

Submission to the Australian Treasury
Patent Box – Discussion paper on policy and design
July 2021

For the past two years I have been researching the taxation benefits of a ‘Patent Box’ regime especially the current model of a Patent Box in the United Kingdom (UK). I have a paper being published at the end of this year in the *New Zealand Journal of Taxation Law and Policy* titled ‘Should Australia and New Zealand introduce a Patent Box regime in response to COVID – 19?’. I have supported the view that a Patent Box would be ideal for Australia and that the UK model provides a very good template.

While this submission does not directly respond to all the issues raised in this discussion paper, it does cover the many of the issues mentioned. This submission also examines one of the major taxation and investment challenges facing Australian companies utilising the Patent Box regime, namely the role of Superannuation funds as potential investors in innovation.

1. Why a Patent Box system is good for Australia

The R&D tax offset focuses on providing a tax incentive for the company to spend money on creating new products and inventions. The current R&D tax offsets are very generous and supportive of innovation in Australia, but they do not provide a tax incentive for the commercialisation process. The Patent Box system focuses on providing companies with the ability to make a profit by exploiting the inventions and enjoying the benefits of a lower rate of income tax from that enterprise. The R&D tax offset is a prerequisite to the introduction of a patent box system as the research may ultimately lead to the results being patented and part of the companies Intellectual Property (IP). The R&D is the ‘front end’, and the patent box is the ‘back end’ of innovation.

Atkinson and Andes contend that R&D tax incentives are on the ‘input’ side. That is, they provide an incentive for firms to invest more in a key building block of innovation, in this case research. But in recent years several nations have gone a step further, creating tax incentives to spur commercialisation of the research outcomes.¹ They go on to state that patent boxes differ from R&D tax credits in that they provide firms with an incentive for commercialisation of innovation, rather than for just the conduct of research. In this context, Atkinson and Andes contend that the commercialisation of innovation, rather than the simple conduct of R&D, is a key driver of economic growth.² This is now of great importance in developing manufacturing in the medical and biotechnology sectors as well as low emission technologies.

¹ Robert Atkinson and Scott Andes, ‘Patent Boxes: Innovation in Tax Policy and Tax Policy for Innovation’, The Information Technology & Innovation Foundation (October 2011) <https://itif.org/files/2011-patent-box-final.pdf?_ga=2.97596055.92560782.1587704642-885616766.1587704642>

² Ibid.

2. Issues relating to obtaining a Patent

From the corporation's perspective, there are many complications facing companies wishing to utilise a Patent Box system. The main problems that have been identified relate to obtaining a Patent on the invention and the complexity of the calculations for claiming the tax relief.³ In terms of obtaining a Patent, there are time delays in the granting of the patent as well as extensive costs with Patent Attorneys and the registration process. Because of the requirement to disclose the new invention, some technology is not deliberately patented by the owners, and this poses a challenge to a Patent Box system.

Aristocrat Technologies was the top-ranked Australian applicant, filing 99 original patents in the areas of computer technology and control. Australia's national science agency, the Commonwealth Scientific and Industrial Research Organisation (CSIRO), was second with 46 original patents in areas including measurement, basic materials chemistry and biotechnology.⁴

Also, as in previous years, medical technology was the leading class with 3,701 applications in Australia. Medical technology was followed by an increase in Pharmaceuticals (3,106), and Biotechnology (2,865).⁵ These are the ideal patents that the Australian government needs to see commercialised if Australia wants to restore its economic sovereignty during times of pandemics. The following statement in the IP Australia Report highlights the impact COVID – 19 has had in this area and is a further reason why a Patent Box system is a very positive step to encouraging innovation:

The COVID-19 pandemic has generated unprecedented demand for innovations that will help end the crisis or mitigate its costs. These include innovations directed at making public places safer by reducing the likely spread of infection, and digital tools that facilitate more efficient long-distance communication and collaboration. Most critically, studies have shown, the rate of pharmaceutical research on coronavirus vaccines and treatments increased substantially as the pandemic became global in March 2020 and reached an order of magnitude greater than during previous epidemics. New pharmaceutical research has focused largely on quick-to-develop projects involving repurposed drugs, with a high share of drug development conducted by small firms. Pharmaceutical patent filings have significantly increased in 2020, well above their historic growth trend of the past decade.⁶

3. The OECD/G20 Action 5 – the Nexus Approach to Patent Box systems

With the introduction of a patent box system, it is important that the 'nexus approach' is assessed in some detail in order to evaluate the taxation implications.

The basis for the nexus approach is to ensure that corporations that obtain tax benefits through the initial R&D phase of creating IP also maintain their connection with that nation when it comes to exploiting the IP and generating income. If a corporation is directly engaged in incurring expenditure on R&D, then the commercial exploitation must have a connection

³ Caroline Walton, Nigel Holmes and Raj Ghose, 'A Clear Picture', (1 June 2019) *Tax Adviser* 4. <<https://www.taxadvisermagazine.com/article/clear-picture>>

⁴ IP Australia, 2021 Report.

⁵ Ibid.

