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16 August 2021

By email - PatentBoxConsultation@treasury.gov.au

Patent Box tax concession – Treasury discussion paper on policy design July 2021
EY Submission

Dear Mr Fischer

Ernst & Young (EY) is pleased to respond to Treasury's July 2021 discussion paper on the policy design of the proposed Patent Box income tax concession announced in the May 2021 Federal Budget.

EY has been calling for the introduction of an Australian Patent Box regime to support innovation and to help Australia compete with attractive tax rates offered by OECD member countries, including many overseas countries with specific lower tax rates on international licensing of intellectual property (IP), to encourage revenue producing royalty and IP income to be generated by Australian taxpayers.

An environment of high Australian corporate tax rates for larger businesses and the attractive general or specific tax rates offered by competing countries makes it increasingly difficult for globally oriented Australian businesses to justify placing their marginal capital investment into developing IP in Australia. This creates particular risks for Australia's mobile businesses with potential third-party IP-related revenues that can relocate the IP and related functions overseas to achieve a lower tax outcome.

An appropriately broad Patent Box regime has the potential to address this uneven tax landscape and provide support to innovative Australian companies in the post R&D and commercialisation phases.

The aim of the concession should be to encourage companies to retain the IP in Australia, and in doing so then develop (through additional research and development activities), commercialise (through new or additional commercial activities here) and so enjoy future revenue flows in Australia rather than overseas.

It is vital that the policy should be directed at retaining IP in Australia and the income from exploiting that IP in Australia – both current IP and newly developed IP. Developing IP is important, but we note that this activity is already supported by Australia's research and development tax incentive scheme. **It is the RETENTION in Australia that the concession needs to be directed at.**

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Other international jurisdictions have implemented IP regimes to encourage IP to remain onshore with their tax competitiveness, such as:

- **UK** – "The Patent Box will provide an additional incentive for companies in the UK to retain and commercialise existing patents and to develop new innovative patented products. This will encourage companies to locate the high-value jobs associated with the development, manufacture and exploitation of patents in the UK and maintain the UK's position as a world leader in patented technologies."[1]
- **Ireland** – "The [Knowledge Development Box] adds a further dimension to our 'best in class' competitive corporation tax offering, which includes the 12.5 per cent headline rate; the R&D tax credit; and the intangible asset regime."[2]

Our key concerns with the policy design of the new regime outlined below are:

- The 17% rate is too high
- The restrictive application of the policy to narrow sectors
- Classification of patented inventions
- Exclusion of existing patents from the regime
- R&D nexus – confirm inclusion of pre-announcement R&D
- R&D nexus - inclusion of related overseas R&D expenses
- Non-patent IP income exclusion
- Eligible patent income sources inclusions
- JV company structures must be catered for
- Regime should be elective

We have also commented on the potential extension of the concession to low emissions technologies.

We have included in an appendix references from Treasury's questions in the discussion paper to our key points below as relevant.

1. Rate

The proposed 17% Patent Box tax rate is still a high rate in comparison with other countries. The rate should be reduced in order to compete and align with global norms. [3]

For example, the following jurisdictions have implemented lower IP tax rates:

- **UK** – 10%
- **Netherlands** – 9%
- **Ireland** – 6.25%
- **Belgium** – 3.75%
- **Switzerland** – Up to 90% tax relief on qualifying patent benefit.

[1] HM Revenue and Customs response to consultation 2011
[2] Ireland Minister for Finance's 2016 Budget speech
[3] OECD intellectual property regimes data table https://qdd.oecd.org/subject.aspx?Subject=IP_regimes

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The high nature of the tax rate of 17% compared with other countries also clashes with the very narrow base of the concession, such that combined the concession becomes jurisdictionally competitively weak.

We do not think a lower rate in line with the above would make the concession a harmful tax practice given there is no ring fencing or other harmful elements proposed and other requirements of the OCED BEPS action 5 guidelines and standards will be met including through the substantial activity requirement.

The OECD'S Corporate Tax Statistics: Third edition[4] notes that, of the 36 non-harmful IP regimes, the tax benefit offered ranges from a reduction of about 40% of the tax rate that would have otherwise applied to a full exemption. The most common reduction is a 50% reduction, and the reduced rate ranges from 0% (in 10 jurisdictions) to 18.75%. A 10% rate would be in line with IP tax rate benefits in the OECD especially if measured against the lower 25% company rate for base rate entities.

