

17 August 2021

Paul Fischer
Corporate and International Tax Division
The Treasury
Langton Crescent
Parkes ACT 2600

By email: PatentBoxConsultation@treasury.gov.au

Dear Mr Fischer,

Patent Box: Discussion paper on policy design

CPA Australia represents the diverse interests of more than 168,000 members, working in over a 100 countries and regions supported by 19 offices around the world. We make this submission on behalf of our members and in the broader public interest.

The Treasury's **Patent Box – Discussion paper on policy design (the Discussion Paper)** seeks submissions on the policy design of the announced patent box regime.

We support initiatives designed to enhance Australia's attractiveness as a centre for research and development (**R&D**) and support efforts to retain the tax revenue benefits of Australian-generated intellectual property (IP) in Australia. The introduction of a patent box provides an incentive for multinational enterprises (**MNEs**) and Australian businesses to invest in R&D and maintains a level of competitiveness with other tax jurisdictions. However, we note that tax concessions are only one tool available to government to incentivise R&D and observe that there are jurisdictions without a patent box regime where significant and valuable R&D activities are undertaken.

The OECD's **patent box framework** as presented in the Action 5: 2015 Final Report, in particular the substantial activity requirement¹, addresses the identified issues with earlier patent box regimes and provides a reasonable blueprint for Australia's design.

Significant and important features

We consider the most important feature of an Australian patent box is the requirement for a concrete geographical link between the **R&D** activities and the granting of the preferential tax rate on the income generated by the resulting **IP assets**.

This is because IP assets do not have a specific geographical location, but rather a nominal location determined by the parent company's tax or legal system, since it is the country of the IP owner that determines the applicable tax treatment. The patent box should therefore be designed to prevent the separation of the location of the IP rights from the location of the R&D activity.

The design should also consider both the implications for the creation of intangible assets (i.e. the research phase) and the subsequent exploitation of those intangible assets (i.e. the exploitation phase). This is because companies may choose to locate their R&D activities in a jurisdiction which has more favourable rules for tax deductions on costs or more attractive input based R&D tax credits (e.g. the Australian R&D tax concession), while locating the ownership of the resulting IP rights in a different jurisdiction with a more attractive output-sided tax incentive.

Patent box competition and the ability for related parties to separate research phase activities from exploitation phase income led to a variety of incentives², as well as base erosion and profit shifting (BEPS) concerns. While the nexus requirement in the

¹ OECD (2015), *Chapter 4 – Revamp of the work on harmful tax practices: Substantial activity requirement*, Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. <http://dx.doi.org/10.1787/9789264241190-en>

² France offers a R&D tax credit of up to 30 per cent of qualifying expenses and the patent box offers a 15 per cent tax rate on IP activity, compared to the 33% normal corporate tax rate. In contrast, Cyprus offers a 2.5 per cent patent box tax rate, Ireland 6.25 per cent and the Netherlands 7 per cent. The Netherlands does not offer any R&D tax credit nor super-deduction for R&D activities.

OECD framework has restricted such tax planning opportunities, companies seeking to access patent boxes are now more likely to centralise their R&D activities in the most favourable jurisdiction, which is determined by factors such as the concessional rate, other tax and transfer incentives, availability of skilled labour and access to facilities.

As such, the Government should complement the patent box with additional incentives to maximise the benefits of locating R&D activities and IP assets in Australia.

We expect that any exposure draft will closely follow the OECD framework and consider the following features as being important in the design of Australia's patent box:

1. The patent box establishes a firm connection between the receipt of preferential taxation and domestic research and commercialisation activities to ensure that the regime encourages the active development and commercialisation of new IP in Australia.
2. The patent box is only available to IP asset holders who are Australian tax residents, since the tax benefits should accrue exclusively to the Australian resident patent owner.
3. Patent boxes are available only for Australian-based R&D activities that are directly related to the IP asset, even when specific other requirements such as start dates or thresholds may be met.
4. The tax benefits of a patent box regime must be directly linked to the amount of expenditure for R&D activities incurred by the taxpayer in developing the income-generating IP asset. The nexus ratio presented in the OECD framework appears appropriate, although there may be challenges in ensuring that a direct linkage to the income generated by the IP asset is properly established.
5. The patent box is not available for income generated from IP assets that are acquired or those developed by contractually outsourcing the R&D activity to related parties.
6. The country where the R&D activity is carried out and the country where the IP asset is located must be the same (i.e. the nexus approach in the OECD rules). The Government should also consider adopting a 'development condition' like the UK and require a company to carry out domestic R&D activities in order to benefit from the reduced tax rate³.

