THE TAX INSTITUTE

16 August 2021

Paul Fischer
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The Treasury
Langton Crescent
PARKES ACT 2600

By email: PatentBoxConsultation@treasury.gov.au

Dear Mr Fischer

Patent Box

The Tax Institute welcomes the opportunity to make a submission to the Treasury in relation to the *Patent Box discussion paper on policy design*, July 2021 (**the Discussion Paper**).

The Tax Institute supports the introduction of a patent box which is consistent and compliant with the Organisation for Economic Co-operation and Development (**OECD**) Base Erosion Profit Shifting (**BEPS**) Action 5 Minimum Standard.

The overall success of the patent box depends on a number of factors. Businesses will require certainty that the regime is commercially viable for them to apply and rely on. This will be evident in the legislation that gives effect to the patent box as well as the way in which it is proposed to be administered. While there are aspects of the legal framework for the research and development tax incentive (**R&DTI**) which are a useful starting point, the patent box has nuanced requirements which require a nuanced approach.

The policy of the patent box is to encourage companies in the chosen sectors to base their R&D operations, to commercialise their innovations, and to retain the ownership of eligible patented innovations, in Australia. Concessional tax treatment that is relatively simple to understand and apply, will not only encourage local businesses to innovate in Australia, it will also help to attract foreign investment both in the form of foreign capital and talent. This can contribute to Australia becoming a global innovation hub. We note that the objective of the patent box regime must be balanced with the need to ensure integrity in the system and retain the benefits of such investment in Australia as much as reasonably possible.

The Tax Institute is of the view that a patent box has the potential to support innovation in the medical and biotechnology sectors and we consider that an extension to the clean energy sector should be pursued. We consider that there are other sectors which would also benefit from concessional tax treatment of IP and we would support the extension of the patent box regime to apply more broadly. This would have the added benefit of reducing a degree of complexity in determining whether a patent is eligible.

We would be pleased to continue to work with Treasury on the development of the patent box regime including draft legislation, to ensure that it achieves its policy objective.

Our detailed response is contained in **Appendix A**.

The Tax Institute is the leading forum for the tax community in Australia. We are committed to shaping the future of the tax profession and the continuous improvement of the tax system for the benefit of all. In this regard, The Tax Institute seeks to influence tax and revenue policy at the highest level with a view to achieving a better Australian tax system for all. Please refer to **Appendix B** for more about The Tax Institute.

If you would like to discuss any of the above, please contact Tax Counsel, Julie Abdalla, on (02) 8223 0058.

Yours faithfully,

Peter Godber

President

APPENDIX A

We have set out below our responses to certain questions contained in the Discussion Paper. We have limited our responds to the questions relating to tax law and policy. Any references to or comments on UK or other foreign laws or regimes are based on our understanding of how the relevant law or regime applies. The numbering below corresponds to the Discussion Paper.

Patent box design considerations

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?

The Tax Institute is of the view that the following features of the UK's patent box would support companies seeking to access the Australian patent box.

Flexibility in income and expense streaming

The UK requires taxpayers opting into the patent box to divide patent related income into various streams, so that the appropriate expenses and a research and development (**R&D**) fraction can be allocated to each stream. The *Corporation Tax Act 2010* (UK) (**CTA UK**) requires new entrants into the UK patent box to divide income into 'streams' based on the qualifying intellectual property (**IP**) rights giving rise to those amounts.[1] This approach is consistent with the framework recommended by the OECD under the BEPS Action 5 Minimum Standard concerning harmful tax practices and preferential tax regimes.[2]

It certain circumstances it may not be practicable to stream income by qualifying IP rights. For example, where there are multiple qualifying IP rights within a single product or where it is not possible to allocate specific R&D expenditure between different qualifying IP rights. In such circumstances, the CTA UK allows taxpayers to stream income by products (either individually or in groups) or by IP process. The R&D fraction is applied to the appropriate product or process sub-stream.[3]

The OECD has indicated that these approaches are also acceptable in cases where organisations produce and sell products resulting from multiple qualifying IP rights, such that the allocation of expenditure to these rights becomes an arbitrary exercise.[4] The OECD added that jurisdictions should ensure that organisations accurately track and trace all relevant expenditure at the product levels and that the benefits under the regime expire at a fair and reasonable time (for example, the average expected life of all IP assets).[5]

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1 *Corporation Tax Act 2010* (UK) (**CTA UK**) sub-s 357BF(2). See also, HM Revenue & Customs (**HMRC**) *Corporate Intangibles Research and Development Manual*, *CIRD271500 - Patent Box: new regime : Streaming income requirement CTA10/ s357BF and s357BQ*.

2 OECD (2015), *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris p 27-34. Accessible via: http://dx.doi.org/10.1787/9789264241190-en (**OECD BEPS Action 5 Final Report**).

