RSM Australia Response to Australian Government Patent Box Discussion Paper: August 2021

A 'Patent Box' is a tax incentive (named as such because the taxpayer literally 'ticks the box' in the income tax return to claim the incentive) that allows a company to pay a lower tax rate on income generated through the commercialisation of Intellectual Property (IP). The first such scheme was introduced in 1973 in Ireland and over twenty countries (including France, Israel, The Netherlands, Singapore and the United Kingdom) currently operate similar regimes. The introduction of Patent Box regimes has not been without controversy, with the Organisation for Economic Co-operation and Development (OECD) reviewing their implementation in the light of international Base Erosion and Profit Shifting (BEPS) actions to counter profit shifting from higher-tax to lower-tax jurisdictions. Internationally, a nexus-based approach, in which Patent Box relief is restricted to profits arising from IP generated through Research and Development (R&D) conducted or substantially conducted within the jurisdiction offering the benefit, has become acceptable.

The Australian Government has announced the introduction of a Patent Box for corporate income associated with patented inventions in the medical and biotechnology sectors, applicable to companies for income years commencing on or after 1 July 2022. As part of the legislative process, Treasury has released a discussion paper and sought responses to a series of questions in the paper to inform the Government's consideration of the detailed design of an Australian Patent Box. In this paper, the following broad design features were introduced:

- An effective concessional tax rate of 17 per cent (from 1 July 2021 the corporate tax rate in Australia is either 25 per cent or 30 per cent, depending on an entity's annual aggregate turnover);
- Only Australian patents with a priority date after the budget announcement (i.e. the provisional patent application was lodged after 11 May 2021) will be eligible; and
- The regime is consistent with Australia's BEPS commitment, requiring a nexus to R&D conducted in Australia.

RSM Australia (RSM) is one of the largest nationally owned accounting firms and forms part of RSM International, the sixth-largest international accounting and consulting organisation worldwide. In Australia, RSM is one of the fastest-growing mid-tier firms, with over 170 Directors/Principals and over 1,250 staff operating from 32 locations across Australia. Our staff operate across a range of industries, public, private, Government and not-for-profit sectors. RSM provides audit, tax and a wide variety of corporate financial and advisory accounting services.

RSM's service offerings include R&D Tax Services for a broad array of industries and technologies, including the biotechnology, pharmaceutical and medical device sectors, and RSM assists entities ranging from start-ups to SMEs, ASX-listed companies and multinationals. RSM has previously made submissions to the many Reviews, Reports and Papers since 2014 that have ultimately resulted in the legislative changes to the R&D Tax Incentive scheme enacted since the May 2020 Budget. Most recently, RSM staff participated in public hearings before the Senate Economics Legislation Committee into a precursor of the enacted Bill that were held in November 2018. The analysis underlying these submissions and hearings, combined with extensive experience in supporting clients in accessing the R&D Tax Incentive has been applied here to the proposed Patent Box regime. Our views on the proposal can be summarised as follows:

- The proposed fixed concessional tax rate of 17 per cent offers a more generous incentive for large companies than for smaller enterprises (those with aggregated revenue of less than $50 million) – greater incentive would be provided to smaller enterprises by offering a concessional rate to all claimants equal to 13 per cent less than their standard corporate tax rate;

- By reducing the effective corporate tax rate for a claimant, the regime will negatively impact the entity's franking account unless a mechanism is included to rectify this impact;
- Linking the Patent Box regime to a taxpayer's history for claiming the R&D Tax Incentive in Australia should enable a straightforward process for claiming the concessional tax rate while also ensuring a nexus between R&D conducted predominantly in Australia and the IP held;
- No other jurisdiction has attempted to limit eligibility to specific technology sectors and any attempt to do so based on patent classification, Australian and New Zealand Standard Industrial Classification (ANZSIC), or Australian and New Zealand Standard Research Classification (ANZSRC) Field of Research (FoR) codes is likely to be overly complicated and fraught with the risk of rendering ineligible IP even though it is in a technology area that is supposed to be eligible;
- Compliance costs in the case of limited accessibility dependent on technology sector will be prohibitive for all but the largest entities (who will have in-house IP lawyers they can access) as all other taxpayers will need to engage patent attorneys at hourly rates to provide the relevant expertise; and
- The possibility of including other forms of IP (e.g., trade secrets, plant breeders rights if agricultural biotechnology is to be included as an eligible technology sector), if there is a nexus to R&D conducted in Australia, should also be considered.