⁶ Ibid.

with the country that provided the tax benefits in the first place. The Action 5 report states that the nexus approach permits nations providing tax benefits for the income arising out of the IP.⁷ The focus is on the expenditure incurred on developing the IP and according to the OECD the expenditure acts as a proxy for substantial activities.⁸ In order for the company to satisfy the nexus approach and take advantage of a patent box regime tax reduction or similar benefit it must show that it incurred qualifying expenditure in developing the IP. The expenditure will only be ‘qualifying expenditure’ if the corporation is a ‘qualified taxpayer’ producing specific IP assets.

The ‘qualified taxpayer’ must have undertaken a significant proportion of the actual R&D activities before the commercialisation income from the IP can qualify for further tax benefits such as that offered by a patent box system.⁹ This would be a requirement in Australia for companies wanting to utilise a Patent Box system.

4. Accounting and Legal issues – the UK experience

The main problems that have been identified relate to obtaining a Patent on the invention and the complexity of the calculations for claiming the tax relief.¹⁰ In terms of obtaining a Patent, there are time delays in the granting of the patent as well as extensive costs with Patent Attorneys and the registration process. The tax relief covers these expenses but not all small to medium corporations have the awareness and skills to make the patent application. The Patent must be granted to the company and not the actual inventor which in some cases may be a problem. The patent can be assigned to the company by an inventor, but this raises tax and legal issues for the inventor.¹¹ Some of the more common problems are summaries as follows and based on the UK experience:

- i. The qualifying IP does not extend to trademarks, copyright and designs;
- ii. A company must notify HMRC in writing that they are ‘electing in’ and the election must be made within two years of the end of the accounting period;
- iii. If they opt out, they may not be permitted to elect back in for five years, as is the case in the UK;
- iv. The calculations required for the patent box are complex particularly for small to medium enterprises (SME’s). Each stream of profit generated from each patent must be accounted for and the tax relief applied to that specific profit;
- v. Companies in a loss-making phase obtain no relief through claiming the tax reduction;

⁷ OECD/G20 Base Erosion and Profit Shifting Project, ‘Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance’, Action 5: 2015 Final Report, 24.

⁸ Ibid.

⁹ OECD (2013), Action Plan on Base Erosion and Profit Shifting, OECD Publishing.
<<http://dx.doi.org/10.1787/9789264202719-en>>, 6.

¹⁰ Caroline Walton, Nigel Holmes and Raj Ghose, ‘A Clear Picture’, (1 June 2019) *Tax Adviser* 4.
<<https://www.taxadvisermagazine.com/article/clear-picture>>

¹¹ Ibid, 4.

vi. Many corporations in the UK are unaware of not only the patent box tax relief but also tax credits for R&D.¹²

Similar challenges would be faced by companies in Australia as today many SME's are either unaware of the R&D tax offset or what is required to make a claim. Moreover, many SME's in Australia are not structured as a company and operate as a trading trust which makes them ineligible to claim the R&D offset.

5. Challenges with encouraging Australian companies and Superannuation funds to invest in innovation

The dividend imputation system and its impact on investment activity in Australia may impact on the success of a Patent Box system and raises challenges for Government. There would need to be a trade-off between domestic shareholders that are the beneficiaries of imputation credits and the wider need to invest in innovation and IP which may not deliver franking credits through income tax payments but will reward investors through an increase in the value of the company. Imputation favours domestic investors over foreign investors, but a patent box system would be likely to attract foreign investment.¹³

The following statement by the Treasurer in a speech to the Business Council of Australia urged Australian companies to grow and expand, to spend on innovation and spend less on dividends and share buy-backs.¹⁴

My message today for business is to back yourself and use your balance sheet to invest and grow. Nine out of every ten jobs in Australia are in the private sector. If we are going to create new jobs and enable people to earn more for what they do, we need businesses to increase their capital expenditure and to adopt new technologies and business practises that effectively integrates capital with labour. ...With Australian corporates enjoying healthy balance sheets, record low borrowing costs and strong equity market conditions, the question is are corporates being aggressive enough in the pursuit of growth? For example, share buybacks and capital returns are becoming increasingly prominent and the default option for corporates but is a buyback always the best option for the future growth of the company and therefore the economy? Over the last 12 months, approximately \$29 billion has been returned to shareholders in the form of buybacks and special dividends compared to an average of \$12 billion over the previous four years - a 140 per cent increase. Understandably management and boards when they are in possession of excess capital either from asset sales or strong operating cash flows will want to be prudent around capital allocation. But the lesson from companies like CSL and Cochlear is to take advantage of conditions, invest in research and development and back yourself to grow.¹⁵

The proposition made by the Treasurer in his speech is that corporations should encourage innovation and growth and not focus on financial returns for shareholders, amplifies the

¹² Ibid.

¹³ For a detailed discussion of dividend imputation and the discrimination against foreign investors in favour of domestic investors see Cormick and McLaren, 'Dividend imputation: a critical review of the future of the system' (2018) 33 *Australian Tax Forum* 141, 149.

