
Is it time for your country to consider the "patent box"?

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Executive summary

Intellectual property ("IP") is highly mobile and can be easily separated from the jurisdiction where it was developed and migrated to low-tax jurisdictions. Over the last few decades, a greater proportion of IP (and the resulting revenue stream) has been moved offshore to minimize tax.

In response, some countries have adopted the concept of a "patent box," a tax regime that sharply reduces the rate of corporate tax applied to income resulting from qualifying IP. Also known as "innovation box" regimes, examples include the Netherlands' application of a reduced rate of five percent to income derived from qualifying IP and Belgium and Luxembourg's exemption of 80 percent of patent income from corporate tax. The use of a patent box also is being considered by the UK. This reform is designed to provide an incentive for companies to exploit in the UK IP developed in that country by reducing the rate of corporation tax applied to the income derived from patents to 10 percent.

The introduction of patent boxes around the world makes holding patents and certain other IP in countries with patent boxes more attractive. As a result, the governments of countries without a patent box regime may want to consider tax policies providing incentives to encourage companies to retain IP in those countries once created.

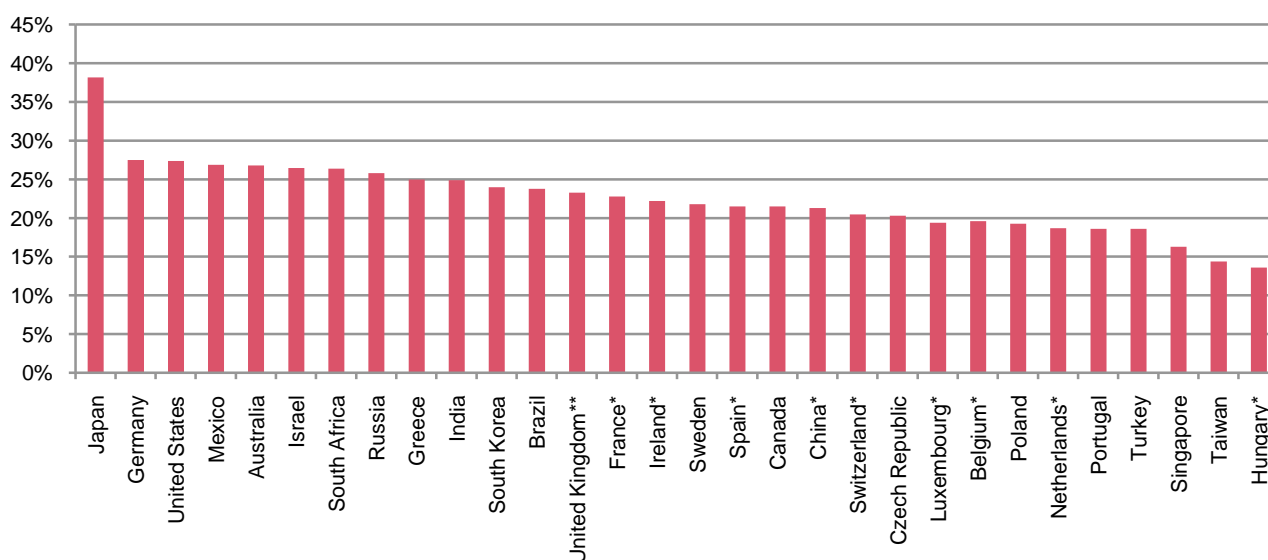


What is a “Patent Box” regime

While R&D tax credits serve to incentivize activities designed to result in innovation, patent box regimes target commercial activities that follow development by providing tax relief on income derived from qualifying R&D projects, patents, or other IP. Relief takes in the form of either (1) the application of a reduced tax rate on income earned in the patent box or (2) a deduction for a portion of the patent box income. Countries that have implemented a patent box regime include Belgium, China, France, Hungary, Ireland, Luxembourg, the Netherlands, and Spain. The UK government has announced its intention to adopt a patent box regime effective in 2013.

Observation: Countries without a patent box regime generally have higher effective tax rates, which may make it difficult to adopt the patent box. See Figure 1.

Figure 1. Effective Tax Rate for Countries With and Without Patent Box Regimes



*Country with patent box regime

**To be enacted in 2013

Source: "Global Effective Tax Rates," April 14, 2011, www.pwc.com/nes, "PwC Intellectual Property and Patent Income Study," April 2010.