3 CTA sub-ss 357BF(2) and (7). See also HMRC *Corporate Intangibles Research and Development Manual*, *CIRD271500 - Patent Box: new regime : Streaming income requirement CTA10/ s357BF and s357BQ*.

4 OECD BEPS Action 5 Final Report p 31 at [56].

5 OECD BEPS Action 5 Final Report p 31 at [55].

The OECD recommends that product streams should not be overly broad that they encompass all of a taxpayer's IP income or expenditures where they are involved in a complex business with multiple products and R&D initiatives, nor so narrow that they require taxpayers to track and trace to a category which is unrelated to innovation.[6] The OECD provides relevant examples of this approach in practice, including in relation to pharmaceutical companies grouping products using the same patented chemical compound but with different dosages, colouring and packaging.

Adopting a flexible approach as such, would allow taxpayers to implement an approach that is appropriate in their business models and structures. This would support such decisions being made in accordance with the appropriate framework of principles and guidelines. Ultimately this would help to ensure that the allocation of expenditure and resulting tax benefits are commensurate with the level of R&D activity associated with eligible patents undertaken in Australia.

Small claims treatment

Taxpayers with small claims under the UK patent box are permitted to apply for Small Claims Treatment.[7] This involves a formulaic approach to determining the profits that may benefit from the concessional tax rate, rather than the standard tracking and tracing process which is otherwise required.[8] Eligible taxpayers may treat as the relevant IP profits, the lower of 75% of the qualifying residual profits of all the company's trades and the small claims threshold (currently £1 million).[9] This permits eligible taxpayer to aggregate income streams into a single global stream so that they do not need to undertake the full calculation in respect of relatively small or immaterial amounts. This generally results in two steams: one for relevant income and one for non-relevant income.[10]

The Tax Institute considers that providing a similar small claims treatment election for eligible Australian taxpayers would allow businesses with smaller claims under the patent box to participate in the regime without the compliance and administrative costs.

Low emissions technologies

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

The Tax Institute is of the view that a tax concession through a patent box would support businesses operating the clean energy sector. Patented innovations relating to low emissions technologies include patents in relation to climate change mitigation technologies (**CCMTs**) related to energy, greenhouse gases, and agriculture.

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6 OECD BEPS Action 5 Final Report p 31 at [57].

7 CTA s 357CM.

8 Under CTA Part 8A.

9 CTA sub-s 357CM(2). See also HMRC *Corporate Intangibles Research and Development Manual*, CIRD220480 - Patent Box: relevant IP profits: elections for small claims treatment: small claims amount: MAR.

10 CTA s 357BNC. See also *HMRC* Corporate Intangibles Research and Development Manual, CIRD273200 - Patent Box : new regime: small claims treatment for global streaming CTA10/s357BNC.

For example, CCMTs related to energy generation, transmission or distribution, CCMTs related to transport and buildings, CCMTs related to the capture, storage, segregation, isolation, disposal of greenhouse gases or the reduction of greenhouse gas emissions, CCMTs related to agricultural machinery or equipment. Other examples include emissions-reducing technologies and renewable energy (for example, solar photovoltaic patents).[11]

As is the case for businesses operating in other sectors, IP rights support the development of new technologies. IP rights including patents encouraging investment by allowing businesses to recover their costs. In sectors such as clean energy, it can take many years for a patented technology to be developed and commercialised, and indeed to generate a profit. A tax concession for income derived from such activities would certainly be beneficial to businesses operating in this field though we note that other support may also be useful, particularly in the earlier stages of the business life cycle. We have considered certain options in our response to question 29 below.

8. What factors drive decisions about the location of clean technology R&D?

There are a number of factors which contribute to the decision to undertake R&D in a particular location. These include the availability of capital (both financial and human), the size of the relevant market relative to international competitors, and of course the applicable tax system. For the clean energy sector, an assessment of the environmental conditions which may hinder or support the development of technology will also contribute to the decision making.

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?

A patent box has the potential to be an effective way of supporting the clean energy sector in the same way as it would support the medical and biotechnology sectors. Concessional tax treatment that is simple to understand and apply will encourage local businesses to innovate in Australia, and will also help to attract foreign investment both in the form of foreign capital and talent. The Tax Institute considers that it is important to ensure that any option pursued is supported by sound tax policy which is focused on the objective of encouraging business to undertake R&D in these areas.

Applying the substantial activity requirement

11. Do existing record keeping systems allow companies to show how R&D expenses are related to patented innovations? Can companies divide this into expenses incurred in Australia and elsewhere in order to calculate the proportion of R&D related to the patented innovation that occurred in Australia?

The Tax Institute understands from our members that many companies should have access to information about whether R&D expenses have been incurred in Australia. However, these businesses may not necessarily have existing record keeping systems that link R&D expenses to patented innovations.

