



## Patenting will significantly reduce tax burden for many UK companies

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These substantial tax savings will be available on worldwide revenues, even if the patents are only held in the UK or certain states of the European Economic Area (see below) and even if the patents are not actively licensed or enforced. The Patent Box therefore significantly changes the cost-benefit calculation that is used to decide whether to patent inventions.

If relevant patents are licensed or sold, or if a court awards compensation for infringement, the resulting profits will also be taxed at a low rate. Patent licensing revenue and court awarded compensation for patent infringement has always been high value revenue, because it goes straight to company profits and is paid by competitors. The new tax regime makes this even more valuable, by allowing these profits to be taxed at only 10%.

### The Patent Box

The Patent Box is an opt-in scheme enabling UK companies to apply a reduced Corporation Tax rate of 10% on a substantial part of the profits arising from selling

patented products, using patented processes and exploiting patents, where the patents are granted by the UK Intellectual Property Office, The European Patent Office or the national patent offices of certain EEA states (see ‘Qualifying for the regime’ below).

The reduced tax rate applies to profits derived from:

- worldwide sales of products and services incorporating the patented invention, including bespoke spare parts (although some of these profits will be excluded);
- use of the patented invention in the company’s trade (the relevant profits for manufacturing process inventions are to be calculated on a notional royalty basis);
- licensing or selling patents, and other qualifying IP rights;
- court-awarded compensation payments for infringement, such as damages or an account of profits that would have been earned, and insurance proceeds.

See ‘More Detail on Qualifying Income’ below. As well as patents, the Patent Box will apply to supplementary protection certificates, plant variety rights, plant breeder’s

rights and some other rights applicable to medicinal and veterinary products.

## Why is the Patent Box being introduced?

The aim of the Patent Box is to create a competitive tax environment, to encourage companies to carry out their research and development and high-tech manufacturing in the UK instead of other European countries. This is expected to increase the UK's competitiveness in sectors such as pharmaceuticals and life sciences, but also in electronics, defence and other high-tech manufacturing.

The UK government has stated that it plans to give the UK "the most competitive corporate tax regime in the G20", partly via the Patent Box's targeted tax savings on the profits earned from patents and their exploitation. The UK government believes the Patent Box will encourage profitable and innovative businesses to base their research, development and high-tech manufacturing in the UK, increasing the number of high-value jobs in the UK associated with this research, development, manufacture and exploitation of patents. Because of this boost, the UK government believes the reduced corporation tax rate of the Patent Box will actually lead to higher tax revenues within 3-5 years than if the scheme was not implemented.

## More Detail on Qualifying Income

There are various types of qualifying IP income from which profits are eligible for the Patent Box savings, including:

- income from worldwide sales of a patented item, or a product incorporating the item, including sales in territories where the item is not protected by a patent or whose patents would not themselves qualify for the Patent Box;

Note that a patented component that is included in several different products will allow profits from those several products to be included in the Patent Box, as long as the component contributes to the working of the product (i.e. not if the patented component is redundant from a technical point of view). Also, profits from bespoke spare parts for patented products can be included.

- worldwide licence fees and royalties from:

- exclusive rights that the company grants others out of its qualifying patents or over the patented item or process, including licences in territories outside the protection of the qualifying patents over the item or process; and
- other non-patent rights granted for the same purpose as the patent rights.

Note that not all exclusive licenses will allow the licensee to benefit from the Patent Box. The license must include rights to develop, exploit and defend rights in the patented invention, including the right to take action for infringement or entitlement to most of the damages awarded in successful court proceedings relating to its rights; and the exclusivity must extend throughout at least one entire national territory.

- income from the sale or disposal of UK and European patents, and other qualifying national patent rights;
- payments received from others accused of infringing the qualifying patent; and
- other compensation, including damages, insurance proceeds and compensation for lost income that would have been relevant IP income.

## Qualifying for the regime

A UK tax-paying company can choose whether to make use of the Patent Box, if it meets certain conditions:

- There must be "qualifying development", which means the UK company itself or another company in the same group significantly contributed to the creation of the patented invention, or performed a significant amount of development of a product or process incorporating the patented invention (e.g. when developing "licensed-in" patented technology); and
- The UK company must either own the qualifying IP right, or must hold an exclusive license to the qualifying IP right in at least one national territory; and
- If the "qualifying development" was carried out by another company in the group, there must be "active

ownership” by the UK company, which means that the company carries out significant management activity for the IP right (for example, the company may be involved in formulating plans and making decisions about the patent portfolio, product development or exploitation – and not merely a passive holding company) or shares the costs.

