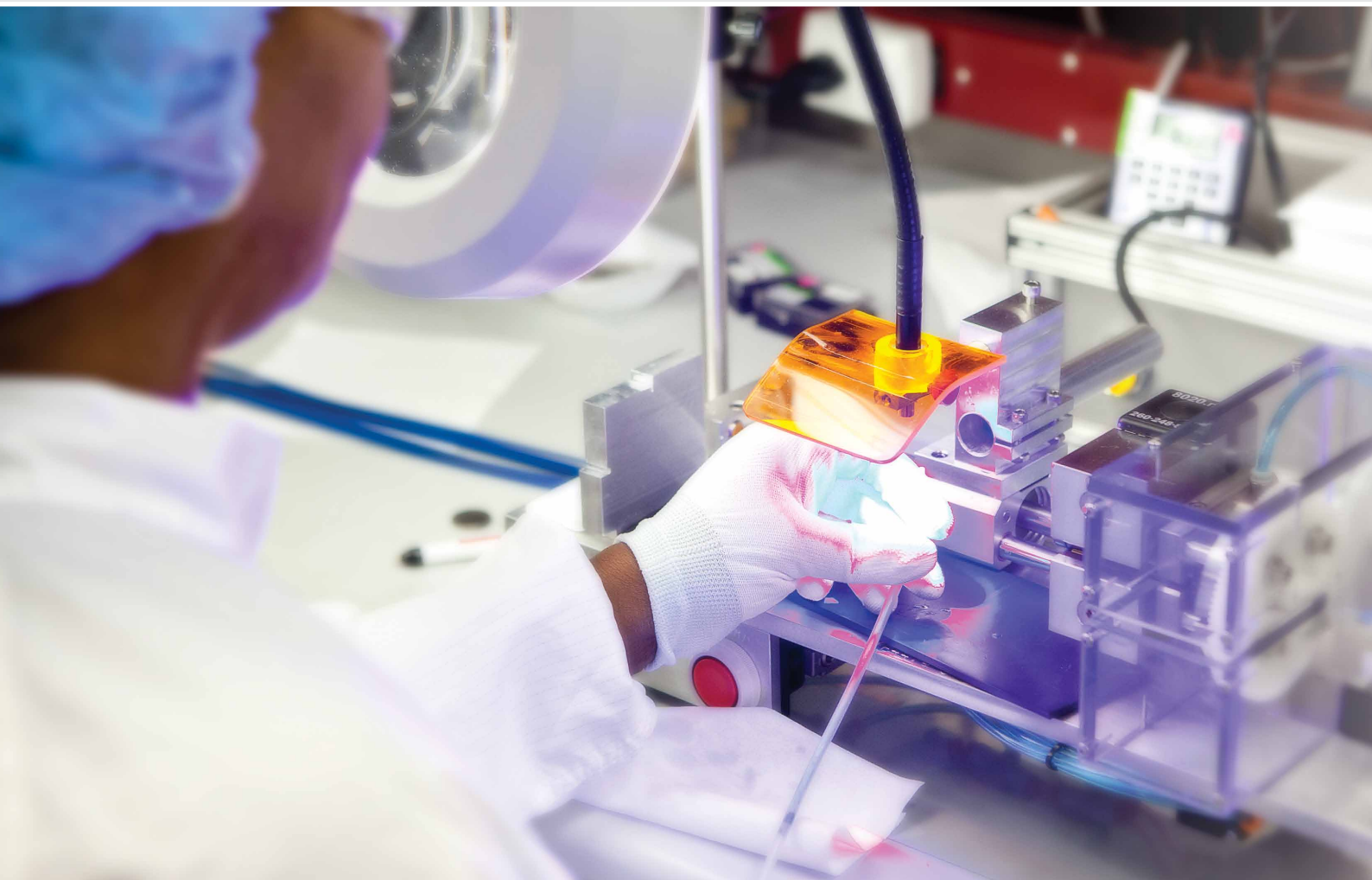


# Australian Innovation and Manufacturing (AIM) Incentive

Who cares about Australia's future?  
**WE DO**



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# Executive summary

To increase Australia's global competitiveness in innovation and manufacturing, a collaboration of Australian industry bodies and companies is urging the Federal Government to implement a 'patent box' style tax incentive, known as the Australian Innovation and Manufacturing (AIM) Incentive, that offers a reduced tax rate on qualifying profit from intellectual property (IP).

