Implementing "Patent Box" Policy as a Strategy to Reduce Corporate Taxes

WHAT IS A "PATENT BOX"

In some countries, corporate taxpayers owning qualifying intellectual property (IP) may be able to benefit from certain tax incentives on income attributable to sales of products protected by that IP. Countries having these tax-incentive policies, known as "patent boxes," include Belgium, France, Hungary, the United Kingdom (UK), Luxembourg, Malta, the Netherlands, Spain, Switzerland, and China. The goal is to promote economic growth and attract research and development (R&D) investment. Similar tax policies are also under consideration in other countries, such as Canada and the United States.

"Patent boxes"

Tax-incentive policies for corporate taxpayers owning qualifying intellectual property

COMMON CONDITIONS THAT MUST BE MET TO QUALIFY

- A company must have taxable income, reportable in the specific country, that is derived in part from IP-protected products.
- In some countries, only income derived from patents and supplementary protection certificates qualifies for the tax incentives. In other countries, income derived from copyrights, designs, models and/or trademarks is also eligible.
- The qualifying income may come from sales of IP-protected products in the specific country, sales or licensing of qualifying IP rights, or other IP-associated income, such as infringement-damage awards.
- The eligible IP rights may be issued by local or foreign authorities (with some restrictions noted in the overview of patent box systems section that follows). For example, a patentee holding a U.S. patent may qualify in some countries to seek tax benefits for U.S. income derived from sales of products covered by that patent.
- All countries, except China, allow R&D associated with the qualifying IP to be performed abroad. Some European countries may require the R&D activities to be undertaken within the European Economic Area (EEA).
- In many countries, an owner or an exclusive licensee of the IP right may realize the tax benefits, assuming certain other conditions are met. For example, some countries require that the entity seeking the tax benefits be actively involved in developing and maintaining the IP rights. In addition, some countries may only allow an entity that initially developed the IP-protected products to realize the associated tax benefits. In the case of co-ownership of IP rights, countries may apply different tests to determine whether a co-owner qualifies for tax benefits.

EXAMPLE: HOW DOES THE PATENT BOX FUNCTION IN A TYPICAL UK SCENARIO?

A UK company owns national patents in the UK, France, Germany, and Italy. It also co-owns patents issued by the European Patent Office (EPO) and the U.S. Patent and Trademark Office. The validity of the UK national patent is currently challenged by a third-party in a UK court proceeding. The products are manufactured by processes covered by the claims of each of the eligible patents.

Does the company hold a qualifying patent or patent right?

The UK patent box applies a so-called "active ownership" test to determine if a company can realize IP-related tax benefits. The active-ownership test is satisfied if: the company has a full ownership interest in the IP or is an exclusive licensee of the IP; if it is a co-owner of the IP that has also created or significantly contributed to the creation of the invention; or performed significant activity to develop the invention.

Can tax benefits be claimed based on the foreign IP? What is the effect of a pending validity challenge to the company's UK patent?

The UK patent box allows lower tax rates on income derived from sales of products protected by patents in only a few, specific foreign jurisdictions. These include national patents issued in France and Germany or patents granted by the EPO. British income based on sales of products protected by national patents in Italy and the United States are not eligible for lower tax rates. The company may still obtain lower tax rates based on the company's UK patent even though its validity is currently being challenged in court. Even if the UK patent is later found invalid, tax benefits are not subject to "claw back" by UK tax authorities. If the patent is later found invalid, however, no further tax benefits based on that patent may be claimed.

How are patent box profits calculated?

The computation method is based on a stepwise formula:

1. The relevant IP income is determined.
2. The qualifying residual profit is calculated based on the formula below. This profit is a measure of the profit created by the IP rather than through routine business activities. A tax advantage can be taken by deducting an amount which is calculated using the formula below.

$$\text{Patent Box Deduction} = \frac{\text{Relevant Profits (RP)} \times (\text{Main Tax Rate} - \text{Patent Box Rate})}{(\text{Main Tax Rate})}$$

For a simple example, assume

- The relevant profit is £1000.
- The company is a small entity taxed at a rate of 20%.
- The patent box rate is 10%.

