Grant Thornton
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Dear Sir/Madam

Patent Box: Discussion paper on policy designs

Grant Thornton welcomes the announcement of a patent box regime to support Australian based R&D and commercialisation. Our core client base is mid-sized business, across a range of industries including life sciences, manufacturing, food and beverage, and energy and resources. A rapidly growing part of our business involves supporting our clients to access grants and incentives for their development and R&D activities. We understand the untapped potential for R&D and innovation in Australia – the innovators are here, but the translation to commercialisation often takes place overseas. It is time to reverse that trend.

This consultation paper's questions relate to many specialised areas, including, patent law, R&D tax, corporate tax, and industry specific knowledge. Grant Thornton has expertise in corporate tax, specialist tax and specific industry knowledge. We have also held extensive consultation with patent attorneys from Griffith Hack. Griffith Hack has provided expert insight into key patent box design considerations and has been instrumental in our responses to questions 1 to 10.

Submissions

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?**

   As provided in the consultation paper, over 20 jurisdictions have patent boxes or other regimes that offer concessional tax treatments to IP derived profits. There are three features of many of these regimes that we believe are significant: broad industry application, competitive concessional tax rates and burden of compliance.

Broad industry application

Patent boxes in other jurisdictions are not limited to certain industries or sectors. This removes the uncertainty associated with claimants having to identify and assess whether they fall into industry definitions. There is inherent complexity when trying to define a sector for tax purposes, and this added uncertainty will likely detract from the aim of the regime to retain ownership of patented inventions in Australia (refer to responses to questions 4 and 5).

Innovation does not occur in industry silos and Australia's entire innovation ecosystem should be supported. A broadly applying patent box regime would also allow industries that Australia has a competitive advantage in (e.g. mining, agriculture) and sectors that the Government has identified as national priorities (e.g. manufacturing sovereignty in relation to space, food and beverage and defence) to benefit from the patent box scheme.

We acknowledge the Government's reasoning to implement the patent box for certain industries and depending on the success of the regime, potentially broaden its application to other industries. If the Government choses to follow this approach, we would suggest that the Government sets out clear targets to determine whether the regime has been successful (e.g. Number of patents filed in Australia, number of claimants, number of patents for which ownership has been retained in Australia), and that the Government guarantee that if the targets are met then it will open up the patent box regime for all industries.

Effective concessional corporate tax rate

We acknowledge that the effective concessional tax rate of 17% proposed by the Government represents a significant decrease from the corporate tax rate. However, in order to achieve the Government purposes of increasing R&D activity in Australia and retaining IP ownership in Australia, the concessional rate should be competitive internationally.

The UK's patent box regime offers an effective concessional tax rate of 10%, and the majority of European nations offer an effective concession tax rate of 10% or lower. We note that while the OECD is pushing to harmonise global minimum corporate tax rates to 15%, this is in its very early stages. To remain competitive internationally, we proposes an effective concessional tax rate to 10% (as opposed to 17%) for companies on eligible profits from eligible patented inventions. This is in line with the stated objectives of the patent box to increase R&D activities undertaken and commercialisation of inventions in Australia.

Reduce Burden of Compliance

We strongly advocate for a patent box regime that reduces the complexity of compliance. We are concerned that this high administrative burden will be a significant impediment to SMEs accessing the patent box regime due to complex data requirements and high compliance costs. For example, an unintended consequence of the UK patent box regime, which has a high regulatory burden (e.g. income streaming, two track system), is that the program is mainly accessed by large corporations. A high cost of compliance significantly reduces any benefit SMEs will be able to access under the proposed patent box regime. If the Government is seeking to increase R&D in Australia and retention of patents in Australia, it should ensure simplified compliance for SME entities, which the Government acknowledges, are key drivers of innovation, employment and growth in the Australian economy.

Eligible IP to enter the patent box

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

It is common for medical and biotechnology companies with domestic R&D operations to hold patents in overseas jurisdictions (and not in Australia) to access larger overseas markets. We support the need for the regime to include patents from jurisdictions with comparable patent quality requirements to Australia.

From our consultations with Griffith Hack, it is particularly difficult to patent software based inventions in Australia compared to overseas jurisdictions. In the UK, the financial sector is one of the largest users of the UK's patent box regime and it is likely that many of these patents relate to software based innovations.

The intersection of artificial intelligence and the medical and biotechnology sectors is a rapidly growing area of innovation. Recognising patents from overseas jurisdictions would allow a greater number of software based medical innovations to benefit from the patent box regime. It is not clear if software based medical and biotechnology inventions would be able to benefit from the patent box if only Australian standard patents are eligible. Given the innovation potential and growth of this area, we highly support a patent box regime that includes patents from other jurisdictions where positions related to software are already beginning to be established.

