SQUIRE SANDERS

Patent Box:
Practical Steps for Chemicals Businesses

SQUIRE SANDERS

Patent Box: Ten Practical Steps Chemicals Businesses Can Take to Maximise the Benefits

In an ever more competitive world, many governments around the world are offering attractive tax breaks to encourage employment and investment in their countries.

In the UK for example, with effect from 1 April 2013, the government is introducing a low tax regime, known as Patent Box, applicable to a company's profits derived from the commercial exploitation of inventions protected by certain types of patents. The UK government thinks that when fully implemented the scheme will cost more than £2 billion annually but hopes that this cost will be more than offset by the additional tax revenues generated by extra employment and corporate activity.

In this article we briefly set out the basic details of the new UK scheme and then provide some guidance as to the practical specific steps which a business in the chemicals sector can take to maximise the tax savings it makes under the new scheme.

Outline of the Patent Box Scheme

How Does the Scheme Work?

Under the Patent Box scheme a company can, when calculating its profit for UK corporation tax purposes, claim an extra deduction against its income so as to reduce the amount of tax it pays on that profit. The scheme is going to be phased in from fiscal 2013 to fiscal 2017: in fiscal 2013 only 60% of the full relief will be available, increasing by 10% a year until 2017. The deduction will mean that for fiscal 2017 a company will only pay 10% corporation tax on relevant income instead of the currently scheduled 22%, a reduction in the tax payable of over 54%.

Companies will be able to make an election to opt into the Patent Box scheme in relation to any accounting period beginning after 1 April 2013[1].

What Kinds of Income Can Benefit From the New Regime?

The following kinds of income can qualify for the Patent Box regime:

- Income from the sale of products which incorporate a patented invention.
- Income from the sale of products designed to incorporate a patented invention and sold with it for a single price.
- Income from the sale of spare parts designed to be incorporated into a patented product or a product containing a patented invention.
- Royalty income from the licensing of patents.
- Income derived from the sale of patents.
- Damages or an account of profits obtained from enforcing a patent.

The income that Patent Box Relief (PBR) can be claimed for is not limited to income earned in the UK nor indeed to countries where there are qualifying patents: a company's worldwide income (including that earned in countries where there are no parallel patents) derived from the exploitation of its qualifying inventions can be put through the Patent Box regime.

Qualifying for the Relief

There are three basic qualifying tests which a company has to satisfy to qualify for PBR:

- The ownership of relevant intellectual property rights (IPR) test
- The qualifying development test
- The active ownership test

[1] Finance Act 2012, section 357GE, part 3, paragraph 7(1).

SQUIRE SANDERS

Each of these tests is briefly explained below.

Ownership of Relevant IPR Test

Provided that a company is either the owner or an exclusive licensee of at least one patent granted by the UK Intellectual Property Office, the European Patent Office or one of a number of approved national patent offices then PBR is available.

Certain other types of IP also qualify for PBR but they are not considered further in this note[2].

For an exclusive licence to confer upon the licensee PBR the licensee must be granted exclusivity for at least one whole country and must be given either (a) a right to bring infringement proceedings without the consent of the patent owner or (b) a right to receive most of the damages awarded in a patent infringement action[3]. An exclusive licence must meaningfully exclude both the licensor and third parties from a clearly defined market.

Qualifying Development Test

To pass this test the company has to either create or significantly contribute to the creation of the invention or perform a significant amount of activity to develop the invention or an item or process incorporating the invention[4].

Active Ownership Test

This will be satisfied automatically if the company satisfies the qualifying development test above[5]. If it does not then it must perform a significant amount of management activity in relation to the development or exploitation of the patented invention[6]. Management activity means formulating plans and making decisions in relation to the development or exploitation of the rights, which would include making decisions in relation to maintaining protection, granting licences, the commercialisation strategy and enforcement[7].

[2] These are supplementary protection certificates, pharmaceutical regulatory data pack rights, plant breeders' rights and European plant variety rights: see the Finance Act 2012, section 357BB(1).

[3] Finance Act 2012, section 357BA(2).

[4] Finance Act 2012, section 357BD(1).

[5] Finance Act 2012, section 357BE(1).

[6] Finance Act 2012, section 357BE(2).

[7] Finance Act 2012, section 357BE(3).

Performing the Patent Box Calculation

Companies can either use a standard formulaic calculation to determine the amount of profits that can be put through the Patent Box regime or alternatively opt to use the "true figures" derived through a process called streaming. Certain simplifying assumptions are available for smaller claimants.

