10 things that those looking to the UK as a location for R&D and commercialisation should know about the Patent Box proposal

On 6 December 2011, the UK Government released draft legislation detailing its proposal to introduce from 1 April 2013 an optional preferential regime providing for a reduced 10% UK corporation tax rate for profits arising from patents (and other limited forms of qualifying IP, such as rights pertaining to the regulatory data protection granted to new pharmaceuticals and agrochemical products and plant variety rights). The proposal is more commonly known as the "Patent Box" and seeks to improve the UK's position as a location for R&D and commercialisation activity.

The Corporate Tax team at HM Treasury is currently seeking comments on the Patent Box proposals and the draft legislation, with the deadline for submissions being 10 February 2012.

We have summarised various key aspects of the proposed Patent Box regime (based on developments to date) below.

Qualifying for the Patent Box regime

It is intended that entities that elect into the "Patent Box" regime will qualify for the reduced rate of UK corporation tax in respect of profits derived from (i) sales income (e.g. income from the sale of patented products), (ii) royalties and licence fees, (iii) the income from the sale or other disposal of a qualifying IP right and (iv) damages paid for infringement of a qualifying IP right -:

1. **Even if they are not the owner of the IP giving rise to such profits.** It is proposed that a company may benefit from the Patent Box where it either owns a qualifying IP right or has an exclusive licence in respect of a qualifying IP right, or has previously held a qualifying IP right or an exclusive licence in respect of a qualifying IP right and is taxable in an accounting period in respect of income derived from the same (provided the company has elected into the Patent Box regime and meets all other qualifying conditions in respect of the relevant part of that accounting period). Broadly, an exclusive licence is a licence which grants rights to the holder to the exclusion of all other persons in one or more territories. The exclusive licence definition was also broadened in the recent draft legislation, with the stated aim of making it easier for groups to qualify when IP is held centrally but actively owned and managed in a Patent Box company. Therefore, it has been proposed that a company will be treated as holding an exclusive licence where it is a member of a corporate group and another company in that group which owns a qualifying IP right or has an exclusive licence in respect of a qualifying IP right grants all of its rights in respect of the same to the first company.

   However, the proposed definition of exclusive licence contains certain additional requirements, so a company would not be deemed to hold an exclusive licence for the purposes of the Patent Box even if the licence holder has rights to the exclusion of all other persons (including the proprietor) in one or more territories, unless the licence holder is also entitled to bring proceedings without the consent of the licensor or any other person in respect of any infringement of qualifying IP rights, or to receive the whole or the greater part of any damages awarded in respect of any such infringement.

2. **Even if they do not hold a UK patent.** The patents that will qualify for relief are patents granted either under the UK Patents Act 1977 (i.e. granted by the UK Intellectual Property Office) or the European Patent Convention (i.e. granted by the European Patent Office (or "EPO")). In addition, the UK Government has announced that it intends to compile a draft list of 'qualifying' EU patent regimes, to be released in Spring 2012.

3. **Even if a qualifying IP right has not been developed in the UK.** A key qualifying condition for the Patent Box is the "*development condition*". This broadly requires that a claimant company (or a corporate group of which the claimant company is a member) has carried out "*qualifying development*" in relation to a qualifying IP right. This includes creating or significantly contributing to the creation of a protected item, or performing a significant amount of activity for the purposes of developing a protected item. It is not necessary that the qualifying development occurs in the UK.

4. **Even if income comes from outside the territorial scope of the qualifying IP right.** It is intended that the Patent Box will apply in relation to all of a qualifying company's relevant worldwide income (e.g. worldwide income earned from inventions covered by a qualifying IP right), not just income falling within the territorial scope of a qualifying IP right.

5. **Even if the profit derives from income from the sale of a product that includes non-patented items or derives from royalties and licence fees paid in respect of rights that include non-qualifying IP.** Income from a combination product comprising patented and non-patented items sold together as a single unit for a single price is referred to as "*mixed income*". In such cases, "*so much of the income as on a just and reasonable apportionment is properly attributable to the sale of the patented item forming part of the combination product*" may constitute "*relevant IP income*" for the purposes of the Patent Box. Similarly, royalties and licence fees received under a licence that relate to qualifying IP and non-qualifying IP may constitute "*relevant IP income*" to the extent that those royalties/fees are, on a just and reasonable apportionment, properly attributable to the grant of rights relating to the qualifying IP right.

Falling outside of the Patent Box regime

Under current proposals, entities subject to UK corporation tax will not benefit from a reduced rate of UK corporation tax under the Patent Box -:

1. **To the extent that profits derive from**:
   - Non-qualifying protected products;
   - products sold which do not actually incorporate an underlying qualifying IP right;
   - qualifying protected items but the profits are attributable to routine business activities (e.g. instead of the exploitation of qualifying IP rights);
   - non-exclusive licences;
   - qualifying patent protected items but the profits are attributable to other forms of IP such as branding/marketing.

These profits will be taxed at the standard UK corporation tax rate (currently, the main rate is 26%, but is set to reduce to 25% in April 2012, to 24% in April 2013 and then to 23% in April 2014).

2. **Where (in certain circumstances) the ownership of a patent rich company changes.** The basic requirement is that where the ownership of a company holding a qualifying IP right changes (e.g. on sale), that company must continue to perform activities of the same description as the "*qualifying development*" in relation to a qualifying IP right for at least 12 months post-acquisition.

3. **Where qualifying IP rights are held by passive IP holding companies.** The "*active ownership*" condition requires that a company which is a member of a group has either carried out "*qualifying development*" in relation to a qualifying IP right or performs a significant amount of "*management activity*" in relation to a qualifying IP right. This can include "*formulating plans and making decisions*" in relation to the development or exploitation of qualifying IP rights. Passive IP holding companies would be expected to fall foul of the "*active ownership*" condition.

4. **Where IP rights are held by an exclusive licensee but its business is comprised of earning income from sub-licensing or selling its licences without it or a group member doing or having done any development.** As noted above, the "*development condition*" is a key qualifying condition under the Patent Box rules. An IP right will not be a "*qualifying IP right*" unless the "*development condition*" is satisfied.

5. **Where the main purpose or one of the main purposes of an arrangement is to secure a "*relevant tax advantage*".** In the December 2011 draft legislation, the Government proposed a 'targeted anti-avoidance rule' or 'TAAR' to target companies which are deemed to be seeking to obtain an artificial tax advantage by increasing the profits subject to the reduced Patent Box corporation tax rate, e.g. by "*the avoidance of the operation of any provision*" of the Patent Box legislation. The TAAR is designed to counteract any such deemed 'tax advantage'.

As the above is only intended as a summary of certain key aspects of the proposed Patent Box regime (based on developments to date), if you have any questions on this alert or on the Patent Box more generally, please contact Sandy Bhogal, Sangeeta Puran or Benjamin Fryer.

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