PATENT BOX
HOW TO MAXIMISE THE BENEFITS

On 1 April 2013 the government introduced a low tax regime applicable to a company's profits, derived from the commercial exploitation of inventions protected by certain types of patents.

Notwithstanding that the regime has now been in place for more than a year, as a law firm we are still getting a lot of enquiries about it and in particular about how to maximize the benefits available under it. We have accordingly put together this guide to help explain the key aspects of the patent box scheme and how companies can look to take best advantage of it.

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 being phased in from fiscal 2013 to fiscal 2017: in fiscal 2013 only 60 percent of the full relief was available, but that percentage increases by 10 percent a year until 2017. The deduction will mean that for fiscal 2017 a company will only pay 10 percent corporation tax on relevant income instead of the currently scheduled 22 percent, a reduction in the tax payable of over 54 percent on its relevant IP profits (see further below).

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]. Companies can backdate claims for up to six years before the grant of a patent – to cover the period during which the patent application was pending but not granted – but not in relation to any part of an accounting period before 1 April 2013[2].

What Kinds of Income Can Benefit From the New Regime?

The following kinds of income can potentially qualify for tax savings under 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.

1 Finance Act 2012, schedule 2, part 3, paragraph 7(1).

2 section 357CQ & 357G, Corporation Tax Act 2010 ("CTA 2010").

The income that Patent Box Relief (PBR) can be claimed for is not limited to income earned in the UK nor to income earned in 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 IPR test
- The qualifying development test
- The active ownership test

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 by 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[3].

For an exclusive licence to confer PBR upon the licensee, the licensee must be granted exclusivity for at least one whole country and must either (a) be given either 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[4]. 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 the subject of the patent or to perform a significant amount of activity to develop the invention or an item or process incorporating the invention[5].

Active Ownership Test

This will be satisfied automatically if the company satisfies the qualifying development test above[6]. 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[7]. 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 in relation to enforcement[8].

3 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).

4 Corporation Tax Act 2010 ("CTA 2010"), section 357BA(2).

5 CTA 2010, section 357BD(1).

6 CTA 2010, section 357BE(1).

7 CTA 2010, section 357BE(2).

8 CTA 2010, 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 they can 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 for the relevant accounting period and any finance expenses.
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 Be Put Through The New Regime" above) – i.e. income derived from patents.
3. Apportion the total gross income as between the relevant IP income and non-qualifying income on a pro rata basis.
4. Deduct a figure equating to a routine return on expenses 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 and machinery and personnel as well as professional services and certain other miscellaneous service costs[9]. The assumption is then made that a ten percent return is made on those expenses. That figure is then deducted from the figure obtained from step 3 above.
5. A further deduction is then made 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 have had to pay to a third party for the exclusive right to use its trademarks and other relevant marketing assets. Smaller companies can (but are not obliged to) simply deduct 25 percent of the profit figure left after step 4 above.

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

The allowable Patent Box deduction =

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

For accounting periods ending after 1 April 2013 only 60 percent of the relief was available so that the deduction was 33.9 percent of the relevant IP income. By 2017 the deduction will rise to 54.5 percent of the relevant IP income, thus saving a company more than half the tax it would otherwise have paid on its relevant IP profits.

For companies with only modest profits the routine return deduction (item 4 above) will greatly reduce the benefits to be had from PBR. Where patented inventions command a material premium in the market – for example for new pharmaceuticals – the tax savings could be very material.

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.

9 CTA 2010, section 357CJ(1).

Eleven Ways of Maximising the Savings From Patent Box

Reviewing and Documenting

1. A company wishing to determine whether or not Patent Box offers scope for tax savings should, as a first step, review where it trades, makes profit and holds its 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, the effect of foreign tax laws on trade conducted overseas and the impact of double tax treaties, as well as the effect of PBR and other equivalent schemes offered by other countries. The cost of the transfer of IP (both tax costs and administrative costs) and the local management of it will need to be borne in mind as will the effect of foreign ownership on enforcement.

   If it is decided that there is scope for using Patent Box then the 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 the size of relevant 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 to evidence that they were made for bona fide commercial reasons and not for the purposes of tax avoidance.

Using IP Holding Companies

2. 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 be materially reduced or wiped out, for many businesses, by the effect of the routine return on investment deduction and the marketing assets deduction. Many manufacturing businesses won't make 10 percent profit on the assets/costs on which the 10 percent routine profits deduction is calculated.