In addition, the acceptance of a lower rate is supported by the OECD's BEPS 2.0 project which is expected to include a Global Anti-Base Erosion Proposal minimum tax rate of at least 15% on a country by country basis (Pillar 2)[5], which is intended to be met on a blended company tax rate basis. As a result a rate of around 10% is a much better competitive rate for such a concession as the blended notion of the BEPS2 Pillar 2 rate would potentially make a 17% rate very uncompetitive with alternative jurisdictional options.

Recommendation 1: That the rate of any Patent Box regime be aligned with comparable economies (such as the UK) at a 10% rate.

2. Restriction to medical biotechnology sectors

The restriction of the Patent Box regime to patented inventions related to the medical and biotechnology sectors is too narrow and should be expanded. Constricting the concession to certain industries creates complexity and limits the potential benefits to Australia from the regime. The fundamentals that require a Patent Box regime, and that provide a benefit to keeping IP in Australia, also apply to other industries - current and emerging.

We note that globally this is out of step with many countries, who do not limit their system to a particular industry or type, but rather seek to provide support to patents from all industries. If the Patent Box aim is support Australian innovators in keeping patents in Australia, and encourage them to commercialise R&D, then we would suggest that this be used to cover all industry types. If it is seeking to do so only for those industries that have long lead times to commercialisation, then there are a range of other industries that could also be supported by a Patent Box (such as low emissions technologies).

The Patent Box is an opportunity to attract and address issues with other industries that develop valuable IP in Australia which may otherwise be transferred offshore at the commercialisation stage. This would include for example IP in:

[4] Released 29 July 2021 https://www.oecd.org/tax/beps/corporate-tax-statistics-database.htm
[5] 1 July 2021 agreement of Inclusive Framework jurisdictions on key components of Pillars One and Two

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- Fintech
- Life sciences outside of the medical space (for example to cover veterinary drug development)
- Low emissions technologies.

Most comparable international IP regimes do not impose sectoral restrictions, allowing any qualifying entity to commercialise qualifying IP and access reduced patent/IP tax rates. Instead they have expanded who can access their IP regimes by, for example, expanding their definition of qualifying IP to support additional sectors that may not rely on patents, such as farming/agricultural sectors (eg, plant breeder's rights, biological crop protection – see more information below).

The regime should apply to all industries as well as to a more inclusive range of IP including software development.

Recommendation 2: That the Patent Box regime be made industry agnostic or as an alternative that it be expanded to cover other significant sectors.

3. Low emissions technologies

There are a number of issues which impact whether extending the proposed Patent Box tax concession to low emissions technology would be an effective way to support the clean technology energy industry or whether other approaches may be preferable.

Restricting the tax concession to a limited range of income generated from Australian registered patents as proposed may not be very effective as Australian clean energy businesses tend to import their IP and apply this IP to develop and commercialise low emissions technology rather than developing and registering patented inventions in Australia.

However, while patents in general play a limited role in commercialisation in this sector, for some companies and projects they are highly significant, especially as companies look to develop the base technology in Australia. In some cases patents can be of value to these projects, and especially if projects have potential global streams, then the location of these patents is important.

Like the medical and biotechnology areas, the lead times of the development of low emissions technology can be long, and so patents can be important in protecting a significant technological edge for some projects. It is also highly symbolic that Australia be seen to support developments in these areas as part of our moves to support innovation and sustainability.

Absent the introduction of more specific measures to further support the sector low emissions technologies, they should be included in the patent Box regime along with an extension to other industries as discussed above.

A broader definition of eligible income would be required, to capture income from a broad range of IP developed in Australia including IP developed using non-Australian registered patents and from trade secrets. Such a broader income basis is available in other countries IP regimes.

In terms of defining the low emissions technology area, this can be tackled by looking at the current definitions used by government in other programs including in ARENA and the Low Emission

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Technology Investment Roadmap (and example can be found at: Low emissions technologies for fossil fuels | Department of Industry, Science, Energy and Resources).

However a tax concession approach may not be attractive to start up enterprises or small to medium sized business which are prevalent in the industry. Additional direct funding support (eg grants or cash rebates) may be more appropriate given extensive lead times to develop products with an estimated 7 to 10 years from inception to the earning of income.

Consideration should also be given to incentives that encourage the adoption of clean technologies in Australia by end users including enhanced capital allowances or tax credits for the purchase of low emissions technology products.

EY's Green Tax Tracker [link] highlights the multitude of tax based approaches taken in other countries to address environmental concerns and to incentivise investment in sustainable green technologies. A review of other countries' approaches and detailed systems would help inform what other incentives might be developed in Australia.

An example is the United States IRC Section 45Q tax credit for any industrial or direct air-carbon capture facility for which construction begins before January 1, 2026 and that captures certain amounts of qualified carbon oxide, depending on its size (available for 12 years, beginning when the carbon capture equipment is placed in service).