A company can decide whether to elect to use the Patent Box for a particular annual accounting period, and profits cannot qualify for the Patent Box unless the company has elected into the Patent Box for that accounting period. The company can revoke a Patent Box election for a subsequent year, but will then be unable to re-elect to join the Patent Box for 5 years. The qualifying rights are:

- Patents granted by the UK Intellectual Property Office (UKIPO) or European Patent Office (EPO);
- Patents granted in certain other states of the European Economic Area that have similar examination and patentability criteria to the UK (i.e. Austria, Bulgaria, Czech Republic, Denmark, Estonia, Finland, Germany, Hungary, Poland, Portugal, Romania, Slovakia and Sweden); and
- A number of other specific rights including supplementary protection certificates granted by the UKIPO or EPO; UK and European plant variety rights and plant breeder’s rights; and marketing authorisations and data protection rights applicable to medicinal and veterinary products.

Note that the Patent Box will apply to patents granted before April 2013, as well as those granted afterwards, but only to profits earned from 1 April 2013. It will be possible to gain the benefit for profits earned from 1 April 2013 even if the patent grants up to 6 years later (the relevant profits can be aggregated and then applied in the year the patent is granted), as long as the company was elected into the Patent Box for the relevant years preceding the grant of the patent.

## Patent applications awaiting approval

If the relevant patent applications are all still pending, the Patent Box benefits are not immediately available. However, the Patent Box can be applied retrospectively to

profits earned in the six years before grant. When calculating the Patent Box savings in the year in which a patent is granted, companies can calculate what the relevant IP profits would have been if the patent had already been granted in each financial year starting from 1 April 2013. These amounts are then aggregated over the period up to grant of the patent (for up to six years from 1 April 2013), and added to the relevant IP profits of the year in which the patent is granted. This cannot be backdated before April 2013 and will not include any years for which the company was not elected into the Patent Box.

## Calculating the relevant IP profits

Calculating the tax relief using the Patent Box normally involves:

- Firstly calculating the qualifying profit, by taking qualifying income and deducting expenses on a pro-rata basis;
- Deducting a 10% “routine return” that is the profit that would be expected if the business had no access to patented technology or intellectual property;
- Removing the profit associated with intangible assets, such as the company’s brand and other marketing assets (this ‘Marketing Assets Return’ can be calculated as a notional royalty for use of the assets that is not related to the patents).

This leads to a calculated figure for the Relevant IP Profits (RP). The allowable Patent Box deduction will then be:

$$RP \times (MR - 10\%) / (MR) \times FY\%$$

Where MR is the main rate of Corporation Tax (currently 23%, but expected to fall to 21% from April 2014) and FY% is an applicable % for each financial year starting with 60% from 1 April 2013 and reaching 100% from 1 April 2017 (see ‘Phasing-in Period’ below).

By 2017, UK companies could be saving more than 50% of the tax they would otherwise have paid on RP. These calculations should be discussed in detail with a specialist tax consultant to determine each company’s potential savings.

## Phasing-in Period

The full benefit of the regime will be phased in over the first four financial years following commencement on 1 April 2013. This will be done by applying an appropriate percentage by financial year to the relevant IP profits of the company for each accounting period. In the financial year starting 1 April 2013, the tax saving will apply to 60% of relevant IP profits in the Patent Box; and this will increase by 10% per year to 100% in the year starting 1 April 2017. Therefore, the effective tax rate for relevant IP profits will be 15.2% from 1 April 2013, with annual reductions until it reaches 10% in 2017. This compares with a rate of 23% on other profits from April 2013, and 21% from April 2014.