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[11] OECD (2018), *Accelerating the development and diffusion of low-emissions innovations*, Background Paper for the 37th Round Table on Sustainable Development. Accessible via https://www.oecd.org/sd-roundtable/papersandpublications/Accelerating%20the%20development%20and%20diffusion%20of%20low-emissions%20innovations.pdf.

If an entity already tracks and accounts for expenses at the IP asset level, it could conceivably separate the expenses incurred in Australia from those incurred outside of Australia. This would allow it to then calculate the proportion of R&D activity that took place in Australia, as linked to Australian patented innovations.

However, where a business accounts for expenditure at a product or project level, it may be difficult to present this information in a way which demonstrates the nexus between R&D expenses and specific patented innovations. Further, although some existing record keeping systems may be capable of showing the link between R&D expenditure and patented innovations, individual companies may not be recognising and classifying R&D expenditure in this way for various reasons, including their business model, group structure or performance measurement considerations.

This becomes more challenging where a product is underpinned by multiple qualifying patents. In such cases, although these businesses may be able to separate R&D expenses incurred within Australia from those incurred offshore, they may not be able to reliably link and apportion expenditure to specific patented innovations.

The Tax Institute is of the view that this issue could benefit from further open consultation.

Definition of R&D

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)?

The Tax Institute considers that the existing legal framework for the R&D Tax Incentive (**R&DTI**) contained in Division 355 of the *Income Tax Assessment Act 1997* (Cth) (**ITAA 1997**) may serve as a good preliminary basis for a determining the type of costs that qualify as R&D activities. However, the legal framework for the R&DTI has not been established with a patent box in mind and therefore has a number of shortfalls. Importantly, it does not address whether the relevant activity relates to the development of a patented innovation, nor the requirement for patents to be registered in Australia.

An issue arises where there are general expenses which partly relate to patents (both eligible and ineligible) and other non-patent related activities which will require apportionment. Guidance will need to be provided around how direct the relationship between a particular expense item and a patented innovation needs to be before it is considered an eligible expense for the purposes of the patent box. The Tax Institute recommends that Treasury consider the following scenarios.

- The enabling legislation should contemplate whether expenditure which partially relates to qualifying patented innovations will qualify to the extent to which it relates to qualifying patents developed and registered in Australia, and whether there is a minimum threshold in order to be included.
- The enabling legislation should also contemplate whether expenses of a general nature which cannot be directly linked to a specific patent right but relate to multiple patents will fall within the scope of the patent box. One example may be where an entity makes undissected payments for outsourced R&D activities to be performed by a third party and some of the activities performed relate to patented inventions.

15. Could any existing definitions of qualifying expenditure (such as in the UK) in relation to the development of patented innovations be adopted in the Australian context?

The Discussion Paper provides that the proposed patent box will be designed to be consistent and compliant with the OECD BEPS Action 5 Minimum Standard. It follows that the scope of qualifying expenditure should closely align with the modified nexus approach provided by the OECD.

The OECD provides that the following expenses should be treated as qualifying expenditure in the context of preferential IP regimes:

- R&D costs incurred by the entity; and
- costs of R&D outsourced to an unrelated party.[12]

The OECD recommends that the following expenses should not be treated as qualifying expenditure:

- acquisition costs for IP assets and rights (although they are included in overall expenditures); and
- costs of R&D outsourced to a related party.[13]

Further, the OECD provides that expenditure of a general nature which cannot be allocated to a specific IP asset or right may be allocated among qualifying IP rights and assets on a pro rata basis.[14]

The Tax Institute considers that the scope of qualifying expenditure for the purposes of the patent box should, at a minimum, broadly align with the scope of expenses which are eligible for the R&DTI. While we have reservations about inextricably linking the two regimes together, we acknowledge that this would reduce the duplication of work performed by taxpayers in calculating and substantiating their tax claims, and the ATO in undertaking compliance and verification activities in respect of these claims. For clarity, The Tax Institute is not of the view that the R&DTI should be a pre-condition for a patent to be eligible for the patent box. Patents may be developed without having incurred R&D expenditure which is eligible for the R&DTI. It is therefore important to ensure that the definition of eligible patent is as broad as possible.

If the Government intends to link the patent box and the R&DTI together, it is imperative that a thorough review of the R&DTI be undertaken to ensure that the end-to-end process fulfils the overarching objective and properly incentivises businesses in these sectors. We consider that to the extent possible, for the purposes of the patent box, a more flexible approach is preferable to an overly technical or narrow approach.

In order to address the issue of linking expenses to patents developed and registered in Australia, and to align the proposed regime with the OECD's recommended framework, R&D expenditure could be grouped into the following categories:

- Specific patent expenses – expenses which are directly related and traceable to particular (qualifying) patents should be allocated against those patents for the purposes of calculating the R&D fraction.

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[12] OECD BEPS Action 5 Final Report pp 27-29.

[13] OECD BEPS Action 5 Final Report pp 27-29.