Questions:

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

As noted above, over 20 jurisdictions offer Patent Box relief to companies generating revenue from IP developed through R&D they have conducted. The most important feature they all share is that none of them attempts to restrict access to the regime depending on the technology sector for which the IP is valid. As noted in more detail at 5. below, any scheme that attempts to classify a patent's field for tax purposes is highly likely to be so complicated as to be inaccessible for all but the very largest taxpayers.

2. Are patents applied for by medical and biotechnology companies with domestic R&D operations generally Australian standard patents?

Yes. Innovation patents in Australia are in the process of being phased out (the last date for filing an innovation patent application being 25 August 2021) because evidence shows they have failed to incentivise R&D in Australia and put Australian innovators at risk in overseas markets (1).

3. In instances where an invention is patented in other jurisdictions but not in Australia, is there a way of judging whether the scope of claims in these patents would be substantially similar to the scope of claims in a standard patent that would have been granted in Australia?

The process of obtaining an Australian standard patent is a multi-step application. An entity may first lodge a Provisional Patent application with IP Australia, which grants the applicant a priority date and signals the applicant's intention to lodge a complete application within 12 months of lodging the provisional application. Usually in medical/biotechnology, the next step is lodging a Patent Cooperation Treaty (PCT)

application with the World Intellectual Property Organization (WIPO), a pathway that gives the application automatic effect in over 150 countries including Australia. A PCT application goes through an examination process and the applicant can then choose which of the WIPO member countries the application will enter National Phase (with all the attendant costs), as a patent will ultimately be granted, or otherwise, in a single jurisdiction.

In our experience, a significant portion of biotechnology entities choose not to enter National Phase in Australia for commercial reasons – the market is considered small (around 2 per cent of the global market compared with around 40 per cent for the US market (2)) and patent application, examination and maintenance fees may well lead to a decision that it is not cost effective for an entity to obtain patent protection in Australia. However, for convenience the overwhelming majority of Australian applicants do initiate patenting by lodging a provisional patent application with IP Australia. The provisional/PCT process therefore readily ensures that the scope of claims in PCT-based international patents is the equivalent of an application that would have been made in Australia, if the applicant had chosen to proceed.

4. What is the best approach to provide certainty around access to the regime for the medical and biotechnology sectors?

As noted above, no other jurisdiction who have introduced a Patent Box have attempted to limit its eligibility to any specific technology sector: the only requirement is that the claimant holds a patent. There are multiple schemes for patent classification (e.g. Cooperative Patent Classification (CPC) or the United States Classification (USPC) systems) and the extreme granularity of patent classification ensures that any attempt to base access to the regime for a specific technology sector will be extremely complex, difficult for a taxpayer to negotiate, and will lead to extremely high compliance costs. Very large companies working in the pharmaceutical or medical device space will have internal resources (i.e. teams of IP lawyers) capable of providing the relevant expertise to deal with such a requirement. All other taxpayers however will not have in-house patent attorneys and will be required to engage external service providers, at hourly rates, to provide the relevant expertise.

Using the ANZSIC/ANZSRC codes currently referenced in an entity's R&D Tax Incentive registration does offer a mechanism for simplifying research field classification. However, the difficulty of reconciling these codes with patent classifications (where they are not used) means that any such approach will be no simpler to use than a scheme based on purely on one or more of the available patent classification systems.

The best approach to provide certainty around access is to allow *any* holder of a patent (or other eligible IP if applicable) to access the regime, regardless of the technology sector they are operating in, if there is a nexus to R&D conducted predominantly in Australia. The only other possible approach that will not necessarily lead to prohibitive compliance costs for taxpayers is to allow a mechanism whereby the applicant obtains a Finding regarding eligibility from AusIndustry (or a private ruling from the ATO). Such an approach will however likely lead to a considerably greater administrative burden for the relevant Government agency.