## Conclusions and recommendations

A number of recommended actions for UK companies are mentioned briefly above. These are explained below:

### **Check all high revenue products have adequate long-term patent protection, and consider whether additional inventions should be patented.**

- For UK-based businesses, the Patent Box lowers the commercial threshold for deciding to file a patent application, and for deciding to proceed when only narrow claims can be obtained, because even patents that have relatively low licensing potential may lead to significant tax savings. Some UK companies are already telling us that they plan to increase their research and development budgets and to increase their patent filings to benefit from the Patent Box.
- The Patent Box justifies a review of current research and development projects to identify inventions that will be incorporated in products, or included in processes used by the company. This can include patentable features with relatively low licensing value, in view of the tax savings of the Patent Box.
- Patents for component parts will allow the revenues from larger products to qualify for the Patent Box, provided the component is intended to be part of the larger product for its operating life.

### **Consider applying to accelerate patent office examination**

- A.A. Thornton & Co is already working with the UK Intellectual Property Office (UKIPO) to obtain patents quickly. We can apply to accelerate the UKIPO examination if we have an adequate justification for acceleration. A desire to apply the Patent Box is not itself accepted as a justification (unless delayed grant would have a significant impact on the company's ability to continue investing in research programmes).

### **If the UK Company is part of a group of companies, it is advisable to document the development and active patent management roles of the UK Company, to ensure qualification for the Patent Box can be demonstrated.**

- The qualification criteria are set out above. Documenting product development, and documenting patent portfolio and licensing decisions, will help to demonstrate that you meet the qualification criteria. This may also justify a review of existing company structures and IP ownership within a group of companies. Regardless of which member of the group owns all IP rights, the Patent Box savings can be obtained if the UK Company has "active ownership" in the sense of being fully involved in patent portfolio decisions.

### **Carefully consider which member(s) of a group of companies should be elected into the Patent Box, to avoid a group member that makes a large negative Relevant IP Profits (RP) cancelling smaller positive RP from other group members.**

- This should be discussed with a specialist tax consultant. If a company's profit from IP is less than a routine return on the costs of earning the income, this would result in a negative figure for their RP. The result is that the company's tax for that accounting period is calculated as normal, i.e. as though it had not entered the Patent Box for that accounting period. However, the loss (referred to as a 'set-off amount') will be brought forward to the next accounting period and deducted from the RP of that period. If the company is part of a group, and another member of that group has also elected into the Patent Box, then the negative RP of the first company will be deducted from the RP of the second company.

### **Reconsider patent ownership and license terms when negotiating agreements.**

- The Patent Box increases the desirability of owning or having an exclusive license to patents that result from outsourced development work, both for a UK company that sells patented products and for a UK development company that wishes to apply a lower tax rate to patent license revenue.

#### **Include product claims within process patent applications, when possible.**

- Under the Patent Box, the tax saving for manufacturing process inventions will be calculated on the basis of a notional royalty. We recommend including product claims within process patent applications whenever possible. For example, it is sometimes possible to include claims to a new product that is defined by the process that creates it (The UK and European Patent Offices currently allow such claims). These “product by process” claims should help companies to get the full benefit of the Patent Box tax relief for revenues earned by sales of such products.

**The UK’s Patent Box will be of most benefit to innovative companies with substantial IP-related worldwide revenues, but a simplified set of calculations can be used by companies making relatively small claims and a single patent can be enough to qualify to use the new regime.**

## Useful Links

- [HM Revenue & Customs – The Patent Box](#)
- [HM Revenue & Customs – Overview of the Patent Box Regime](#)

## How A.A. Thornton & Co. can help

Please contact us if you would like more information on the Patent Box, or if you would like our recommendations on how to take advantage of the available tax savings. We offer a wide range of patent services that can help clients to exploit the Patent Box, including:

- IP portfolio and product review – we can help you to review the relationship between your existing patent portfolio and your highest revenue products, to assess the benefits that will be available from 1 April 2013. We can discuss your IP strategic planning and portfolio management with reference to the Patent Box savings.
- New invention review and filing – we can work with you on invention reviews and new patent filings, to identify new inventions that will provide future savings.
- Existing application review – we can check that your patent claims apply to the latest versions of your products, and in some cases accelerate patent prosecution to obtain the tax savings as early as possible.
- We can help you to determine whether your processes and agreements are compliant with the qualification criteria for the Patent Box.
- We can work with your accountants (or our specialist tax advisors) to ensure that you maximize your available tax relief.

If you would like to discuss any issues raised in this document, please contact a patent attorney at A.A. Thornton & Co. or visit our website at [www.aathornton.com](http://www.aathornton.com).

## Contact

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