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TREASURY BRIEFING NOTE

Minute No. 13 October 2014

Treasurer cc: Minister for Finance, Acting Assistant Treasurer

PATENT BOX REGIMES

Timing: As requested by you, following the September G20 Finance Ministers and Central Bank Governors meeting.

KEY POINTS

- A patent box is a preferential tax regime that offers tax benefits for companies to develop or exploit intellectual property (IP) in a particular country. This is done by reducing the corporate tax rate on income from qualifying IP, particularly patents.

- 11 European countries (including Belgium, France, Hungary, Luxembourg, the Netherlands, Spain and the UK) and China have introduced patent box policies.

- Patent boxes seek to achieve one or a combination of the following outcomes:

  1. to encourage additional research and development (R&D) investment to be undertaken in the country;

  2. to discourage IP developed in the country from being relocated offshore to low tax countries; or

  3. to attract IP developed offshore to gain the revenue and/or economic activity benefits from the exploitation of that IP.

- Patent boxes which encourage the first and second outcomes are not generally considered to be harmful. This is because they clearly link incentives to R&D expenditure that has taken place in the relevant country (i.e. there has been 'substantial activity' in the country).

- Patent box regimes designed to attract IP, however, have proven to be controversial. The OECD is still working towards an agreed approach to determine whether and in what circumstances these regimes will be harmful.

  – Countries with these patent box regimes generally consider that they attract some degree of economic activity (e.g. further R&D or management functions) and therefore should not be considered to be harmful.

  – Other countries argue that there is no substantial activity being undertaken in the patent box jurisdiction. Consequently, this encourages the transfer of IP between related parties across different jurisdictions which can erode the tax base of the country where the IP was developed.

    : Theoretically, the transfer of IP should be subject to income or capital gains tax in the seller's country. However this may not occur due to the difficulty in valuing IP transferred between related parties.

Implications for domestic tax policies

- We note that the Government made an election commitment to consider the applicability of a patent box regime in Australia. This is being examined in the context of the Tax White Paper.
  - Any consideration of a patent box regime in Australia should take into account the OECD's final approach for assessing intangible preferential tax regimes, which should be known by mid-2015.
- Of course, even if a particular patent box regime is not assessed as harmful under the OECD process, the Tax White Paper will need to consider the economic rationale for patent boxes, their effectiveness and assess the alternative policy options to achieve the same result.

Patent boxes in the context of the G20/OECD BEPS Action Plan

- 40 out of 44 OECD and G20 countries (including Australia) are comfortable with the 'nexus approach' that requires patent box concessions to be connected to R&D expenditure incurred in a jurisdiction to be considered non-harmful.
  - The [redacted] s 33(1)(a) do not support the nexus approach. As consensus has not been reached, it will require further work and/or a political resolution.
  - Australia has not had a prominent role in these discussions.
- [redacted] s 33(1)(a)
  - You have an upcoming bilateral meeting with [redacted] s 33(1)(a) in which you may seek to discuss the likelihood of reaching consensus on this issue prior to the G20 November Leaders' Summit.

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Consultation: G20 Policy Division, Small Business Tax Division, ATO

ADDITIONAL INFORMATION

OECD BEPS Action Plan Item 5 — Countering harmful tax practices more effectively, taking into account transparency and substance

- The OECD requires its member countries not to engage in harmful tax practices. Through its Forum on Harmful Tax Practices (FHTP), it monitors and evaluates any preferential tax regimes of member countries. If they are found to be harmful, the respective country is expected to remove or appropriately modify the regime.

- The OECD's BEPS Action Plan Item 5 is intended to reduce the distortionary influence of taxation on the location of mobile financial and service activities, thereby encouraging an environment in which free and fair tax competition can take place.
  - Action Item 5 will be delivered over two years, with further deliverables due in September 2015 and December 2015.