Australia already supports the research and development (R&D) phase of IP creation via the R&D Tax Incentive, before leaving it vulnerable to being sold, managed or manufactured overseas at the critical point. The resulting community and economic benefits such as jobs, exports, manufacturing and clinical trials go with it.

IP is highly mobile and can be easily separated from the jurisdiction where it is developed, and its management and manufacturing migrated to low tax jurisdictions that offer ongoing incentives. If Australia is serious about becoming a knowledge based economy, we need public policy that will encourage IP and its flow on benefits to stay in Australia, thereby creating wealth and jobs.

Manufacturing is one of the major sources of innovation in Australia. While the sector makes up just 8% of the economy, it is responsible for a quarter of all investment in R&D. Innovation and manufacturing are different sides of the same coin. A constant push-pull operates, whereby innovation in product design encourages innovation in manufacturing processes, and vice versa. For this reason, the Harvard Business School advises against the separation of R&D and manufacturing<sup>1</sup>.

The AIM Incentive is designed to address the gap that leaves our IP vulnerable, and support Australian innovators and manufacturers, while retaining our home grown IP and attracting IP created overseas to be commercialised and managed from Australia. The implementation of the AIM Incentive should make the commercialisation of IP and manufacturing in Australia more genuinely viable for businesses, especially, if coupled with other measures, such as cutting red tape and increasing flexibility in industrial relations.

There are currently 10 countries in the world (nine in Europe and China) that have adopted a 'patent box' or 'innovation box' policy with many more looking to introduce similar regimes in the future.

Rather than a direct subsidy, the AIM Incentive would see the Federal Government provide tax relief based on the retention of IP ownership and associated commercialisation of IP in and from Australia. It would also support companies that make goods outside Australia where significant 'value add' activities are performed in Australia and the net benefit from its sales will benefit the Australian economy.

An excellent example of this kind of model working in practice is provided by the UK, where a 10% tax rate is applied to qualifying profit (as opposed to the corporate tax rate of 21%). GlaxoSmithKline (GSK), one of the world's largest pharmaceutical companies, is centralising its pharmaceutical IP in the UK and has announced a new investment of over AU\$1.1 billion in the UK, including the first plant to be built by GSK in the UK in almost 40 years<sup>2</sup>.

The collaboration participants recommend that the Government consider adopting the UK model and adapt the policy to suit the Australian environment. Under the UK model, the definition of qualifying IP for the AIM Incentive purposes is limited to patents, a license to a patent and data exclusivity rights. In Australia, this would include certified innovation patents. Qualifying income for the lower tax rate includes the following:

- license fees, royalties and milestone payments;
- sales income from patented products;
- contract manufacturing income (provided a patent is involved in the process and to the extent the profit is attributable to the patent);
- income from the provision of a service reliant on a patented tool (to the extent the profit is attributable to the patent); and
- income from patent enforcement.

It is imperative that Australia takes action to remain competitive and relevant on the world stage, especially, when economies such as the UK, France, Switzerland and China are already reaping the benefits of their patent box regimes. If we are to maximise Australian innovation and reinvigorate the manufacturing sector in Australia, it is vital that the existing R&D Tax Incentive be complemented with an end-to-end tax regime that can secure Australia's competitiveness for the future.

# Australian manufacturing in 2014 and beyond

Manufacturing feeds and clothes the families of over a million Australian workers and accounts for more than \$106 billion (or 8.3%) of our GDP<sup>3</sup>. However, hiding behind these figures is the sobering reality of an industry in crisis.

