

MAKING PATENTS PAY

Getting to grips with the fingerprint of the pending UK patent box rules could reduce corporation tax bills, says **James Ross**

June saw the release of the government's detailed proposals for a patent box regime, which promises a 10% rate of corporation tax for profits derived from patents. Originally proposed by the Labour government in 2009, the patent box has been adopted by the coalition as part of its strategy to encourage innovative high-tech companies to locate in the UK and to create high-value jobs. Similar (though mostly more generous) regimes have been introduced in Spain and the Benelux countries in recent years.

OUTLINE OF THE RELIEF

The new relief will be elective, and will apply for corporation tax purposes only, meaning that individuals who derive income from patents will need to transfer their patent to a company to benefit from the relief. The relief will give companies an additional corporation tax deduction from net patent revenues so that they are effectively taxed at a rate of 10%.

In order to qualify for relief, the products or processes in question must be the subject of a patent granted by either the UK Intellectual Property Office or the European Patent Office. Once such a patent is secured, the relief will

apply to the worldwide profits arising from the sale of any products falling within the scope of the patent. The relief may be claimed not just by those companies which own patents but also by those holding exclusive licences.

The relief will extend to patent royalties, profits from the sale of patents and also to damages secured in respect of the infringement of a patent that represents compensation for lost income. No relief will be available before a patent is granted, but a successful applicant will then be allowed to claim relief retrospectively for pre-grant profits generated over the previous four years (though not for any profits that pre-date the relevant patent application).

Relief will cease where a patent is invalidated, but there will be no clawback of any relief already granted. The new relief thus offers a clear incentive to companies to apply for patent protection at the earliest opportunity.

CALCULATION OF PROFITS

The most complex part of the proposals involves the calculation of the profits attributable to the relevant patent(s). The consultation document proposes a formulaic method based on the 'residual profit split' approach: a recognised

CASE STUDY

HOW TO APPLY THE NEW PATENT BOX REGIME



A company has taxable trading income of £1,000. Of that amount, £700 (70%) is attributable to the sale of patented products. Deductible expenses are £795, comprising:

■ Raw materials	£200
■ Outsourced manufacturing	£150
■ Research and development	£100
■ R&D enhanced relief	£20
■ Marketing	£75
■ Other costs	£250

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PRO-RATA PROFIT ATTRIBUTABLE TO PATENTED PRODUCTS

Qualifying income: £700
 Qualifying expenditure:
 70% of £775 (excluding
 R&D enhancement) = £543
 Pro rata profit: £700 - £543 = **£157**

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EXCLUDE ROUTINE PROFIT

Total pro rata trading expenses: £543
 Deduct costs not marked up:
 raw materials (70% of £200): (£140)
 outsourcing (70% of £150): (£105)
 Total costs for mark-up: £298
 Routine profit (£298 @ 15%) £45
 Residual profit: £157 - £45 **£112**

transfer pricing method which is designed to capture the additional profit attributable to patents and other forms of IP over and above the profits made by companies without valuable IP.

The first step is to identify the profits that are attributable to the sale of patented products. This calculation will be based on the company's taxable profits, excluding any enhanced research and development deduction, and interest and financing costs, and involves a simple apportionment based on the proportion of trading income that derives from the patented product. However companies will, in certain circumstances, be able to opt for the 'divisionalisation' approach described below.

Once this profit has been identified, a notional 'routine' profit is deducted. This is calculated as a 15% mark-up on costs (excluding outsourcing costs and goods purchased for resale). A further deduction is then made in respect of profits attributable to other intellectual property (particularly brands). The attribution of the elements of profits between patents and brands will be calculated by reference to the company's relative spend on research and development, and marketing, respectively. This could prove problematic for companies whose spend in these areas is inherently 'lumpy', although the government is considering providing special rules in such cases.

The remaining profit after the deduction of routine profit and profit attributable to non-patent IP will be regarded as attributable to the patent(s), and will benefit from the relief.

No relief is available in respect of service income, or for profits attributable to patented processes, as the government has taken the view that to include such profits is outside the remit as they are not directly linked to the patent or innovation. Companies with profits of this nature may only be able to adopt a 'divisionalisation'



The relief will only apply where the claimant company remains actively involved in the decision-making connected with the exploitation of the patent

approach, whereby the company is divided into two or more divisions, and the division holding the patent or providing use of the patented process is deemed to charge a notional arm's length royalty to the other division.

The relief is planned to come into force on 1 April 2013 and will apply to all patents whenever applied for. However, the relief will be phased in over five years, with only 60% of the ultimate benefits being available in the first year rising to 100% in 2017/8.

OTHER CONDITIONS

The consultation document contains several measures which are designed to ensure that the relief does not benefit passive recipients of patent royalties. The relief will only apply where the claimant company remains actively involved in the decision-making connected with the exploitation of the patent and where it or another group member has performed significant development activity in respect of the patent. Neither of these concepts has yet been defined in any detail.

CONCLUSION

Consultation on these proposals closed in early September, and the final form of the relief should become clear later in the autumn, when the government is expected to bring forward draft legislation for inclusion in the Finance Bill for 2012. However, both companies and individuals need to start thinking now about whether, where and how they should be seeking patent protection so that they are in a position to take advantage of the relief once it becomes available.



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IDENTIFY PATENT AND NON-PATENT INCOME

Total R&D and marketing spend:	(£100 + £75)	£175
R&D as share of total:		57%
Share of residual profits eligible for patent box:		
57% of £112:		£64

COMPARISON WITH CURRENT POSITION

Current position:	PCTCT of £205: CT of £53.30 (@26%)
Position in 2014-5 if taxpayer does not elect into patent box:	PCTCT of £205: CT of £47.15 (@23%)
Position in 2014/5 if taxpayer does elect into patent box:	Patent box profit of £64: CT at effective rate of 10%: £6.40 Non-patent box profit of £141: CT @ 23% = £32.40 Total corporation tax liability: £38.80

Savings from electing into patent box: £8.35