   This is where IP holding companies, which license patents to group companies, may be helpful. Not only will such IP holding companies have very much lower capital allowances, premises, personnel, plant and machinery costs than trading companies but they will also typically have no marketing assets so the notional marketing royalty will also be nil[10]. Putting relevant patents into a group IP 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 IP holding company, will attract PBR. Group companies to whom exclusive licences are granted by a group IP holding company will also be able to claim PBR in their own right, 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.

   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.

10 See for example the calculation at paragraph 3.154 of the Patent Box Technical Note and Guide To the Finance Bill ("the Guidance Notes").

Patenting Component Parts

3. 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[11]. For example, the entire sale proceeds of a car which contains a patented gearbox 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 could 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. A gearbox for a car would 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 has no intention of ever enforcing the patent then it can consider obtaining patents for inventions which will be granted but won't, 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 particular 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[12]. 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.

How You Sell Matters

4. The income from the sale of products designed to incorporate a patented item, and which are sold with it as a single unit for a single price, attracts PBR[13]. This means that how goods are sold and packaged may matter: if, for example, a printer cartridge is the only part of a printer which is patented then if it is sold separately from the printer then the income from the sale of the printer cannot be put through the Patent Box regime. The two items need to be sold together within the same packaging and for a single price. The patented printer cartridge does not need to be actually installed into the printer at the time of sale but it must be included in the same packaging[14].

Spares

5. The income from the sale of spare parts, which are specifically made for a product, which is itself patented or includes a patented invention attracts PBR. Therefore a company should produce product-specific spare parts – which are not generic – if it wants the income from the sale of the spares to attract PBR. If it cannot do that then it should consider obtaining patent protection for the spare parts themselves or at least features of them, should it wish the income from the sale of them to be covered by PBR.

Consider Licensing, Not Just Selling

6. A company that merely sells a patented product to its customers potentially misses an opportunity to extract more revenue from PBR. If the supplier grants one of his customers 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 new patented titanium alloy tubing to a bicycle manufacturer. The bicycle manufacturer builds and sells bicycle frames with the new tubing and whole bicycles made with those frames. No other parts of his bicycles are covered by any patent owned by or exclusively licensed to him and the bicycle manufacturer therefore cannot claim PBR on the income he makes from the sale of the frames or the bicycles.

   Now assume that the tubing supplier grants the bicycle manufacturer an exclusive licence in the UK, under his patent, to make and sell bicycles with frames made from the patented alloy tubing, which he supplies. Assuming that the bicycle manufacturer otherwise qualifies for PBR then he can now claim PBR for his entire income from the sale of the bikes made using the patented frames. In such a situation it will be important to include within the licence a right for the licensee to sue others who use the new tubing in bicycle frames, as without such a right the licence won't qualify for patent box relief as HMRC take the view that the effect of the licence must be to give the licensee some real and substantial additional rights which he did not have already on the mere acquisition of the patented item. The licensee will already have had the right to make and sell frames and bicycles made with the patentee's tubing on purchasing it and merely making that right exclusive in, for example, the UK won't be sufficient to attract PBR[15] 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 just or mainly to secure PBR, will not confer PBR on the licensee[15]. As noted above, an exclusive licence which does grant the licensee something of value, which he does not acquire on a mere purchase of the patented item, should qualify for PBR.

11 The Guidance notes paragraph 3.31.

12 CTA 2010, section 357FA(1).

13 CTA 2010, section 357CC(5).

14 CTA 2010, section 357CC(2)(b) and the Guidance Notes, paragraphs 3.29 – 3.32.

15 See HMRC patent box manual at CIRD210120.

16 CTA 2010, section 357F.

Bundling IP into Licences

7. The royalty income, which can be put through Patent Box, includes not just royalties on qualifying patents but also income which the licensor receives "under an agreement" from licensing other IP rights, subsisting in relation to the item which is covered (or a part of which is covered) by the relevant licensed patent[17].

   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, where the purpose of the grant of all the multiple rights is to enable the licensee to make and sell the item covered by the patent, as that will ensure that the income from the licence of all such rights (and not just the patents) attracts PBR[18]. For many businesses, which operate principally in the licensing of e.g. trade marks (such as franchisors), there will often therefore be a significant incentive to bundle at least one patent into their trade mark licences, providing there is some objectively justifiable reason for doing so.

