



Australian Government
The Treasury

TSY/AU

Patent Box

Discussion paper on policy design

July 2021

Notes to participants

The issues canvassed in this paper are intended to facilitate consultation by Treasury and have not been endorsed by the Australian Government.

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Consultation Process

Request for feedback and comments

Interested parties are invited to comment on the issues raised in this paper.

While submissions may be lodged electronically or by post, electronic lodgement is preferred.

All information (including name and address details) contained in formal submissions will be made available to the public on the Australian Treasury website, unless it is indicated that you would like all or part of your submission to remain confidential. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain confidential should provide this information marked in a separate document.

A request made under the *Freedom of Information Act 1982* for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

Closing date for submissions: 16 August 2021

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Patent Box

Context and consultation objective

On 11 May 2021, the Australian Government announced that it will introduce a patent box for corporate income associated with patented inventions in the medical and biotechnology sectors. The patent box will apply to companies for income years commencing on or after 1 July 2022.

'Patent box' is a generic term for regimes that apply a concessional tax treatment to profits derived from eligible intellectual property (IP). Currently, over 20 jurisdictions, including the UK, Singapore and many European countries have patent boxes or other regimes that offer concessional tax treatments to IP derived profits.

The aim of the Government's policy is twofold:

1. To encourage companies to base their medical and biotechnology research and development (R&D) operations, and commercialise innovation, in Australia. R&D investment is mobile and a range of factors influence companies' decisions. While it usually takes a number of years for innovations to become profitable in the medical and biotechnology sectors, a concessional tax rate on those profits will create an additional incentive to locate R&D in Australia.
2. To retain the ownership of eligible patented inventions in Australia.

The objective of this discussion paper is to inform the Government's consideration of the detailed design of the patent box announced in the 2021-22 Budget.

This paper sets out the key design features of the patent box for which Treasury is seeking further information. Consultation questions are included as a guide only and submissions do not need to be confined to those questions.

Following consideration of responses to this discussion paper, the Government will issue and consult further on exposure draft legislation prior to introducing legislation into Parliament.

Through this discussion paper, the Government is also consulting on the potential expansion of the patent box approach to low emissions technologies and whether it is an effective way to support the development of those technologies.

Patent box design considerations

In Australia, profits on corporate IP are taxed at the relevant corporate income tax rate, which is currently either 30 per cent or 25 per cent from 1 July 2021 (depending on an entity's annual aggregate turnover).

The ownership of patented inventions and any associated profits can be relocated offshore, making patent profits sensitive to preferential tax treatments. More than 20 countries have implemented patent boxes. The design features of these regimes vary significantly.

The following broad design features will form the basis of Australia's medical and biotechnology patent box:

- an effective concessional tax rate of 17 per cent for companies on eligible profits from eligible patented inventions;
- only inventions claimed in standard patents granted by IP Australia, which were applied for after the Budget announcement (that is, have a priority date after 11 May 2021), will be eligible; and
- the patent box will be designed to be consistent with the OECD/G20 Forum on Harmful Tax Practice (FHTP) framework governing IP regimes, including the OECD's Base Erosion and Profit Sharing (BEPS) Action 5 minimum standard.
 - This includes that the concessional tax treatment will only apply to company profits from patented inventions in proportion to the amount of associated R&D that was conducted in Australia by the company.

The Australian Government will draw on approaches in comparable international jurisdictions with patent boxes to maximise effectiveness and minimise compliance burdens.

Questions

1. What features of patent boxes in other jurisdictions are most significant and important for designing the Australian patent box to support the medical and biotechnology sectors?

Eligible IP to enter the patent box

The scope of the Government's announcement relates to profits derived from inventions that would fall within the scope of Australian standard patents (including where the invention is protected by foreign patents). Standard patents are granted in Australia if there is sufficient evidence of the invention or process being new, inventive and useful. Standard patents provide protection in Australia for up to 20 years and up to 25 years for some pharmaceutical patents.

Questions

2. Are patents applied for by medical and biotechnology companies with domestic R&D operations generally Australian standard patents?
3. In instances where an invention is patented in other jurisdictions but not in Australia, is there a way of judging whether the scope of claims in these patents would be substantially similar to the scope of claims in a standard patent that would have been granted in Australia?

Targeting medical and biotechnology

The Government's aim is to target the patent box regime to new patented inventions related to the medical and biotechnology sectors.

Limiting the patent box regime to these sectors will be based on the use or classification of individual patented inventions, rather than the overall industry classification of the company that owns the patented invention. This could be achieved using a number of approaches including:

- Patent-level test: Patented inventions only qualify for the regime if the invention defined in the patent claim is primarily used or classified¹ in the medical and biotechnology sectors. All their eligible profits would then receive the concessional rate, including eligible profits attributable to activity in other sectors.
- Income streaming test: All patented inventions qualify for the regime, but only eligible profits attributable to activity in the medical and biotechnology sectors would receive the concessional rate.

Regardless of the ring-fencing approach, definitions of medical and biotechnology sectors or patents will need to be clearly identified.