[14] OECD BEPS Action 5 Final Report p 27 at [39].

- General patent expenditure – expenses which relate to more than one (qualifying) patent should be aggregated and allocated on a pro rata basis, as recommended by the OECD. General expenses which only partially relate to patents registered and developed in Australia should only be included to the extent that they meet this nexus requirement.[15]
- Non-patent expenditure – all other R&D expenses that do not meet either of the above classes should fall within this category and should not be relevant for the purposes of the patent box.

In this way, taxpayers would not need to take additional steps to determine whether or not expenses are eligible for the patent box. They would only need to determine the appropriate categorisation of the expenses already claimed under the R&DTI when calculating claims under the patent box. From a regulatory perspective, the ATO should only need to review the categorisation of the expenses, rather than verifying the other aspects of these expenses such as eligibility or the amounts being claimed.

Implementation and start date

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)?

A patent's priority date is the date on which an entity first files a patent application. The application to only patents with a priority date after 11 May 2021 will mean that otherwise qualifying patents that have previously been registered, or those which applied for registration without it necessarily having been granted, will miss out on receiving the concessional treatment.

We anticipate that targeting the patent box at new patented innovations may have the following implications.

Increase in patent registrations

The targeting of the patent box at new patents may mean that companies are more willing to register and develop patents over methods, materials and processes, with a view to incorporating successful patents into products on the market.

This may result in an increase in R&D activity related to patented innovations. It could also therefore lead to companies making more of their knowledge accessible to the public in the form of products available on the market.

We note that there is the potential for companies to seek to register several patents over a specific process or method which previously, they may have registered under a single patent. That is, it may lead to potential exploitation of the system by attempts to granularize different processes and concepts into patents in order to expand the possible avenues to claim concessional tax treatment for commercialised products. This may be viewed as maximising the potential avenues through which such companies may benefit from the tax concessions under the patent box.

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[15] OECD BEPS Action 5 Final Report p 27 at [39].

Exclusion of patents which are otherwise eligible

The targeting of the patent box at patents with a patent priority date of after 11 May 2021 would mean that patents which have not yet been commercialised and which would otherwise qualify for the patent box will not be able to benefit from the related concessional tax rate. According to an article published by the University of Queensland, new medical drugs take between nine to 12 years on average to reach final approval from initial discovery in a laboratory.[16]

This indicates that there may be R&D activities conducted in Australia relating to patents which are at a similar stage in the development life cycle, but will be excluded from the patent box regime due to the timing of registration and grant of the relevant patent.

Due to the lag times between the registration of a patent and the time it takes for a related product to reach the market (and generate a profit), we consider it would be in the interests of fairness to permit such patents to benefit from concessional treatment under the patent box regime, when they are unlikely to reach the market in the next few years.

We acknowledge that entities who registered for patents prior to 11 May 2021 may not have been collecting and recording the relevant information to support a claim under the patent box. However, companies which have registered patents between 11 May 2021 and the date on which the enabling legislation receives Royal Assent will have been equally unaware of any record keeping and tracking requirements, yet still eligible to benefit from the patent box.

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?

Taxpayers' ability to prepare for the regime will ultimately depend on what is required of them not only in terms of demonstrating eligibility but also in relation to record keeping requirements. Taxpayers will require time to understand their reporting obligations and to ensure that they have appropriate systems and processes in place to ensure that they comply with them.

We consider it is appropriate for the Government to allow a transitional or grace period in relation to the way in which entities track and record expenses for the purposes of the patent box. Such a period should be provided for in legislation and given the force of law. In addition, we would recommend that the ATO in its capacity as the relevant regulatory, adopt a safe harbour and rule on transitional arrangements to provide assurance to entities seeking to access the patent box in its early stages.

The Government could adopt a similar approach to the UK by only requiring companies to adhere to the specific requirements after enabling legislation comes into force. For example, subject to any exemptions, generally new entrants that elect into the UK patent box must track and trace expenditure from 1 July 2013. However, given that date was before the relevant legislation was enacted, companies may not have had the required information or sufficiently detailed records relating to that period.

[16] Sabine Braat et al, 'How drugs go from discovery to the pharmacy shelf' (University of Queensland, Centre for Health Services Research, 11 October 2017).

In such cases, HM Revenue & Customs (**HMRC**) accepted that if the company explained this, it may commence tracking and tracing records from 1 July 2016. In cases where R&D expenditure may have occurred prior to these dates, a company may elect to include earlier R&D expenditure for a particular IP asset to achieve an accurate R&D fraction, provided they do this within the patent box calculation. In such circumstances, the earliest date that can be included is 20 years before the last day of the relevant accounting period.[17]

We consider that this kind of flexible approach ensures that taxpayers are not unduly penalised due for failing to keep the required records and information in an appropriate format, without having been aware of the relevant specific record keeping and evidentiary requirements.