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?**

   From our discussions with Griffith Hack, it would be suitable to recognise patents filed with the IP5 Patent Prosecution Highway pilot as eligible patents for the purposes of a patent box. The IP5 is a forum of the five largest patent offices globally that have robust patent systems and uphold rigorous standards and processes. These are: the United States Patent and Trademark Office (USPTO), European Patent Office (EPO), the Japan Patent Office (JPO), the Korean Intellectual Property Office (KIPO), and the State Intellectual Property Office of the People's Republic of China (SIPO).

   We recommend including patents filed in these jurisdictions as eligible standard patents for the purposes of the patent box regime. It is very likely that if a medical or biotechnology company has not patented in Australia, that it would have filed a patent in one of the IP5.

Targeting medical and biotechnology

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

   There is inherent complexity when attempting to define a sector, in and of itself, let alone for the purpose of tax. We note that while a piece of tax law may start off relatively clear, as integrity issues are identified it invariably becomes more and more complex. Further as we have seen with the R&D tax incentive and, say – software claims, there can be issues of interpretation which may result in confusion.

   We suggest an approach that uses definitions which are already understood by the sector or used in legislation/regulations associated with the sector, and which keep pace with changes in the sector. This would mean classifications and definitions based on what we already know to be regularly updated or have definitions broad enough to encompass emerging and novel technologies that cannot be presently contemplated.

   Having said this, we also acknowledge that using definitions that are too broad (e.g. ANZIC codes) will not give sufficient certainty to business. From our consultation with expert patent attorneys at Griffith Hack, we support using pre-existing patent classifications as definitions (e.g. WIPO classifications, the International Patent Classification System, or the Co-Operative Patent Classification system). Once a classification system has been chosen, we also suggest separate consultation as to what classes and sub-classes will fall into the medical and biotechnology sectors. Having a clear list of what classes and sub-classes of patent classification are eligible will make it easier for tax professionals to identify if a company is eligible to access the patent box regime.

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?**

   The medical and biotechnology sectors encompass an incredibly broad range of concepts and applications from new drug development, to medtech, regulatory technology (related to the medical industry) and medical equipment. Further, as noted above, a definition must also be capable of encompassing emerging and currently unknown medical and biotech innovations, including software and process innovations.

Low emissions technologies

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?**

   Businesses that own inventions related to lower emission technologies include automotive or energy generation. In automotive you have both technologies to reduce emissions from traditional ICE (internal combustion engine) applications and that of new technology such as electrification, hydrogen, and compressed air. The energy sector is clearly developing technology in support of clean coal, hydro, wind, solar and nuclear. In fact, the Government's own Modern Manufacturing Initiative roadmaps highlights low emissions and sustainability as a primary goal across all six priority sectors. Low emissions innovations could come from anywhere in the economy.

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)?**

   Patents play a strong commercial role in the clean technology sector. For example, the automotive industry is highly regulated and any new technology needs to comply with a countries design rules – by default a business must protect their technology to deal with the lag between development and acceptance.

   From our consultation with Griffith Hack, we note that patents in the clean technology sector largely relate to process driven innovations. Consideration needs to be had as to how the patent box regime applies to process innovations, particularly what falls within the definition of eligible profits for process innovations.

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

   There are many factors that drive decisions about the location of clean technology R&D, including:

   - Capital equipment costs and return on investment,
   - Access to investment, collaborative and support businesses or government agencies,
   - Access to infrastructure that supports development,
   - Corporate tax rates & any concessions,
   - Environmental factors,
   - Market access, and
   - Public perception.

   Many businesses involved in the development of clean technology will also be looking to a response from the Australian Government in terms of the nation's carbon emissions reduction strategy during the UN Climate Change Conference (COP26) in November 2021.

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

   From our discussions with Griffith Hack, we suggest using pre-existing patent classifications as definitions (e.g. WIPO classifications, the International Patent Classification System, or the Co-Operative Patent Classification system). As above, there should be a separate consultation as to what classes and sub-classes of whichever classification system is chosen will fall into the clean technology sector. Having a clear list of what classes and sub-classes of patent classification are eligible, will make it easier for tax professionals to identify if a company is eligible to access the patent box regime. We would again note that having a program which applies to all sectors would remove the need for classifications and definitions particularly where technology is evolving. It would also align with the current Modern Manufacturing Initiative.

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?**

    Patent box is only one form of support. We would also suggest considering the role superannuation funds can play, complemented with government grants and other tax based incentives.

Applying the substantial activity requirement

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?**

    From our experience, companies record direct costs and revenue for a particular product or service. However, existing record keeping systems, as a matter of course, do not attribute a nexus between expenses and revenue, other than at a company level. Therefore the attribution of revenue to a particular patent or patents will invariably require human intervention and manual analysis and calculation.