If the Government is concerned at the quantum of revenue foregone by expanding the scheme to any entity who held appropriate IP and who could demonstrate a nexus to R&D conducted in Australia via its registration for the R&D Tax Incentive, two factors should allay any concerns:

- The revenue gained through expanding manufacturing in Australia, including increased employment (leading to increased employee PAYG contributions, state payroll tax contributions) and the value add through marketing finished goods

internationally rather than commodities will almost certainly far outweigh the revenue foregone through the concessional income tax rate; and
- The UK experience shows the revenue foregone is surprisingly modest. In 2017/18, the latest year for which detailed statistics are available, Her Majesty's Revenue and Customs, 1,305 companies (across all sectors) claimed a total value of £1,101 million relief (3).

5. What are the core concepts/applications that need to be covered by any definition of the medical and biotechnology sectors for the purpose of defining access to the patent box?

We cannot see a mechanism that can be simply applied that will enable clear and consistent definition of whether a quantum of IP is eligible or not if the Patent Box is restricted to 'medical and biotechnology' sectors. Furthermore, any such mechanism is likely to impose prohibitive costs on almost all companies even if they do have eligible commercialised IP. As such, a Patent Box is not going to provide an incentive to commercialise IP that was generated from R&D conducted in Australia if steps are taken to restrict access to any one (or a few) technology sectors. Our reasons for reaching this conclusion include:

- The extreme granularity of patent classification means that any single patent will have multiple classifications, that will include such classifications as 'FoR – physics' for a device to aid breathing (the physics of airflow) or for an invention that is applicable to the chemical analysis of blood (the physical methods used to quantitate blood components such as the iron in haemoglobin);
- Any scheme that relies on patent classification will need significant input from IP lawyers – very large companies are likely to have the relevant expertise in-house but all other entities will need to out-source this work, incurring significant costs in the process;
- How is 'medicine and biotechnology' to be defined?
    - Will a medicine that has both human and veterinary applications be included? Would a purely veterinary medicine be included? The potential for inconsistencies of this nature would almost certainly make any classification scheme unworkable;
    - Will the definition include agricultural biotechnology? If it does unworkable inconsistencies would almost certainly arise if the eligible IP did not include plant breeders rights (codified in a similar manner to patents by IP Australia);
    - Will biotechnology as applied to mining processes (bacterial leaching of minerals), beverage production (e.g. beer, wine, kombucha, kefir), food (e.g. bread, cheese) be included? If yes, will for example bread be included for biotech inventions regarding the yeast but not the wheat (if plant biotechnology is excluded)? Again, the potential for inconsistencies would rapidly lead to the complete unravelling of the regime.

If the Government does wish to provide additional support to the medicine/biotechnology sector, expanding eligibility to any product (medicines and medical devices) included in the Australian Register of Therapeutic Goods (ARTG). International precedence for such a move is available in Israel (4). This move would require recognition of other forms of IP (e.g. trade secrets) as eligible which would need to be codified by an IP lawyer, including a nexus to R&D conducted in Australia.

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

Anecdotally, based on the clients we have operating in this sector, patented inventions relating to low emissions technologies are held by a broad cross section of entities operating in this space, including:

- Energy generation;

- Device manufacturing, including both power generation and power storage devices;
- Companies engaged in process development; and
- Companies developing controller devices and software to manage microgrids and grid interactions.

Large energy infrastructure entities (e.g. grid management) are unlikely in our experience to own large patent portfolios.

The main sub-sector that will be undertaking significant IP generation that is unlikely to be patenting inventions are the developers of controlling software. Software is inherently difficult to patent because of difficulties passing the 'manner of manufacture' test for computer implemented inventions. If the Government wishes to support entities operating in this space then serious consideration will need to be made toward recognising other forms of IP (e.g. trade secrets, copyright) as eligible for the regime.

7. Do patents play a strong commercial role in the clean technology energy sector, or are other strategies for using IP more important (such as being first to market)?

