the patent box regime.

Additionally, companies should review their transfer pricing policies so that any future transactions with other patent box companies qualify for the regime.

Companies involved in the active development of patented technology should clearly document their patent-related decision-making as evidence of their management activity because only active ownership will allow a patent holder to benefit from the regime. The criteria around active ownership and the development conditions will directly affect IP holding companies, which will need to be structured in the right way and sufficiently involved in the process of development of exploitation so that their income can qualify for the beneficial tax treatment.

Companies will want to consider moving high-profit patents into special-purpose companies in order to maximise patent box profits and limit the number of deductions under the patent box calculation.

In addition, companies that hold a range of intellectual property rights using a number of products should have a system in place to trace which of those rights are used in which products so that their calculations of patent box profits are accurate.

Despite the fact that the avowed intent of the patent box regime is to “encourage companies to locate the high-value jobs associated with the development, manufacture and exploitation of patents in the UK”, the regime’s real heart is ownership of qualifying technology. An IP holding company based in the UK can claim patent box treatment for its profits derived from the treatment of, say, EPO patents elsewhere across the EU as long as the company is genuinely and actively involved in decision-making associated with developing and exploiting its qualifying IP portfolio. The actual development may take place outside the UK.

Contact:

Alistair Maughan
+44 20 7920 4066
amaughan@mofo.com

Trevor James
+44 20 7920 4087
tjames@mofo.com

About Morrison & Foerster: