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Attn: Mr Paul Fischer

**By email:** [PatentBoxConsultation@treasury.gov.au](mailto:PatentBoxConsultation@treasury.gov.au)

17 August 2021

Dear Sir/Madam

### **Submission on the Treasury Patent Box Consultation Paper**

We welcome the opportunity to respond to the consultation paper regarding the proposed patent box regime (the **Consultation Paper**) released for comment on 5 July 2021. We support the Government's initiative to encourage innovation and consider that an appropriately designed patent box regime would assist in promoting Australia's global competitiveness.

The attached submission sets out our views on a number of design aspects of the proposed regime for your consideration. They can be summarised as follows:

- To achieve the policy objectives of driving greater innovation and high value job creation, consideration should be given to expanding the regime to apply to all industries, or at the least, high growth industries identified by the Government and its agencies.
- The scope of the regime should be broadened to apply to patents owned by the eligible Australian holders and registered anywhere in the world or at least in jurisdictions where the patent registration involves a similar rigorous process as in Australia. There is also merit in broadening the regime to apply to other forms of intellectual property, such as copyrighted software with appropriate qualifying limits — the regime would become more akin to an Innovation Box rather than merely a Patent Box regime.
- The design of the regime in terms the types of income to which the concessional tax rate would apply is important both in terms of capturing appropriately attributable income and ease of compliance. In this regard, the UK Patent Box regime contains a number of well-designed elements which may be considered.
- Given the typical long lag time for commercialisation of patents, to maximise the immediate benefits and objectives of the regime, we would recommend that the regime apply to all new and existing patents from the relevant date of effect (or at least, all patents registered in the five years prior to the relevant date of effect for example).

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- The compliance burden may be significant particularly if current limited scope of the proposed regime is maintained. In this regard, the level of tracking required over a long period of time to substantiate claims may be quite onerous. Accordingly, the aim should be for a self-assessment regime that is as straightforward as possible including a simplified record keeping approach.

We would like to take this opportunity to thank Treasury for the opportunity to contribute to the consultation process. We look forward to working further with you on this important policy matter over the coming months. In the meantime, please reach out to me at [ali.noroozi@pwc.com](mailto:ali.noroozi@pwc.com) or on 0466 008 476 as required.

Yours sincerely

A handwritten signature in black ink, appearing to be 'Ali Noroozi', written over a horizontal line.

Ali Noroozi  
Partner



## Submission on the Treasury's Patent Box Consultation Paper

We have set out below our views on the key design features of the proposed Patent Box regime. We have focussed on the following areas:

- Industries covered by the regime;
- Scope of the intellectual property (IP);
- Identifying qualifying income;
- Concessional tax rate;
- Start date; and
- Administrative complexity.

### Industries covered by the regime

The policy objective of the proposed patent box regime is broadly to encourage the development and retention of IP in Australia, to create and retain high value jobs in Australia and cultivate innovation in Australia. However, the regime as currently designed is quite narrowly defined, applying only to a specific industry (or industries), and this may lead to limited success in achieving these objectives.

We believe that the regime should have broader application to achieve its objectives, simplify its administration and ease its compliance burden. To provide some international context, we note that comparable IP regimes, in countries such as Belgium, the United Kingdom (UK), Switzerland and the Netherlands, apply to all industries.

Accordingly, consideration should be given to expanding the regime to include all industries or at the very least to cover a range of industries such as the six key growth industries identified by the Department of Industry, Science, Energy and Resources<sup>1</sup>:

- Advanced manufacturing
- Cyber security
- Food and agribusiness
- Medical technologies and pharmaceuticals
- Mining equipment, technology and services (METS)
- Oil, gas and energy resources

Other growth areas that may also be included are those noted in the Government's Digital Economy Strategy<sup>2</sup> such as artificial intelligence (AI) and blockchain technology.

We appreciate that expanding the scope of the regime beyond the medical and biotechnology sectors will increase the cost to revenue. If this is a significant concern, then a roadmap approach could be considered to progressively incorporate more sectors over time. In this scenario, it will be important that the initial design of the regime is sufficiently flexible to allow for the addition of new sectors with relatively little legislative change.

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<sup>1</sup> Refer <https://www.industry.gov.au/policies-and-initiatives/industry-growth-centres>

<sup>2</sup> Refer <https://digitaleconomy.pmc.gov.au/>



To the extent that the regime is to be limited to medical and biotechnology industries, defining these industries may present some challenges. We are unaware of any legislative or universally accepted legal definitions. Accordingly, it may be appropriate that such a task be undertaken in conjunction with peak industry bodies and a panel of industry expert.

If the regime is expanded to include clean energy or clean technology, as suggested in the Consultation Paper, the definition of these terms will also require careful consideration. What constitutes production of clean technology should be determined. For example, it may be appropriate to include a range of technologies as broad as hydrogen, solar, wind, energy storage, batteries, other forms of energy production just to name a few.