Over the past six years, more than 100,000 manufacturing jobs have been lost, with a further 85,660 forecasted to go before 2018<sup>4</sup>. Each job loss represents a personal tragedy for those people and families involved.

There have been countless examples of late regarding the state of manufacturing in Australia, none more prevalent than Australia's automotive industry and the associated job losses show the damage the current climate is inflicting on a proud Australian workforce. Yet, it need not be like this. Structural reform in manufacturing is moving to high value, low volume goods where we have a competitive advantage globally. Australia is a forward thinking nation that drives innovation; a fact reflected by the high number of patents Australians have generated in recent years. Over the past decade alone, 28,811<sup>5</sup> patent applications have been filed.

This success in innovation is linked to our traditional prowess in manufacturing. As any advanced manufacturer will tell you, most innovation with respect to products, ideas and advancements originates on the factory floor.

Australia's manufacturing future lies in a number of high-tech and medium-tech industries, such as pharmaceuticals, medical devices, scientific instruments and electronics, to name but a few. Australia needs a policy framework that supports all industries of the future, as well as traditional manufacturers, to maximise their potential for a stronger manufacturing and innovation sector in Australia.



# Commercialising Australian innovation

When it comes to fundamental discovery research, Australia is a legitimate and impressive global contributor, producing 3% of the world's research publications with only 0.3% of the population. However, our ability to translate this strength into products to benefit the Australian community continues to fall short of expectations.

For example, the 2013 INSEAD Global Innovation Index ranks Australia 11th in terms of innovation input and 32nd in innovation output, but when these figures are converted to innovation efficiency ratio, Australia dives to 116 out of 140 countries assessed. This stark measure shows that Australians are brilliant at coming up with ideas but poor at translating them into products.

Relative to the number of papers published and patents issued, Australia lags in key global commercialisation benchmarks and in creating significant public companies, commercial products, jobs and income. This means that,

in addition to not gaining health benefits from those innovations, Australia misses out on the commercial and economic benefits that would also become available.

It is unfortunately a common story that as research findings are developed and near commercialisation, Australia loses the IP overseas. Australia already supports the research and development phase of innovation and IP creation via the R&D Tax Incentive, only to leave it vulnerable to being sold or manufactured overseas at the critical point. The resulting community and economic benefits go with it.

IP is highly mobile and can be easily separated from the jurisdiction where it was developed and migrated to low tax jurisdictions or where there are ongoing incentives. If Australia is serious about becoming a knowledge based economy, we need public policy that will encourage IP commercialisation and the associated manufacturing to stay in Australia.



# Standing still is not an option

Recognising the importance of innovation to Australia's future, policy makers have already taken one important step by implementing the R&D Tax Incentive. This Incentive is an effective tool in promoting investment in research and encouraging collaboration between business and research centres in the development of new and improved products.

The benefits of R&D tax incentives are widely recognised globally, with 30 countries, including the top 10 global manufacturing countries, now offering R&D tax incentives. As R&D incentives become more commonplace around the world, a number of governments have demonstrated that to stay ahead, it is necessary to address the other side of the innovation coin - manufacturing. Manufacturing is an important way of translating IP into benefit to society. If IP just remains at an academic level or just sits in someone's drawer - it is of limited value to society.

There are currently ten countries in the world (nine in Europe and China) that have adopted a 'patent or innovation box' style policy with many more looking to introduce similar regimes in the future. This policy is intended to build upon the benefits derived from the investment in the R&D phase by encouraging companies to locate all activity associated with the development, manufacture and exploitation of that IP (and hence jobs) within the home country.

The UK is the latest country to introduce a 'patent box' regime, offering companies a 10% rate of tax (as opposed to the general corporate tax rate of 21%), for the income streams derived from qualifying IP commercialised in the UK (whether through licensing,

sale of products manufactured in the UK or by providing services using patented technology).