Eligible revenue to enter the patent box

20. What types of patent-related revenue should be eligible for the patent box?

In the UK, the following five categories of revenue are eligible for the patent box.

1. Selling patented products including:
   - the patented product;
   - products incorporating the patented invention; or
   - bespoke spare parts.
2. Licensing patent rights.
3. Selling patented rights.
4. Infringement income.
5. Damages, insurance or other compensation related to patent rights.[18]

The above categories broadly align with those identified in the Discussion Paper and are widely accepted ways in which revenue is derived from intangible assets. The Tax Institute considers that it would be appropriate for these principles to apply for the purposes of the patent box. Including all patent-related sources of revenue ensures that all eligible taxpayers are able to benefit from the patent box, regardless of how they operate their business model or commercialise their patented inventions.

We note that the first three revenue streams identified above have been expressly accepted by the OECD under the BEPS Action 5 Minimum Standard.[19] We consider that it is appropriate for infringement income, and damages, insurance and other forms of compensation (also identified in the Discussion Paper), to fall within the scope of the patent box as this accords with the common law principle that the character of compensation should follow the character of the income it seeks to replace.[20]

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[17] CTA s 357BLF. See also HMRC *Corporate Intangibles Research and Development Manual*, CIRD272200 - Patent Box: new regime : when to start tracking and tracing R&D expenditure CTA10/s357BLF.

[18] HMRC, Guidance: Use the Patent Box to reduce your Corporation Tax on profits, 1 January 2007 (last updated 7 May 2020).

[19] OECD BEPS Action 5 Final Report p 29 at [48].

[20] See *Federal Commissioner of Taxation v Dixon* (1952)10 ATD 82.

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?

The Tax Institute is of the view that the principles applied in the UK patent box regime could be appropriate here. Broadly, the UK rules provide that only qualifying companies can benefit under the regime. At a very high level, to be a qualifying company, a company must, for the relevant period, hold:

- any qualifying IP rights; or
- an exclusive licence in respect of any qualifying IP rights.

Where the company is a member of a group, it must satisfy a condition of active ownership in relation to substantially all of its qualifying IP rights. This broadly requires the company to take undertake a significant amount of management activity in respect of the qualifying IP rights.

Under the UK regime, if a company holds a licence to use a patented technology, it may utilise the patent box if it meets all of the following conditions.

The licensee must have:

- rights to develop, exploit and defend rights in the patented invention;
- one or more rights to the exclusion of all other persons (including the licensor); and
- exclusivity throughout an entire national territory (rights to manufacture or sell in part of a country would not qualify).

The licensee must either:

- be able to bring infringement proceedings to defend its rights; or
- be entitled to the majority of damages awarded in successful proceedings relating to its rights.

Income derived by manufacturers and service providers may be eligible for the patent box where they:

- manufacture using a patented process; or
- provide a service using a patented tool.

The Tax Institute considers that preferential tax treatment under the patent box regime should follow the asset. The entity which retains the ownership rights or exclusive licensing rights in relation to the patent should accordingly benefit from the preferential tax treatment.

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?

As outlined in our response to question one above, for the purposes the calculation of eligible revenue and the associated R&D fraction where a single product comprises of a group of related patents, we consider that taxpayers should be permitted to stream and apportion income and expenditure by product or products, product families or by patented processes. This would ensure that taxpayers have a consistent basis for linking qualifying income and expenditure with qualifying patents, particularly where they do not ordinarily track income and expenditure at a patent level.

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)?

A taxpayer's ability to separate non-patent revenue from eligible revenue would depend on how they classify and recognise revenue in their accounting systems (i.e. whether on an IP asset basis, project basis or product basis). Given the nature of medical and biotechnology companies, we expect that commercialised products often would be tracked at a product level in order for them to determine whether such products were profitable or not. In such cases, these companies should already have the existing systems which would allow them to separate non-patent revenue from eligible revenue. Again, we consider that this matter could benefit from further open consultation, particularly to assist Treasury to gain insights into the systems operated by businesses likely to seek to access the patent box.

Subtraction of related patent expenses from eligible revenue

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

Each business will have its own accounting systems and policies around general ledger codes and the level of detail and granularity in which they classify expenses. The systems used by businesses should generally contain information about the entity that incurred the expense, as well as a description to some degree of the expense. To the extent that taxpayers can readily distinguish their expenditure in this manner, this would be the optimal method for taxpayers to separate eligible expenses from ineligible expenses. While it is important for businesses to segregate expenses in this way, we consider that it may be difficult and indeed unnecessary, to prescribe a uniform method to do so.

Treatment of losses and related offsets with the patent box

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?

In the sectors to which the patent box is proposed to apply, businesses may, particularly during the early stages, derive income without necessarily generating a profit, or may generate profits that do not equal or exceed the costs incurred. In such cases, these businesses may incur losses.