Questions

4. What is the best approach to provide certainty around access to the regime for the medical and biotechnology sectors?
5. What are the core concepts/applications that need to be covered by any definition of the medical and biotechnology sectors for the purpose of defining access to the patent box?

Low emissions technologies

The Government is committed to the Paris Agreement; meeting and exceeding our 2030 Paris target of reducing greenhouse gas emissions by 26 to 28 percent below 2005 levels by 2030; and to achieving net zero emissions as soon as possible, and preferably by 2050.

The Government is taking a practical, technology-focused approach to reducing emissions. The Technology Investment Roadmap will guide \$20 billion of Australian Government investment in low emissions technologies by 2030, including through the Australian Renewable Energy Agency and the Clean Energy Finance Corporation, which backs early stage technology through the Clean Energy Innovation Fund. The Government is seeking to maximise co-investment and exceed at least \$80 billion of total public and private investment in low emissions technologies over the decade.

A patent box may provide an additional lever for the Government by encouraging further innovation in low emissions technologies.

Questions

6. What sort of businesses own patented inventions relating to low emissions technologies, and would introducing a tax concession through a patent box support the clean technology energy sector?

¹ The World Intellectual Property Organisation has a suggested breakdown of the international patent classification system, which IP Australia uses, for medical technology and biotechnology. This suggested breakdown is a potential option for targeting the medical and biotechnology sectors.

7. Do patents play a strong commercial role in the clean technology energy sector, or are other strategies for using IP more important (such as being first to market)?
8. What factors drive decisions about the location of clean technology R&D?
9. How would the clean technology sector best be defined for the purposes of a patent box?
10. Would a patent box be an effective way of supporting the clean technology sector? Are there other options available to encourage growth in this sector?

Applying the substantial activity requirement

International tax cooperation has been elevated by the Organisation for Economic Co-operation and Development's (OECD) Base Erosion and Profit Shifting (BEPS) agenda in recent years. Over 135 countries and jurisdictions are collaborating to implement various measures to tackle tax avoidance, improve the coherence of international tax rules and ensure a more transparent tax environment. To protect Australia's reputation for strong international tax cooperation and to provide certainty to taxpayers who engage in the patent box, the Government will implement a regime design that accords with OECD guidelines and standards.

For all IP regimes, the nexus approach requires a link between the benefits of the IP regime and the extent that the underlying R&D that generated the IP asset was undertaken within the home jurisdiction, known as the substantial activity requirement. In relation to income earned from a patented invention, concessional treatment will only apply to net IP income where the company undertook the associated R&D within the home jurisdiction.

The nexus is implemented by requiring businesses to adjust their qualifying IP income by the R&D fraction – which represents qualifying Australian R&D expenditure as a proportion of overall R&D expenditure on the IP asset. The proportion of expenditures on associated R&D is therefore a proxy for substantial activities.

R&D expenditure conducted in Australia with the Australian Government's support can be included when calculating the R&D fraction.

Where possible, expenditure should be linked directly to a specific patented invention. However, general and speculative R&D could be divided pro rata across patented inventions. Since a patented invention is often not directly correlated to a product, or a single R&D project, there is a need to understand how R&D expenses will be recorded and reported to the ATO to allow for the OECD standards to be met transparently.

It is desirable to design requirements that are flexible enough to accommodate different businesses whilst providing a clear framework to ensure IP regime benefits are commensurate with a company's relevant domestic R&D activities.

Questions

11. Do existing record keeping systems allow companies to show how R&D expenses are related to patented inventions? Can companies divide this into expenses incurred in Australia and elsewhere in order to calculate the proportion of R&D related to the patented invention that occurred in Australia?
12. How much R&D activity (related to patented inventions) occurs outside Australia? How is R&D usually split between related and unrelated parties?

Definition of R&D

The substantial activity requirement necessitates a definition of qualifying R&D expenditure.

The Research and Development Tax Incentive (R&D Tax Incentive or R&DTI) has an existing definition of R&D activities. The R&DTI helps to offset some of the costs an eligible entity puts into eligible R&D activity. This may help guide the definition of R&D expenditure for the purposes of the patent box.

R&D activities eligible for the R&DTI are comprised of 'core R&D activities' and 'supporting R&D activities', as defined in section 355-25 and 355-30 of the *Income Tax Assessment Act 1997* (ITAA 1997).

- Core R&D activities are defined as experimental activities whose outcome cannot be known in advance but can only be determined by applying a systematic progression of work, and conducted for the purpose of generating new knowledge. Some activities are expressly excluded, such as market research, minerals exploration, management studies, research in social sciences, aspects of patenting and licensing, statutory compliance, commercial reproduction and computer software for internal administration.
- Supporting R&D activities are activities directly related to core R&D activities. Certain activities must be undertaken for the dominant purpose of supporting core R&D activities to be considered supporting R&D activities.

Under the substantial activity requirement, the definition of qualifying expenditure must only include expenditures that are incurred for the purpose of actual R&D activities directly connected to the IP asset. It can include the types of expenditures that currently qualify for the Australia's R&DTI but need not be limited to activities and expenditure eligible for the R&DTI.

