Patent Box Discussion paper on policy design

KPMG Submission

KPMG Australia

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Executive Summary

As a leading professional services firm, KPMG Australia (KPMG) is committed to meeting the requirements of all our stakeholders – not only the organisations we audit and advise, but also employees, governments, regulators and the wider community. We welcome the opportunity to provide a submission to the Patent Box Discussion Paper (the Paper) released by Treasury.

KPMG supports the government's proposal to introduce a Patent Box regime that complies with Organisation for Economic Cooperation & Development guidelines. The Patent Box has the opportunity to provide a meaningful incentive for businesses to carry out research and development ("R&D) in Australia and to retain an economic interest in patents arising from that R&D.

In KPMG's recent submission to the Second Issues Paper released by the Senate Select Committee on Financial Technology and Regulatory Technology, we noted that a patent box regime can reward business for both developing and commercialising intellectual property in Australia.

Several jurisdictions around the world are offering Patent Box regimes and in an increasingly competitive landscape it is timely for the federal government to review its options for attracting footloose R&D expenditure and incentivising capital investment.

In supporting the Patent Box regime, this submission recommends that Treasury consider the eligibility of foreign patents and previously lodged patents. We also support the use of existing legislative concepts and definitions where possible and further consultation on how business tracks and records relevant expenditure and revenue. Lastly, the inclusion of clean energy technology in the patent box would be a welcome next step once the regime has been successfully implemented across the biotechnology and medical technology sectors.

KPMG looks forward to continued engagement with the Australian Government as it develops its final policy approach to Patent Boxes over the coming months.

Regards,

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Accelerating Business Growth

KPMG Australia

Background

About KPMG

KPMG is a global organisation of independent professional firms, providing a full range of services to organisations across a wide range of industries, governments and not-for-profit sectors. We operate in 146 countries and territories and have more than 227,000 people working in member firms around the world. In Australia, KPMG has a long tradition of professionalism and integrity combined with our dynamic approach to advising clients in digital-driven world.

Accelerating Business Growth

KPMG's Accelerating Business Growth (ABG) team is dedicated to developing integrated advice aimed at supporting the growth ambitions of our clients. We work with our clients to understand their business needs and assist in delivering holistic advice that enables them to help reach their growth potential.

Our R&D team within ABG assists some of Australia's most innovative companies gain access to government grants and incentives for R&D activities undertaken in Australia. We also assist companies in developing governance frameworks, policies and procedures to streamline their R&D processes and substantiate their R&D activities, and look to provide opportunities for further government support through our local and global network and our connections within the federal and state government agencies and industry bodies. Through these initiatives, we work with our clients create long term value, and assist in providing a competitive advantage for Australian companies.

Section 1: KPMG recommendations

Recommendation 1:

Revenue from a foreign patent, derived by an Australian taxpayer entity, should also be eligible for the patent box provided the associated R&D meets the threshold for Australian nexus and the criteria for obtaining the patent in the overseas jurisdiction are similar to or more stringent than those in Australia.

Recommendation 2:

Revenue from a patent granted in the 12 months prior to 2021 Budget night should also be eligible, providing an incentive to retain these patents within the Australian tax net. These patents are unlikely to have commenced generating major revenue before 1 July 2022. It could otherwise take much longer for the program to have a meaningful impact on an innovative business's tax position.

Recommendation 3:

There will be a requirement for a range of definitions in terms of eligible revenue, allocation of expenses to the patent box, Australian nexus of the R&D, etc. Insofar as is reasonable, the regime should consider using streamlined formulae rather than detailed calculations and make use of existing definitions and concepts contained in the tax law and generally accepted accounting principles.

Recommendation 4:

There should be consultation with industry bodies on using administrative approaches that will align with how these businesses already record and track their revenue and expenditure (which could include for example accounting principles around segmentation).

Recommendation 5:

Inclusion of clean energy technology in the patent box (in addition to currently proposed medical and biotechnologies) would be welcome. It may be preferable to assess the impact of the new regime on the first-wave industries before expanding the scope. We recommend further consultation with clean energy industry participants with relevant patents and especially those who are working towards obtaining such patents.