¹⁴ Josh Frydenberg, Treasurer, <<https://ministers.treasury.gov.au/ministers/josh-frydenberg-2018/speeches/address-business-council-australia>>

¹⁵ Ibid, 4.

dilemma facing any board of directors in Australia. If more money is spent on innovation and R&D then less is spent on paying income tax and dividends, thus distressing the shareholders.

Given the above situation it may be very difficult for companies to change their approach to keeping their shareholders and institutional investors such as superannuation funds satisfied if dividends were to reduce along with the level of imputation credits. Are Australian shareholders especially the superannuation funds prepared to invest in growth or are they wanting to favour companies that pay dividends carrying imputation credits? The research conducted by Aelee Jun et al found that both pension funds and unit trusts in Australia were overweight, relative to the market index in stocks with fully franked dividends.¹⁶ In their summary they contend that both pension funds and unit trusts are underweight in stocks paying unfranked dividends and that their evidence supports the tax advantage hypothesis in explaining the fund's dividend choices.¹⁷ Without the existence of the dividend imputation system in Australia these pension funds and unit trusts would not be overweight in equities that paid franked dividends.

Cormick and McLaren contend that superannuation funds in Australia have 'captured' the government when it comes to making changes to the status quo.¹⁸ Given the superannuation industry are significant investors in public companies and the Australian economy, the pressure of such companies may be seen under 'capture theory'¹⁹ to influence the decisions of both law makers and public companies. If the current dividend imputation system was to be modified by the government, the superannuation industry would engage in a variety of actions to prevent any change. As a result, the industry associations would exert pressure on the government in such a way that it would try to dictate government policy. This behaviour would be an example of capture theory or regulatory capture.²⁰ Given this situation, it is suggested that the promotion of increased investment by Australian corporations in innovation and patents and a reduction in the size of dividends and imputation credits would put the superannuation industry on a collision course with the Australian Treasurer and the Government.

Australian companies that do elect to take advantage of the Patent Box system pay less company tax and this may be of concern to the public and their shareholders if the company is listed on the stock exchange. An example of how important this issue could be for the company is found in the announcement to the London Stock Exchange by Victrex PLC on 4 September 2017.

Reduction in Group's effective tax rate under Patent Box

¹⁶ Aelee Jun, David Gallagher and Graham Partington, 'Institutional Dividend Clienteles Under an Imputation Tax System', (2011) 38(1) *Journal of Business Finance & Accounting* 198, 201.

¹⁷ Ibid, 222.

¹⁸ Rhys Cormick and John McLaren, 'Dividend imputation: a critical review of the future of the system' (2018) 33 *Australian Tax Forum* 141, 149.

¹⁹ For a summary of capture theory, see: Kerri Sadiq and Janet Mack, 'Re-thinking" the influence of regulatory capture in the development of government regulation' (2015) 43 *Australian Business law Review* 379, 387.

²⁰ For a detailed examination of how the mining industry captured the Commonwealth Government with its introduction of the MRRT see Kerri Sadiq and Janet Mack, 'Re-thinking" the influence of regulatory capture in the development of government regulation' (2015) 43 *Australian Business law Review* 379.

Victrex plc, an innovative world leader in high performance polymer solutions, today announces that, based on recently granted UK patents and following discussions with Her Majesty's Revenue & Customs (HMRC) about the UK's Patent Box legislation, we now expect our tax rate to be materially lower than previous guidance.

With a strong history of investing in research and development (R&D) and of patenting our Intellectual Property (IP), Victrex's strategy of moving downstream from Polymer to Parts, and further differentiating our business through product leadership, will continue to be supported by our approach to R&D investment, to innovation and IP protection.

Starting in the current financial year ending 30th September 2017, we anticipate the annualised impact of Patent Box to reduce the Group's effective tax rate from approximately 21% to around 12%, with an ongoing favourable impact on earnings per share (EPS) and cash, although no cash benefit would be seen in FY17.²¹

This stock exchange announcement by Victrex PLC highlights the impact the Patent Box was expected to have on the shareholders resulting in less tax being paid but the outcome being a 'favourable' impact on the companies' earnings per share and cash.

The UK does not have a dividend imputation system for the taxation of corporations and shareholders and as a result companies does not have to concern themselves with the amount of income tax they pay to provide franked dividends to their shareholders. Similarly, the UK shareholders may prefer growth and innovation in the companies that they choose to invest in, unlike the Australian situation where a large proportion of after-tax profit is being returned to shareholders at the expense of investment in growth and innovation.

In the future in Australia the culture of investment and the approach taken to developing innovative technologies may have to change especially if Australia wants to restore its specialised manufacturing sovereignty in the face of a pandemic. The introduction of a Patent Box regime may help to create that change.

Dr John McLaren

Senior Lecturer Taxation

Tasmanian School of Business and Economics

University of Tasmania

²¹ Victrex PLC, announcement to the London Stock Exchange, 4 September 2017.

www.investegate.co.uk/victrex-plc--vct-/rns/reduction-in-effective-tax-rate/201709040700056641P/