- The OECD's FHTP is undertaking the work on Action Item 5. In 2014, it focused on:
  - reviewing 30 member country preferential tax regimes to determine whether they are harmful;
  - developing a revised approach to the 'substantial activity' requirement; and
  - a framework to exchange rulings on preferential tax regimes.

- 15 of the regimes under review relate to the tax treatment of intangibles, with the majority being patent box regimes. The review of these regimes is dependent on the approach to the 'substantial activity' requirement, which was scheduled to be revised by December 2015.
  - The FHTP has undertaken significant work on a revised approach to the 'substantial activity' requirement, with a view to an early agreement on it to enable the finalisation of the intangible reviews this year.
  - However, agreement on the revised approach has not been achieved.

- Some countries s 33(1)(a) are pushing for consensus on this issue before the G20 Leaders' Summit in November.
  - s 33(1)(a)

Proposed change to the 'substantial activity' requirement for assessing intangible regimes

- The current 'substantial activity' approach requires that the economic or commercial activities that give rise to the IP or rights (the income which attracts the preferential tax treatment) must have been undertaken in the country providing the preferential tax treatment.

- The FHTP is considering three potential approaches to strengthen the requirement for 'substantial activity':

i. a transfer pricing approach that requires tax benefits to be connected to the 'important functions' (i.e. design and control, management, budget, strategic decisions, etc.) to take place in the jurisdiction providing the tax concession. It is not necessary for the IP to be developed in the country providing the tax concessions. s 33(1)(a) s 33(1)(a) trongly support this approach, and s 33(1)(a) has also shown some support for it;

: s 33(1)(a)

ii. a nexus approach that requires tax benefits to be connected directly to R&D undertaken in the country providing the tax concession, or outsourced to an unrelated party. 40 out of 44 G20 and OECD countries (in particular, th s 33(1)(a) s 33(1)(a) are comfortable with this approach.

iii. a value creation approach which combines the transfer pricing and nexus approaches. This approach requires tax benefits to be connected to a minimum number of 'active management activities' and 'significant development activities' undertaken in the jurisdiction providing the tax concession. There was no support for this approach in the OECD due to its complexity.

UK patent box

- The UK patent box is one component of the UK Government's commitment to creating the most competitive tax regime in the G20, which also includes lowering the headline corporation tax rate to 20 per cent from April 2015.

- Under the UK patent box, qualifying worldwide profits relating to patents are taxed at a concessional corporate tax rate of 10 per cent.

- Generally, a UK company that qualifies for the UK patent box must meet two conditions:

  – A development condition – a UK company or its related party within the worldwide group must have significantly contributed to creating or developing the IP (i.e. simply acquiring the rights to the IP, marketing, commercialising or defending the IP would not meet this condition); **and**

  – An active management condition – a UK company must be involved in the planning and decision making activities and have clear substantive responsibilities associated with developing or exploiting the IP.

- The IP does not necessarily have to be owned or developed in the UK. The scope of the UK patent box regime is broad and allows for rights over the IP to be developed elsewhere in the worldwide group and sold or exclusively licensed to the UK company to qualify for the regime.

s 33(1)(a)

- s 33(1)(a) There are specific rules requiring companies to be trading and to be carrying on active ownership of the IP in the UK. This will disqualify passive holding companies (who are purely in receipt of licence or royalty income) from qualifying for the regime.

Analysis of the UK patent box under the nexus approach

- The UK patent box is being reviewed by the FHTP. If the nexus approach prevails, the UK patent box is at risk of being deemed harmful because it allows for IP to be developed outside the UK (provided it is outsourced to a related party within the worldwide group which meets the development condition).
  - Under the nexus approach, only R&D outsourced to third parties would qualify.
- s 33(1)(a)

Coalition election policy commitment

- In its election policy document, *The Coalition's Policy to Boost the Competitiveness of Australian Manufacturing* (pp.7-8), the Coalition committed to 'use the scheduled 2014 changes to the R&D Tax Incentive programme to review access to R&D tax support' and 'also examine the potential applicability to Australia of the "patent box" model that has been implemented in a number of overseas countries'.

