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For the attention of Anna Floyer-Lea and Richard Rogers

2 September 2011

Dear Sirs

Revenue Law Committee response to the consultation document on the Patent Box

The City of London Law Society ("CLLS") represents approximately 14,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. This response in respect of the consultation on the Patent Box has been prepared by the CLLS Revenue Law Committee.

We address below the questions raised in the consultation document in turn.

1. **CHAPTER 2: QUALIFYING PATENTS**

1.1 **Question 1: Will the requirement for a patent granted by the IPO or EPO cause significant commercial distortion? Do you believe that patents granted by any other EU national patent offices should be included, and if so which jurisdictions?**

We consider that the proposed EU Community Patent should be included. Additionally, where the patent approval process in other jurisdictions is demonstrably comparable with that in the UK, we consider that patents in those

jurisdictions should also be included. We would suggest that a power to add qualifying overseas patents by regulations should be included in the legislation, leading to a list which could be kept under review.

We are interested to note that the consultation document appears to envisage that only patents from other EU countries might ever qualify, rather than patents from elsewhere in the world. Whilst we understand that there may be EU law concerns if the regime treats UK patents more generously than other EU patents, the government's approach in amending all other areas of UK tax law which have faced issues of compatibility with EU law has been to apply the changed regime worldwide. We do not see any reason for a different approach here if it can be demonstrated that the other jurisdiction's patent approval process is comparable to that of the UK.

1.2 **Question 2: Do the ownership criteria adequately permit on-licensed patents and patents developed or commercialised in commercial cost sharing, partnership and joint venture arrangements to qualify for the Patent Box?**

We are pleased to see that patents developed or commercialised in commercial cost sharing, partnership and joint venture arrangements may now qualify for the Patent Box (subject to the company receiving qualifying income satisfying the development criteria). Similarly, we think that it is right that acquired patents are included.

We note that transfers between groups are possible without losing Patent Box eligibility (i.e. the development criteria applies on a group basis). Further thought might also be given to whether a similar principle should apply in relation to transfers to or between participants in cost sharing arrangements, partnerships and joint ventures (eg an incorporated joint venture has been developing the patent and then transfers the patent to one of its members; a partnership has been developing the patent and the patent is then transferred to one of the partners).

1.3 **Question 3: Do businesses think that the development criteria are workable or are there commercial situations which should be included but would fall outside these rules?**

Whilst simplicity and certainty are important goals, we do not consider that it would be appropriate to apply a simple threshold test. Firstly, as the consultation document notes, it would inevitably have a "cliff edge" effect. This would be unfair, and would also lead to purely tax-driven behaviour designed to ensure that arrangements stayed on the right side of the cliff edge. In turn this would lead to a need for greater degrees of HMRC scrutiny due to the disproportionate tax effects of potentially minor changes in the commercial position.

Secondly we would note that different types of invention require very different degrees of development to be brought to market. At one end of the spectrum is the "eureka" idea, where once it has been thought of, relatively little further development is needed. A phenomenally successful historic example of this would be the Black & Decker Workmate (a workbench that doubles as a vice). At the other extreme you have new drugs where the time and cost needed to make the core idea marketable is enormous.

We would suggest a third possibility which might be a hybrid, i.e. the second approach (judge whether significant in all the circumstances) but with a "safe

harbour" type test if the company/group's expenses exceed a pre-defined proportion of the value of the patent on acquisition (akin to first approach). This has the benefit of flexibility (backed up by the clearance procedure) and certainty.

In any event, even if despite the points above the first option was preferred, we are not sure that a test which looks at the joint costs incurred by unrelated parties is appropriate as an exclusive test; in practice it would be difficult to ensure that this information was available to the relevant company in all cases.

2. CHAPTER 3: QUALIFYING INCOME

2.1 **Question 4: Do businesses believe that it is necessary to set out rules to more closely define the circumstances where a composite tangible or intangible product should be considered a single functionally interdependent item? Or can this requirement be tested through a motive test on a case-by-case basis?**

As with question 3, we think a hybrid approach may be best here. In other words there should be some hard and fast criteria which, if met, allow the taxpayer to tick a box and know that their patent qualifies. But the last criterion should be that the composite product should be considered a functionally interdependent item and a motive test is satisfied.

We consider it is too difficult to define functional interdependence precisely in a way which will operate fairly (ie everything that should fall within the box is within, whilst everything that should fall without the box is without) without a motive based sweeper.

2.2 **Question 5: The Government would welcome views on how the arm's length profit attributable to patents used in processes or to provide services should be calculated.**

No response.