To carry out the PBR calculation, using the formulaic approach, the following steps are required:

1. Determine the total gross income of the relevant trade, excluding any finance income (such as interest on loans etc.) but adding back any R&D tax credit relief given.
2. Work out the proportion of the total income, from step 1 which is relevant IP income (see under the heading "What Kinds of Income Can Benefit From the New Regime?" above).
3. Apportion the profits of the whole trade to the relevant IP income on a pro rata basis.
4. Deduct a figure equating to a routine return to arrive at what is called the qualifying residual profit: this is the profit which the business might have been expected to make if it had not had access to the patented invention(s). This is done in practice by aggregating certain routine deductions from income, such as capital allowances, costs of premises, plant, machinery and personnel as well as professional services, and certain other miscellaneous service costs[8]. The assumption is then made that a 10% return is made on those assets. That figure is then deducted from the figure obtained from step 3 above.
5. Make a further deduction to remove the return achieved from marketing assets such as trademarks. For larger companies this will be a notional marketing royalty which the company would pay to a third party for the exclusive right to use its trademarks and other relevant marketing assets.

[8] Finance Act 2012, section 357CJ(1).

SQUIRE SANDERS

Smaller companies can (but are not obliged to) simply deduct 25% of the profit figure left after step 4 above.

Whichever route is taken, the figure left after the marketing assets return is deducted, which is known as the relevant IP profits, is then used to calculate the available deduction thus:

The allowable Patent Box deduction =

$$\text{Relevant IP profits} \times \left(\frac{\text{main rate of corporation tax minus 10\%}}{\text{main rate of corporation tax}}\right)$$

In 2013 only 60% of the relief will be available so that the deduction will be 33.9% of the relevant IP income. By 2017 the deduction will rise to 54.5% of the relevant IP income, thus saving a company more than half the tax it would otherwise have paid.

For many commodity chemicals manufacturers the routine return deduction (item 4 above) will greatly reduce the benefits to be had from PBR.

Anti-avoidance

The PBR provisions of the Finance Act 2012 contain detailed anti-avoidance provisions, which will need to be borne in mind when considering how best to maximise the savings available from Patent Box.

Ten Ways a Company in the Chemicals Sector Can Maximise the Savings From Patent Box

1. Reviewing and Documenting

A chemicals company wishing to determine whether or not Patent Box offers scope for tax savings should, as a first step, review where it trades and makes profit and where it holds IP and consider, with experienced specialist tax counsel, the best place for it to locate its IP, bearing in mind controlled foreign company and transfer pricing rules as well as the effect of PBR and other equivalent schemes offered by other countries. Numerous factors will need to be taken into account such as the costs of transfer of the IP and the local management of it as well as the effect of foreign ownership on enforcement.

If it is decided that there is scope for using Patent Box then the chemicals company should review the current state of its patent protection to determine whether or not there are as yet unpatented inventions which it would make sense to patent, bearing in mind income streams and the effect of PBR. Consideration should also be given to accelerating existing applications to grant, which is possible in many jurisdictions. Ownership structures should also be reviewed to see if they maximise the benefits of PBR (see point 2 below).

If PBR is to be applied for then procedures should be put in place to document development, active ownership, licensing and royalty rate decisions.

2. Using IP Holding Companies

Although the Patent Box net is cast very wide – worldwide income from the sale of products which merely include a patented invention – its generosity will for many businesses be materially reduced or indeed wiped out by the effect of the routine profits deduction and the marketing assets deduction. As noted above, many manufacturers of commodity chemicals will not make 10% profit on the assets/costs on which the 10% routine profits deduction is calculated.

This is where IP holding companies may be helpful. Not only will they have very much lower capital allowances, premises, personnel, plant and machinery etc. costs than a trading company but they will also typically have no marketing assets so the notional marketing royalty will also be nil[9]. Putting relevant patents into a group holding company, which does enough to satisfy the active management test, may therefore lead to material savings. A much higher proportion of the licence fees earned by the licensor will attract PBR. Group companies to whom exclusive licences are granted by the IP holding company will also be able to claim PBR, in addition to the group IP holding company: this will often be attractive as their relevant IP income will be much higher than that of the IP holding company.

[9] See for example the calculation at paragraph 3.154 of the Patent Box Technical Note and Guide to the Finance Bill (the Guidance Notes).

SQUIRE SANDERS

Any licences granted should be on an arm's length open market commercial basis and the basis for the chosen royalty rate should be contemporaneously documented.

3. Patenting Component Parts

The income from the sale of a larger item which incorporates a patented invention will qualify for PBR, providing that the patented part is intended to be part of the larger item for the duration of its operating life[10]. For example the entire sale proceeds of a car which is painted with a paint containing a patented pigment will qualify for PBR. However a patented memory stick sold with a computer will not make the sale proceeds of the whole computer eligible for PBR because the memory stick can be used with any computer. Businesses should therefore ensure (a) that they have patents in place which cover at least a part of the products which they sell and (b) that such parts will form part of the larger item for the duration of the life of the patented part. Pigments in paint for cars will qualify on both grounds.

