

# TAXeNEWS

## Corporate Tax Reform III – 4.10.2013

### **The United Kingdom Patent Box – a model for Switzerland?**

The fourth issue of TAXeNEWS dated 13 June 2013 was devoted to a Swiss Licence Box solution. To this end the Licence Box systems in Belgium, Liechtenstein, Luxembourg, the canton Nidwalden and in the Netherlands were compared with one another.

Commencing from 1 April 2013 the United Kingdom also has a frequently cited and elaborate „Patent Box“, which privileges qualifying income from Intellectual Property (IP) with a reduced tax rate of 10%.

This issue of TAXeNEWS highlights the key features of the UK Patent Box solution and its suitability for Switzerland.

#### **1. How the UK Patent Box works**

##### **1.1 Eligibility**

A company qualifies for use of the UK Patent Box:

1. if it is the owner of qualifying Intellectual Property Rights („IPR“) or is the holder of an exclusive license of such rights; and
2. has contributed to their existence by its own development activities.

If another group company performs the development activities, the company qualifying for the Patent Box must at least actively manage or exploit the IPR.

##### **1.2 Holding of qualifying intellectual property rights**

The IPR qualifying for the Patent Box include patents, supplementary protection certificates, certain regulatory registrations of pharmaceuticals and plant variety protection rights, but not trademarks.

A company is deemed to be the owner of a qualifying IPR, if it is registered as the holder of the patent. The holding of an exclusive licence, which confers the right to bring infringement proceedings or rights to most of the damages from infringement, for at least one country also qualifies.

In addition the Patent Box rules contain provisions, which allow companies participating in partnerships, joint venture or cost sharing arrangements to fulfil the

criterion of adequate development activities. For such purposes qualifying IPR may be held jointly by the participating companies. In these cases it is not necessary that a single company holds the IPR or an exclusive licence.

##### **1.3 Own development activities**

The criterion of adequate development activities is broadly defined and includes:

1. Creating or „significantly contributing“ to the creation of a patented invention as such; or
2. Significant activity to develop a patented invention, product or process.

„Significant activity“ includes both the coming up with suggestions or work to test and enhance the viability or usefulness of an idea. Whether a contribution to the creation of the invention is significant, is measured by reference to the costs, time, effort, value, impact between the parties who made contributions.

Against this background, in most cases the criterion of significant development activities can in practice be fulfilled. Further, the development activities may be performed on behalf of group companies resident outside the United Kingdom. In this case it will be necessary to provide to the British tax authorities evidence of the development activities performed by foreign group companies.

If the development criterion is fulfilled by another group company, the company holding the IPR must fulfil another criterion: that of Active Ownership (active management or active exploitation).

This criterion requires that the UK Patent Box company performs a significant amount of management activity to the IPR. Management activity includes decisions about the scope of the protection, granting of licences or researching other applications of the intellectual property. Whether such a contribution is „significant“ depends on the relevant resources, breadth of IP responsibilities and impact of decisions of the UK Patent Box company vs. other group companies. It is not necessary for the Patent Box company to take all decisions about the management of the intellectual property at all times. However, the company must be actively involved in plans and have “clear substantive responsibility”.

## 1.4 Categories of income

If the above criteria are fulfilled, the UK Patent Box is then open for the following five categories of income:

1. Income from the sale of products, which embody at least one current patented invention („embedded income“). This includes income from sale of spare parts;
2. Patent royalties and qualifying licence income;
3. Income from the sale of IPR;
4. Patent infringement income; and
5. Other remuneration.

Notional royalties, which arise primarily from the use of own patents in the manufacturing process and from the sale of correspondingly patented products or in the rendering of services, can under certain circumstances be brought within the scope of the UK Patent Box.

## 1.5 Determination of the privileged Patent Box profit

### Profit calculation

The profit calculation can be illustrated as follows - simplified:

	Patent income	Other income	Total
<b>1. Stage: Profit Split</b>			
Income	1'050	450	1'500
Attributable tax effective costs	-840	-360	-1'200
Profit	210	90	300
<b>2. Stage: less Routine Return</b>			
	-30		
<b>3. Stage: less Marketing Assets Royalty</b>			
	-32		
Patent Box profit	148		
Patent Box deduction (148 x ((23-10)/23))			-84
Taxable profit			216
Effective tax payable			50
Tax saved			19

**1. Stage:** The company's total revenues are split between income from patents and other income (e.g. financial income and income from non-patented products). The attributable tax effective costs are considered in the appropriate proportion ( $1'050/1'500 = 70\%$ ). As an alternative the company can elect for divisional accounts („streaming“), or in certain cases be required to.

**2. Stage:** A so-called routine return of 10% is deducted on internal value adding costs associated with the patent revenues. The costs covered by the routine return are defined in the law and comprise people costs, premises and plant and machinery. On the other hand costs of research and development and costs of raw materials and certain services are excluded.

In the Example the costs covered by the routine return amount to 300.

**3. Stage:** The final stage in calculating the profit is to deduct a so-called Marketing Assets Royalty for assets such as brands. This amount has to be determined by the company based on a notional marketing royalty, which is to be determined according to the OECD transfer pricing guidelines.

In the Example the Marketing Assets Royalty is 3% of the income from patented goods.