Recommendation 3: Low emissions technology should be included in an industry agnostic or expanded Patent Box regime and consideration should also be given to introducing targeted tax concessions and other incentives and support.

4. Classification of patented inventions

There will be various practical issues with determining eligibility for the concession based on the proposed limitation that it would only be available to the medical and biotechnology sectors.

The system adopted should provide as much certainty to taxpayers as possible as part of the self-assessment tax environment. It should allow taxpayers to make an assessment of eligibility which is enduring (set and forget) rather than requiring any on-going re-assessment. On this basis we would prefer a "patent level test" rather than an "income streaming test." Without doing this, there is the potential for further dispute, and creation of additional areas of uncertainty and complexity (as has been the experience in some overseas jurisdictions, where income attribution and apportionment has to be made for a patent that might be utilised across multiple industry areas).

While this has the potential to impact the range of IP that can qualify, this can be handled by allowing a broader range (rather than narrower range) of patent classifications, including the medical and biotechnology classification. This would capture income from the whole patent provided it has been approved in any of the relevant areas (even if these cover more than the medical and biotechnology classification).

An alternative system would be to simply cover all patents held by an entity that are in the medical and biotechnology space (as defined under the ANZIC classifications that government already use).

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This would for example cover a patent on a laser for medical applications, even is this patent had been categorised in an area outside of medical/ biotechnology.

Recommendation 4: A simple system to ensure classification will be based on either self- classifying the patent upon submission or based on the entities ANZIC industry code classification.

5. Exclusion of existing patents from the regime is a major problem

The exclusion of existing patents from the regime will negatively impact the intended outcomes of the proposals

Whether the patent was previously registered or newly developed the eligible Patent Box income will be limited by the amount of R&D development in Australia under the substantial activity requirement R&D fraction adjustments to qualifying IP income required under OECD rules. Therefore, it is less of an issue if patents were granted before the date of announcement.

The process of developing new patentable inventions in the medical, biotechnology and other sectors may take many years. The benefits of the proposed Patent Box regime will therefore not be seen by business for some time. Lead time from the start of development to the commercialisation of new inventions may typically be:

- Medical device technology – +5 years
- Pharmaceuticals – 8 to 10 years
- Biotechnology – 8 to 12 years

The delay in the benefits of the Patent Box concession flowing through to participants in covered sectors will mean that those sectors will continue to consider developing IP offshore or moving IP developed in Australia offshore at the commercialisation stage as part of their usual business practices. The earlier that these businesses can see further benefits in keeping IP in Australia the earlier that they will change their business model or resist moves to migrate IP.

The risk of IP being migrated offshore is greatest in the first years after the development of that IP as commercialisation scales up rather than for mature IP with established income streams. The extension to existing patents (and other IP) could be limited to those granted in a discrete period before the date of announcement, eg in the last 5 to 10 years.

Other countries have allowed existing IP to be brought into their Patent Box regimes and the Australian system will be less favourable than our competitor countries if this is not a feature of the proposed concession. For example:

- **Ireland** – A "qualifying patent" specifically includes patents pre and post implementation date. Post implementation date patents are subject to substantive examination for "novelty and inventive step"
- **Belgium** – Taxpayers can apply for the income innovation deduction the moment they apply for the patent
- **Switzerland** – Inconsequential when patent was granted. Patent will qualify for Patent Box until the patent protection has expired

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- **Netherlands** – Taxpayers can apply for innovation box as soon as they apply for the patent to reduce lag time.

Retaining current IP will have a spill over effect to stimulate Australian business activity with the full range of IP development, enhancement, management, protection and exploitation activities not simply the back-office administration, leading to increased employment of scientists, researchers, and STEM students with the involvement of the Australian tertiary sector.

As noted earlier, a limit might be placed on the length of time before the commencement of the Patent Box concession such that previous patents can be included. We recommend this period should be 10 years and no less than 5 years to meet the stated aim.

Recommendation 5: To achieve the aim of ensuring that IP is retained in Australia, qualifying patents should be extended to cover the typical 10 year development cycle, and allow for the inclusion of any patents developed in say the 5 to 10 years prior to the announcement.

6. R&D nexus - pre-announcement R&D

The substantial activity nexus approach will require businesses to adjust their qualifying IP income by the R&D fraction, being the proportion of qualifying Australian R&D expenditure to overall R&D expenditure on the IP asset.

It is important and should be made clear that this calculation includes R&D expenditure before the date of announcement of the proposed Patent Box income tax concession, which relates to the activities on specific IP projects or on general and speculative R&D which has some connection to the IP.