2.3 **Question 6: Do businesses think that the proposed claim of retrospective benefits for the period while a patent is pending is fair and workable?**

Yes. Given that the patent holder has already had to wait until patent grant to receive the Patent Box tax benefit, the Government may wish to consider whether the retrospective benefits should be repaid as a lump sum, rather than by way of a tax credit.

3. CHAPTER 4: CALCULATION OF PATENT BOX PROFITS

3.1 **Question 7: Do businesses agree that the proposed model will produce an acceptable result in most circumstances, given the flexibility provided by the ability to apply the model to company divisions separately if required?**

For the Patent Box to be attractive to patent holders, the administrative burden of its implementation should be kept to a minimum. We, therefore, agree that it would be appropriate to use a specified formula, although we have a number of concerns in relation to the current proposed formula.

Step 1: Whilst we do have no issue *per se* with the principle that a company should apportion its total taxable trading profits and expenses on a *pro rata* basis between qualifying (i.e. patent related) and non-qualifying (i.e. non-patent related), we would note that it may not be easy in practice to ascertain:

(a) which products incorporate qualifying patents and which do not; and

(b) what proportion of the trading profits in relation to such profits is as a result of the patent(s).

In respect of the issue identified at paragraph (a), we note that the Government suggests that "divisionalisation" may assist companies which make use of a patented process where the products they produce are not covered by any patent, in that they will be able to treat the patent as owned in a separate division which charges an arms-length royalty for its use. In this respect, we would, however, note that such "divisionalisation" may involve a disproportionate amount of computational effort. It is, therefore, key that "divisionalisation" remains optional, as suggested, and that companies can still opt to self assess whether they have one or more patents that cover a product or process as part of their normal CT self-assessment procedure. Given the complexity in determining the incorporation (or not) of a patent in a product or process, HMRC should issue clear guidelines on its approach to technical disputes.

The issue identified at paragraph (b) is dealt with in our comments on Step 3.

Step 2: Whilst we do not have an issue with the concept of a "routine return", our view is that the proposed rate of 15% of almost all trading expenses (excluding the enhanced element of R&D deductions and finance costs) is too high. It may also disadvantage UK companies which carry out R&D activities themselves, on the basis that the cost of outsourced activities may not include such a high mark-up. We would suggest a routine return of 5% would be more representative of profit created through routine business activities.

We would also note that it is arguable that the R&D costs are, in any event, directly related to the generation of Patent Box profits. If so, it may be argued that there are no grounds for separating profits into a routine excluded element and a non-routine, included element.

Step 3: We do not agree that it would be appropriate to equate annual R&D expenditure with patent innovation and marketing expenditure with every other type of innovation. This is because significant inventions can arise from little R&D and much UK innovation is in service industries. Such an equation would furthermore heavily favour companies operating in the business-to-business sphere and could end up giving rise to distortions in the marketplace; for example, two companies with an equal amount of R&D expenditure could end up with different amount of income of the Patent Box solely as a result of one company spending more on marketing. Companies would also be penalised after incurring launch costs and the effect would be exacerbated for smaller groups with fewer products on the grounds that for such groups there would be big swings in relative spend on R&D and marketing.

Generally though, we would acknowledge that this is probably the most difficult part of the proposals to get right. The underlying policy decision to allow a wider range of profits to fall within the box than many competitor regimes is welcome, but it brings with it inevitable definitional issues. Distinguishing between brand value and patent value is particularly difficult, especially when dealing with companies (for example, Sinclair historically and Apple currently) whose brand derives to a large extent from a reputation for innovation. Given these issues we suspect that a "rough and ready" approach of the type suggested may be the only practical way forward, acknowledging that it will not give a perfect answer in all cases. There is also an attraction in applying numerical formulae (such as

percentage routine return) as these may easily be tweaked in future if it is considered that the regime is proving more or less generous than hoped without the need for fundamental changes to the legislation.

3.2 **Question 8: Is there any alternative basis of apportioning residual profits between different products which is more appropriate without introducing excessive complexity?**

See Question 7 response.

3.3 **Question 9: Should there be special rules for any one-off items of income or expenditure? If so what form should the rules take?**

No response.

3.4 **Question 10: Is divisionalisation the most effective and least burdensome way to deal with a wide range of situations in which pro-rata allocation of profits and expenses would produce an inappropriate result? Are the conditions set out above to govern the use of divisionalisation appropriate? The Government would welcome any alternative suggestions, and would appreciate sufficient detail that these can be evaluated by HMT and HMRC.**

See Question 7 response.