Section 2: Response to Consultation Questions

Part 1: Consultation questions

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?

Features of patent boxes in other jurisdictions that would be effective in supporting the government's policy objectives include:

a) Inclusion of income from foreign patents which relate to Australian R&D, where the requirements for obtaining a patent in the foreign jurisdiction are similar to, or more stringent than, those which apply in Australia (for example in terms of the level of novelty and innovation that the applicant must demonstrate). Jurisdictions which include foreign patents in their patent box publish a list of the acceptable foreign locations.
b) The categories of income related to a patented product or process that are eligible for the patent box should be broad and include licensing income, sales of product that include the patented item and all income from infringements or claims for economic loss. An entity that has a licence for exclusive use of a patent in another jurisdiction should also be entitled to use the patent box, where it meets the other eligibility criteria.
c) Any formula for calculating the qualifying R&D fraction should include an uplift that recognises the expenditure an entity incurs that indirectly supports the R&D activity that it undertakes or controls. For example, the UK allows the "good" R&D expenditure (i.e. in-house and subcontracted to an unconnected party) to be multiplied by 1.3 in the numerator of its qualifying fraction. The denominator would include these elements (without the uplift), R&D subcontracted to a connected party and any costs of purchasing intellectual property.

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?

Innovation patents are less common than standard patents in almost every field and are in the process of being phased out in Australia, with applications no longer being accepted from 26 August 2021. Data collected in 2016 for the Productivity Commission's final report into *Intellectual Property Arrangements* indicates that innovation patents comprise of approximately 1-2% of total patents granted in the medical technology and biotechnology fields. The relative use of innovation patents was similarly low across all chemistry-related technologies including pharmaceuticals and molecular chemistry.

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?

Patents are granted on a jurisdiction-by-jurisdiction basis and apply only within the territory in which the rights have been granted. This means patent protection must be applied for in each jurisdiction in which the relevant business seeks protection and will be subject to the requirements of that country or regional patent office's (i.e. European Patent Office) patent laws.

Australia is a signatory to the multilateral *Patent Cooperation Treaty* (PCT) administered by the World Intellectual Property Organisation ("WIPO"), which enables organisations and individuals to file a single international application with each PCT signatory simultaneously instead of filing several separate national or regional applications.

However, the PCT is simply an administrative mechanism and does not harmonise patent requirements as between the 150 contracting states. As the granting of patents remains a national or regional responsibility, the success of an application in Australia for an invention patented in other jurisdictions depends on whether it meets the relative requirements under Australian law, including being sufficiently inventive and non-obvious when compared with the prior knowledge base.

Applicants who have had patents granted in other jurisdictions have a 12-month priority period in Australia from the date of their first patent application overseas as per the *Paris Convention for the Protection of Industrial Property*.

The Productivity Commission's *Intellectual Property Arrangements* inquiry indicated that Australia has a relatively low inventive step threshold when compared with, for example, European standards. Given the threshold is different in Australia to other countries, the patent application process is not entirely comparable between jurisdictions, making it difficult to assess the likelihood that the scope of claim for a patent granted in one jurisdiction would result in a patent being granted in another jurisdiction.

Based on the findings of the *Intellectual Property Arrangements* inquiry there is, however, some evidence to suggest IP Australia grants broader claims than the European Patent Office, therefore increasing the likelihood that a patent granted in the EU would also meet the inventiveness requirements under Australian patent law.

The UK and Ireland, for example, allow patent box treatment for certain patents granted by the European Patent Office and by listed foreign jurisdictions.

Ireland's approach is to accept foreign patents where the granting authority carries out "*substantive examination for novelty and inventive step*" prior to the grant. Its listed foreign jurisdictions include the European Patent Office, various European countries, Japan and the United States.

Targeting medical and biotechnology

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

The regime should classify intellectual property in the same way as the body granting the patent would classify it. Therefore, it would be appropriate to consider the IP Australia and WIPO classifications in the context of the range of patent-granting bodies that are ultimately within the scope of the patent box legislation. The eligibility for the patent box should follow the classification of the product or process, not the classification of the business that obtains the patent.

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 eligibility test should be at the level of the patent classification not at the level of the product developer's industry classification.

