



Date: 2 September 2011

CT Reform
Corporate Tax Team
HM Treasury
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London
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VIA EMAIL ONLY: corporatetaxreform@hmtreasury.gsi.gov.uk

Dear Sirs

SCOTTISH LIFESCIENCES ASSOCIATION RESPONSE TO CONSULTATION ON THE PATENT BOX

I am writing on behalf of the **Scottish Lifesciences Association (SLA)** to communicate the SLA's views on the Patent Box consultation announced by the Treasury in June 2011.

Established in 2010, the SLA seeks to represent the interest of the Scottish life sciences industry to Government to ensure that policy and support for the industry is maintained and increased. We represent nearly 70 member companies who operate across the full spectrum of the life sciences sector. **Our mission is to sustain and grow life sciences in Scotland as a key sector of the country's economy.**

The SLA welcomes the Coalition Government's continued commitment to the Patent Box initiative as a central part of its Plan for Economic Growth. The Government's recognition of the importance of strong patent protection to innovation is particularly welcomed. In the Scottish life sciences sector, strong patent rights are often a vital foundation for companies within this innovative sector. Furthermore, due to the exceptionally high research and development costs which are associated with bringing new products and therapies to market, coupled with the high risk of failure, the provision of strong and robust patent rights is a necessity to secure initial investment.

The SLA has 2 main points to make, as set out in the remainder of this letter.

Service income where the service is directly linked to a patented product

The SLA notes that no direct relief is available in respect of service income, even where the services are directly linked to a product which is protected by patent protection. It seems to us to be inconsistent that patents granted for new and inventive processes do not provide access to the Patent Box without the need for recourse to the "divisionalisation" rules. While it is understandable that pure service income would be excluded from the

Rules, in the life sciences sector, new methods of manufacture can be the essence of the innovation and may have central or complete role in the associated innovation.

Furthermore, screening and diagnostic methodologies are central to many areas of medicine and therefore fundamental to the development of products in the life sciences sector. For example, so called “compound libraries” can be compiled and used to identify drug screening candidates, while novel methodologies can be developed to improve the efficiency of medicines under development, particularly in the field of biologics and pharmaceutical drugs, two areas which are key to the UK’s current and future economy.

UK and European patent law provides that products obtained directly by a patented process are protected by virtue of the process claim (Art 64(2) EPC and Section 60(1)(c) Patents Act). Thus a patent for a process is, *de jure*, a patent for the product obtained directly by that process. This applies whether or not the product is independently patentable. Furthermore, the 2004 House of Lords decision in the case of *Kirin Amgen v Hoescht Marion Roussel* decided that the protection conferred by a patent relating to a process of making a product extended to that product, despite the fact that the patent may not contain product claims, *per se*.

It seems inconsistent that access to the Patent Box should be denied in respect of such directly-obtained products, which are ‘patented’. It would seem fair that access to the Patent Box is permitted for such products, but not to products made by non-patented processes. In this way the Patent Box would align itself with patent law, which seems desirable from many perspectives, and would provide fair benefit to innovations in process technology, which allow improved production of products.

Additionally, a new and inventive product which can only be defined by the process of its manufacture will be patented with a claim referencing its method of manufacture. This is quite common in chemical inventions, where definitive structural analysis of the product is not always possible. It is assumed that holders of such patents (which are manifestly for products *per se*, despite the use of process wording in the patent claims) would not be deprived of access to the Patent Box.

Accordingly, the SLA strongly advocates a reconsideration of the exemption relating to service income and in particular would welcome the revision of these provisions such that relief under the Patent Box could be sought in certain circumstances, for example where the patented process played a fundamental part in the development of a product in the medical field.

Definition of “actively” holding a qualifying patent

The SLA seeks clarification as to what the requirements are in respect of a UK business “actively” holding a qualifying patent. In particular, a clarification of the term “actively” is sought. For example, clarification should be provided on whether a UK based company could invent a patentable product in a country other than the UK, yet manage the patent filing from the UK and thus have access to the Patent Box. Many UK headquartered

companies have international operations, hence guidance should be provided as to whether “significant development activity” must take place in the UK.

The attached Annex provides our detailed responses to the specific questions set out in the consultation.

If we can provide you with any further information relating to these issues, please do not hesitate to contact our Director of Policy, John A Brown at johnabrown@scottishlifesciencesassociation.org.uk

Best regards

A handwritten signature in black ink, appearing to be 'SJ', with a long horizontal stroke extending to the right.

Scott Johnstone

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Annex

SLA Response to specific Patent Box Consultation questions:

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 the current provisions to be generally fair and appropriate. The overwhelming majority of companies seeking patent protection, and which pay UK corporation tax and are thus able to benefit from the Patent Box, will obtain patents via the UKIPO or the EPO.