As per our response to 6. above, it will depend on the precise niche that a specific entity is operating in. With the massive changes that are underway in the energy generation/utilisation sector as a whole, it is unlikely that any single strategy (e.g. patenting vs first to market vs conducting public domain trials to demonstrate utility of a specific technology vs maintaining trade secrets) is going to be of overriding importance for commercial success. The sector is in such flux that we have not yet reached an definitive decision point for any single technology type, and the prevailing wisdom is that the field is likely to remain highly technologically diverse.

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

The clean energy sector covers a wide range of emerging technologies, that by their nature will be widely dispersed. Examples, from which this requirement should be self-evident include:

- Wind turbines (requiring steady winds and space, incompatible with urban areas);
- Roof-top solar panels (optimal in areas with abundant sunshine, ideal for suburban locations);
- Large-scale solar, including solar thermal (e.g. the Merredin Solar Farm in WA, the Nyngan Solar Plant in NSW and the Sundrop Farms solar thermal plant at Pt August in SA);
- Geothermal energy (although Australia has excellent geothermal resources they are mainly in remote locations and the sector is still in the very early stages of development in Australia);
- Marine energy (generating electricity from tides, waves or ocean currents);
- Green hydrogen production (could be located anywhere electricity from any of the above is available); and
- Biofuels, including waste to energy (ethanol and biodiesel production, and numerous waste-to-energy developmental projects around the country associated with municipal waste processing).

Due to the nature of the above, R&D is frequently located in remote areas – in particular if the R&D focus is end-of-grid or microgrid stability control, as these issues are unlikely to arise in metropolitan areas.

9. How would the clean technology sector best be defined for the purposes of a patent box?

As per our response to 5. above, any attempt to restrict access to the regime by allowing access only to a limited number of technology sectors is likely to be unworkable. Furthermore, any such mechanism is likely to impose prohibitive costs on almost all companies even if they do have eligible commercialised IP.

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?

Potential issues in supporting the clean technology sector through a Patent Box regime are the same as for any other sector.

First, as per our response to 5. above, any attempt to restrict access to the regime by allowing access only to a limited number of technology sectors is likely to be unworkable. Furthermore, any such mechanism is likely to impose prohibitive costs on almost all companies even if they do have eligible commercialised IP.

Second, in general Patent Box regimes have the potential to create distortions in the economy if not implemented carefully. International evidence shows that sector- and/or location-specific tax incentives can create tax-planning opportunities and potential for policy capture, as well as the strong potential for increasing the costs of tax administration (5). The OECD has noted that benefits of Patent Box regimes likely accrue mainly to large enterprises and do not necessarily assist credit constrained (and pre-revenue!) start-ups as IP-related incomes are likely to only materialise years after the initial investment. The nexus provision to R&D conducted in Israel's regime is however noted as having the potential to attenuate this effect, and Australia's R&D Tax Incentive, by providing cash refunds to smaller enterprises is cited as a good example of such a mechanism in the OECD discussion cited above.

Other potential options in the Australian context will focus on direct Government support. The Federal Government already offers direct support in this sector through the Australian Renewable Energy Agency (ARENA). While direct support has the advantage of being easier to target to projects with high social returns, tax incentives including the R&D Tax Incentive and the Patent Box avoid "picking winners" and will also require far fewer administrative resources to operate (5).

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

Record keeping requirements will be readily satisfied if a formal nexus is established between the Patent Box regime and the existing R&D Tax Incentive. This includes the identification of expenditure incurred overseas as R&D Tax Incentive claimants typically need to exclude overseas expenditure (unless the entity has an overseas finding in place, which may be granted in limited circumstance), or account for it to ensure that overseas expenditure remains less than expenditure incurred in Australia (if the entity does have an approved overseas finding in place, thereby enabling it to include the overseas expenditure in R&D Tax Incentive claims).

Note also that when an entity lodges a patent application (under the provisional application/PCT/National Phase path outlined under 3. above) the 12 month period between the initial provisional application and moving to international phase through the PCT process, can be and is used by applicants to conduct additional R&D to strengthen supporting information for the original claims. Related R&D does not stop when the claim progresses to PCT, and notably for pharmaceuticals may well progress for many years,

even after a patent is granted. Furthermore, regulatory authorisation to market a pharmaceutical typically takes at least a decade from the initial proof-of-concept R&D, a fact that is recognised in the extra 5 years (25 years instead of 20 years) of patent validity for pharmaceuticals. This time is predominantly required to conduct the R&D necessary to demonstrate the safety and efficacy of the new medicine.