It is likely that for many businesses PBR will in effect lower the commercial threshold for patenting. Not all patents which are granted by patent offices are valid: many of them are subsequently held to be invalid when their validity is considered by courts in the context of infringement proceedings. Prior to Patent Box there was sometimes little benefit to be had in obtaining a very weak patent as it would be difficult to enforce against third parties in practice. However if all a company wants is to obtain PBR and it has no intention of ever enforcing the patent then it can consider obtaining patents for inventions which will get granted but will not in practice be strong enough to be sensibly enforceable against third parties.

Similarly it will often be possible for companies to obtain very narrow patent protection which covers only their products and not those of their competitors. Again obtaining such protection will make much more sense given the availability of PBR.

However some caution is required here. If the main purpose or one of the main purposes for the inclusion of a patented item into a larger item is to obtain PBR then the income from the sale of the larger item will not attract PBR[11]. Therefore there should be some objectively justifiable reason (lower cost and/or improved functionality) for the inclusion of a patented alternative to an existing non-patented item into a larger item and that reason should be documented contemporaneously.

4. How You Sell Matters

The income from the sale of products which are designed to incorporate a patented item and which are sold with it as a single unit for a single price attracts PBR[12]. This means that how goods are sold and packaged matters: if, for example, a company sells its standard unpatented testing equipment separate from a patented consumable then the income from the sale of the testing equipment cannot be put through the Patent Box regime. The two items (testing equipment and patented consumable) need to be sold together within the same packaging and for a single price. The patented consumable does *not* need to be actually installed into the testing equipment at the time of sale but it must be included in the same packaging[13].

5. Spares/Consumables

The income from the sale of spare parts/consumables specifically made for a product which is patented or includes a patented invention attracts PBR. Therefore a company should produce products or range specific spare parts/consumables that are not generic if it wants the income from the sale of the spare parts/consumables to attract PBR. If it cannot do that then it should consider obtaining patent protection for the spare parts/consumables themselves or at least features of them should it wish the income from the sale of them to be covered by PBR. For example a manufacturer of industrial printing machines should consider making the inks it sells printer model specific or should patent the formulation of the inks if that is not practical.

[10] The Guidance Notes, paragraph 3.31.

[11] Finance Act 2012, section 357FA(1).

[12] Finance Act 2012, section 357CC(5).

[13] Finance Act 2012, section 357CC(2)(b) and the Guidance Notes, paragraphs 3.29 – 3.32.

SQUIRE SANDERS

6. Consider Licensing and Not Just Selling

A chemicals company that merely sells a patented chemical product to its customer potentially misses out on an opportunity to extract more revenue from PBR. If the supplier grants its customer an exclusive licence to use a patented invention in a specified field of use then the customer may in turn be able to claim PBR. An example illustrates the point: a supplier supplies his bicycle frames, made with its new patented titanium alloy, to a bicycle manufacturer. The manufacturer builds bicycles with the frames and sells them. No other part of its bicycles is covered by any patent owned by or exclusively licensed to it and the manufacturer therefore can claim no PBR on the income it makes from the sale of the bicycles.

Now assume that the frame supplier grants the bicycle manufacturer an exclusive licence in the UK, under its patent, to sell mountain bikes with frames made from the patented alloy, which it supplies. Assuming the bike manufacturer otherwise qualifies for PBR then it can now claim PBR for its entire income from the sale of the bikes made using the patented frames.

The point is that there may be commercial opportunities for the licensor to share the licensee's upside derived from PBR. Care will be needed here as again an exclusive licence, which is granted only or mainly to secure PBR, will not confer PBR on the licensee[14]. However an exclusive licence does grant the licensee something of value, which it does not acquire on a mere purchase of the patented item: the licensor has locked itself and others out of the market. It will be important for the licensee to show that this is a benefit or real rather than hypothetical value: for example that the patent does indeed defend higher pricing and/or market share in practice.

7. Bundling IP Into Licences

The royalty income that can be put through Patent Box includes not just royalties on qualifying patents but also income from other IP rights, subsisting in relation to the item which is covered (or a part of which is covered) by the relevant licensed patent[15].

The effect of this provision is that trademarks, design rights, copyrights and other IP rights should in many cases be licensed in the same agreement as any patents so that the income from the licence of them attracts PBR. For example a manufacturer of improved dyes for use with particular yarn dyeing equipment may wish to license not just the patents subsisting in relation to the dyes but also the copyright in software written to operate the dyeing equipment with those dyes as well as brands used in relation to the dyes themselves – if their use adds benefit in downstream sales of the dyed yarn.

For many businesses which operate principally in the licensing of e.g. trademarks (such as franchisors), there will often be a significant incentive to bundle at least one patent into their trademark licences.