The fact that, in the event of the existence of only one patented invention, the entire profit from a product is allocated to the Patent Box, makes the tax measure relatively broad in its application. In this connection the following principles can be stated:

1. An element can fall within the scope of the Patent Box, even if it is not protected by a patent. The element has only to include a different patent protected element and must be sold together with it as a unit at a specific price. For example, a non-patent protected printer may fall within the scope of the Patent Box, if it incorporates a specially developed and patented printer cartridge and the printer is sold together with the printer cartridge as a unit.
2. Elements, which are not patent protected and were designed to be integrated in patent protected elements, may fall within the scope of the Patent Box. For example, printer cartridges sold separately may also be included within the scope of the Patent Box, if they were developed wholly or mainly for a printer created with patented inventions. In this way spare or replacement parts, which are not patent protected, but are parts of a unit, in which there is a patented invention, qualify for the Patent Box.

## 1.6 Determination of tax deduction

The calculations result in a Patent Box profit (or loss), based on which a tax deduction is calculated, which gives rise to a tax reduction in the amount of the difference between the standard tax rate of currently 23% and 10% (i.e. 13%).

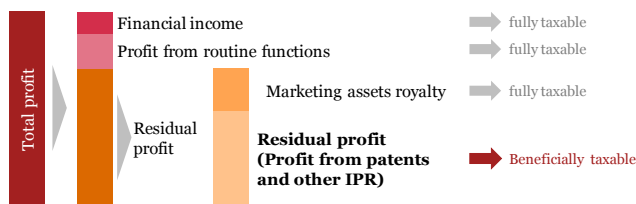
As an alternative to calculating the Marketing Assets Royalty, smaller companies may in certain circumstances elect for a simplified procedure („Small claims treatment“). Under this treatment the Patent Box profit

is the lower of the following amounts: (1) 75% of the profit less the routine return or (2) GBP 1 Mio.<sup>1</sup>

## 2. Interim conclusion

What is special about the mechanism of the UK Patent Box is the indirect calculation of the profit from intellectual property rights to be privileged. If a company holds a qualifying patent or is the exclusive licensee of such a patent and the other activity criteria are fulfilled, the entire value creation from any intellectual property rights, whether protected or not, with the exception of a notional marketing royalty, falls within the scope of the Patent Box calculation. However, the cost mark-up of 10% on the routine costs for determining the routine return is relatively high. For companies in industries with a relatively small overall margin, the remaining residual profit and the Patent Box privilege have therefore only a minor impact. In contrast, where the business is in segments with a higher margin, in which the qualifying residual profit is larger, the privilege can be more effective.

The indirect approach to determining the residual profit relevant for the Patent Box privilege is illustrated below:



## 3. Suitability of the UK Patent Box for Switzerland

In designing a national Licence Box solution there are numerous levers, some of which are of special importance. They include in particular the design of the catalogue of qualifying IPR, the consideration of self-developed and purchased IPR or the possibility of own use of IPR and therefore the integration of intellectual property components in the sales price of products and the derivation of notional royalties.

In contrast to most other Licence Box solutions, the UK Patent Box solution differs in that, in determining the measurement base, in certain circumstances revenues can be included, which do not fall under the definition of qualifying IP rights. For example, the entire proceeds from the sale of a vehicle can fall into the Patent Box, if for example only its airbag system is patent protected. Equally the entire sales proceeds of a printer can fall within the scope of the Patent Box, if only the specially created and exchangeable printer cartridge is patented.

With the aid of such a design it is clear that a greater part of the profits earned can benefit from privileged taxation.

The UK Patent Box rules require consideration of a profit on the routine functions and of a Marketing Assets Royalty. This indirect approach to determining the box profit to be tax privileged is interesting particularly for companies with high margins.

The design of the catalogue of qualifying IP rights is of key importance. The extended consideration of patents, utility models, brands, designs, topographies, software, technical and scientific databases or know-how would make a Swiss Licence Box regime incomparably more attractive than its UK equivalent. In addition, supplementary protection certificates, certain pharmaceutical registration rights or plant variety protection rights could also be included in the catalogue of protected rights. In this way a large number of innovative companies could benefit from the scope of a Swiss Licence Box solution.

With a view to international developments and international acceptance it is important to determine, to what extent a Swiss Licence Box regime, like that of the United Kingdom, should make specific demands as to the human resources in respect of own development and ownership of IP rights. The necessity of evidencing appropriate substance in exploiting IPR is already given in principle by the OECD transfer price guidelines. But, in view of the OECD's current work on BEPS, the formulation of specific substance requirements is probably necessary.

## 4. What next?

Because a homogeneous design of the Licence Box rules does not exist internationally, Switzerland is well advised to find in the detail the optimal combination of factors relevant for the Swiss objectives. The UK Patent Box solution offers interesting ideas.

Improvements from the Swiss perspective could be achieved in particular by establishing a lower routine return and also by extending the catalogue of qualifying IP rights. In this way a Swiss Licence Box solution would be open to a larger number of sectors and businesses, regardless of whether the IP rights are included in the sale of products, licensed or used for internal processes respectively the rendering of services.

This issue of TAXeNEWS is the fifth in a series, in which aspects of CTR III are specifically addressed and discussed.

<sup>1</sup> If more than one group company elects for the Patent Box, the GBP 1 Mio. is reduced, i.e. divided by the number of associated companies, which have elected for the Patent Box, plus 1.

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