- R&D arrangements and patent box regimes are being considered in the Tax White Paper.

TREASURY MINISTERIAL SUBMISSION

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Treasurer

PATENT BOXES

TIMING: For information only. The UK patent box was raised by journalists on your recent visit to the UK.

- A 'patent box' is a preferential tax regime that concessionally taxes income generated from intellectual property (IP).
  - Many such regimes may have originally been merely intended to encourage 'home grown' IP to remain within a jurisdiction. However, international tax competition has now seen the taxing rights of global multi-national companies' profits attributable to IP become a major focus of the latest phase of the OECD's *Base Erosion and Profit Shifting* (BEPS) process relating to digital tax.
  - As a result, the merits of patent boxes need to be considered in the light of the international developments on digital taxation, recent action against countries' potential harmful tax practices, and Australia's policy on *Research & Development* incentives. We will provide more detailed briefing on each of these issues in coming weeks.
- There are 14 OECD jurisdictions that currently have preferential IP-income regimes including the UK. Patent boxes aim to attract mobile IP and the associated economic activity.
  - The design of patent boxes varies widely depending on the objectives of the jurisdiction implementing them. Generally there are two forms of tax relief for IP that are observed. First is a reduced corporate tax rate and second is a tax free threshold for a portion of corporate income that is earned from the commercialisation of IP.
- Patent boxes, including the initial version of the UK's, have been criticised by the OECD as potential harmful tax practices and could run counter to the G20/OECD work on digital tax.
  - As part of its work on the tax challenges arising from digitalisation, the OECD is considering a proposal that would impose a global minimum effective tax rate on corporate profits. This proposal is designed to limit the scope of global tax competition and deter companies from shifting profits to low tax jurisdictions.
  - Patent boxes can encourage firms to artificially relocate IP developed in another jurisdiction just prior to commercialisation in order to receive a lower tax rate.
  - However, patent boxes can also be designed to encourage research and development in the jurisdiction where the IP will be commercialised. These are not considered harmful. The OECD has developed a 'modified nexus' approach to patent boxes which requires some research activity to be undertaken where the patent is located.
- Australia has had a longstanding approach to provide concessional R&D tax support to claimants who conduct eligible R&D activities in Australia. s 22

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- – Compared to R&D support, patent boxes provide a tax benefit at the commercialisation stage. This stage is generally less risky with fewer spillover benefits than during the R&D phase.

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ADDITIONAL INFORMATION

UK patent box regime

The UK patent box enables companies to apply a lower rate of corporate tax to profits earned after 1 April 2013 from their patented inventions and equivalent forms of intellectual property. The relief has been phased in from 1 April 2013 and the full benefit of the patent box has been available from 1 April 2017. The standard rate of UK corporate tax is currently 19 per cent (scheduled to fall to 17 per cent in 2020-21).

The concessional tax rate of 10 per cent applies from income earned from at least one of the following:

- selling patented products;
- licensing out patent rights;
- selling patented rights; and
- damages, insurance or other compensation related to patent rights.

The value of the relief claimed by companies has generally increased year on year since the patent box was introduced. The published data indicates continual increases between 2013-14 and 2015-16 (the most recent full year of data). The number of companies claiming relief has also increased annually.

To be eligible for the patent box, companies must own or have an exclusive licence to the patent and have incurred qualifying development costs in the UK by either:

- creating or contributing to the patented invention; or
- performing a significant amount of activity to develop the patented invention or any item of process which incorporates the patented invention.

The UK legislation also includes the following anti-avoidance rules. The patent box will not apply where:

- the main purpose of granting an exclusive licence is to obtain the benefit of the patent box;
- the main purpose of incorporating a patented item into a product is to bring income from sales of that product within the patent box; or
- the company seeking the patent box deduction is part of a scheme and one of the purposes of the scheme is to increase the patent box deduction.