To ensure integrity and reduce ambiguity for taxpayers, it is anticipated that certain expenses, such as head office costs and finance costs, will not be an eligible expense in the calculation of qualifying R&D undertaken to generate the eligible IP.

Questions

13. Is the existing legal framework for the R&D tax incentive appropriate for determining R&D conducted in Australia for the purposes of the patent box? Do companies already collect this type of data and report it to the Government in some way (such as for the R&DTI)?
14. To what extent are the R&D expenses of Australian patented inventions not entirely the subject of R&DTI claims?
15. Could any existing definitions of qualifying expenditure (such as in the UK) in relation to the development of patented inventions be adopted in the Australian context?
16. How significant is the role of R&D that occurs after a patent has been applied for? What portion of an invention's total R&D would this typically account for in the medical and biotechnology sectors?
17. To what extent are Australian-based manufacturing processes subject to their own patents in the medical and biotechnology industry?

Implementation and start date

The patent box is a long-term tax measure to attract R&D activity and retain IP income in Australia. The benefit any taxpayer can receive from the patent box will be dependent on R&D undertaken in Australia.

Given that commercialisation of intellectual property can occur many years after the initial R&D takes place, taxpayers may have to track R&D expenditure split between Australia and other jurisdictions over a long time period.

Questions

18. What will be the implications of targeting the patent box to new patented innovations (i.e. have a patent priority date after 11 May 2021)?
19. Would a start date for the patent box's concessional tax treatment of income years commencing on or after 1 July 2022 give companies enough time to prepare for the regime? How would it impact on new R&D?

Eligible revenue to enter the patent box

Value derived from IP comes in many forms. But the following revenue forms are most commonly associated with the commercialisation of patented inventions:

1. Royalties or licence fees derived from an eligible patented invention
2. Revenue embedded in the sale of patented good or services or the use of patented processes in production
3. Revenue from damages or an account of profits for infringement of an eligible patented invention
4. Revenue by sale or assignment of an eligible patented invention

Where a royalty or license fee is not applied, revenue from sales of a product or performance of a service will be partially attributable to an underlying patented invention or group of patented inventions and partly attributable to certain downstream activities. The OECD's substantial activity requirement places limits on the extent to which IP tax regimes can provide concessional treatment to the revenue attributable to downstream activities.

Once a company starts producing revenue from an eligible patented invention, the company will require an apportionment mechanism to separate eligible revenue and non-eligible revenue for the purposes of the patent box.

Under the previously discussed substantial activity requirement, only companies that conducted the relevant R&D in Australia would be able to include revenue in the patent box.

Questions

20. What types of patent-related revenue should be eligible for the patent box?
21. How far downstream can the patent box's concessional treatment apply, and what principle should be used to define eligible income derived from the patented innovation?

22. In circumstances where a single product comprises of a group of related patented innovations, what approach could the patent box use to simplify the calculation of eligible revenue and the R&D fraction?
23. As non-patent revenue will need to be separated from the eligible revenue, how might this be achieved optimally (having regard to existing systems and record keeping)?

Subtraction of related patent expenses from eligible revenue

Expenses that arise in developing, exploiting, generating, and maintaining the relevant patented invention need to be subtracted from eligible patent revenue, and hence separated from non-eligible expenses that are unrelated to the patented invention.

Similar to patent box regimes overseas, there will need to be rules to ensure that expenses relevant to earning eligible revenue are included in the patent box design.

Questions

24. Having regard to existing systems and record keeping how might eligible expenses be optimally separated from non-eligible expenses?

Treatment of losses and related offsets with the patent box

Tax losses arise when a business's allowable deductions exceed its assessable profit. For corporate tax purposes a tax loss can be carried forward into future years until the entity returns to profitability. It follows that by default a taxpayer not subject to tax on profits due to losses does not benefit from the concessional rate under the patent box until those losses have been utilised. However, providing arrangements to allow firms to benefit during loss making years could add to the regime's complexity and pose integrity risks.

Questions

25. How should losses associated with either the development of a patented invention or its commercialisation be treated, both within the patent box and for general corporate tax purposes?

Administration and compliance

The patent box will be administered as part of the corporate tax system. To determine eligibility a taxpayer will need to be confident that they can evidence:

- Nexus 1: Appropriate nexus between R&D activity and eligible patented invention
- Nexus 2: Appropriate nexus between eligible patented invention and eligible profits

Questions

26. What is the likely regulatory burden in relation to administrative, record keeping or evidentiary requirements required to access the patent box concession?
27. Are there design features of any existing patent boxes that, if adopted in Australia, would minimise the regulatory burden on companies?

28. The ATO will administer the patent box via taxpayer self-assessments within the corporate tax system. What types of evidence would taxpayers be able to provide that would support claims that patented inventions relate to eligible sectors?

Other considerations

Questions

29. Are there any other issues you would like to raise for consideration in the design of the patent box?