The types of IP that qualify for preferential tax treatment vary. Patents are treated as qualifying IP in all countries with a patent box regime. Some countries (e.g., Ireland, Luxembourg, Spain, and Switzerland) have expanded lists of qualifying IP, including designs, copyrights, models, and certain types of information. China's regime also extends beyond patents to include certain forms of commercial "know-how."

A patent box regime adopted by a country without one, such as Australia, Canada, Japan, or the United States, could be designed by reference to the first adopted regimes in Belgium, the Netherlands, and Luxembourg ("the Benelux countries") or the proposed UK patent box regime. Each of these patent box regimes is examined in detail below.

Patent box regimes in four countries

Belgian patent income deduction regime

Introduced in 2007, the Belgian patent income deduction (PID) is designed to support R&D-related activities by allowing a Belgian company or a Belgian permanent establishment (“PE”) of a foreign company to deduct from its taxable basis an amount equal to 80 percent of qualifying gross patent income. Therefore, only 20 percent of gross patent income is taxable at the normal corporate tax rate, resulting in a maximum effective tax rate (ETR) of 6.8 percent (i.e., 20 percent of the Belgian statutory rate of 34 percent). In addition, most expenses, except license fees related to an acquired patent and amortization of an acquired patent, remain deductible at the 34-percent rate. As a result, the deduction of these other expenses, as well as other available tax deductions (e.g., losses carried forward, notional interest deduction, and R&D tax credits) may lower the ETR to zero.

The PID is available where patents or supplementary protection certificates are owned by a Belgian company or PE as a result of its own patent development activities (partly or fully) in an R&D center in Belgium or abroad. The PID also applies where patents or supplementary protection certificates are acquired by a Belgian company or PE from a related or unrelated party, in full ownership, joint ownership, usufruct, or via license agreement, provided the Belgian company or PE it has further improved the patented products or processes in the company’s R&D center in Belgium or abroad. It is not required that these improvements lead to additional patents.

To benefit from the PID, the R&D center must qualify as a “branch of activity” or “line of business,” which means that it should be a division of an entity that is capable of operating autonomously. The Belgian company or PE should have relevant substance to perform and supervise R&D activities, but may use subcontractors, related or unrelated, in its development of the patents or extended patent certificates. The PID law specifically provides that the R&D center can be located outside Belgium as long as the center belongs to a Belgian legal entity. Belgian companies or PE’s acting as “contract R&D” service providers on behalf of another company cannot qualify for PID because they are not the owners, holder of beneficial rights to, or licensee of the resulting patents.

Belgian law explicitly excludes from the PID other intellectual ownership rights (other than patents or supplementary protection certificates) such as know-how, trademarks, designs, models, secret recipes or proceeds, and information concerning experience with respect to trade or science. However, the tax administration has indicated that know-how closely associated with patents or supplementary protection certificates may also qualify for the PID.

Capital gains realized upon the disposal of patents are not covered by the PID.

To the extent that the Belgian company or PE licenses the patents, the PID is calculated based on royalties received. The amount of those royalties eligible for the PID is limited to the amount that is part of the taxable income in Belgium and corresponds to the fee that would have been agreed to between unrelated parties.

For patents used by the Belgian company or PE for the manufacture of patented products, manufactured by itself or by a contract manufacturer on its behalf, the PID is 80 percent of the license fee (known as embedded royalties) that the Belgian company would have received had it licensed the patents used in the manufacturing process to an unrelated party.

Dutch innovation box regime

The Netherlands was the first Benelux country to introduce a patent box tax regime, which became effective on January 1, 2007. Under the initial regime, income from qualifying IP was taxed at an ETR of 10 percent and subject to certain limitations. As of January 1, 2010, the patent box regime was expanded significantly and, thereafter was referred to as the “innovation box.”

As of January 1, 2010, the innovation box provides for taxation on qualifying income at an ETR of 5 percent. Before January 1, 2010, the maximum amount of income that could benefit from the reduced rate was four times the development costs and a specific maximum of EUR 400,000 for income related to R&D assets (intangibles that cannot be patented). Under the regime as in force as of January 1, 2010, there is no maximum amount of income that can benefit from the 5-percent ETR.

Under the innovation box regime, losses from qualifying IP are deductible at the general rate of 25 percent. (The Dutch government has proposed lowering this rate to 24 percent as of January 1, 2012.) Losses from qualifying IP deducted from taxable profits in previous years first must be recaptured at the general rate before the lower ETR applies. This also applies to R&D costs that are deducted at once before an innovation box election is made for the qualifying IP. This makes the innovation box combined with the possibility of deducting R&D costs upfront attractive even for companies that are uncertain about the economic prospects of their R&D activities.