The Tax Institute considers that losses incurred during the development or commercialisation of a patented invention should be able to be carried forward to later income years. The carry-forward treatment of these amounts would support the policy intent behind the patent box of providing tax concessions on patented inventions once they start to generate a profit.

We consider the UK approach is a potentially appropriate option which should be considered further. The UK patent box reduces the rate of tax for qualifying companies by allowing an additional deduction (referred to as the 'patent box deduction') from the profits of the trade for UK corporation tax purposes for each relevant period.[21]

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[21] CTA UK s 357A.

At a very high level, under the UK system, there are a number of consequences to incurring losses (referred to in subsection 357C(3) of the CTA UK as 'relevant IP losses'). The business is not able to benefit from the patent box.[22] That is, where there are no relevant IP profits, there can be no patent box deduction.

A company with a relevant IP loss may choose not to elect into the patent box in the relevant period. However, if a company has elected into the UK patent box regime, it will still be able to utilise actual trading losses (the UK system segregates certain kinds of losses) as if it had not elected into the patent box.

A company that has elected into the patent box regime must still determine the amount of the relevant loss as that amount will limit other patent box benefits.[23] For example, a relevant IP loss reduces the relevant IP profits of other group members (noting that the UK grouping rules operate distinctly to Australia's tax consolidation regime).[24] Any balance is carried forward to reduce future relevant IP profits in the same company.[25]

Importantly in the UK context, a relevant IP loss is not the same as a normal corporation tax trading loss of a company. A company with relevant IP loss either reduces a corporation tax profit, turns such profit into a loss or increases a corporation tax loss. The patent box does not impact how a corporation tax loss is utilised. A company making a patent box election can still group relieve (broadly, the transfer of certain losses between group companies) or carry forward its corporation tax loss at the full corporation tax rate as normal.

We refer to our comments in response to question 29 in relation to the impact of the proposed patent box concessional tax rate on the headline Australian corporate tax rate.

Administration and compliance

26. What is the likely regulatory burden in relation to administrative, record keeping, or evidentiary requirements required to access the patent box concession?

The Tax Institute anticipates that the likely burden from a regulatory and administrative perspective in order to access the patent box may be as follows.

Depending on the specificity of the enabling legislation, taxpayers may need to seek assurance, whether through public or private rulings from the ATO, or enter agreed compliance approaches, in relation to the proper allocation of general expenses that may not relate to any specific patent, but relate to patents generally.

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[22] CTA UK sub-s 357A(3). See also HMRC *Corporate Intangibles Research and Development Manual*, CIRD201020 - Patent Box: reduced CT rate for profits from patents: patent box election.

[23] HMRC *Corporate Intangibles Research and Development Manual*, CIRD240100 - Patent Box: relevant IP losses: overview.

[24] CTA UK s 357EB. See also HMRC *Corporate Intangibles Research and Development Manual*, CIRD240130 - Patent Box: relevant IP losses: set-off amount: allocation within a group.

[25] CTA UK s 357EC. See also HMRC *Corporate Intangibles Research and Development Manual*, CIRD240140 - Patent Box: relevant IP losses: set-off amount: carry-forward.

Taxpayers may need to develop new approaches for allocating general expenditure, such as wages and overheads, to R&D activities conducted in connection with qualifying patents under the patent box. This information may need to be documented in a form that may be used to substantiate claims under the patent box. This could potentially involve requiring employees to track time spent on various projects and devoting resources to ensure compliance with these policies and procedures.

Some taxpayers will not have historically categorised income and expenditure in a way that would enable them to separate eligible income and expenditure from ineligible income and expenditure. In such cases, they will need to adjust and tailor their accounting systems and policies to accommodate for the reporting requirements under the patent box. It is difficult to quantify the impact of this as it will vary from business to business depending on a range of factors including their existing processes and systems, and their capability to introduce and adapt to new practices.

27. Are there design features of any existing patent boxes that, if adopted in Australia, would minimise the regulatory burden on companies?

We refer to our response to question one, in respect of flexibility in income and expense streaming, and small claims treatment. We consider that adoption these features would assist to minimise the associated regulatory burden on companies. In addition, we note the following in respect of the UK patent box regime which we consider would also support this objective.

The UK patent box regime provides taxpayers with a number of concessions which minimise the regulatory burden on companies and could be adopted in Australia. For example, taxpayers are required to divide income streams by IP rights at the first instance, if possible, but may separate them by product or product group where this is not possible (for example, where there are multiple patents which contribute to a particular product).[26]

The UK regime also allows taxpayers to skip the step of calculating the R&D fraction and take it to be equal to one if they can provide evidence to substantiate that all their R&D fractions cannot be less than one (for example, because all the R&D was conducted in-house and there have been no related acquisitions). Under the UK self-assessment system, they may rely on such evidence instead of tracking and tracing actual R&D expenditure.[27] Adopting a similar concession would reduce the compliance process for companies that wholly conduct their R&D activities in Australia.