Changes to the UK regime to address harmful tax practices

- Following introduction of the UK patent box, the OECD identified it as being a harmful tax practice. This is because there was no requirement that the IP subject to the patent box was developed in the UK or by a UK company.

- In response, in 2016 the UK changed the design of the patent box regime to comply with the OECD's Forum on Harmful Tax Practice (FHTP) standards.
  - This involved the implementation of a 'modified nexus approach', which places a 30 per cent limit on expenditure undertaken outside the UK in developing the IP subject to the patent box.
- The 'modified nexus' has applied since 1 July 2016. Transitional provisions for this rule apply to companies that are already part of the scheme until 30 June 2021.

The purpose of patent boxes

- 'Patent box' is a term used to refer to a preferential taxation regime for IP. These taxation regimes are generally intended to encourage jobs and activities associated with the commercialisation and development of IP to be undertaken in a country. They may also assist in preventing IP from being relocated offshore to lower tax countries.
- Some countries have introduced patent boxes that are intended to increase their tax revenue and economic activity by encouraging firms to relocate IP developed offshore to the patent box jurisdiction. Patent boxes designed to attract IP from other jurisdictions are a harmful tax practice and erode the tax base of the country where the IP was developed.

Advantages and Disadvantages of patent boxes

- There is no single design for patent boxes and there is significant variation in design amongst countries, which influences the behaviour of companies. Belgium, China, France, Hungary, Israel, Italy, Netherlands, Portugal, Spain, Switzerland – Canton of Nidwalden, Turkey and the UK have patent boxes with different design features.
- The relative significance of the advantages and disadvantages of patent boxes presented below will vary depending on the design of the patent box chosen.
  - For example, the appropriate attribution of commercial value to 'marketing intangibles' is currently a contentious issue for large corporate taxpayers and the ATO. If Australia were to create a patent box, the borderline between observable IP (such as registered patents) and other intangible assets would be critical for determining cost to revenue, integrity risks and whether it is a 'harmful tax practice'.

Advantages and disadvantages of a generic 'patent box'

Patent boxes will likely increase Australia's share of new patent applications. Patent boxes could encourage commercialisation of IP in Australia instead of moving to other countries to take advantage of lower taxes or other factors.

However patent boxes will decrease the revenue collected from already profitable IP rich companies. The UK patent box was forecast by HM Treasury to cost the UK revenue £1.1 billion per year in net terms. It is unclear if manufacturing investment would increase significantly as a result.

Potential issues arising from the development of a patent box regime

Patent boxes designed to attract IP developed offshore to gain revenue and economic activity have proven to be controversial. Sometimes there is no substantial activity being undertaken in the patent box jurisdiction and multinational firms can be encouraged to transfer IP within related companies.

A patent box must comply with the OECD's FHTP standards to not be a harmful tax practice. The OECD considers the following factors as harmful:

- The tax regime imposes no or low effective tax rates on income generated from geographically mobile activities.
- The regime is isolated from the domestic economy, i.e. not generally available to domestic economic activities.
- The regime lacks transparency.
- There is no effective exchange of information.

To ensure a patent box is not harmful the OECD recommends a nexus between expenditures, activity, IP assets and income.

- Non-eligible income indirectly earned from the IP income is taxed at a higher rate.
- A cap of 30 per cent of expenditure that is outsourced or acquired from outside of the home jurisdiction.
- An effective enforcement mechanism that promotes compliance.

Australia's existing IP regime

Australia provides concessional R&D tax offsets to claimants who conduct eligible R&D activities in Australia. The law permits some overseas R&D activities to be claimed in Australia. This is generally where they cannot be efficiently undertaken in Australia due to a lack of specialised equipment or skills required for the project.

There is no requirement for IP arising from Australian R&D activities to be retained in Australia. Firms can move IP and R&D activities overseas to access overseas tax incentives and efficiently commercialise IP. Australia has lower rates of patent registrations based on R&D expenditures compared to overseas developed jurisdictions.