Both resident and nonresident taxpayers can benefit from the Dutch innovation box regime. The election for the application of the innovation box is made with the filing of a Dutch corporate income tax return. Taxpayers can elect whether to apply the innovation box separately for each qualifying IP.

The Dutch innovation box regime applies to all net positive income (gross income minus related expenses and depreciation) attributable to, and net gains derived from, qualifying IP. To qualify for the innovation box, IP must meet the following conditions:

- The IP must be self-developed for the risk and account of the Dutch taxpayer and must have become a business asset after December 31, 2006;
- A patent or an R&D declaration needs to be obtained for the IP (“R&D IP”); and,
- In the case of a patent right, more than 30 percent of the derived income should be attributable to the patent right.

Note: While for patented IP, the R&D should be developed for the risk and account of the Dutch taxpayer, the R&D should not necessarily be performed in the Netherlands. For IP for which an R&D declaration has been obtained, the R&D should at least for 50 percent be performed in the Netherlands or the Dutch entity should have a decisive coordinating role.

R&D IP is IP that results from technical innovative activities conducted by or on behalf of a taxpayer and for which the taxpayer does not obtain a patent but for which it has obtained an R&D declaration from the Dutch government. Consequently, the innovation box also can be used by companies that do not intend to apply for patents for the products of their R&D efforts or that develop products that are not patentable, such as software-related intangibles and trade secrets.

Generally, in order for IP to qualify for the Dutch innovation box, the IP must be self-developed. Acquired IP may qualify if it is further developed for the risk and account of the Dutch taxpayer. More than 30 percent of the derived income should be attributable to the patent right. This requirement does not apply to the R&D IP declaration. The Dutch innovation box does not apply to trademarks, logos, or similar rights.

The Dutch innovation box applies to all income derived from qualifying IP. It is not restricted to the income strictly attributable to the patent or R&D IP. It can also apply to the qualifying IP remuneration embedded in the sales price of goods and/or services. Allocation issues are resolved through transfer pricing methods and are eligible for Advance Pricing Agreements with the Dutch tax authorities. The Dutch tax authorities have a dedicated Innovation Box team, which deals with Innovation Box rulings.

Luxembourg patent box regime

The Luxembourg patent box regime, which combines features of the Belgium and Dutch systems, was introduced into law in December 2007. The regime provides for an 80-percent tax exemption of the net income deriving from the use and the right to use qualifying IP rights acquired or self-developed after December 31, 2007. Therefore, only 20 percent of net IP income will be taxable at the standard combined corporate tax rate, resulting in a maximum ETR of 5.76 percent (i.e., 20 percent of the Luxembourg statutory rate of 28.8 percent for 2011). Amortization, research and development expenses, interest charges, other related expenses can be deducted against the gross IP income.

Qualifying IP rights include patents, trademarks, design, domain names, models, and software copyrights. Know-how, copyrights (other than related to software), formulas, and client lists do not qualify for the beneficial treatment. Furthermore, for the IP rights to qualify, they should not be acquired from a directly associated (10-percent direct parent, subsidiary, or sister) company.

The 80-percent exemption also covers capital gains realized on the sale of qualifying IP. The regime also provides for a full net wealth tax exemption of the IP.

For self-developed patents used internally by a taxpayer, a notional deduction is available that amounts to 80 percent of the income that the taxpayer would have earned if it had licensed the right to use the patent to a third party.

For self-developed IP, all expenses in direct relation to the IP development must be capitalized in the first year the benefit of the regime is claimed. The purpose is to ensure that all the related expenses incurred are taken into consideration for determining the IP net positive income.

UK's proposed patent box regime

In November 2010, Her Majesty's Revenue & Customs and Her Majesty's Treasury issued a substantial consultation document setting out a series of corporate tax reforms. On March 24, 2011, the UK Chancellor of the Exchequer delivered the annual Budget setting out the fiscal plans for the government for the coming year. Both the consultation document and the Budget confirm the UK government's intention to introduce a patent box regime effective April 1, 2013, as part of a strategy to encourage companies to locate high-value jobs and activities associated with the development, manufacture, and exploitation of patents in the UK. The adoption of a patent box regime will supplement the UK's existing R&D tax credit regime.