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?

As outlined above, The Tax Institute is of the view that the scope of the patent box should be expanded to encompass patents in other sectors. To the extent that it is limited to particular sectors, we consider that it should suffice for taxpayers to provide copies of correspondence provided by IP Australia in respect of the registration and grant of the relevant patent and potentially a brief description of the relation between the invention and the patent. This could be entered in the company tax return or reserved for circumstances which warrant further ATO enquiry audit activity. This would limit the additional compliance burden resulting from the patent box as taxpayers would have this information readily available.

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[26] HMRC *Corporate Intangibles Research and Development Manual*, CIRD271500 - Patent Box: new regime: Streaming income requirement CTA10/ s357BF and s357BQ.

[27] HMRC *Corporate Intangibles Research and Development Manual*, CIRD272000 - Patent Box: new regime: Tracking and tracing R&D expenditure CTA10/s357BLB.

Other considerations

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

We have set out below certain issues for consideration in the design of the patent box which have not been otherwise addressed in the preceding sections.

Impact of the patent box concessional tax rate

Regardless of the way in which the effective concessional tax rate of 17% is proposed to be structured, The Tax Institute is of the view that it should not impact the rate of the R&DTI that a business applies (which is currently based on relevant company's corporate tax rate and uplift). The Information contained in the Discussion Paper does not specify whether the patent box mechanism will be a schedular approach or addressed through a tax offset. Based on our understanding of the proposed regime, it is The Tax Institute's current view that this regime would be best delivered through a non-refundable tax offset. This would avoid ambiguity surrounding entitlement to other incentives including the R&DTI. We currently envisage that this would result in fewer unintended consequences which could otherwise arise under a schedular approach.

Expansion to other sectors

As noted throughout this submission, The Tax Institute is of the view that the patent box regime should not be limited to the medical and biotechnology (and potentially the clean energy) sectors. We consider that is should be expanded at the outset to apply to more sectors. The policy of the patent box is to encourage companies in the chosen sectors to base their R&D operations, to commercialise their innovations, and to retain the ownership of eligible patented innovations, in Australia. There are a number of industries in which patents are used and to which this policy should be extended. The development, commercialisation and retention in Australia of patents relating to technology and computer related inventions, advances in engineering, and certain business methods have the potential to have a significant impact. This includes not only creating jobs in these fields and boosting the economy, but also potentially supporting valuable inventions which improve different aspects of life.

Inclusion of software

The Tax Institute notes that many foreign jurisdictions include software-related inventions in the scope of their concessional regimes for IP. For example, 17 out of 21 European Union member states with patent box regimes include software in the scope of their respective regimes.[28] However, as currently proposed, software-related R&D activities are not within the intended scope of the Australian patent box.

The patent box is currently intended to be available to companies in the medical and biotechnology sectors (with the potential extension to businesses in the clean energy sector). As outlined above, The Tax Institute is of the view that the patent box should have a wider scope in terms of the sectors to which it applies. However, even within the prescribed industries, there may be companies which develop and commercialise relevant software which, as currently proposed, would not be eligible for the patent.

[28] Elke Asen and Daniel Bunn, Patent Box Regimes in Europe, (Tax Foundation, 2020)..

If the Government intends to extend the scope of the patent box beyond the currently proposed sectors, increasing the scope of the patent box to include software-related R&D activities would support companies engaged in non-patented innovations to be rewarded for investing into these activities.

While allowing non-patent-related software R&D could potentially lead to disproportionate tax benefits being offered to businesses operating in the technology industry, the enabling legislation could include limitations to ensure that the concessions are only available in respect of particular kinds of software with a demonstrable level of scientific and technical investment and rigour (such as the existing eligibility requirements under the R&DTI). Further, as the patent box only provides tax benefits to businesses once the software has been commercialised, businesses will only be able to benefit from the patent box once the resulting product has generated sufficient economic activity to generate a profit.

Interaction with the tax consolidation rules

The Tax Institute recommends that Treasury also considers the potential interactions between the enabling legislation for the patent box with the tax consolidation rules as set out in Part 3-90 of the ITAA 1997. We envisage that the following scenarios could arise which will need to be addressed in the design of the enabling legislation to the patent box:

The single entity rule under subsection 701-1(1) of the ITAA 1997 provides that members of the same tax consolidated group are taken to be parts of the head entity. Transactions occurring between the members of a consolidated group are disregarded for income tax purposes. The enabling legislation should clarify whether the entity that incurred the qualifying R&D expenditure must also be the same entity that holds the patent rights and ultimately derives the patent-related income, or whether the head company is eligible to access the patent box provided that all relevant activity is undertaken within the same tax consolidated group.