    It might be suggested that companies could establish procedures in the system to undertake linking of expense to activities. There are several challenges with this:

    - From a systems perspective, it would be rare that all tracking would be in one system,
    - The presumption that a company knows from the outset that its innovation will be patentable and / or it intends to patent the innovation, and
    - Potential difficulties in relating expenses or income where one product encompasses multiple patents, or a single patent relates to multiple products.

    We also note the importance of providing clarity regarding the meaning of ‘related’. From a tax perspective, terms like ‘related’ have the potential to be interpreted broadly and again lead to outcomes which were not envisaged at the outset. To provide companies certainty, and therefore confidence, to factor patent box into future plans, we suggest clear guidance, or else adopt an approach which allows ‘safe harbours’ for cost allocations.

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

    The proportion of R&D activity that occurs outside Australia depends on the industry, the company and the innovation being developed.

    Medical and biotech companies conducting R&D activities to develop new drugs or biomedical devices need to undertake large scale clinical trials in order to obtain regulatory approval. Overseas testing is necessary to access sufficient populations, especially in cases of developing a solution for a rare diseases. Further, medical and biotech companies conduct trials overseas on animal populations that are not available for testing in Australia.

Further, we often see R&D activities moved offshore in instances where Australia does not have the capability, facilities or skills to conduct the R&D, and where it is more commercially viable for activities to be conducted overseas (i.e. cheaper labour, more competitive tax regimes).

From our experience in the R&D tax space, there are no 'usual' ways of splitting R&D between related and unrelated parties. R&D undertaken by unrelated parties is for entity who owns the IP, so from that perspective the R&D is not 'split'. We note that for R&D tax purposes, this is only an issue when related entities to not form part of a tax consolidated group.

Definition of R&D

In response to questions 13 and 14:

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)?**

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

The R&D Tax Incentive framework has not been designed to apply to a patent box regime. While the R&DTI would be practical, pre-existing tool to determine R&D conducted in Australia, we note several limitations.

First, activities conducted to generate a patent are not necessarily eligible R&D activities under the R&DTI. This position has been confirmed in AusIndustry's Guide to Interpretation for the R&DTI. For example, if an entity invents a new product or process without the need for experimentation (i.e. the outcome was known in advance) then the entity would not have an eligible core R&D activity because the activity does not follow a systematic progression of work for which the outcome could not be known or determined in advance.

Second, there are activities which are deemed by the legislation not to be core R&D activities (see exclusions from the definition of core R&D activities). Further there are supporting activities which are subject to dominant purpose tests. There could be scenarios where such activities and expenses could be related to items which are patentable.

Third, the R&DTI legislation has specific rules regarding what expenditure can be deducted under the incentive and also specifies expenditure which cannot be deducted. Fundamentally, companies are required to distinguish between R&D and non-R&D (sometimes referred to a 'business as usual'). Again some these 'business as usual' activities may be related to the patent, for example, the task of applying for the patent itself.

Finally, not all companies elect to access the R&DTI regime due to administrative complexity and compliance cost.

We suggest that while the R&DTI could be one framework to identify R&D activities conducted in Australia, that the Government accepts other methodologies. We believe that the R&DTI could be a good framework for some entities but it will not cover all circumstances.

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?**

As above, definitions of qualifying expenditure should be consistent with OECD guidelines (e.g. BEPS action 5). We note that the definition of qualifying expenditure should not be limited to the definition of R&D expenditure under the R&D tax Incentive program for the reasons provided in response to Questions 13 and 14.

We also suggest consideration of definitions and approaches of past Government programs, e.g. Australian Automotive Transformation Scheme for Automotive component producers.

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?**

    From our experience, there is a significant amount of R&D that is conducted after a patent is applied for. This could be R&D that eventually results in a second patent, or it could be continued improvements to remain commercially competitive. Many companies will conduct significant R&D to develop an alpha prototype (or version 1) which the company patents before taking to market. However, continued R&D and improvements to the initial version often results in a dramatically improved / altered beta prototype (version 2) that a company may also elect to patent. This cycle is continuous and the delineation of where the R&D related to one patent ends and another begins is complex.

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

    No comment on the extent to which Australian-based manufacturing processes subject to their own patents. As above, consideration should be had as to the treatment of qualifying expenses and income in relation to process related innovation.

Implementation and start date

In response to questions 18 & 19:

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)?**

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?**

    A patent priority date after 11 May 2021 will dramatically limit the immediate benefit of the patent box to many companies. This is particularly the case in the medical and biotechnology sector due to the significant time lag to start new R&D processes and file for a provisional patent. We would recommend that the patent box regime also apply to any patent granted as at 11 May 2021. We acknowledge that retrospective start dates may be impacted by the fact that not all companies will have existing record keeping systems in place. However, postponing the priority date will result in a long time lag before many companies can access the regime which will adversely impact the program's objective to increase R&D spend and retain intellectual property in Australia. Further, consideration should be given to establishing a transitional period to give companies (particularly SMEs) immediate benefit of the program and more time to organise and implement requisite records.