This is important to encourage continued work on existing projects to develop IP in Australia, to align with tracking on a project by project basis and to support the important need to retain IP in Australia and not just to encourage further R&D in Australia.

We note the OECD's BEPS 5 guidelines on the substantial activity requirement states that "the calculation requires both that "qualifying expenditures" include all qualifying expenditures incurred by the taxpayer over the life of the IP asset and that "overall expenditures" include all overall expenditures incurred over the life of the IP asset."[6]

Recommendation 6: It should be made clear that the substantial activity nexus calculation applies to all relevant R&D expenditure including expenditure before the announcement of the proposed regime.

7. R&D nexus – inclusion of related overseas R&D expenses

Often R&D has to be conducted overseas, whether with related parties or third parties, due to resource restraints and the lack of facilities in Australia. For example the development of Australian medical and biotechnology requires offshore pre-clinical and clinical trials research. This research can

[6] Paragraph 45, Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5: 2015 Final Report [OECD 2015]

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be a significant proportion of the overall development costs of the patent/other IP over a number of years.

In order for an appropriate and meaningful R&D fraction to be obtained, this overseas expenditure should be included in the R&D nexus calculation as qualifying Australian R&D expenditure.

The Research and Development Tax Incentive (R&DTI) allows R&D activities conducted overseas to qualify through an application process and as part of conditions requires the costs of overseas R&D activities to be less than the costs of related R&D activities undertaken solely in Australia.

Adopting the existing definitions of R&D activities and the R&DTI framework would allow such eligible overseas expenditure in respect of core and supporting R&D activities to be included. Such an approach would be consistent with the BEPS 5.0 guidelines.

Recommendation 7. Allow overseas expenditure on R&D activities to be included in qualifying R&D expenditure where such expenditure is <50% of total expenditure as allowed by current R&DTI rules.

8. Non-patent IP income exclusion

The proposed application of the concession to only income from Australian patents is too restrictive. This limits the benefit of the regime and makes it less attractive to innovation compared to other regimes.

The concession should be extended to also include IP income from copyright protected software licencing, algorithms and other identifiable IP income. [7]

Software is a significant component of many inventions. This is particularly relevant to the medical industry where commercial decisions may be taken not to register patents that would disclose software code to the market.

The Therapeutic Goods Administration (TGA) acknowledges[8] that the use of software in medical devices is becoming more prevalent and is becoming a medical device in its own right. This trend gives weight to the idea that non patent protected software IP should be afforded the same access to a concessional taxation regime.

BEPS action 5 supports including other IP such as software in Patent Box regimes. The UK, Belgium, Switzerland, Netherlands and Irish regimes all include software as well as other types of IP.

In addition to software, other international jurisdictions also allow:

- **UK** – Supplementary Protection Certificates ('SPCs') and Data Market exclusivity rights
- **Ireland** – Certified patentable IP (to support SMEs, avoid expensive patent process), certain SPCs and plant breeders' rights
- **Belgium** – SPCs, orphan drug designations and Data Market exclusivity rights

[7] OECD'S Corporate Tax Statistics: Third edition indicates that 26 of the 36 non-harmful IP regimes offer benefits to copyrighted software

[8] https://www.tga.gov.au/regulation-software-based-medical-devices

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- **Switzerland** – SPCs, topographies, medical registrations and plant variations under legislation
- **Netherlands** – Plant breeders rights, biological crop protection, distribution rights for pharmaceuticals

Patents granted in Australia where the invention is protected by foreign patents are eligible for the regime. Where a licence of the patent is granted in Australia rather than an Australian patent being taken out and innovation occurs to improve or adapt the underlying invention, income from the resulting additional value added should qualify for the concession. The eligible income would be restricted by the extent that R&D is undertaken in Australia.

Patent income from foreign patents, in jurisdictions with substantial similar regimes for patent granting as Australia, which are founded on or result from an Australian patent should also be included. It is very common practice for protective patents to be taken out in the overseas market jurisdiction in which the IP is exploited, where the protective patent is based on the original Australian patent.

Recommendation 8: The concession should be extended to also include IP income from copyright protected software licencing and other identifiable IP income and income from foreign patents which are founded on or result from an Australian patent.

9. Eligible patent income sources

The proposed concession needs to include more income sources.