A licence does not have to be exclusive for the licensor to take the benefit of Patent Box in relation to the licence income it receives.

The inclusion of trademarks into a licence presupposes that the licensor has trademarks to license and if it does then that will likely bring in the marketing asset deduction from relevant IP profits referred to above.

8. Internal Processes

PBR can also be claimed in relation to the use of a patented process which a company carries out internally[16]. The company can in effect charge itself a notional arm's length royalty for the use of the process patent, for which PBR can be claimed.

Much chemical process know-how is commercially sensitive and companies need to weigh up carefully the advantage of having PBR against the disadvantage of sharing (via published patents) their know-how with their competitors, whose subsequent use of it may be difficult to discover and prove.

Such a notional royalty can also be charged in relation to the use of patented production machinery.

[14] Finance Act 2012, section 357F.

[15] Finance Act 2012, section 357CC(6)(b).

[16] Finance Act 2012, section 357CD.

SQUIRE SANDERS

9. Getting the Right Patent Protection

The notional royalty which a company can charge itself for the use of a patented process or a patented machine means that only a very small proportion of its total income will be eligible for PBR. For example, if the notional royalty is 5% of turnover in the item made using the patented process then only 5% of the income will be eligible for PBR.

To be able to put 100% of the turnover made on the sale of a product through PBR the product made using the process needs itself to be an item in respect of which a patent has been granted[17]. There is some uncertainty as to whether or not a product which is not the subject of a product claim itself, but is either made by the use of a patented process or by the use of a patented machine, is itself an item in respect of which a patent has been granted within the meaning of the Finance Act 2012. In any event a prudent business to be certain of getting the maximum PBR will instruct its patent attorneys to include in its patent applications not merely claims to processes and production equipment but also to products made using such processes and equipment. This should ensure that the full PBR can be claimed and not merely a notional royalty on it.

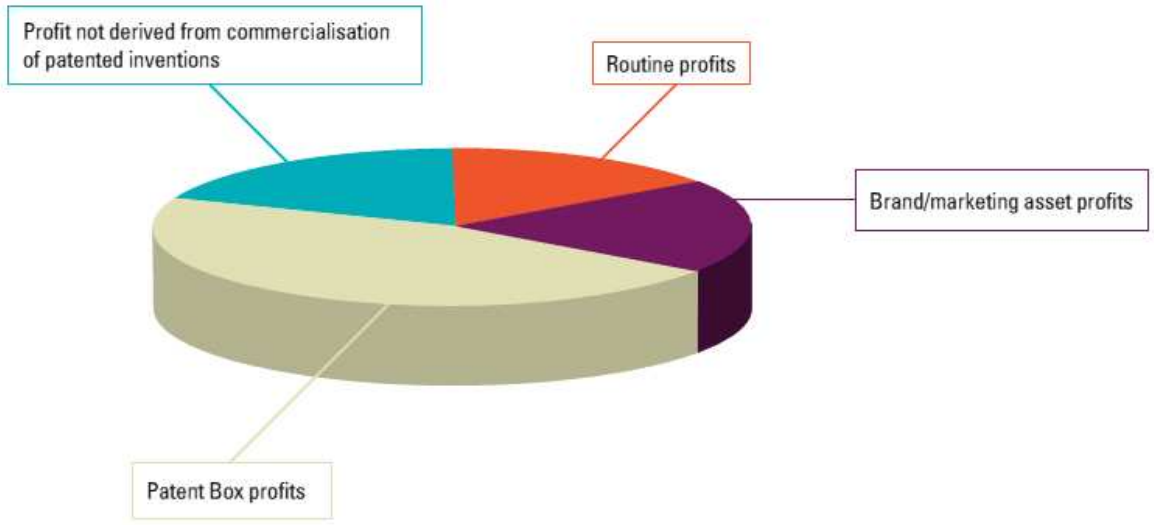
10. Infringement Provisions in Licence Agreements

For an exclusive licensee to take the benefit of PBR the licence must grant it either the right to commence infringement proceedings against third parties without the consent of the patent owner or the right to most of the damages obtained from such an infringement action[18].

Many licensors are reluctant to let their licensees enforce their patents on their behalf and many patent licences will fall foul of this provision as they will generally preclude the licensee enforcing the licensed patents. Exclusive licensees who wish to qualify for PBR on the basis of their existing licence agreements should therefore check the infringement provisions of the licence carefully and seek to renegotiate the terms of it if appropriate.

Contact

For further information in relation to Patent Box please contact Andrew Clay at andrew.clay@squiresanders.com or on +44 (0)121 222 3358.



[17] Finance Act 2012, section 357CC(2)(a).

[18] Finance Act 2012, section 357BA(1)(b) & (2).