3.5 **Question 11: Are there any other circumstances in which divisionalisation should be mandatory?**

We do not consider that mandatory divisionalisation is appropriate for the reasons given in our Question 7 response.

3.6 **Question 12: The Government would welcome views and evidence on the appropriateness of step 2 in identifying residual profits, as well as on how outsourced functions should be defined and whether there are any other costs which should be excluded from the mark-up.**

See Question 7 response.

3.7 **Question 13: The Government would welcome business' views on an appropriate formula to allocate residual profit to patents, and on what types of expenses should be taken into account in calculating the relative contribution made by the patent and brand to the residual profit.**

See Question 7 response.

Question 14: Can businesses suggest any alternative ways of effectively separating patent profits from those arising from other types of IP? If a relative contribution approach is chosen, is the proposed safe harbour set at an appropriate level to simplify smaller claims?

We consider that the safe harbour approach seems reasonable for smaller businesses.

Question 15: Are the proposed rules for the carry-forward of Patent Box losses appropriate? Should Patent Box losses also have to be set against Patent Box profits of other group companies in the same accounting period, in order to achieve a symmetrical treatment of Patent Box profits and losses?

No, Patent Box losses should not be set against Patent Box profits of other group companies in the same accounting period. Patent Box profits are calculated on a company not group basis save that the development criteria is looked at on a group basis.

Question 16: Do businesses consider that taking pre-commercialisation expenses into account in these circumstances is proportionate and fair, or are there better ways of ensuring that the benefit accrues to total net patent profits?

This approach appears reasonable.

CHAPTER 5: COMPUTATIONAL ISSUES

Question 17: Do respondents see any practical or technical problems with the approach of implementing the 10% Patent Box rate through a computational tax deduction?

We cannot envisage any practical or technical problems with the approach of implementing the 10% Patent Box rate through a computational deduction. See, however, Question 6 response for treatment of claims of retrospective benefits.

Question 18: Do respondents have any initial comments about interaction with double tax relief rules or have any views on the Government's stated aims for giving relief?

We would agree that it is appropriate to give double tax relief for withholding tax suffered on royalties up to the lower of the overseas tax suffered and the tax payable in the UK on profits deriving from the licensed assets after taking the Patent Box deduction into account.

Question 19: Would having to comply with transfer pricing rules for transactions with associated companies in cases of tax avoidance be an unreasonable burden for smaller companies?

We are of the view it would be acceptable to require smaller companies to comply with transfer pricing rules in circumstances where the transactions have been effected with the main purpose of avoiding tax through the artificial manipulation of profits between associated companies.

3.8 **Question 20: Can respondents suggest any alternative ways to prevent artificial tax avoidance abuse of the Patent Box?**

See Question 19 response.

3.9 **Question 21: Do respondents consider that other aspects of the formula apart from divisionalisation and step 3 will give rise to clearance applications? Will the current non-statutory clearance system be sufficient to respond to the range of enquiries that the Patent Box is likely to generate?**

We believe that the computation of Patent Box profits will give rise to uncertainty, for instance, in respect of what constitutes "actively holding" a patent and the pricing of notional royalties under the divisionalisation approach. A clearance system will, therefore, be critical.

4. **CHAPTER 6: COMMENCEMENT OF THE PATENT BOX**

4.1 **Question 22: The replacement of a cut-off date with a phase-in approach will have different effects for each company. The Government would welcome comments on the impact of this proposal on different sectors as well as views on whether businesses prefer a cut-off date as originally announced or would favour the proposed phase-in approach.**

We would generally support the replacement of a cut-off date with a phase-in approach. We do not, however, have any information on the way in which this approach will impact specific sectors.

5. **CHAPTER 7: TAX IMPACT ASSESSMENT**

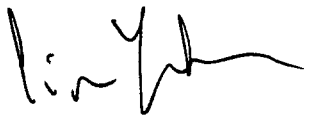
5.1 **Question 23: The Government would welcome comments or evidence to support the assessment of the impacts of the regime.**

We believe that the introduction of a patent box regime is an important step in incentivising companies in the UK to retain and commercialise existing patents and to develop new patented products.

5.2 **Question 24: The Government would welcome comments on the best forum for dealing with emerging issues once the Patent Box is introduced.**

We consider that it will be important to establish a specialist forum at which taxpayers can discuss issues emerging out of operation of the patent box on a regular basis with HM Treasury and HMRC.

Yours faithfully,



Simon Yates
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THE CITY OF LONDON LAW SOCIETY
REVENUE LAW COMMITTEE

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