Low emissions technologies

KPMG supports the eventual extension of the patent box to low emission technology patents. We recommend that this occurs after there has been the opportunity to consider any necessary refinements to the features of the scheme based on the experience with the medical and biotechnology patents.

We have not commented specifically on Question 6 to 10.

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?

In general, a business would carefully track expenditure that it expected to be eligible for the research & development tax incentive ("RDTI"), including differentiating between expenditure incurred on R&D carried out in Australia and R&D carried out in other jurisdictions. However, expenditure that qualifies under the RDTI is not an exact match for what a business would typically consider part of the cost of the R&D activities.

We expect that the allowable expenditure incurred in developing a patented product or process should be generally broader than what is eligible for the RDTI and therefore it may be necessary for businesses to augment their processes for tracking their R&D expenditure (whether in Australia or overseas) if they intend to access the patent box.

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

This is highly variable across industries and across different sizes of business. For medical and biotechnology R&D activities, a significant proportion of the R&D is usually undertaken by unrelated parties (e.g. clinical research organisations) and the degree to

which the R&D is undertaken in Australia can often depend on access to facilities, equipment, expertise and populations (e.g. toxicology studies, Phase II clinical trials for orphan indications, etc.)

Therefore, it would be reasonable for the patent box to treat R&D necessarily carried out by a foreign subcontractor under the direction of the taxpayer business as qualifying expenditure for the purposes of the numerator of an eligibility fraction. The extent of this approach would be subject to the OECD's guidelines.

Definition of R&D

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)?

Companies would track and report R&D expenditure that they expect to be eligible under the RDTI. Consequently, there may be a mismatch as ineligible R&D expenditure may not be tracked to the same degree (e.g. excluded expenditure, overseas R&D expenditure, etc.).

For instance, expenditure eligible under the RDTI is generally less than a business might regard as the total expenditure on R&D activities related to the development of a patented product.

Therefore it would be prudent for there to be further consultation with businesses engaged in medical and biotechnology R&D about appropriate principles for defining any patent-related expenditure that does not fall within the definition of eligible expenditure for the RDTI, but which should be deductible in calculating patent box profits rather than general profits (e.g. legal costs, core technology, interest, etc.).

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

There are certain exclusions from the scope of the RDTI. For example, expenditure is typically ineligible or subject to downward adjustment to the extent that is not at risk, forms part of the cost base of a tangible depreciating asset, relates to a government recoupment (e.g. grants) or represents patent attorney costs. Therefore, it is reasonable to expect that actual R&D expenditure related to a patent would often exceed the amount tracked as eligible for the RDTI. In some cases, the difference could be considerable.

Please refer to our response to Question 13 for further comments.

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?

Generally, yes. The UK has an approach of uplifting the entity's own R&D activity, and the activity that it controls but subcontracts out to third parties, in the numerator of the qualifying fraction. This recognises the costs that the entity incurs that are not R&D, but which are necessary in order for the in-house and subcontracted R&D to take place.

A similar approach should be considered for the Australian qualifying expenditure calculation.

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?

There can be significant R&D expenditure that occurs after a company has applied for a patent. An example would be where the patent relates to one component of a product on which more R&D work is required before the product can be sold to the public.

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

We recommend that Treasury undertake detailed consultation with businesses undertaking innovative work in the medical and biotechnology fields in order to obtain relevant insights on this point.

Implementation and start date

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)?

As proposed, the regime will not provide any incentive for an Australian business to retain a patent, where it applied for the patent prior to 11 May 2021. Further, as revenue associated with a patent can first arise many years after the priority date, limiting the regime to priority dates after 11 May 2021 may greatly reduce the value of the regime (and therefore its efficacy) in its first few years.

If the purpose of the patent box regime is to not only encourage Australian-based R&D, but also to encourage companies to retain ownership of the new products or processes in Australia, then this second objective will not be as well-served by excluding pre-May 2021 patent applications.

We acknowledge that it may not be sustainable from a budgetary perspective to allow the patent box to apply to all patents granted prior to 11 May 2021. However, we recommend consideration of permitting patents granted within the 12 months prior to that date to be eligible. Such patents are likely to be at best only in the very early stages of revenue generation by 1 July 2022.

