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Dear Mr Fischer

Submission in response to Patent Box Discussion Paper July 2021

We refer to the *Patent Box Discussion Paper on Policy Design* dated July 2021 (**Discussion Paper**).

Ashurst is a global full-service law firm with offices in most of the world's leading financial centres (including London, Singapore, Paris, Luxembourg, Sydney and Melbourne among others). We are commonly asked to advise multinational companies on both tax and intellectual property (**IP**) matters.

We are pleased to provide below our comments on selected questions posed in the Discussion Paper. We have only addressed those questions that we believe are within our expertise and experience as tax and IP lawyers. These are questions 1, 2, 3, 4, 18, 23, 25 and 27. We also provide comments in relation to the interaction between the proposed patent box regime and the dividend imputation system, in section 9.

1. QUESTION 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?

We consider that there are four key features of patent boxes in other jurisdictions that will be critical for designing the Australian patent box regime. These features are:

- **Tax rate and interaction with other tax rules:** Clearly, the concessional tax rate is a critical aspect of the regime, and it is imperative that the tax rate is set at a sufficiently low level to be attractive to companies to locate, or relocate, their research and development (**R&D**) activities to Australia in preference to other jurisdictions.

In this respect, the proposed concessional rate of 17% is significantly higher than rates offered in other jurisdictions. By way of example, this rate is significantly higher than the rates in Ireland (6.25%), the Netherlands (9%) and the UK (10%). This means that, where tax is the major factor being considered in a global business' decision as to where to locate R&D activities, the proposed Australian regime is likely to be uncompetitive. We do note that, if the G-20 "global minimum corporate tax" rate of 15% is ultimately implemented, the lower rate patent box regimes may need to lift their rates closer to the proposed Australian rate. However, in the meantime, a lower patent box tax rate could be considered to make the Australian regime more competitive with other jurisdictions.

In addition to the headline tax rate, it will also be important to consider how the patent box interacts with other tax rules, including the R&D tax offset, loss rules and imputation system, to ensure that the way the patent box interacts with those other rules does not operate as a disincentive to elect into the patent box.

We address this further in our responses to question 25 and in section 9 below.

- **Scope:** Patent box regimes in other jurisdictions are not restricted to patents in selected business sectors. In contrast, the current proposal is to limit the Australian regime to patents in the medical and biotech sectors (potentially extended to the clean tech sector). In our view, this limitation will act as a serious disincentive to locate R&D activities in Australia as compared with other jurisdictions where this limitation does not exist.

We address this further in our response to question 4.

- **Eligible profits:** Given the length of time that can be taken for a patent to be granted, it is in our view imperative that profits earned during the application phase are eligible for the concession. Similarly, to provide certainty for business, it is also imperative that the regime does not "unwind" the benefit of the concession should a patent, once registered, be successfully revoked through litigation.

We address these further in our responses to questions 18 and 27.

- **Compliance burden:** The experience of other jurisdictions is that the compliance burden associated with the patent box regime can act as a serious disincentive to elect into the regime, particularly for small business and start-ups, who may not be in a position to bear the cost of establishing the systems and processes needed to comply with the regime. Minimising compliance costs (particularly for small and medium enterprises (**SMEs**)) should therefore be a key goal for the design of Australia's patent box.

We address this further in our responses to questions 3 and 23.

2. QUESTION 2

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

Yes, patents applied for by medical and biotechnology companies will ultimately be granted as Australian standard patents.

There are three ways that a medical and biotechnology company may apply for a patent:

- (a) Provisional patent application – a provisional patent application is filed to secure a priority date and signals an intention to file a complete application. A provisional patent application does not provide patent protection on its own and a complete application must be made within 12 months. A provisional patent application provides an applicant with time to determine whether to proceed with a complete application (for example, to test whether the invention is effective and/or will be able to be successfully commercialised).
- (b) PCT application – this is an international patent application filed under the Patent Cooperation Treaty. This provides the applicant with the opportunity to designate a number of countries where they may ultimately seek patent protection for the invention. A PCT application defers national filing in Australia by up to 31 months.
- (c) Complete application – this is an application for a standard patent in Australia.

The time taken for a patent to proceed to grant will depend on the application process that the applicant elects.

It is important to note that innovation patents are presently available in Australia. However, they are currently being phased out and applications for innovation patents will not be accepted after 25 August 2021. For this reason, we consider it appropriate that innovation patents are not included within any patent box regime.

3. **QUESTION 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?

Determining whether the scope of claims in a standard patent granted overseas would be substantially similar to the scope of claims that would have been (but have not been) granted in Australia is not a straightforward exercise.

Patent laws are territorial and there is considerable variance in the law from one jurisdiction to another. In this context, determining the likely scope of claims in a hypothetical Australian patent based on reviewing an overseas granted patent would be a fraught exercise.

