GETTING YOUR PATENTS SHIPSHAPE TO MAXIMISE PATENT BOX OPPORTUNITIES

Patent Box is scheduled to be with us on 1 April 2013. Patent Box offers a company with qualifying patents the opportunity to materially reduce its corporation tax bill by utilising a low 10% tax regime for income attributable to the commercialisation of patents owned or exclusively licensed to the company.

This brief review focuses on one aspect of the new regime which is relevant to businesses, which either have pending patent applications at the UKIPO or the EPO or are likely to file them in the future.

Relevant IP Income -v- IP Derived Income

Schedule 1 of the Finance Bill for 2012 contains the provisions relating to Patent Box. Those provisions draw an important distinction between:-

- Relevant IP Income
- IP Derived Income

Relevant IP income (see section 357CB of the Finance Bill) is basically the income generated from:-

(i) sales of a product which embody "items protected by" a qualifying patent;

(ii) licensing such a patent;

(iii) the sale of such a patent; and

(iv) infringement proceedings in respect of such a patent, (i.e. damages or an account of profits).

IP Derived Income (see section 357CC of the Finance Bill) is defined as being a company's income "arising from things done by the company that involve the exploitation by the company" of its relevant patents but which is not Relevant IP Income. This rather obscure language is intended to cover for example:-

- income obtained from the sale of a "non-patented" item, made by or using a patented machine or tool; and
- income from the sale of airline tickets by an airline, whose pilots are trained using a patented flight simulator.

These examples are taken from paragraph 3.39 of the Treasury's guide to the draft legislation, published on 6 December 2011. Some readers will no doubt be surprised at the reach of the Patent Box regime.

There is a very important distinction between how Relevant IP Income and IP Derived Income are treated for the purposes of calculating the Patent Box relief, (i.e. what income is subject to the 10% tax regime as opposed to the much higher applicable standard rates of corporation tax).

All Relevant IP Income goes into the Patent Box calculation algorithm whereas in relation to IP Derived Income only a notional royalty proportion of that income goes into the algorithm, (see section 357CC(3) of the Finance Bill).

In other words if the only basis on which your business can claim Patent Box relief is the use of a patented machine to make a non-patented product then you will get only a fraction of the relief that would have been available if the item was "protected" by a qualifying patent. The fraction is likely to be a small one (perhaps 1 – 10% in most cases) as the notional royalty will have to be calculated in accordance with Article 9 of the July 2010 OECD Model Tax Convention and the OECD's Transfer Pricing Guidelines. It will be the arms length royalty that would be paid between unconnected parties in an open market situation.

Implications Of This For Your Patents

For a qualifying UK company what this means is that if you file a patent with claims for production machinery then you should be careful to ensure that your patent attorney also includes claims of the "a [widget] made by or using a machine substantially as described herein" type: the failure to do that could lead to your business losing out on a substantial proportion of the Patent Box relief.

Uncertainty Remains

A question of considerable importance is what precisely is meant by the expression "items protected by a qualifying IP right", used in section 357CB (2)(a) of the Finance Bill. Clearly such items include products covered by a product claim of a patent but do they also cover a product, made by a process which is patented, which product is not itself separately the subject of a product claim of a patent.

It is an infringement of a patent for a process to dispose of, offer to dispose of, use or import any product obtained directly by means of that process or to keep any such product for disposal or otherwise, (section 60(1)(c) of the Patents Act 1977). The seemingly open question is whether or not the provisions of section 60(1)(c) are sufficient to enable income from the sale of a product, made by a patented process but which is not itself the subject of a product claim, "Relevant IP Income" as opposed to "IP Derived Income".

The guidance notes on the Finance Bill say (paragraphs 3.17 – 3.18) state that :-

> "A qualifying item is an item which is protected by a qualifying IP right. For a patent, this will be the patented invention. The June 2011 Consultation Document explained that as well as sales of the invention itself, the Patent Box is intended to extend to income from the sale of items that include the patented invention…."

Paragraph 3.10 of the guidance notes further states in relation to the notional royalties that are use in relation to IP Derived Income that they :-

> "enable[s] some part of otherwise non-qualifying types of income to be treated as qualifying income. An example is income from services and processes that are carried out using patented inventions"

Paragraph 3.38 also states that notional royalties were :-

> "proposed in the June 2011 consultation document, in particular to cover patents used in processes that create non-patented products…"

The answer to this important question is therefore currently unclear.

Dealing With The Uncertainty

Until this question is settled one way or the other prudent clients will get their patent attorneys, who are drafting claims for process patents, to also include in the application claims to products, made using the claimed process. This will maximise their chances of claiming the full Patent Box relief.

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