12. How much R&D activity (related to patented inventions) occurs outside Australia? How is R&D usually split between related and unrelated parties?

A meaningful answer to this question would require a full and detailed economic study. The varying circumstances under which any individual taxpayer conducts R&D precludes citing individual examples, but as a general response we make the following observations of some of the myriad contributing factors:

- In pharmaceutical studies (small molecule drugs, biologics or medical devices) the need to conduct R&D outside of Australia will depend on, amongst other factors, whether the following are available in Australia:
  - The necessary technical expertise to conduct and/or interpret a study;
  - Whether relevant, validated and verified pre-clinical models (such as specific animal models of disease) are available;
  - Whether a specific population is available (e.g. sufficient numbers of individuals with a specific disease, a genetic variant that causes or is linked to a specific disease or condition, or sufficient numbers of a specified ethnic group);
- For entities conducting clinical trials, Australia is an attractive jurisdiction for early phase clinical studies (Phase 1 – safety in healthy volunteers or patients, are typically conducted with around 20 individuals; Phase 2 – safety and efficacy in patients, are probably in the range of 20 to 200 subjects) but the size of both the total population and specific subgroups (either specific patient populations and/or specific ethnic groups) all but mandates that a significant portion of later stage clinical studies (Phase 2B or Phase 3, safety and efficacy in up to several thousand subjects) will have to be done internationally;
- A large entity is more likely to have more of the relevant technical expertise in-house than a start-up and is more likely to not have to out-source specific R&D tasks to unrelated parties, but even a very large entity will not necessarily have the relevant technical expertise (including validated animal models for specific diseases) required for a specific project in-house; and
- Even large entities are likely to out-source a lesser or greater portion of the tasks required to conduct and evaluate clinical studies, such as regulatory affairs (obtaining approvals to conduct studies), subject recruitment, monitoring of trial participants, data recording and interpretation (including biostatistics) and reporting of any trial adverse events.

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)?

If companies do not already collate this type of data in the preparation of an R&D Tax Incentive claim, their ability to use the data in a subsequent Patent Box claim will provide an overwhelming incentive to do so accurately.

14. To what extent are the R&D expenses of Australian patented inventions not entirely the subject of R&DTI claims?

Again, a meaningful answer to this question would require a full and detailed economic study. Anecdotally, if an invention has been patented by a company incorporated in Australia, they are very likely to have claimed the R&D Tax Incentive. An accurate

answer to this question could be determined from the difference between the Australian Bureau of Statistics (ABS) estimate for Business Expenditure on Research and Development (BERD) (around $17.4 billion in 2017/18 (6)) and the total claimed expenditure reported to the ATO (the ATO made payments of around $2.46 billion to R&D Tax Incentive claimants for R&D conducted in the 2017/18 income year but do not include the total claimed expenditure in their annual report (7)).

Two other circumstances are likely to lead to patented inventions not being entirely the subject of R&D Tax Incentive claims:

- A portion of the R&D is conducted by a tax-exempt entity through funding provided by Federal Government research councils such as the ARC or NHMRC with subsequent commercialisation including the formation of a spin-out that holds the IP; or
- A portion of the R&D is conducted by an overseas entity who establish a subsidiary in Australia to conduct clinical studies to take advantage of the ease with which Phase 1 clinical studies can be conducted here under the oversight of the Therapeutic Goods Administration (TGA).

In each of these cases, mandating a clear nexus between IP and R&D Tax Incentive claims will ensure that the entities in question are not eligible for the Patent Box, maintaining the integrity of the regime.

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

The UK definition of qualifying is in our view both workable and appropriate in the Australian context. The possibility of mandating a nexus between R&D Tax Incentive claims and the Patent Box in Australia will ensure this, while simultaneously providing a simple mechanism for ensuring compliance.