Furthermore, it is unclear whether eligibility would be determined by the industry in which the holder of the patent operates or it is to be done on patent-by-patent basis or a combination of the two. There are significant complexities associated with each of these approaches. For example, in the case of the former, one question that arises is, at a minimum, what percentage of the relevant patentholder's activities should be in the eligible industries. Similarly, in the patent-by-patent approach, how is the nexus with the eligible industries defined.

The above illustrate some of the complexity and limitations of a narrowly defined regime.

## **Scope of the intellectual property**

### *Types of IP covered*

The scope of the IP covered by the regime is an important design principle. The Consultation Paper and the 2021-2022 Federal Budget announcements outline that the intention is to limit the regime to granted patents.

A feature of patent box regimes is that their benefits do not typically arise until patents are commercialised, i.e. income is derived from patents. There is a significant time lag between patent registration and commercialisation, thereby limiting the immediate benefits of these regimes. By broadening the regime beyond patents to other forms of IP and the types of qualifying income to which the concessional tax rate applies, the benefit of the regime could be appropriately expanded to cover a wider group of industry participants at various stages in their IP development cycle.

A regime that focuses primarily on patents may be appropriate for the medical and biotechnology industries to the extent that it reflects their business model. Other industries do not necessarily use patents as the primary means for exploiting their IP. This is particularly the case in sectors where technology is rapidly advancing and changing and the half-life of new innovations is relatively short.

A good example is the clean technology sector in which patents are not commonly used. The focus is more on first mover advantage and scale, rather than IP protection in the form of patent registrations. However, this may change if the regime is clear in its scope. Some of the emerging clean technology opportunities relate to hydrogen, batteries and intercontinental export of power. These ventures involve more than equipment, i.e. they involve significant systems design, optimisation and the understanding of supply chains (which could be subject to a patent if appropriately defined). In this regard, the Australian Renewable Energy Agency (**ARENA**) currently plays a role in supporting the development of emerging clean energy technologies. This could be an opportunity for ARENA and the Government to work together to assist these emerging ideas to be patented.



When put in a global context, other countries that have implemented patent box-like regimes provide much broader coverage in terms of the scope of IP that is subject to the concession. Examples include the Dutch Innovation Box regime, which extends its concessional tax treatment to IP such as software-related intangibles and trade secrets. Examples implemented by other jurisdictions include the Belgian Deduction for Innovation Income regime, UK Patent Box and Swiss cantonal level patent box regime.

Some of these foreign regimes have been reviewed by the OECD as part of its Harmful Tax Practices review on Preferential Regimes as part of Action 5 of the Base Erosion and Profit Shifting (BEPS) Project and have been found to be “not harmful”.<sup>3</sup> It may be appropriate for us to draw inspiration from their scope and design in developing our patent box regime.

#### *Expansion of the regime to cover copyrighted software*

Another example of a broader spectrum of IP qualifying for the regime is the inclusion of copyrighted software in the scope of IP regimes. We understand that inclusion of copyrighted software in such regimes would not lead the OECD to classify them as harmful.<sup>4</sup>

Generally, new software is created in the form of code and is protected by copyright as an original literary work. To qualify as a literary work and therefore attract copyright protection, the author must demonstrate that they have utilised their skill and labour to create the software, without duplicating someone else’s work. Notwithstanding this, it is not a requirement for the code to be ‘original’ in the sense that nobody has written similar code in the past. Accordingly, if the patent box regime was to be expanded to include copyrighted software, some constraint would be required to ensure that the scope is not too broad and too costly for the Government. A balance would have to be struck between ease of compliance and the cost to the measure.

Relevantly, countries such as the Netherlands have included ‘copyrighted software’ as a qualifying IP asset in their innovation box regimes.

Expanding the scope of our patent box regime to include such intangible assets as copyrighted software would encourage greater investment in the software development industry in Australia. Such expansion may lead to attracting top talent from overseas, leading to further software innovation and their commercialisation.

Whilst being mindful of the OECD’s harmful tax practices approach, further consideration should also be given to including other types of IP such as data and marketing exclusivity.

#### *Application to Australian registered patents vs patents registered worldwide*

The Consultation Paper poses the question of whether the regime should apply only to Australian registered patents. We understand that broadly, patent registration is sought in jurisdictions or markets where there is most competition in the relevant industry. For example, in the case of medical

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<sup>3</sup> OECD Harmful Tax Practices – Peer Review Results, Inclusive Framework on BEPS: Action 5 (Update - as of August 2021): <https://www.oecd.org/tax/beps/harmful-tax-practices-peer-review-results-on-preferential-regimes.pdf>

<sup>4</sup> OECD/G20 Base Erosion and Profit Shifting Project – Action 5, 2015 Final Report – Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance’: <https://www.oecd-ilibrary.org/docserver/9789264241190-en.pdf?expires=1628856612&id=id&accname=guest&checksum=E4BC7FD39E58B41F32A70355E8BD6177>. See paragraphs 34 to 36.



and biotechnology products, the relevant jurisdictions would include US, China and Japan. It may be the case that registration in Australia may not always be necessary or otherwise the highest priority.