An excellent example of this kind of model working in practice is provided by the UK. Following the introduction of the Patent Box regime in the UK with effect from April 2013, GlaxoSmithKline (GSK), one of the world's largest pharmaceutical companies, is centralising its pharmaceutical IP in the UK and has recently announced a new investment of over AU\$1.1 billion in the UK, including the first plant to be built by GSK in the UK in almost 40 years<sup>2</sup>.

It is imperative that Australia takes action to remain competitive and relevant on the world stage, especially, when economies such as the UK, France, Switzerland and China are already reaping the benefits of their patent box regimes. If we are to maximise Australian innovation and reinvigorate the manufacturing sector in Australia, it is vital that the existing R&D Tax Incentive be complemented with a commercialisation tax regime that can secure Australia's competitiveness for the future.

The implementation of the AIM Incentive should make the commercialisation of IP and manufacturing in Australia more genuinely viable for businesses, especially, if coupled with other measures, such as cutting red tape and increasing flexibility in industrial relations.

One of the purposes of the AIM Incentive is to increase the commercial viability of taking R&D based technology to market and undertaking the required steps in a business life cycle in or from Australia.



# The AIM Incentive: an investment in Australia's future

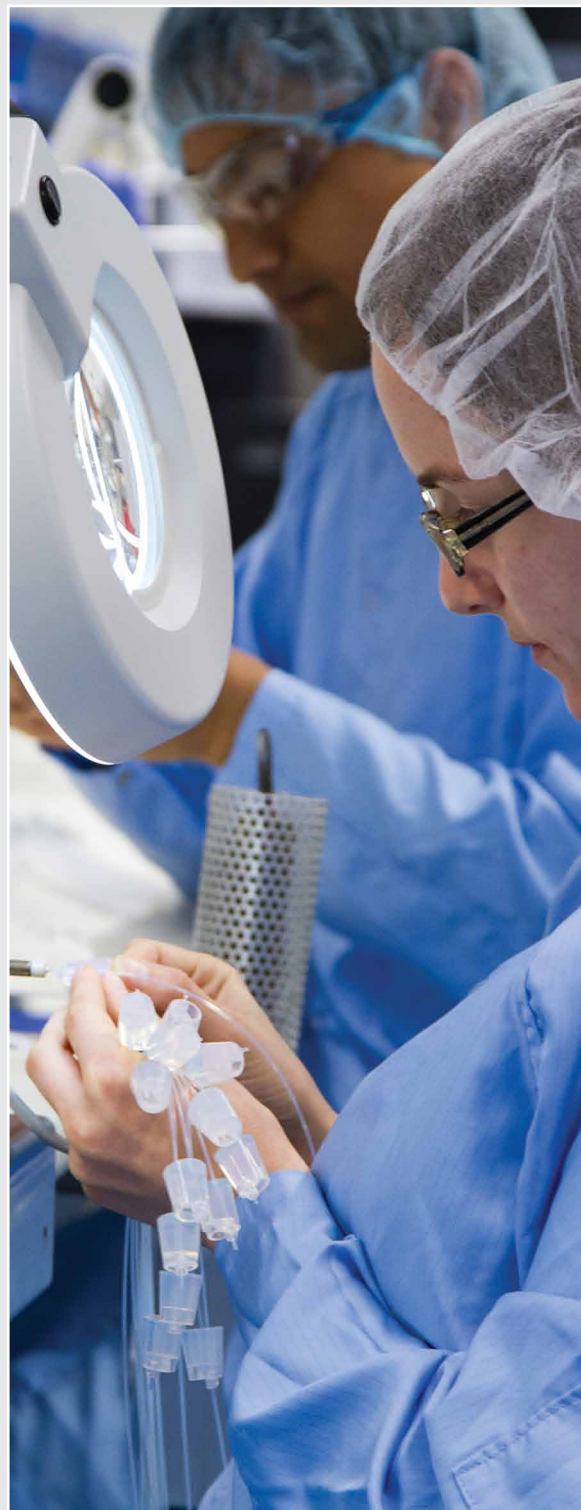
The goal of the AIM Incentive is to stimulate commercialisation of innovation and manufacturing within Australia. Currently, the Australian company tax rate sits at 30%. In the 2014 Federal Budget a 1.5% reduction was announced, to take effect from 1 July 2015. Despite the drop, it is still one of the highest in the developed world. This challenge, along with other factors, such as high labour and operating costs, combined with the departure of some of our best minds to overseas markets and a lack of foreign investment, have all contributed to a bleak outlook for Australian industries.