The design of the patent box will need to contemplate situations where an entity or tax consolidated group acquires an entity that qualifies for and benefits from the patent box. The enabling legislation should stipulate whether the head company may benefit from the patent box in such circumstances, or whether the acquisition will somehow disqualify the group from the regime.

The entry history rule in section 701-5 of the ITAA 1997 provides that, with some exceptions, everything which happened to a subsidiary before joining a tax consolidated group is taken to have happened to the head company. It should follow that the head company should become able to benefit from the patent box following the acquisition of an entity which has been eligible for it. However, there is a question of whether it should be treated as part of the costs of acquisition (for the purposes of the R&D fraction). In such case, the group may not receive the benefits of concessional tax treatment under the patent box as it did not contribute to the development of the relevant patent.

Allowing the head company to benefit from the patent box may not sit squarely with the Government's policy intent, or the OECD recommendation that acquisition costs be excluded from eligible expenditure, particularly where the group did not contribute to the R&D activities giving rise to the patent-related income. However, this should be considered in light of the policy underpinning the tax consolidation regime.

Agencies responsible for the administration of the patent box

The Tax Institute suggests that the design of the patent box should also consider the proper roles and responsibilities of the government agencies involved and that these roles and responsibilities should be clearly legislated. We anticipate that IP Australia will continue in its role in assessing and approving patent applications. We also envisage that the ATO will primarily be responsible for the tax administration of the patent box including verifying the eligibility of income and expenditure for the purposes of the regime, as well as the calculation and verification of any claims made by taxpayers under the scheme.

However, we note that the Discussion Paper indicates that the patent box may leverage elements of the existing framework underpinning the R&DTI. The R&DTI is jointly administered by the ATO and Industry Innovation and Science Australia (**IISA**) and the Department of Industry, Science, Energy and Resources (**DISER**). AusIndustry (as a part of the DISER), delivers the R&DTI on behalf of IISA. AusIndustry determines whether certain activities are eligible to be registered for the R&DTI. Regard should be given to the extent to which it may be appropriate for AusIndustry to also become involved in determining whether activities giving rise to income and expenses are eligible for the patent box.

We note there are a number of challenges with introducing a third agency into the administration of the patent box regime, including additional pressure on each such organisation (some of which may require significant additional resourcing), and a compounding of some of the challenges faced in a dual-agency administration system (such as those currently being considered by the Board of Taxation (the **Board**) in its review of the dual-agency administration model for the R&DTI.

Regardless of the agencies that are ultimately involved in the administration of the patent box regime, we recommend that Treasury consider the outcome of the Board's review and the learnings which may be applied from the administration of the R&DTI to the proposed patent box. Importantly, it will be crucial to ensure that the division of responsibilities between the relevant agencies is appropriate for their remit and does not involve in a duplication (or triplication) of work among the agencies or for taxpayers in their dealings with each.

Other options to support the sectors to which the patent box regime is open

Our response to question 10 above was limited to alternative options that may support growth in the clean technology sector. We consider that if the Government's objective is limited to encouraging the operations of businesses in these specific sectors to take place and remain in Australia, direct funding (whether through grants or otherwise) may be a preferable option. There is an inherent degree of complexity in any patent box regime and having a very narrow scope in some ways increases the complexity. It may not be worthwhile to introduce an additional layer of complexity to an already complex tax system where the benefits are very limited in scope.

Other (non-tax) options which would support these sectors (and indeed any other sectors to which the patent box regime could be extended), include reductions in application fees for patents, and expediting examination and approval processes by IP Australia. We note that provided that certain conditions are met, small and medium enterprises (**SMEs**) can apply for patent applications to be fast tracked by IP Australia provided that the relevant invention is in the field of green technology. We envisage that a number of these options could be made available as a package rather than offered in the alternative.

APPENDIX B

About The Tax Institute

The Tax Institute is the leading forum for the tax community in Australia. We are committed to representing our members, shaping the future of the tax profession and continuous improvement of the tax system for the benefit of all, through the advancement of knowledge, member support and advocacy.

Our membership of more than 11,000 includes tax professionals from commerce and industry, academia, government and public practice throughout Australia. Our tax community reach extends to over 40,000 Australian business leaders, tax professionals, government employees and students through the provision of specialist, practical and accurate knowledge and learning.

We are committed to propelling members onto the global stage, with over 7,000 of our members holding the Chartered Tax Adviser designation which represents the internationally recognised mark of expertise.

The Tax Institute was established in 1943 with the aim of improving the position of tax agents, tax law and administration. More than seven decades later, our values, friendships and members' unselfish desire to learn from each other are central to our success.

Australia's tax system has evolved, and The Tax Institute has become increasingly respected, dynamic and responsive, having contributed to shaping the changes that benefit our members and taxpayers today. We are known for our committed volunteers and the altruistic sharing of knowledge. Members are actively involved, ensuring that the technical products and services on offer meet the varied needs of Australia's tax professionals.