Accordingly, we believe that the preferred approach would be for the proposed patent box regime to apply to patents owned by the eligible Australian holders and registered anywhere in the world or at least in jurisdictions where the patent registration involves a similar rigorous process as in Australia. That is, the policy approach should be based on the Australian ownership of IP (i.e. the entity with legal ownership and the ability to derive income as an Australian tax resident), and not limited to IP that is registered in Australia.

## Identifying qualifying income

Another important design feature of the regime is the types of income to which the concessional tax rate will apply. The regime should address different forms of income such as royalties or license fees, income embedded in sales income, revenue/capital gains arising from the sale or assignment of the patent, revenue from damages or an account of profits on infringement of the patent. The relevant income should also be defined to include all worldwide and downstream income, subject to appropriate identification of eligible revenue.

The UK Patent Box regime contains a number of well-designed elements which should be considered. Introduced from 2013, the UK Patent Box regime provides a concessional tax rate of 10% to companies that have elected into the regime, make a profit from exploiting patented inventions, own or have exclusively licensed-in the patents and have undertaken qualifying development on the patents. We have sought to draw out certain relevant helpful features of the UK Patent Box regime in our comments below.

The Consultation Paper raises the question of whether the qualifying income should be considered on a patent-by-patent level. Given that patents typically represent only a portion of the overall value in a product from which income is earned and that the potential income may relate to multiple patents, assessing qualifying income at a patent-by-patent level may introduce significant complexity for the applicant and the administrator alike. It may be helpful to consider the qualifying income on a product-by-product basis, as is the case in the UK, to help eliminate this complexity and better encourage innovation.

A broad summary of the design principles of the UK regime in relation to calculating eligible income is set out below:

- Relevant IP income are identified under five headings, namely:
  - i. income arising from the sale of items in respect of which a qualifying IP right has been granted;
  - ii. income consisting of any licence fee or royalty under an agreement granting another person a right in respect of any qualifying IP right, item or process;
  - iii. income arising from the sale or other disposal of a qualifying IP right or an exclusive licence in respect of such a right;
  - iv. any amount received in respect of an infringement, or alleged infringement, of a qualifying IP right; or
  - v. any amount of damages, proceeds of insurance or other compensation, other than amount in respect of an infringement or alleged infringement of a qualifying IP right, which is received by the company in respect of any event and is paid in respect of items



that fell within category (i) or represents a loss of income which would, if received, have been relevant IP income.

- A routine return (being 10% of routine deductions such as capital allowances, cost of premises, personnel costs, professional services costs) is deducted from each relevant IP stream (this excludes cost of sales, raw materials, Research & Development (**R&D**) related expenses and finance costs);
- A marketing asset return is deducted (the purpose is to remove income from the patent box claim which is deemed to relate to relevant marketing assets rather than IP);
- The proportion of relevant IP profits that can benefit from the concessional tax rate is limited to the “Nexus fraction” which cannot be greater than 1 and is broadly:
  - the relative amount of qualifying R&D expenditure incurred (this may be R&D undertaken in-house (in the UK) and/or outsourced to a third party) which is subject to a 30% uplift in the calculation, compared to
  - qualifying R&D expenditure undertaken in-house, outsourced to a third party, subcontracted to related parties and certain adjustments.

The Nexus fraction (referred to as the ‘modified nexus approach’) above requires a link between the income benefitting from the IP regime and the extent to which the taxpayer has undertaken the underlying R&D that generated the IP asset. This approach is required in order for the regime to avoid being deemed “harmful” under the OECD Harmful Tax Practices guidance.<sup>5</sup>

The effect of this Nexus fraction in the UK regime is such that if an eligible company undertakes all of its R&D in-house in the UK (and not subcontracted to a related party), the fraction should be 100%, i.e. all of the computed income should be subject to the concessional tax rate. This has the effect of incentivising qualifying R&D activity to be undertaken in the UK by the particular entity that owns the registered patent(s). There are also certain requirements including ensuring there is an appropriate level of qualifying development for the patent by the UK company (or its group companies).

Further, similar to the UK regime, the proposed Australian regime should include losses associated with either the development of a patented invention or its commercialisation in the calculation determining the overall patent box profits. That is, the net patent box income (i.e. after offsetting patent box losses against patent box profits) should be the amount subject to the concessional tax rate.