To ensure that the claims of an overseas patent satisfied the requisite criteria, a company would need to seek an expert opinion. Any opinion obtained would likely be heavily qualified. Therefore, this requirement would make electing into the patent box scheme on the basis of a foreign patent costly and potentially risky (for example, if the ATO took a different view on the scope of the claims of the foreign patent). In other jurisdictions (eg, the UK), taxpayers are able to claim benefits for patents registered in other jurisdictions that have been nominated as comparable to their home jurisdiction. This results in significant compliance cost savings as taxpayers are not required to obtain expert advice with regard to whether a foreign patented innovation would meet local requirements for registration such that it is eligible for the local patent box regime.

In our view, there would be considerable merit in Australia adopting a similar approach, such as "white listing" those countries with sufficiently comparable patent regimes to Australia such that registration in these jurisdictions will be considered to meet the Australian patent box registration requirement. We note that there is precedent for this type of approach elsewhere in the tax law (eg, under the "controlled foreign companies" rules).

4. **QUESTION 4**

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

As noted in our response to question 1, the proposed Australian patent box is unusual in that it will be limited to particular sectors, being the medical and biotech sectors and, subject to consultation, the clean tech sector.

Where a patent box regime is limited to certain sectors, we believe that this will act as a disincentive for businesses to locate their R&D in Australia.

For example, a company's R&D might cover multiple complementary sectors - that is, it may be the case that there is complementary research being undertaken that might lead to a patent in multiple sectors. If only one patent, and not all patents, registered in consequence of that research qualify for the concession, there will be an incentive to conduct the research in those jurisdictions where all the resulting patents are eligible.

In addition, there might be a risk that the research a business conducts will not (despite the initial hypothesis) ultimately lead to a patent in the medical and biotech (or clean tech) sector, but may lead to a different path of discovery and a patent registered in another sector. This exposes businesses to a serious risk that R&D undertaken in Australia will not qualify for the patent box, despite the initial purpose of the research.

In our view, limiting the scope of Australia's patent box regime will lead to material uncertainty and risk, and will pay insufficient regard to the fact that research may be relevant to and cover a variety of different sectors, and sometimes the relevant sector will not be known until after the research has commenced and progressed to a significant extent. While this risk is perhaps less prevalent in the medical and biotech sectors, it is a significant issue in the clean tech sector.

In our view, consideration should be given to expanding the scope of the patent box to all sectors, or else Australia risks being seen as an unattractive place to locate R&D in comparison with other jurisdictions whose patent box regimes are not similarly limited.

5. **QUESTION 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)?

The application process for a patent is lengthy (see our comments in relation to Question 2, above). It typically takes at least 1 year for a patent to proceed to grant and it can take much longer (particularly if the patent is applied for following a provisional application or if it is an international application through the PCT system).

If the priority date must be after 11 May 2021 in order to qualify for the patent box regime, it will take 1-3 years before the first standard patents that could take advantage of this regime are granted. If instead the regime applies to patents granted after 11 May 2021, then there would be a more immediate benefit as that would cover currently pending applications. If, from a policy perspective, the intention is to influence new investment decisions rather than applying to decisions that have already been made, then the former approach is appropriate.

A related matter not addressed in the Discussion Paper is whether the Australian patent box regime should apply to profits earned while a patent application is pending or only once the patent is granted. Other regimes, including in the UK and the Netherlands, permit pre-registration profits to qualify for regime benefits. The UK achieves this by way of an additional deduction in income years in which the patent is granted to achieve an effective tax rate of 10% on profits accrued during the patent pending phase. An alternative approach would be to allow an unlimited period to amend tax returns to claim the concession retrospectively.

In our view, given the length of time that can be taken for a patent to proceed to grant, it is an important design feature for Australia's patent box regime that profits earned during the application phase are eligible for the concession.

6. **QUESTION 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)?

Under the proposal, the profits that will qualify for the concession are the profits derived directly from the patent itself. This requires that income be accurately apportioned between the value provided by the patent and the value attributable to other components (eg, brand, goodwill, marketing or components of the product that are not the subject of the patent).

There are experts who deal with apportionment and assessment of profits and what they are attributable to, eg, branding vs the patented invention. However, it would significantly

increase the compliance costs for participants in the regime if, for example, complex valuations are required to accurately apportion income to different value components. This would be a significant disincentive in particular for small business and start-ups to elect into the patent box regime.

To simplify this process, consideration should be given to standard formulaic apportionment mechanisms, for example, to deduct a standard or "routine" return for brand, marketing and other value inputs based on a legislatively prescribed formula.

7. **QUESTION 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?

The most straightforward approach to dealing with "patent box losses" is to quarantine them so that they must be set off against patent box profits of that company or other group companies (through the tax consolidation regime) or carried forward to offset patent box profits in future income years. This is the approach taken in the UK and France. We do not see any policy reasons for quarantining losses from one patented innovation from others and a pooling approach appears to be most equitable. Such losses could be subject to the normal loss integrity rules, although consideration could also be given to relaxing the carry forward loss rules for patent box losses to further increase attractiveness of the regime, particularly for start-up companies that often have difficulty meeting the existing integrity rules due to frequent capital raisings and business changes in the start-up phase.