The UK patent box will be optional, to avoid placing unnecessary compliance burdens on businesses that will not benefit significantly from it. For those who opt in, income derived from qualifying patents will be taxed at 10 percent instead of the normal rate of corporation tax, which has been 28 percent (expected to be reduced to 26 percent effective as of April 1, 2011). This lower rate will apply to royalty income and 'embedded' income included in the price of patented products, which will be determined using a formula that remains under discussion. The patent box likely will apply only to net patent income after associated expenses, including pre-commercialization expenses, rather than to gross income.

According to the UK government, patents have a strong link to the high-tech R&D and manufacturing activities it wants to encourage. As a result, the proposed patent box regime is limited specifically to patents. It will not apply to other forms of IP, such as trademarks or designs, as they are perceived by the government to be less directly linked to industrial innovation. It remains to be seen whether the benefits of the regime will apply to patents granted around the world or will be restricted to patents granted in the EU (under European law, eligibility criteria for inclusion in the patent box cannot include restrictions that patentable technologies be created in the UK).

Detailed qualifications and transitional rules have not been developed, but it appears that all patents first commercialized after November 29, 2010 will qualify for the patent box regime. There may be a "clawback" mechanism for patents commercialized prior to that date for which related expenses have been deducted at the standard corporate rate. As part of the regime's anti-avoidance measures, the UK government is considering linking the amount of income attributable to the patent box to the level of associated R&D or manufacturing. The government does not intend any such measures to limit the benefit of the box to those businesses actively engaged in the patent development cycle.

Comparison of four patent box regimes

The patent box regimes of the Benelux countries and the UK's proposed patent box regime are summarized and compared below.

Tax Factors	Belgium	Netherlands	Luxembourg	UK
ETR	0 percent to max. 6.8 percent	0 percent to max. 5 percent	0 percent to max. 5.76 percent	10 percent
Qualifying IP	Patents and extended patent certificates	Patented IP or IP for which an R&D declaration is obtained ("R&D IP")	Patents, trademarks, design, domain names, models, and software copyrights	Proposed for only patents
Acquired IP?	No, unless further developed	No, unless IP is further developed	Yes	Unknown
Cap	No	No	No	No
Type of income	Gross patent income	Net income and net capital gains derived from qualifying IP	Royalties and capital gains	Net patent income after associated expenses
Can work be performed abroad?	Yes, if qualifying R&D Center	Yes for patented IP; For R&D IP: strict conditions	Yes	Unknown
Year of enactment	2007	2007 / 2010	2008	Proposed for 2013
Applicable to existing IP?	Qualifying patent granted or commercialized after 01/01/2007	Qualifying IP > 12/31/2006	Developed or acquired IP > 12/31/2007	Commercialized Patent > 11/29/2010

Designing a patent box regime for other countries

Australia, Canada, Japan and the United States, like the UK have legal and regulatory environments that are strong compared with many other locations. However, these countries, among others, may need to improve the competitiveness of their corporate tax regimes in order to prevent movement of IP offshore and to encourage retention of new patents. Furthermore, the R&D tax credit does little to solve a vexing issue facing all high-tax countries: the transfer of IP to low-tax jurisdictions for post-development commercial activity.

The introduction of patent box regimes around the world will make holding patents and certain other IP in countries with a patent box more attractive. As governments recognize this migration issue, they may decide to adopt tax policies providing incentives to encourage companies to retain IP in-country once created, such as adoption of a patent box regime.

A checklist of some possible issues in the design of a patent box regime may include:

- Qualifying IP
 - In-country patent
 - Other IP, e.g., copyright, formula, process, design, pattern, knowhow, format?
 - Self-developed, contract, and acquired IP?
 - IP development (R&D) activities required to be performed in-country?
- IP Income in "Box"
 - Gross or net IP license income
 - Capital gains?
 - Self developed IP embedded in price of goods or services?
 - Bundled IP licenses
- Treatment of Income in "Box"
 - Deduction or partial exclusion?
 - Use of NOLs and credits against tax on income in box
 - AMT treatment?
 - Cap on tax benefit?
- Elective or Mandatory? If elective, for all IP or per unit of IP?
- Coordination with Existing R&D incentives ("double dip" issue)
- Revenue Cost

The Big Picture

In general, most businesses would prefer general tax relief in the form of an overall corporate tax rate reduction. However, since in some countries incentives can be viewed politically as more feasible than reducing overall corporate tax rates, an alternative tax reform scenario could be the adoption of a patent box regime. Such a regime likely would encourage companies to locate the high-value jobs and activity associated with the development, manufacture, and exploitation of patents in-country.

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