

AUSTRALIAN PATENT BOX POLICY RECOMMENDATIONS

AUGUST 2021

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PREAMBLE

This submission sets out policy responses and recommendations in respect of Treasury's Discussion Paper on Policy Design dated July 2021 and titled Patent Box. The party making this submission is **VT Advisory Pty Ltd** (ABN 89 625 442 033) ('**VT Advisory**' or '**the firm**'). Our comments contained in this document and any other submission, be it written or verbal, are directed toward Treasury. The firm's submission is subject to the disclaimer set out at the end of this document. In consideration for reading this document parties agree to the terms and conditions contained in this disclaimer.

VT Advisory is a vertically integrated professional services firm that has assisted many clients to commercialise intellectual property in Australia and globally. The firm rather than respond to each individual question has instead provided this submission in accordance with a structure that is conducive to the proposal of policy recommendations.

The submission is set out as follows:

1. Terms of Reference – Which will set out and define the policy issue or problem the firm will address with its submission
2. Ecosystem and Roadmap – Outlines the actors that could reasonably be expected to be impacted by these measures and the pathway they typically follow in commercialisation of their intellectual property
3. Global Policy Framework – A brief snapshot of the Patent Box of other States is outlined for context as well as recently announced global tax policy that could conceivably impact upon the effectiveness of an Australian Patent Box
4. Key Policy Recommendations – Given the policy architecture set out in the submission, policy recommendations will be set out and referenced back to the questions in Treasury's discussion paper
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TERMS OF REFERENCE

The Terms of Reference seek to narrow the scope of VT Advisory's response to the core objectives of Treasury in their discussion paper. VT Advisory reasons that Treasury's discussion paper is considered exploratory and would welcome some input into structuring of the Proposal. The three core objectives of Treasury's discussion paper appear to be as follows:

- Increase foreign investment into Australia within the healthcare industry
- Attract and retain relevant intellectual property assets and the benefits that flow from them within Australia
- Streamline and reduce the regulatory burden on impacted stakeholders seeking to apply any proposed concessions

VT Advisory in addressing these aims believes that a systematic architecture that seeks to contextualise Treasury's proposal both within the existing regulatory framework (both domestic and global) as well as practically within the private sector would provide Treasury with the most value.

VT Advisory's policy recommendations are not restricted to simply increasing the flow of capital and Gross Domestic Product ('GDP'). The policy responses proposed in this submission extend to ensuring the Patent Box concessions seek to appropriately contemplate, on one hand, this sizable investment in forgone tax that would be made by Australia over the long term against the net structural increase in GDP the measures may derive.

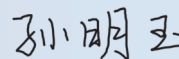
The Terms of Reference of this submission aims to de-risk Australia's return on this investment into these Patent Box concessions in the sense that the structural GDP benefits are more likely to materialise and be retained by the Country. At the same time, the submission should provide a useful framework that Treasury can use in further consultation with the Private sector.

This represents the views of VT Advisory:



Signed (Bill, Tom & Bonnie)

Dated: 15 August 2021



ECOSYSTEM & ROADMAP

The Treasury's Discussion Paper designed to attract and retain the world's best and brightest and the intellectual property they create is certainly welcome. This is becoming a progressively more difficult task as States compete for this resource. The difficulty is compounded by the recent recognition that inventions such as artificial intelligence, in Australia at least, can be patented by other inventions rather than just people.¹

Australia as a State has always punched above its weight. We're a nation of innovators that in recent years have, at least from the perception of the private sector, unfortunately seen a 'form slump'. The Discussion Paper is an indication by Treasury of a willingness for Australia to re-assert itself as a leader on the world stage.

The perceived deterioration in innovation is difficult to measure other than qualitatively and relative to other States. Australia has seen its rank slip to 23rd in the World as measured by the Global Innovation Index 2020², from our rank at 17th as little as five years prior³.

Australia has several advantages in creating innovation compared to other jurisdictions. We're ranked #1 in the World for technological readiness and #3 in the World for the number of universities in the World's top-100⁴. Yet this is arguably not materialising into greater levels of innovation.