16. How significant is the role of R&D that occurs after a patent has been applied for? What portion of an invention's total R&D would this typically account for in the medical and biotechnology sectors?

Please refer to our response at 12. above. As noted, this will vary widely depending on the nature of the commercialised IP and its intended end use. In specific cases it will range from negligible to the majority of total expenditure.

17. To what extent are Australian-based manufacturing processes subject to their own patents in the medical and biotechnology industry?

Again, a meaningful answer to this question would require a full and detailed economic study. The extent to which any company relies on patent protection versus other forms of IP protection such as trade secret, copyright or plant breeders rights, will depend on the company in question and the nature of the products/services on which their revenue depends. See also our answers at 5., 21. and 29.

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)?

Given the long lead times (on average in the region 5 – 7 years) between lodging a provisional patent and the granting of a standard patent, it will be many years before any company claims the Patent Box concessional tax rate if targeting the patent box only

to new inventions (priority date after 11 May 2021) is maintained in the Patent Box legislation.

This situation will be further exacerbated for patents protecting commercial rights associated with medicines. The long time required for regulatory authorities such as e.g. the TGA, the Food and Drug Administration (FDA, the regulatory authority in USA) or the European Medicines Agency (EMA) to authorise the sale of new medicines, means that it will be at least 10 – 15 years before any new drug with a priority date of 12 May 2021 is generating revenue.

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?

Given the long lead times between lodging a provisional patent and the granting of a standard patent noted at 18. above, unless the Patent Box regime allows taxpayers to also claim patents that have a priority date before 11 May 2021 it will be many years before any company claims the Patent Box concessional tax rate. Hence, companies will certainly have adequate time to prepare for the regime.

As noted under 10. above, ensuring a nexus between Patent Box and R&D Tax Incentive claims will not only ensure that there is a link to R&D conducted in Australia, thereby attenuating any potential deleterious effects of the introduction of a Patent Box scheme, but will also make conducting R&D in Australia more attractive, as it will reward both the R&D phase and the commercialisation phase of the project if both are conducted here.

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

For legislative simplicity, all types of patent-related revenue should be eligible if there is a nexus to one or more Australian R&D Tax Incentive claims. This will enable entities who have conducted R&D in good faith and commercialised the outcome, either through product development or IP licencing, to enjoy the benefit of the concessional tax rate. Patent trolls, those who acquire patents with no intent of further developing, manufacturing or marketing the patented invention but instead seek to generate revenue by opportunistically enforcing patents against one or more alleged infringers, will not be able to access the Patent Box as they will not be able to demonstrate a nexus to their own R&D Tax Incentive claims.

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 answer to this question will depend on Government policy. The standard treatment internationally is to grant the concessional tax rate for the life of the patent. The UK Patent Box (for example) also allows a company to accrue up to six years revenue while a patent was pending (8). An alternate approach has been taken by Israel who, as noted at 5. above, in 2019 expanded their Patent Box to include any product registered under the Israeli Pharmaceutical Ordinance or approved by foreign compatible laws (4). Under this latter approach the concessional tax rate will be available for the life of the product in question.

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?

Taxpayers accessing the UK Patent Box regime must now (as of July 2021) use a 'profit streaming' method to calculate eligible revenue. In this, the entity's income statement needs to be broken down into separate sub-streams relating to each patent held and a 'standard income stream', each in effect a separate profit and loss account. This is readily achievable if, for example, a patent covers a particular product, or with royalty income associated with granting rights over the use of a specific patent by a third party. However, for a patent used within multiple products or a product that incorporates more than one patented technology, it is only possible to stream based on a product or product group (8).

In the UK Patent Box, the 'R&D fraction' is based on the amount of in-house R&D expenditure incurred by the entity in generating the IP, plus expenditure incurred in subcontracting R&D tasks or activities to third parties. The fraction will be 100 per cent when all R&D has been undertaken directly by the company, but will be reduced if the company has subcontracted R&D to connected entities, or paid to acquire the IP. These measures ensure the claimed R&D fraction achieves nexus requirements and ensures that groups cannot manipulate their affairs to enable entities benefiting from the Patent Box if they did not create the relevant IP through their own R&D.