The AIM Incentive put forward in this paper has been designed not only as a tool to help innovators and manufacturers in Australia, but also to alleviate the financial pressures on the Australian Government by reducing the need for up front direct subsidies.

The proposed AIM Incentive is closely based on the current UK Patent Box model, which in its early stages, appears to be highly effective, and on the available evidence to date, is achieving its objectives.

The proposed AIM Incentive model has been designed to stem the flow of manufacturing off-shore whilst providing a solution for future jobs for Australians and a competitive advantage for Australian companies. The design of the AIM Incentive would provide opportunities for Australian based businesses to reach maximum effectiveness/impact in achieving their objectives. At the same time, it should also be robust, so that it is not open to abuse, can be enforced and be efficient in terms of cost of compliance/use.

Companies qualifying for the AIM Incentive are also likely to be performing significant R&D activities and, therefore, would be expected to qualify for the R&D Tax Incentive. The AIM Incentive should be designed to complement the R&D Tax Incentive and companies claiming the R&D Tax Incentive should not be penalised when calculating their profits for the AIM Incentive. However, given that it would be desirable to attract overseas IP and associated manufacturing, to claim the AIM Incentive, the IP in question would need to be actively managed and controlled in Australia even if the underlying R&D took place outside of Australia.



# How would the AIM Incentive work?

Implementation of the AIM Incentive would make the commercialisation of IP and manufacturing in Australia more genuinely viable for businesses. It will provide a reduction in the tax payable on any profits derived from the commercialisation of qualifying IP in Australia (either via licensing or manufacturing and sale of products incorporating qualifying IP).

Qualifying IP under the AIM Incentive would be patents (including certified innovation patents), data exclusivity periods and corresponding licences to those patents. This would allow for ease of administration, as it would not include non-registered and often subjective types of IP, such as 'know-how'. Qualifying IP can either be developed in Australia or in sourced (acquired or licenced) from outside of Australia if it brings benefits for Australia. One of the purposes of the AIM Incentive is to increase the commercial viability of taking R&D based technology to market and undertaking the required steps in a business life cycle in or from Australia. Manufacturing should be defined broadly to include significant value-add in Australia for products that are partially manufactured overseas.

Broadly, qualifying IP profit would be taxed at the lower rate (e.g. 10%) with the standard corporate tax rate to be applied to other income.

The AIM Incentive would apply to income generated from 'qualifying IP', which should include the following:

- license fees;
- royalties;
- milestone payments;
- sales income from patented products;
- contract manufacturing income (provided a patent is involved in the process and to the extent the profit is attributable to the patent);
- income from the provision of a service reliant on a patented tool (to the extent the profit is attributable to the patent); and
- income from patent enforcement.

## Income arising from patent enforcements

This would include income arising as a result of action taken against others for infringing against a company's rights under a patent.

## Anti-abuse

Anti-abuse features should be incorporated to ensure that the AIM Incentive is properly targeted and applied. Based on the UK Patent Box regime, the following situations would be against the law:

- where a functionally irrelevant patent is incorporated into a product with the sole purpose of achieving the AIM Incentive eligibility;
- commercially irrelevant grant of exclusivity with the sole purpose of achieving the AIM Incentive eligibility; and
- any scheme designed to inflate artificially qualifying IP income or qualifying AIM Incentive profits.