The tax payable is therefore calculated as follows:

$$\text{Patent box deduction} = \frac{£1000 \times (20\% - 10\%)}{20\%}$$

$$\text{Patent box deduction} = £500$$

$$\text{Profits chargeable to corporation tax} = £1000 - £500$$

$$\text{Profits chargeable to corporation tax} = £500$$

$$\text{Tax payable} = £500 \times 20\%$$

$$\text{Tax payable} = £100$$

In this example, the relevant IP profits of £1000 are effectively taxed at a 10% rate (£100).

The regime will be phased in from the 2013/2014 tax year (when only 60 percent of the patent box benefit will be available) with the full benefits only becoming available as from the 2017/2018 tax year.

CONSIDERATIONS FOR IP STRATEGY

In order to make use of patent box policies, a company may consider:

- Identifying its IP-related global income, including income derived from product sales, licensing royalties, and court damage awards, to determine if tax benefits can be obtained;
- Reviewing its global IP portfolio to identify IP covering existing and pipeline products that may qualify for tax benefits;
- Reviewing current strategies for filing and prosecuting patent applications, given that any patents associated with products on sale, however narrowly defined, may qualify for tax benefits;
- Determining whether products currently sold incorporate patented inventions or can be modified to include patented inventions such that sales of those products can qualify for benefits.

OVERVIEW OF PATENT BOX SYSTEMS IN VARIOUS COUNTRIES

BELGIUM

- Effective tax rate: 6.8%
- Qualifying IP includes: patents and SPCs[1]
- Local and foreign patent offices can issue patents
- IP can be acquired from others, but new owner must further develop the invention

FRANCE

- Effective tax rate: 15%
- Qualifying IP includes: patents and SPCs
- Local and foreign patent offices can issue patents[2]
- IP can be acquired from others, but conditions apply

HUNGARY

- Effective tax rate: 9.5%
- Qualifying IP includes: most IP rights[3]
- Local and foreign patent offices can issue patents
- IP can be acquired from others

LUXEMBOURG

- Effective tax rate: 5.8%
- Qualifying IP includes: most IP rights
- Local and foreign patent offices can issue patents
- IP can be acquired from others, but must be purchased from a nonaffiliated entity

MALTA

- Effective tax rate: 0%
- Qualifying IP includes: most IP rights
- Local and foreign patent offices can issue patents[4]
- IP can be acquired from others

THE NETHERLANDS

- Effective tax rate: 5%
- Qualifying IP includes: patents and certain other technical IP[5]
- Local and foreign patent offices can issue patents
- IP can be acquired from others, but new owner must further develop the invention

SPAIN

- Effective tax rate: 15%
- Qualifying IP includes: patents, designs, models, and know-how
- Local and foreign patent offices can issue patents
- IP cannot be acquired from others

SWITZERLAND

- Effective tax rate: 8-12%
- Qualifying IP includes: most IP rights
- Local and foreign patent offices can issue patents
- IP can be acquired from others

THE UNITED KINGDOM

- Effective tax rate: 10%
- Qualifying IP includes: patents, SPCs, and plant-variety rights
- Local and foreign patent offices can issue patents[6]
- IP can acquired from others, but new owner must further develop or actively manage the invention

CHINA

- Effective tax rate: 15%
- Qualifying IP includes: patents and know-how
- Local and foreign patent offices can issue patents (with restrictions)[7]
- IP can be acquired from others (with restrictions)[8]

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1. Supplementary protection certificate.
2. Patents must be recorded or eligible to be recorded in France at the Institut National de la Propriété Industrielle (INPI).
3. Patents, trademarks, designs, domain names, models, secrets, and software copyrights.
4. The invention must be patentable under Maltese law.
5. IP resulting from technical innovation for which R&D declaration is obtained from Ministry of Economic Affairs.
6. Allows foreign patents issued from certain jurisdictions, including the EPO and the national offices of Austria, Bulgaria, the Czech Republic, Denmark, Estonia, Finland, Germany, Hungary, Poland, Portugal, Romania, Slovakia, and Sweden.
7. High and New Technology Enterprises (HNTE) stipulates that qualifying enterprises must own "core" IP in China or have "worldwide rights to exclusive use" of IP for five or more years.
8. *Id.*

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