This disconnect between advantages in creating innovation and the driving of innovation is examined in the context of medical and health care patents to assess whether a Patent Box is appropriate to drive innovation in this sector.

However, one of our primary recommendations is that a broader strategic consideration of the emerging types and trends of technology is performed by Treasury. This is so that Australian policy responses can be tailored in encouraging development in areas of strategic value to Australia.

The more specific examination of healthcare innovation is best performed by reviewing the tax policy applying at the various stages of the lifecycle of vehicles that undertake this innovation. The figure over the page provides a broad picture of this lifecycle, existing policy and where the Patent Box would apply.

¹ *Thaler v Commissioner of Patents* [2021] FCA 879.

² World Intellectual Property Index, 'Global Innovation Index 2020' <https://www.wipo.int/edocs/pubdocs/en/wipo_pub_gii_2020/au.pdf>

³ World Intellectual Property Index, 'Global Innovation Index 2015' <https://www.wipo.int/edocs/pubdocs/en/wipo_gii_2015.pdf>

⁴ Shanghai Ranking Consultancy, 2020, Academic Ranking of World Universities

REGULATORY ROADMAP

Stage	1 Concept	2 Research	3 Pre-Commercialisation	4 Commercialisation	5 Capitalisation
Incentives	Black hole immediate write off for business related costs ⁵	Research & Development Incentive for eligible expenses and activities ⁶	Early Stage Innovation Concessions for Investors in eligible early stage companies ⁷	Loss Recoupment ⁸	Patent Box
Commentary / Impact	<p>Negligible, but these do not act as an impediment to innovators establishing a structure.</p> <p>In addition, the compliance in establishing a company with the Corporate Regulator, ASIC has a low barrier to entry for most participants.</p>	<p>This is a World-Class initiative by the Australian Government.</p> <p>Referring to our "Worldwide Rates" schedule the Australian incentives are World-Class and a strong contributor to our global competitiveness in research.</p>	<p>This is another World-Class initiative by the Australian Government, one where we're unable to find a directly comparable measure globally.</p> <p>This incentive for investors to invest in Australian start-ups provides a 20% offset and 10 year exemption from Capital Gains Tax.</p> <p>However this incentive appears under-utilised with inventors not generally aware of this measure.</p>	<p>We see the commercialisation stage as the Achilles heel of the Australian Government's policies to support innovators.</p> <p>During the commercialisation phase, the business is turning toward being cash-flow positive and its largest incentive is claiming-back the historical losses incurred during the first three stages of operation.</p> <p>At this stage, access to concessions becomes increasingly harder to meet.</p> <p>There are two main tests for the recoupment of company losses, these are explored more fully below.</p>	<p>The subject of this discussion paper is in our view another World-Class initiative to close-out "The Journey" for innovators and provides a great 'hook' to bookend the Australian Government's policies for innovators for Healthcare innovation.</p> <p>Referring to our "Worldwide Rates" schedule the Australian incentives are competitive on the Global Stage, albeit they could be streamlined for simplicity given Research and Development cross-play in factoring for the discounted company income tax rate proposed in the discussion paper.</p>
Medical & Healthcare Operation	Concept and feasibility testing	Research and hypothesis testing including prototype development	Patenting and Fundraising for commercialisation, initial market testing	Obtain enterprise agreements and revenue generation commences	Profitable vehicle has de-risked product

⁵ s.40-880, *Income Tax Assessment Act 1997* (Cth)

⁶ Division 355, 'Research and Development', *Income Tax Assessment Act 1997* (Cth)

⁷ Division 360, 'Early Stage Investors in Innovation Companies', *Income Tax Assessment Act 1997* (Cth)

⁸ Division 165 & 166, 'Income Tax Consequences of Changing Ownership or Control', *Income Tax Assessment Act 1997* (Cth)

Commercialisation Stage – Difficulty in Accessing Concessions

For innovators and start-ups that have survived the 'Valley of Death' (stages 1-3 in the table above) and sit at the precipice of cash-flow neutrality and eventual cash-flow surplus, they're met with stark choices. This does not consider the consolidated groups that typically make up the related parties that support these innovation companies.