We also note that clarity will be required in terms of defining qualifying taxpayers, IP assets (e.g. those patents registered in Australia, functionally equivalent assets or certified assets) and qualifying expenditures, including consideration of if and how to allow general or speculative expenditure.

Further aspects that should be considered include:

- Availability of rollovers or transfers between related entities located in the same jurisdiction
- The availability of grouping provisions or permitted related party transactions between resident entities so as not to unnecessarily confine activities and/or IP assets to specific entities within an Australian group
- The level of administrative complexity and compliance burden.

Losses and related offsets

In the context of a patent box, losses and interactions with the existing R&D tax incentive (**RDTI**) raise a number of policy and administrative considerations. To the extent that the Government intends the RDTI and patent box to work in concert to significantly reduce the tax paid on activities related to the creation of IP assets, then the regimes should be designed to interact as closely as possible.

However, the two concessions target somewhat different outcomes and the question arises as to whether patent box qualifying expenditures should specifically adjust for expenditures on core and supporting R&D activities for which notional deductions have been calculated and the RDTI offset has been claimed.

With respect to losses, we support the application of general principles where a company in a taxable loss position overall would not be able to access the patent box concessional rate. Assuming that the nexus ratio would be applied to taxable income or loss to determine the percentage of profit subject to the concessional rate, where the company is overall in a taxable loss position despite generating qualifying income from IP assets, that income would not be subject to tax. Once the company is overall in a taxable position, then the nexus ratio percentage would be used to determine the concessional amounts under the patent box. Should the Government seek to treat losses differently under the patent box, issues such as quarantining, conditional application and timing will need to be considered.

Administrative complexity

The OECD framework reflects the potential complexity of patent box rules and the UK's design – while conceptually simple – requires significant detail to administer properly.

³ Daniele Fabris (2019), To open the box or to close the box? "Patent Box" regimes in the EU between R&D incentives and harmful tax practices, Amsterdam Law Forum, Winter 2019, p 45.

While there may be some interaction with the RDTI in the Australian design, it is unlikely that definitions and parameters will align, not least because access to the patent box is more restrictive and qualifying expenditures for patent box purposes will be intentionally different to the RDTI rules.

The recent focus on the administration of the RDTI reflects the challenges of ensuring consistent assessment of eligibility and compliance with the requirements. We assume that the patent box would be solely administered by the ATO, rather than jointly with AusIndustry, which will assist in providing consistent interpretation and certainty. However, the conceptual basis of the patent box requires taxpayers to link expenditure and income to specific IP assets which raises a range of record-keeping, substantiation and timing issues.

Taxpayers will be required to keep specific records in relation to qualifying expenditures. However, it is often highly uncertain as to whether a particular set of R&D activities will result in a successful, income-generating patent. There can also often remain an element of subjectivity in determining which expenditures were directly linked to the creation and improvement of the IP asset, thereby creating uncertainty and the need for detailed substantiation.

Larger companies, particularly those availing themselves of in patent boxes in other jurisdictions, are more likely to be familiar with the requirements and compliance challenges. However, the Government should also consider de minimis or safe harbour rules for start-ups and smaller companies to reduce the burden and provide certainty.

Access to the patent box

We are supportive of the patent box being made available to other IP assets, including those related to clean energy and climate-related technologies. We also suggest that in line with the Government's announcement on the digital games tax offset, further consideration be given to expanding the patent box beyond the medical and biotechnology sectors.

Holistic approach required

While the patent box is one form of incentivising R&D activities, it is not a singular solution to attracting companies to base their R&D operations in Australia. It is important to note that countries such as Sweden, Finland, Germany and Denmark, which do not have special tax incentive mechanisms for R&D activities, are the most advanced in the EU in terms of both intensity of and specialisation in R&D activities. The main reasons given for their success in this field are their well-educated labour force, strong R&D structure and preference for transfer payments to support R&D⁴.

As such, the Government should ensure that the patent box is complemented by significant investments in the Australian R&D ecosystem with a particular focus on non-tax factors such as the labour force and provision of R&D facilities to encourage commercial investment.

If you have any queries about this submission, contact Elinor Kasapidis, Senior Manager Tax Policy on +61 3 9606 9666 or elinor.kasapidis@cpaaustralia.com.au.

Yours sincerely,



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⁴ Ayse Yigit Sakar (2015), Innovation for a New Tax Incentive: patent Box Regime Turkey and the EU Application, *Procedia - Social and Behavioural Sciences*, 195, p 544 - 553