Eligible revenue to enter the patent box

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

    We suggest that the following types of patent-related revenue be eligible for the patent box:

    - Royalties or licence fees derived from an eligible patented invention
    - Revenue embedded in the sale of patented good or services or the use of patented processes in production
    - Revenue from damages or an account of profits for infringement of an eligible patented invention

- Revenue by sale or assignment of an eligible patented invention
- Revenue generated where a patent pending
- Revenue generated from an invention that qualifies for patent application.

The last two points above demonstrate the issue in recognising eligible revenue derived from an innovation for which an eligible patent has not yet been granted.

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?**

    It should be applied to all entities that own, licence or exploit the patent.

    Challenges may arise when dealing with entities within a tax consolidated group – but the issue will be more around determination and identification of qualifying revenue generated within the group (which will by necessity give rise to greater administration).

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?**

    The Government can reduce the administrative burden on companies by removing the need for income streaming for each patent and allow for patent box calculations on the basis of the aggregated patents.

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)?**

    For simplicity purposes, look to adopt reasonable and justifiable apportionment methodologies. If necessary, the existing tax system allows for differential tax rates (exempt income labels for example). Another similar concession is in the finance sector with concessional tax rates applicable for income derived by Offshore Banking Units. The concern as always is with the extra compliance burden – even more so with cash poor but idea rich organisations.

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?**

    Qualifying expenses should be allocable against qualifying revenue. The issue then occurs in early years, where qualifying revenue exists but a patent has not yet been granted. While these amounts could be quarantined and to be applied in the future, this would disadvantage organisations in the process of commercialistion which requires substantial time and cash flows (i.e. no benefit would be provided to a company that is starting to generate revenue relating to an innovation with a pending patent). We suggest linking this back to the definition of eligible revenue (see response to Question 20), such that if the revenue is in relation to patentable activity or a pending patent, then the concessional tax rate apply immediately to the revenue from the income.

    From the R&D experience, this would be need to be a manual allocation process.

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?**

Please refer to the comments above in Question 24 – to reduce further administration burden, once the determination is made around patentable activity, the losses are immediately deductible (albeit at the reduced rate). If the company is in losses, the existing carry forward loss rules should apply, subject to these losses being quarantined at the reduced rate.

Administration and compliance

In response to questions 26 and 27:

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

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

    The regulatory burden on companies in relation to administrative, record keeping and/or evidentiary requirements has the potential to be quite onerous. Based on the questions posed by this consultation paper there would be the requirement to:

    - document R&D activities conducted in Australia that is related to a patent,
    - the spilt between R&D activities and expenses in Australia verses overseas,
    - expenditure incurred on R&D that leads to a patent,
    - revenue generated from patents being distinguished from other sources of revenue.

    We are concerned that this high administrative burden will be a significant impediment to SMEs accessing the patent box regime due to complex data requirements and high compliance costs. For example criticism of the UK patent box regime, which has a high regulatory burden (e.g. income streaming), is that the program is mainly accessed by large corporations. While the UK regime allows taxpayers with smaller claims to aggregate incomes streams into a single global stream, this is not sufficient to reduce the administrative burden and encourage SMEs to access the regime.

    It is generally accepted that SME entities are a key driver of innovation and growth in the Australian economy. While there will be, by necessity, an increased compliance burden, focus should be on establishing simple and clear guidelines, such that utilisation of the self-assessment system will minimise excessive administrative burden on companies. Consideration should be given to further mechanisms (e.g. safe harbour provisions) and alternative compliance requirements to reduce obstacles for SMEs seeking to benefit from the regime. All existing record keeping and evidentiary requirements can be maintained, but any further administrative requirements should be limited.

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?**

    The Government should consult separately as to what classes and sub-classes of whichever classification system is chosen will fall into the medical and biotechnology and clean technology sectors. Having a clear list of what classes and sub-classes of patent classification are eligible, will make it easier for tax professionals to identify if a company is eligible to access the patent box regime. We acknowledge that this may also require companies to also consult with patent attorneys as to whether patents held or those that will be applied for fall within a class covered by patent box.

Other considerations

29. **Are there any other issues you would like to raise for consideration in the design of the patent box?**
    A key consideration in the design of the patent box is how that program will be administered. For instance, will it be administered only by the ATO or also by the Australian patent office and / or AusIndustry? From the R&D tax experience, dual administration results in additional complexities and higher administrative burden. We would suggest that the program only be administered by the ATO.

Yours sincerely

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