It would also seem reasonable to allow patents granted by EU national patent offices, in which substantive examination takes place, such as the French, German, Dutch, Norwegian and Swedish Patent Offices to qualify. However, as mentioned above, the vast majority of applicants will use the EPO route, with a minority of UK-based companies choosing the UKIPO route, and thus it would seem that such an extension to such countries would affect relatively few cases. Nonetheless, as there would be relatively little additional burden in granting relief based on patents granted in these countries, and given that the criteria applied in granting patents in these countries is generally well harmonised with practice at the UKIPO/EPO, it would perhaps be simpler and fairer to include them.

The SLA welcomes the extension the Patent Box provisions to cover Supplementary Protection Certificates.

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 consider the provisions set out in paragraphs 2.10 to 2.12 to be reasonable and workable, with one notable exception; the “development criteria”. We provide our comments in this regard in respect of our response to Question 3, below.

We support the decision to allow patents developed under partnership, joint venture and cost sharing arrangements to qualify for the regime. We consider that it is important that the legislation provides that patents which qualify in the hands of a partnership or joint venture should continue to qualify if one of the partners or one of the parties to the joint venture acquires the patents. Conversely, patents which qualify in the hands of a group should continue to qualify if transferred into or licensed to a joint venture or partnership in which the original owner (or a member of the group) has a significant stake.

In relation to academic research projects, many further research institutes and universities may, by virtue of their charitable status, retain ownership of patents and/or a share of income from research funded by industrial partners. This should not prevent the funding partner from benefitting from the Patent Box in respect of income related to patents resulting from the research.

In respect of an exclusive licence situation, it would appear that the licensee does not have to demonstrate that it meets the “development criteria”, this is welcomed, as it is likely that many licensees may not meet such criteria.

We note that the consultation refers to exclusive licences which are limited by territory. In such a case, clarification should be provided as to whether profit which is derived from sales originating outside of the licenced territory would be included? For example, such sales could be legitimate if, for example, the territorial extent of the patent was limited to Europe and the US, but sales were made in countries out with these jurisdictions, such as Asia where no patent protection is in force.

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?

It is our opinion that the term “development criteria” is vague, and would seem to impart a fairly heavy and nebulous onus on parties in a joint venture to justify their role and entitlement to the Patent Box. The burden on such a party would appear to be far higher on parties in a joint venture than in a licensor/licensee relationship.

It is not clear to us what function this aspect of the Patent Box is trying to achieve, particularly as there are no examples given of when a party might be “merely passive recipients of income from holding patents”. Furthermore, it is not clear exactly what the “patent development cycle” is. Does it relate to work conducted in inventing or further exemplify a patented technology? Or is it something beyond that? The term “patent development cycle” is not in common use in the IP field, and its meaning is far from clear.

For example does the “patent development cycle” extend to work performed by companies whom licence in patented or patent pending technologies and then spend considerable cost and effort further developing the technology to a stage where it could be commercialised? Such an example in the life sciences sector could be a diagnostic kit, where marketing can only progress after the product has met certain strict criteria. Furthermore, in some cases UK or Scottish companies may licence in early stage patented technology from outwith the UK and then spend significant resources developing this. In such a case, the UK company would not have contributed to the creation of the initial invention, but they would have had a fundamental and material role in developing the technology to a stage where it could be placed on the market and commercialised. Furthermore, a company may licence a patented product and spend considerable resources on activities fundamental to commercialisation such as the undertaking of marketing research, marketing trials or clinical trials. The Rule should make clear whether these activities fall within or out with the development cycle.

It would seem, on the face of it, that if a company jointly holding a patent is generating profit from the exploitation of a patented technology, then it should be able to seek the benefits provided by the Patent Box. The commercial reality is that two parties will not generally share ownership unless there is a very good and genuine reason to do so. It must be borne in mind that shared ownership is a less than ideal situation in many cases, with each party in the relationship being restricted as to the acts which it can carry out without the other party’s agreement (e.g. assignation or licensing).

This aspect of the Patent Box would seem to exclude a number of legitimate joint ventures if they do not involve:

- “Active involvement in the on-going decision making connected with the patent”;
- AND

- “Significant development activity....which must extend beyond activities related to the management of a financial investment or the legal protection of the patent”.

In some instances, a partner in a joint venture may wish to take a back seat as far as commercialisation of a technology goes. Similarly, a licensor might take a back seat once a licensee takes the lead. In such instances, it would seem unfair that the partner be ‘penalised’ through prevention of access to the Patent Box. It would appear that joint owners may be incentivised to actually assign ownership to a single party and put a “licence-back” in place to avoid this problem, and that would seem undesirable.

Accordingly, it is our opinion that this issue is disproportionate and should be revised.

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?