On the other hand, a quarantining approach could act as a disincentive for profitable taxpayers to elect into the regime, who may value immediate access to losses to reduce tax on non-patent box profits (at a higher effective rate), thereby preserving cashflow within the business.

Another approach, which we favour, would be to permit "patent box losses" to reduce the taxpayer's ordinary income from other sources by way of an allowable deduction (perhaps after adjusting the deductible amount to take into account the difference in the patent box and ordinary tax rates). If this resulted in an overall tax loss for the income year, or increased an existing carried forward loss position, a policy decision could be made as to whether to quarantine the unutilised patent box loss for use only against future patent box profits or (if the amount of the patent box loss has been previously adjusted for the tax rate difference) to allow it to be carried forward as an ordinary tax loss for use against ordinary profits.

Another related aspect is how the patent box will interact with the existing R&D concession. For example, will the R&D offset applying to R&D expenditure incurred in creating a patented invention be calculated based on the patent box rate of 17% or the normal corporate tax rate (either 25% or 30%)? Other jurisdictions permit taxpayers to take full advantage of the R&D concession without diluting the patent box benefits.

In our view, it would be a serious disincentive, particularly for small and start-up companies, to forgo the benefit of the R&D tax offset at the higher corporate rate, which many SMEs and start-ups rely on for immediate cashflow, in exchange for the possible patent box concessional tax rate should their research ultimately result in a patent which is both granted and also successfully commercialised.

8. **QUESTION 27**

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

BEPS Action 5 recommends countries adopt the "modified nexus approach" for patent box tax regimes to ensure that patent boxes do not give rise to harmful tax practices. BEPS Action 5 has been endorsed by Australia and the Australian Government has stated that it

will follow the OECD's guidelines to ensure the patent box meets internationally accepted standards.

In other jurisdictions, the experience with the modified nexus approach is that it increases administrative costs of compliance, penalising in particular small to medium enterprises (**SMEs**) with limited resources.

To deal with this, some jurisdictions include certain concessions or "short-cuts" for SMEs in applying the modified nexus approach to ease compliance costs. For example, in the UK, SMEs are able to use a standard rate of return to determine the element of profit that relates to the company's brand and marketing assets. This avoids the need for those entities to engage in costly transfer pricing exercises to calculate the notional marketing asset return.

We also note that, in Ireland SMEs can access the "Knowledge Development Box" in respect of certain IP without the need for the relevant IP to be patented. Again, this may encourage innovation without SMEs needing to expend significant time and money seeking a granted patent.

More generally, other jurisdictions have found that calculating the profit attributed to patents from total profits using a step-by-step method using prescriptive formulae increases certainty and reduces administrative burdens compared to requiring businesses to value each patent individually according to "principles based" definitions.

One other element that we think will be particularly important is dealing with the risk of a patent ultimately being found to be invalid. In this respect, once a patent is registered, its validity can be challenged by third parties and where such a challenge is successful, the patent registration may be revoked. The legal effect of this is that the patent is void ab initio.

It will be necessary for a policy decision to be made as to whether patent box benefits claimed by a former patent holder should be clawed back in such situations or whether they can retain any claimed benefits up to the date that a patent is revoked. In our view, it would be an unacceptable risk to taxpayers if they are exposed to a potential for the concessional tax rate to be clawed back for a period of up to 20 years (being the length of a standard patent in Australia) or even 25 years (for patents relating to pharmaceutical substances) if the patent is ever revoked.

We consider that the appropriate policy outcome is to allow the concession to be claimed up until the patent is actually withdrawn, with no clawback for historic profits claimed. We note that this is the approach taken under the UK patent box.

9. **OTHER RECOMMENDATIONS**

9.1 **Dividend imputation**

The interaction between the patent box regime and the dividend imputation system will require careful thought.

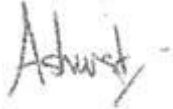
Take up of the new patent box regime may be hindered if the benefits of the lower effective tax rate on eligible patent box profits is effectively unwound when those profits are distributed to Australian shareholders because the lower level of franking of such distributions results in higher tax payments by those shareholders (by way of so-called top up tax to 47%). That is, taking into account the overall tax burden on Australian shareholders, there will be no tax savings resulting from participating in the patent box regime, unless the imputation system is modified.

Further, unless this issue is addressed, there will be an inherent bias in favour of foreign resident shareholders who may not suffer the same increase in tax burden when receiving partially franked dividends (eg, under many Australian double tax agreements, there is a nil or very low rate of dividend withholding tax on certain unfranked dividends paid by an Australian company to a foreign parent).

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Please contact Sanjay Wavde (02 9258 6135), Nina Fitzgerald (02 9258 6778) or Paul Glover (02 9258 6016) if you have any questions or wish to discuss our submission.

Yours faithfully

A handwritten signature in black ink that reads "Ashurst". The signature is written in a cursive, slightly slanted style.

Ashurst