## **Concessional tax rate**

To ensure the Australian Patent Box regime is globally competitive, the concessional tax rate would need to be in line with other comparable countries such as the UK or European regimes. For example, the UK provides a 10% concessional tax rate. However, it should be noted that, in the context of the current work being undertaken by the OECD in respect of Pillar 2 (the Global Minimum Tax Rate), the concessional rate in the regime may ultimately need to be aligned with the rate that is negotiated as part of the Pillar 2 work (which is currently expected to be 15%).

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<sup>5</sup> OECD/G20 Base Erosion and Profit Shifting Project – Action 5: *Agreement on Modified Nexus Approach for IP Regimes*: <https://www.oecd.org/ctp/beps-action-5-agreement-on-modified-nexus-approach-for-ip-regimes.pdf>





## Start date

The Federal Budget announcements indicated that the proposed patent box regime would apply from income years starting on or after 1 July 2022 and in respect of granted patents which were applied for after 11 May 2021 (the date of the Budget announcement).

As stated earlier, there is a significant time lag between registration and commercialisation of a patent; this lag time could take longer than 10 years in the medical and biotechnology industries. Accordingly, the above application dates would result in limited immediate benefits to the targeted taxpayers. It may, therefore, be preferable for the regime apply to all new and existing patents from either the date of the Budget announcement (11 May 2021) or income years starting on or after 1 July 2022.

We understand the UK Patent Box regime also took the approach of applying to all existing and new patents from its effective date. If this approach is not feasible, the regime should at the very least apply to patents registered in the 5 years prior to the relevant date of effect for example.

It should also be noted that broadening the scope to cover existing IP, may result in IP currently held overseas to be brought onshore and income from it to fall within the Australian tax net provided that the applicable concessional rate is also made more attractive.

## Administrative complexity

The compliance burden of the proposed regime may be significant particularly if the current limited scope is maintained. For example, the level of tracking required over a long period of time to substantiate claims may be quite onerous. Accordingly, the aim should be for a self-assessment regime that is as straightforward as possible with a simplified record keeping approach.

To ensure that the regime is relatively easy to administer and self-assess, the Australian Taxation Office (ATO) should provide clear guidance (for example in the form of a Practical Compliance Guideline (PCG) or Law Companion Guide (LCG)) on the level of documentation or evidentiary support to avoid the need for taxpayers requiring rulings or other forms of administrative certainty from the ATO. We acknowledge that some jurisdictions that have adopted patent box regimes do provide some form of revenue authority ruling system in order for taxpayers to obtain certainty over their methods and outcomes. If the ATO were to adopt a similar approach for the proposed regime, we would recommend this to be as streamlined a process as possible. The relevant administrative and record keeping processes should be flexible to cater for the practical and commercial realities of large, medium and small entities.

### *Interaction with Australian R&D regime*

Careful considerations should be given to the linkages between the proposed patent box regime and the existing R&D tax incentive to ensure they work harmoniously to incentivise activities and maximise the benefit for industry participants throughout the IP lifecycle.

Implementing a new patent box regime is not expected to have a discernible impact on levels of R&D in Australia in the short term. Large entities that typically conduct research and patent inventions in multiple jurisdictions may, over time, increase the amount of R&D undertaken in Australia but because such research programs commonly take place over several years, the effects of a change in approach are unlikely to be seen immediately. To a lesser extent, the same is likely to apply to smaller





and pre-revenue companies as the benefit of the proposed regime may not be sufficiently immediate to prompt a short-term change in approach to a company's IP protection strategy.

Taxpayers will need some degree of lead time to complete the relevant registrations, prepare the relevant documentation and update their internal systems to cater for the new information requirements under the proposed patent box regime. The existing R&D Tax Incentive regime and its record keeping requirements can be a sensible starting point for the proposed patent box regime. For example, records typically maintained to substantiate the eligibility of R&D claims such as records of R&D activities, staff timesheets, invoices for R&D expenditure, may be useful for future "patent box claims". However, the extent to which existing record-keeping systems will be adequate for this purpose will differ amongst taxpayers. For example, smaller companies/start-ups are less likely to have the relevant documentation as the commercialisation of patented inventions is likely to be many years away. Furthermore, not all patented inventions may have been the subject of registered R&D activities.

The UK Patent Box regime provides a good example of how existing R&D records can be used synergistically for future patent box claims. Whilst R&D claims are usually made many years before patent box claims, in practice, some larger UK companies would start producing the relevant information or patent box claims at the same time. This may be due to the fact that the UK Patent Box regime requires R&D expenditure information from 2016 (or as far back as the past 20 years if a certain election is made by the company) to be used to determine the relevant R&D fraction (Nexus fraction) for its calculations.

#### *Other considerations*

Finally, the interaction of other provisions of the Australian tax law, such as general deduction rules and loss recoupment rules, as well as the anti-avoidance provisions, with the Patent Box provisions should be considered as part of the implementation of the regime.