To fund development and reach the commercialisation phase, innovation vehicles have two broad avenues open to them. Practically, innovation vehicles often utilise both of these avenues or a combination of them both throughout their journey. These avenues are as follows:

- Re-investing earnings; and
- Issuing more capital

In the context of medical and healthcare patents, the commercialisation stage invariably requires the issue of more capital by way of equity or debt given the capital-intensive nature of the sector.

Re-Investing Earnings

Re-investing earnings is a simple enough exercise to undertake but one that may have a prohibitive after tax cost for those who have diluted their equity along their commercialisation journey.

For companies that can pass the continuity of ownership test, all their earnings from cash-flow surpluses can be re-invested into the business applying this test to allow these surpluses to be shielded from income tax by the losses previously incurred.

For those that have diluted equity along their commercialisation and innovation journey however, they may no longer meet the eligibility for this continuity of ownership test. This means to claim the relevant losses they will need to apply the similar business test. The similar business test has historically been interpreted by the courts strictly. It would be questionable whether a vehicle that has only ever performed research and development would meet the similar business test on commercialisation because of the fundamentally different type of activity this represents.

The lack of eligibility to access these tax losses may result in income tax of between 17-30% of the innovation entity's surpluses for income tax depending on their corporate classification and whether or not the Patent Box is applied. This represents a significant portion of these entities' earnings. This policy of tax loss exclusion is relevant when considering Australia's competitiveness in fostering innovation generally and in this healthcare sector in particular.

Issuing More Capital

The other alternative available to innovation companies to fund their activities is to issue more capital by way of debt or equity. Typically debt investments are closed to this sector given their risk profile and the conservative attitude of Australian debt markets.

When successful equity investment provides instantaneous solutions to the funding problems of innovators. However, this type of funding comes with the tax costs. These are the potential to no longer meet tests that allow the tax losses of these businesses to be claimed.

Our view is that a policy gap exists for stage 4 companies given the way tax loss tests apply to them. Our recommendation would be Treasury consider this policy gap when evaluating whether a Patent Box is suitable for the Australian innovation landscape.



GLOBAL POLICY FRAMEWORK

The next part of our submission firstly provides a selection of Patent Box tax rates and R&D deduction rates as follows.

Country	Patent Box (Y/N)	Summary of Regime	Tax Rate	R&D Special Deductions (Y/N)	R&D Tax Credit
Belgium	Y	An 85 percent deduction from corporate income for qualifying income related to IP. The corporate income tax rate is 25%, so the deduction results in a 3.75% tax rate on qualifying IP income.	3.75%	Y	13.5% or 20.5%
France	Y	A reduced rate of 10% applies to profits from IP rights.	10.00%	N	30%
Hungary	Y	50% of the profit from royalties from qualifying IP is exempt from corporate income tax up to 50% of the profit before tax. The corporate tax rate is 9% so the effective rate on IP royalties is 4.5%.	4.50%	Y	N/A
Ireland	Y	The Knowledge Development Box provides a tax rate of 6.25% for profits from qualifying assets.	6.25%	Y	25%
Italy	Y	The patent box exempts 50% of the income from qualifying IP.	13.95%	N	20%
Luxembourg	Y	An 80% exemption from corporate taxes applies to income from qualifying IP. Qualifying assets also receive a full exemption from Luxembourg's net wealth tax.	4.99%	N	N/A
Poland	Y	The tax rate on qualifying IP is 5%.	5.00%	Y	N/A
Slovakia	Y	A 50% exemption from income from qualifying IP.	10.50%	Y	N/A
Spain	Y	A 60% exemption for qualifying IP income.	10.00%	N	25%
Turkey	Y	Technology developed in certain designated zones can face a 100% exemption from corporate taxes. Otherwise a 50% exemption for income from sale or lease of patents may apply.	0% or 11%	Y	N/A
United Kingdom	Y	Income from qualifying IP faces a tax rate of 10%.	10.00%	Y	13%
United States	Y	An 37.5% deduction applies to income from exports related to qualifying IP.	13.13%	N	20%

The other critical contextual matter to consider is the recent OECD policy announcements for a two pillar reform agenda to international taxation. 90% of OECD nations have agreed to the new framework.⁹ The pillars are described as follows:

“Under Pillar One, taxing rights on more than USD 100 billion of profit are expected to be reallocated to market jurisdictions each year. The global minimum corporate income tax under Pillar Two - with a minimum rate of at least 15% - is estimated to generate around USD 150 billion in additional global tax revenues annually. Additional benefits will also arise from the stabilisation of the international tax system and the increased tax certainty for taxpayers and tax administrations.”¹⁰

The Patent Box rate should be considered closely in light of this announcement. The tax arbitrage between the proposed 17% rate and the global 15% rate may result in multinational capital flows not materialising in Australia. This coupled with the other domestic Patent Box rates and other incentives in international jurisdictions are in our view critical to formulating a domestic Patent Box.

Our suggested policy responses therefore implicitly include engaging in a strategic review of any proposal to determine whether it will result in meaningful flow of capital into Australia.

⁹ <https://www.oecd.org/newsroom/130-countries-and-jurisdictions-join-bold-new-framework-for-international-tax-reform.html>.

¹⁰ Ibid.

KEY POLICY RECCOMENDATIONS

There are a number of opportunities to ensure the success of the Patent Box proposed in the Discussion Paper. As aforementioned, we believe these suggested policy responses will assist in maximising the number of innovative companies' ability to leverage the benefits offered by the Patent Box but also encourage domestic and international investment in Australia.

These suggested policy responses that Treasury should consider in light of the International and Domestic environment are as follows:

- A modified continuity of ownership test to include in the calculations any shares that are issued under the Early Stage Innovation Company scheme (ESICS). This would:
 - decrease the barriers to passing this test
 - increase the access to applying these concessions
 - assist companies retain all their surpluses to re-invest in scaling the business
 - Streamline loss recoupment with ESICS
- A PAYG withholding rebate for any loss-making companies in their Stage 4 commercialisation phase. The rebate would be applied to new hires and capped at 20% of the PAYG withholding or \$250k (whichever is lesser). This would:
 - Encourage scaling and expansion with a more aggressive approach needed for innovators to commercialise
 - Offer new jobs and career pathways for University students landing jobs in new industry to facilitate knowledge and human capital transfer
- Design of a similar regime of 'expenditure-weighting' as that used in the Petroleum Resource Rent Tax to eligible start-up businesses and innovative companies.¹¹
- Consider related parties and consolidated groups that support innovation companies. The integrity measures built into the Patent Box regime should appreciate how these groups are currently structured but also ensure intra-group capital flows are treated differently to third party investment. Treasury may wish to test eligibility on a group level akin to aggregated turnover and maximum net asset value tests under the Small Business CGT regime.¹²

¹¹ Subdivision 40-H, 'Capital Expenditure that is Immediately Deductible', *Income Tax Assessment Act 1997* (Cth)

¹² Division 152 of the *Income Tax Assessment Act 1997* (Cth).

CONCLUSION

We consider the opportunity of a Patent Box in the Australian jurisdiction as a tremendous opportunity but one that's not without the existing risks of taxation arbitrage in the Global landscape. We suggest historically that investment decisions are driven by these rates of taxation ie. 'race to the bottom' when advisors assess the global marketplace.

If Australia does not want to compete directly with other jurisdictions on the Patent Box rate, Treasury may want to consider other policy responses that would make investment more attractive in our jurisdiction notwithstanding the higher rate.

The policy responses outlined in this submission, go a way to addressing the shortfall of the proposed Patent Box rate when compared globally to similar regimes.

Ultimately, Australia has strong foundations in Research & Development and in our view, Treasury should assess the totality of the regulatory environment in supporting the commercialisation of this Research & Development.

Currently, the Patent Box discussion paper contemplates industries in Healthcare and to a lesser degree, low-emissions technologies. We would appreciate access to the strategic thinking behind Treasury's decisions which led to these industries being selected. In our view, critical evaluation of this strategic decisions is necessary and may lead to an extension of the Patent Box to other industries, particularly emerging high-value industries where Australia can be world-first.

In advocating for clients in these sectors, we would like to be invited to discuss our submission and Treasury's discussion paper more broadly.

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