   A licence does not have to be exclusive for the licensor to be able to claim PBR in relation to the licence income it receives under it.

   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 (referred to above) from relevant IP income.

Internal Processes

8. PBR can also be claimed in relation to the use of a patented process which a company carries out internally[19]. 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 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.

Getting the Correct Patent Protection

9. 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 percent of the turnover in the item made using the patented process then only 5 percent of the income will be eligible for PBR.

   To be able to put 100 percent of the turnover, made on the sale of a product, through the PBR calculation the product made using the process needs itself to be an item in respect of which a patent has been granted[20]. This means that the product or at least a component part of it must itself be the subject of a patent claim for PBR to be claimed.

   An item 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 not itself an item in respect of which a patent has been granted within the meaning of the Finance Act 2012. It is generally not possible to get a product patent for a new way of making a known thing: only a process patent will be capable of being obtained, which will only attract the notional royalty under the Patent Box rules.

   A prudent business will therefore, wherever possible, instruct its patent attorneys to try to obtain patent claims in respect of products as well as processes. This should ensure that the full PBR can be claimed and not merely a notional royalty on it.

Infringement Provisions In Licence Agreements

10. For an exclusive licensee to take the benefit of PBR the licence must grant him 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[21].

    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 their licence carefully and seek to renegotiate the terms of it if appropriate.

    HMRC's guidance on this requirement[22] does helpfully state that a licence will still entitle the licensee to PBR even if the licensor "has priority in deciding whether to take action" provided that if it does not do so that the licensee is then permitted to do so. Presumably if the licensor does take action when exercising his priority right, then the licensee would still have to have a right to retain more than 50% of any damages/accounts of profits obtained from the infringer, for it to be able to claim PBR.

Timing of the Patent Box Election

11. For the accounting period in which a patent is granted a retrospective claim can be made for up to six years accounting periods during which the patent was pending[23]. No part of any accounting periods ending prior to 1 April 2013 can be taken into account however. So for example if a patent is applied for on 9 May 2013 but not granted until 27 September 2017, when electing into the patent box regime for the accounting period containing 27 September 2017 a further deduction can be obtained for all the relevant profits made in the interim patent pending period. It may be worth delaying the grant of a patent until later as the cumulative deduction for all the intervening years will then be available at a higher percentage of the available relief, as the PBR is gradually phased in.

    The PBR election must be made within a fixed period – within 24 months from the accounting reference date on which the relevant accounting period ends[24]: i.e. typically within a year of filing the tax return.

17 CTA 2010, section 357CC(6)(b).

18 See HMRC patent box manual at CIRD220200 & CIRD220210]

19 CTA 2010, section 357CD.

20 CTA 2010, section 357CC(2)(a).

21 CTA 2010, section 357BA(1)(b) &(2).

22 See HMRC patent box manual at CIRD210120.

23 CTA 2010, section 357CQ(2).

24 CTA 2010, section 357G(3).

The election must specify the first accounting period of the company for which the election is to have effect[25]: in practice this should include all the patent pending period after 1 April 2013.

Failing to opt into PBR in time could lead to a loss of back relief in respect of previous years, which could be disastrous if the profits made in the lost back years were significant. Given the number of professionals who might be involved in making patent box elections it may be easy for such elections to fall between the cracks. The smart thing to do is to elect in as soon as the patent application is filed and then the time limit issue is completely avoided. A company does not have to own granted patents either at the time it makes the election or for the accounting period for which the election first has effect[25]. While clearly if the patent(s) have not yet been granted a company can't make a Patent Box deduction for that period in its tax return, being able to elect in before the patent(s) are granted shoud enable the company to preserve its position to subsequently back claim patent box relief[26] for the patent pending period (potentially to the later of April 2013 or up to six years prior to the grant of a relevant patent) in its tax return for the accounting period during which the patent is finally granted. – but no relief or back relief can in fact be claimed until the tax return is filed in respect of the accounting period in which the patent is granted.

Contact

For further information in relation to Patent Box please contact:

Andrew Clay
Consultant
T 0113 284 7655
E andrew.clay@squirepb.com

Patrick Ford
Partner
T +44 161 830 5014
E patrick.ford@squirepb.com

Timothy Jarvis
Partner
T +44 113 284 7214
E timothy.jarvis@squirepb.com

25 http://www.hmrc.gov.uk/manuals/cirdmanual/cird260100.htm

26 Under section 357 CQ of the CTA 2010.