As a comparison, qualifying profits in international jurisdictions consist of:

- UK
  - Selling patented products including:
    - the patented product;
    - products incorporating the patented invention; or
    - bespoke spare parts
  - licensing out patent rights
  - selling patented rights
  - infringement income
  - damages, insurance or other compensation related to patent rights.
- **Ireland** – Royalties, licensing income, embedded royalties from sales, insurance/damages/compensation relating to a qualifying asset
- **Belgium** – License fees, embedded royalties from sales, damages from IP infringement, capital gains from selling IP rights
- **Switzerland** – Royalties, capital gains from selling patent rights, embedded royalties from sales
- **Netherlands** – Any profit attributable to the patent (excluding brand/production/sales & production value)

Recommendation 9: Any of the profit referable to the patent/eligible IP should be included – some proxies to determine this will be needed.

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10. JV companies must be catered for

It is common for the development of inventions to be undertaken by a joint venture company arrangement especially in the medical and biotechnology sectors.

Where the JV company applies the concession to its profits then dividends which it subsequently pays out to its JV partners will have correspondingly low franking and the benefit of the concession will be lost at the JV partner level due to the partners paying top up company income tax on the unfranked portion.

The loss of the benefit at the JV partner level will make the concession unattractive to those which have adopted JV structures and such structures are prevalent in the industry, especially often with Universities and other Research organisations.

Recommendation 10. Treasury should consider how the benefit of the lower Patent Box tax rates can be flowed through a JV arrangement.

11. Regime should be elective

Application of the regime should be by election by the company.

The concession would then apply to all eligible income from the year of election, including the extended eligibility for types of IP and income and in respect of patents granted and other IP developed before that year (subject to grandfathering restrictions) as discussed above.

The election is important to allow companies to avoid issues with applying the concession while they are in losses. Where losses are claimed outside the Patent Box, then consistent with some other countries these losses can then be recouped within the Patent Box once a decision is made to enter the IP into the Patent Box regime. This fixes the problem of how to deal with losses.

It also deals with an important corollary issue, namely, how to avoid the loss of Foreign Tax Credits on foreign source royalty income derived from the IP whilst the project is still in a loss making phase. Such credits can only be carried forward and offset against taxable years, but these would be lost in a low or no tax Patent Box regime. Allowing a taxpayer an election as to when to enter such a regime mitigates this risk.

Recommendation 11. Application of the regime should be by election by the company and the timing of when to enter the IP into the regime should also be decided by the company.

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Should you have any queries in relation to the above or to discuss these matters in further detail please contact Ezra Hefter (08 9429 2222, ezra.hefter@au.ey.com) or Hank Sciberras (03 8650 7986, hank.sciberras@au.ey.com) in our R&D and Government Incentives tax practice or Alf Capito (02 8295 6473, alf.capito@au.ey.com) or Tony Merlo (03 8575 6412, tony.merlo@au.ey.com) in our Tax Policy Centre.

Yours sincerely,

Ernst & Young

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Appendix

Question Number	Question	Will EY respond to question?	EY submission points
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?	Y	See above
Eligible IP			
2.	Are patents applied for by medical and biotechnology companies with domestic R&D operations generally Australian standard patents?	N	No comment
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?	N	No comment
Targeting medical and biotechnology			
4.	What is the best approach to provide certainty around access to the regime for the medical and biotechnology sectors?	Y	See above
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?	N	No comment
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?	Y	See above
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)?	Y	See above
8.	What factors drive decisions about the location of clean technology R&D?	N	No comment
9.	How would the clean technology sector best be defined for the purposes of a Patent Box?	Y	See above
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?	Y	See above

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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?	N	No comment
12.	How much R&D activity (related to patented inventions) occurs outside Australia? How is R&D usually split between related and unrelated parties?	Y	See above
Definitions 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)?	N	No comment
14.	To what extent are the R&D expenses of Australian patented inventions not entirely the subject of R&DTI claims?	N	No comment
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?	N	No comment
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?	N	No comment
17.	To what extent are Australian-based manufacturing processes subject to their own patents in the medical and biotechnology industry?	N	No comment
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)?	Y	See above
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?	N	No comment
Eligible revenue to enter the Patent Box			
20.	What types of patent-related revenue should be eligible for the Patent Box?	Y	See above
21.	How far downstream can the Patent Box's concessional treatment apply, and what principle should be used to define	Y	See above

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	eligible income derived from the patented innovation?		
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?	Y	See above
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)?	Y	See above
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?	N	No comment
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?	Y	See above
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?	N	No comment
27.	Are there design features of any existing Patent Boxes that, if adopted in Australia, would minimise the regulatory burden on companies?	N	No comment
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?	N	No comment
Other considerations			
29.	Are there any other issues you would like to raise for consideration in the design of the Patent Box?	Y	See above