Australia has taxing rights on domestically generated IP. Capital gains tax (CGT) applies when IP is sold. However:

- IP is difficult to value and much of the value is generated when the product is commercialised;
- often when IP exists in Australia, little to no tax is paid because the IP is sold before commercialisation; and

- firms can enter into agreements meaning that an Australian subsidiary can conduct R&D in Australia, but the R&D is offshored to another jurisdiction through an assignment of the knowledge. These agreements may reduce the amount of tax payable in Australia.

Australia has reviewed its R&D support and innovation policies a number of times, including through the National Innovation and Science Agenda, Review of the R&D Tax Incentive and the Productivity Commission's Inquiry into Intellectual Property Arrangements. These reviews did not recommend the implementation of a patent box.

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Patent Box

- In the 2021-22 Budget, the Government announced that it will introduce a patent box for medical and biotechnology innovations. The patent box will tax profits derived from Australian developed medical and biotechnology patents at a 17 per cent effective concessional corporate tax rate, with the concession applying from income years starting on or after 1 July 2022.

- The detailed design of the patent box will be settled following consultation with industry. The Government will also consult closely with industry to determine whether a patent box is an effective way of supporting the clean energy sector.

  – The Government will release a discussion paper shortly to allow time for Treasury and industry to work through the design considerations.

- The patent box will compliment other government support for innovative businesses, such as the Research and Development Tax Incentive.

- The measure is estimated to decrease the underlying cash balance by $206.4 million over the forward estimates period.

Policy Commitments

- The Government is supporting businesses to invest, grow and create more jobs by providing significant temporary tax incentives for businesses to invest.

- The Government is encouraging companies to invest in, and retain, Australian medical and biotechnology innovations by introducing a patent box.

- The Australian Government is empowering businesses to grow investment in digital technologies.

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Pages 4 and 5 are outside the scope of the request and have been deleted

Background – Patent box: Tax concession for medical and biotechnology innovations

- Patent income is highly mobile and other countries actively target it with lower tax rates, meaning Australian-developed innovations can be offshored for tax purposes.

- By taxing income from certain patented innovations at a more internationally competitive rate, the patent box will reduce offshoring and make Australia a more attractive location for research and development.

  - Australia already has an extremely supportive Research and Development Tax Incentive to support industries to do R&D in Australia. The patent box measure focuses on the commercialisation stage and provides a competitive tax rate for this stage of innovation.

- Australia will join over twenty countries who currently have patent boxes, including the UK and France.

- The Government has heard a strong case for a patent box from the medical and biotechnology technology sectors, who have indicated a patent box would lead to more of the patents being developed in this sector being retained and exploited in Australia rather than overseas.

  - The Government is also consulting on whether a patent box could provide effective support to the clean energy sector.

- The government will follow the OECD's guidelines on patent box regimes to ensure the patent box meets internationally accepted standards.

  - In 2015 the OECD agreed guidelines for patent boxes to prevent them from being harmful tax practices. The guidelines require that the companies conduct research and development in Australia in order to be eligible. Where this only a partly occurs in Australia, a proportionate fraction of the income would be eligible.

- Patent boxes have been implemented all around the world in various forms. This reflects variation in intellectual property regulatory frameworks and commercial practices between countries. However, the Government has taken some high level decisions.

  - A 17 per cent rate, which is a substantial (13 percentage point) reduction on the top corporate rate (and an 8 percentage point reduction from the small and medium business corporate rate).

  - Income earned from standard patents applied for after budget night will benefit from the lower rate.

Costings

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Patent Box: Tax concession for medical and biotechnology innovations (impact on underlying cash balance)

($m) UCB	**2021-22**	**2022-23**	**2023-24**	**2024-25**	**Total**
Patent box – receipts	-	-	-100.0	-100.0	-200.0
Patent box – ATO funding	-1.3	-2.7	-1.2	-1.2	-6.4