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?

This should provide adequate time for companies to prepare for the regime.

Eligible revenue to enter the patent box

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

The revenue types listed in the Discussion Paper should all be included in the patent box regime.

Revenue from a court judgment or settlement for economic loss arising from infringement of the patent should include all elements of such an amount received by the holder of the patent, including any interest component, as this is indicative of the current value of the revenue that the patent owner has lost as a consequence of the infringement.

In addition, the legislation should provide clarity on whether revenue derived prior to the patent priority date is eligible for the patent box. In some cases, before obtaining the patent, a business may receive milestone payments from a party that expects to benefit from the ultimate patent once it has been granted. In principle, provided the patent is obtained and the taxpayer business can demonstrate the link to the patented item, there should be no need to differentiate between revenues based on when they are derived.

There should also be consideration, of allowing patent box status for a "notional royalty" amount, where a business sells a product that it has made by using a patented process or tool. This treatment is available in the UK's patent box regime. We recommend that Treasury consult with businesses that carry out medical and biotechnology R&D in order to determine how beneficial this would be in their context.

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?

In the first instance, all revenue associated with a product or service that includes the patented item should be brought into the patent box.

In the case where it was considered appropriate to reduce the eligible revenue by certain amounts (such as a "routine return" on the costs associated with deriving revenue from the product) there should be further consultation with industry bodies about how this can be done in a manner which does not cause disproportionate compliance costs.

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?

It would be reasonable to allow a business to have the option to stream revenue on a product basis in this situation, rather than require the business to allocate the revenue from one product across its constituent patent components.

The business could then calculate its R&D fraction for the product revenue using a weighted average of the R&D fractions for the constituent patented components. The UK, for example, allows an option of this type.

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)?

Please refer to our answer at Question 21.

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?

A first step would be to identify the RDTI-eligible expenditure that related to the specific patent. Generally, one would expect that the company has tracked this expenditure relatively carefully. However as noted above, the business may need to extend its tracking system to include expenditure types which are ineligible for the RDTI, but which rightly fall within the R&D cost of developing the patent.

A next step may be to look at the accounting treatment of expenditure, in terms of any product-based segmentation that the entity may undertake for statutory or management accounting purposes.

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?

Expenses incurred in a year of income on R&D activity which may ultimately lead to an application for a patent should be deductible in the usual way against general (non-patent box) income that the entity derives in that year, or, where eligible, attract the RDTI tax offset at the premium to the standard tax rate. However, the entity should also track that R&D expenditure for the purpose of working out a future qualifying R&D fraction which may be required.

Where an entity has elected for a patent to be included in the patent box, but in a year of income the expenses related to that patent exceed the income, then the excess should be deductible from general income in the year that the expenses were incurred. To the extent that the expenses incurred are eligible for the RDTI tax offset, this should also be allowed at the premium to the standard tax rate.

Requiring the entity to either deduct the excess expenses against patent box income from other patents, or to carry them forward, would undermine the perceived benefits of the regime, and could be particularly detrimental to smaller entities which need to conserve cash.

Separately, in relation to foreign income tax offsets ("FITO"), for example where a royalty is subject to withholding tax ("RWT") in the jurisdiction of the paying entity, it would be appropriate for these to be pooled across all the patent revenue that is in the patent box.

The reason for this is that in some cases the rate of RWT may exceed the patent box tax rate, thereby reducing the benefit of the patent box tax rate if the value of the tax offset is restricted to that particular source of revenue.

Administration and compliance

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

There is the potential for the patent box regime to involve significant compliance costs unless certain definitional and administrative requirements can be streamlined.

We therefore encourage further consultation with not only medical and biotechnology industry groups, but also tax and accounting professionals in order to identify where there is the opportunity to adopt administrative approaches that will reduce compliance costs.

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

Features that may assist in managing the regulatory burden include the use of definitions and concepts that are already in common usage within the targeted industries, together with the use of simple formulae rather than precise valuation of certain inputs to the eligible profits calculation.

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?

Eligibility could be driven by the classification of the patent. Treasury can consult with industry and identify those patent classifications that would match the government's opinion of what constitutes the in-scope sectors.

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