In Australian R&D Tax Incentive claims, payments to connected entities are already identified, to ensure that non-arm's length transactions do not include a mark-up, and 'Core Technology' expenditure – payments to acquire formed IP – is specifically excluded. Therefore, by ensuring a nexus between R&D Tax Incentive claims and a Patent Box claim, these measures will enable simple calculation of an R&D fraction.

23. As non-patent revenue will need to be separated from the eligible revenue, how might this be achieved optimally (having regard to existing systems and record keeping)?

As per our response under 22. above, the UK income streaming method offers a reasonable method for achieving separation of non-patent revenue that will use a taxpayers existing bookkeeping and accounting systems.

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

As per our response under 22. above, by mandating a nexus with one or more R&D Tax Incentive claims, eligible expenses will already be separated from non-eligible expenses.

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?

Any treatment of losses, for the sake of procedural fairness, should be consistent with the treatment of tax losses under the R&D Tax Incentive scheme: that is, an entity loses the ability to carry forward tax losses to future income years if instead accessing through a tax incentive scheme. This treatment should also not require a deferred franking debit for any benefit received for the entity, to ensure that it is a permanent tax benefit at the company level.

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

The administrative burden, record keeping and evidentiary requirements will be considerably greater if access to the patent box regime is restricted to any particular

industry sector. Without restriction, the main requirements for entities wishing to access the regime will be identifying related income and demonstrating a nexus to the R&D supporting the IP – easiest demonstrated through taxpayers identifying the R&D that leads to a patent application in one or more activities registered through R&D Tax Incentive.

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

All international Patent Box regimes are available to any company holding a patent regardless of the sector they operate in. Ensuring the Australian Patent Box is available to all patent holders, not just those operating in specific sectors, is the surest way to minimise the regulatory burden on companies wishing to access the regime.

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?

To meet Australia's commitments under the OECD's BEPS Action Plan, taxpayers accessing the Patent Box regime will be required to demonstrate a nexus to the R&D supporting the IP. Using previous years' R&D Tax Incentive registrations to demonstrate this is a readily available mechanism that could be relied on both by taxpayers and the ATO that would not lead to a significant increase in the regulatory burden. While we recognise that commercial, legal and administrative aspects of patenting are specifically excluded from being core R&D activities (and are highly unlikely to meet the dominant purpose test to be eligible for inclusion as supporting R&D activities) under Australia's R&D Tax Incentive, any claimant will still need to identify the associated costs in order to exclude them from a claim. Claimants also need to identify the FoR using ANZSRC codes as part of the R&D Tax Incentive registration. It would be a straightforward matter to restrict eligible claims to specified FoR codes if the decision to restrict access to 'biotech' or renewable energy sectors is maintained. As such, using costs identified – whether claimed or not claimed – through a R&D Tax Incentive claim is the most straightforward mechanism for ensuring both the nexus to R&D conducted in Australia and the relationship to an eligible sector.

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

Privately-conveyed experiences from colleagues in the UK support our contention that to restrict access to the Patent Box to one or a few industry sectors (no other country who have instigated a Patent Box regime have restricted it) will likely require a mechanism so complex as to be unworkable. Even if a mechanism can be developed that enables fair determination of whether commercialised IP is 'biotech' or something else, its inevitable reliance on patent classification schemes means that only the very largest companies will be able to access the necessary expertise in IP law to conduct the necessary self-assessment (we note that one single company comprises over half of the market capitalisation of the ASX 200 Health Care Sector). Smaller companies will not have the internal teams of IP lawyers and will have to out-source this function at hourly rates. The requisite expenditure will almost certainly ensure that none of these companies seek to access the Patent Box regime.

If the Government wishes any but the very largest companies in Australia to access the scheme then it must be open to all patent holders, regardless of the industry sector they operate in.

If the Government does wish to provide a special incentive for Australian-based manufacturing in the biotechnology/healthcare space, then the scheme should also be expanded in line with the expanded access enacted in Israel (4), to include all medicines and medical devices included in the ARTG for which a nexus with R&D Tax Incentive claims in Australia can be demonstrated.

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