In our opinion, it would appear difficult or impossible to define simple and all-encompassing rules that cover all the possible circumstances. The wording set out in the consultation appears a very reasonable basis for setting out the requirements in the legislation. There will of course be difficult cases as it is a difficult and “grey” area. Accordingly a case-by-case approach would seem the best approach.

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.

We do not have a comment on this question.

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

In our opinion, this is reasonable. We note however, that patents can take longer than 3.5 years to be granted, particularly if processed before the EPO. However, we also appreciate that pendency times at the UKIPO are considerably less and in many instances, it is possible to request expedited examination to bring forward patent grant. Hence, this would seem a reasonable figure given that many businesses could prosecute applications faster if desired.

It would be useful if the Rules clarified that all profit, including international income from countries other than UK and EPO territories, from a product with a granted patent in the UK or EPO territories was assessable to the Patent Box.

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?

The use of a formula to calculate patent box profits has the merit of simplicity. However, it cannot realistically be expected to determine an arm’s length level of profits attributable to

patent rights in the majority of cases. The intention of the proposals is to arrive at a broad approximation of the residual profit attributable to the patents, however the use of a pro-rata allocation based on turnover is likely to systematically understate profits attributable to products that include patented inventions.

The consultation document recognises that significant additional value can be derived from patents, but the proposed formula for Step 1 results in the same overall level of profitability being assigned to qualifying income and non-qualifying income. As a result the formula will inevitably disadvantage many companies, resulting in a significantly lower level of patent box profits than should be available on an arm's length basis. We accept that this potential disadvantage is dealt with as a result of the company having the flexibility to apply the divisionalised approach. However, we believe that an alternative, more robust, formula for arriving at the qualifying income attributable to patents should be considered. Most businesses are able to segment their gross profits on a product line basis. As gross margins often vary by product line and are likely to be influenced by the level of innovative technology contained in the products, we consider that gross profit / margin provides a better allocation key than turnover.

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

SLA has no comment on this question.

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

As previously noted, the three step model is not intended to arrive at an arm's length result. The formula proposes that residual profits attributable to qualifying income should be calculated by deducting a 15% routine return. It is not clear how this percentage has been arrived at, but given that it is not intended to reflect a true arm's length result, the percentage proposed would appear to be reasonable in light of the proposed expenses to be included and excluded from the calculation.

The proposed method under Step 2 includes the exclusion of certain costs from the mark-up calculation. We consider that the brand costs and R&D costs in Step 3 for the purposes of allocating the residual profit between patent and non-patent drivers should also be excluded from this calculation, otherwise there is an element of double counting of the same costs under the proposed model. Accordingly, a routine 15% return should not be assigned to these costs.

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.

SLA finds this approach reasonable and supports it.

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

It is the opinion of SLA that there should always be a choice as to whether divisionalisation is used.

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.

SLA has no comment on this question.

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.

For many life sciences companies, as they will be heavily focussed on research and development, they are unlikely to have substantial valuable attributable to brands. For many life science companies patent rights will be the main or sole IP right underpinning innovation.

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?

Many life sciences companies will be heavily focussed on research and development, and are unlikely to have substantial valuable attributable to brands. Accordingly, it is our position that the proposed option of 50% for smaller claims is too low and in such circumstances, a higher percentage of 100% would be more appropriate, particularly as patent rights will be the main or sole IP right underpinning innovation in the life sciences sector.

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?

SLA has no comment on this question.

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?

SLA agrees with the proposals.

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?

SLA has no comment on this question.

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?

The SLA has no comment to make on this matter.

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?

The majority of SLA member companies would be exempt from transfer pricing rules. If a company currently exempted is to have its status changed in that regard, then HMRC should provide clear direction to that company that they are to follow transfer pricing rules. This will avoid unnecessary time and expense of exempt companies making provision for compliance with the transfer pricing rules. Clear and specific Rules should therefore be provided.

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

Ensuring that the Rules are clear and specific will ensure that they are not construed too broadly.

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 nonstatutory clearance system be sufficient to respond to the range of enquiries that the Patent Box is likely to generate?

Companies may wish to obtain clearance for transfer pricing arrangements that impact on the Patent Box. The current statutory clearance system is perfectly adequate to deal with such transfer pricing arrangements but would not apply to the Patent Box calculations as the profits under this regime are not calculated based on the arms length principle.

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.

The SLA supports the proposed phase in approach.

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

It would be our suggestion that HMT and HMRC should monitor the uptake of any implemented Patent Box system by regular survey of the number of claimants by their sector and size. Due to the proposed phased introduction of the relief, it may be that initially, the relief available may not offset the additional administrative costs required to calculate and claim relief, hence it may be several years into the initiative before the full impact can be assessed.

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

The SLA would be happy to contribute to any mechanism set up by HMRC or HMT to discuss any emerging issues.

SLA
2 September 2011