Reasonable and commercially-appropriate steps to restructure corporate arrangements to take advantage of the AIM Incentive should be considered acceptable, as the AIM Incentive's objective is to incentivise companies to keep their IP in Australia or to come to Australia. As a further integrity measure, companies would be required to prepare audited accounts to be eligible for the AIM Incentive.





It is possible to phase in the AIM Incentive, similarly to the way it was done in the UK as evident in the table below. That is, initially, the incentive would cover a percentage of qualifying IP profit, with the percentage increasing from year to year until it reaches 100% of the qualified profits. This would allow the benefits of the AIM Incentive to catch up with the cost associated with the reduced revenues collected by the government.



Fiscal year	2013-14	2014-15	2015-16	2016-17	2017-18 onwards
% of qualifying IP profits eligible for Patent Box incentive	60%	70%	80%	90%	100%

**Example 1 - Sale of product from qualifying IP (\$AU)**

	Without AIM Incentive	With AIM Incentive
Sale of products from qualifying IP	\$75m	\$75m
Interest income	\$3m	\$3m
Sale of other products	\$22m	\$22m
IP related COGS	(\$11.25m)	(\$11.25m)
Other costs	(\$20m)	(\$20m)
Profit	\$68.75m	\$68.75m
Total tax without the AIM Incentive	(\$20.625m)	
Tax on IP profit under AIM Incentive @10%		(\$6.375m)
Tax on other income @30%		(\$1.5m)
Total tax with the AIM Incentive		(\$7.875m)
Profit after tax	\$48.125m	\$60.875m

**Example 2 - Income from licencing qualifying IP (\$AU)**

	Without AIM Incentive	With AIM Incentive
Licence of qualifying IP (royalties)	\$75m	\$75m
Interest income	\$3m	\$3m
IP related costs	(\$20m)	(\$20m)
Profit	\$58m	\$58m
Total tax without the AIM Incentive	(\$17.4m)	
Tax on IP profit under AIM Incentive @10%		(\$5.5m)
Tax on other income @30%		(\$0.9m)
Total tax with the AIM Incentive		(\$6.4m)
Profit after tax	\$40.6m	\$51.6m

# The bottom line

It is widely acknowledged that building Australia's capacity as a technologically innovative country is vital for our economic future. The AIM Incentive is focused on patents rather than other forms of IP as they have a strong link to R&D and manufacturing in a wide range of sectors.

In a time where technological innovation, knowledge and networking are the drivers of productivity, Australia has great expertise in many areas which should be leveraged to our economy's advantage.

Australia needs to reverse the current skills shortage and loss of industry jobs by offering the same support that is so readily available outside of Australia. By harnessing the skills that workers already have and upgrading and utilising them in new industries, as well as training new members of the workforce, there is an opportunity to keep Australia's diverse manufacturing tradition alive.

According to the Australian Bureau of Statistics, 222,037<sup>6</sup> students completed their schooling in 2011. With the manufacturing sector accounting for 8.4%<sup>7</sup> of the total labour force, that's over 17,000 eighteen year olds who are destined to work in the manufacturing sector. It is, therefore, imperative that we take action now to foster Australia's future innovation and manufacturing talent.

The greatest attribute that any industry can contribute to an economy is the opportunity to flourish. The Prime Minister's Manufacturing Taskforce Report of the Non-Government Members states that over the past six years, 106,775 Australian manufacturing jobs have been lost and it is anticipated that another 85,600 jobs will go

in the next five years<sup>8</sup>. That is approximately the loss of 200,000 jobs over a ten-year period.

By implementing the AIM Incentive, policy makers have the opportunity to provide companies with the additional resources required to invest in their growth, whilst allowing them to produce more quality products and potentially employ additional staff. For Australia to compete on a global level, the development of greater economic diversity should be seen as a high priority and with the introduction of policy such as the AIM Incentive it fosters opportunities, that are currently deteriorating, to future generations entering the workforce.

The increase in employment due to greater investment by foreign and domestic companies would increase income tax collections and national insurance yields, whilst concurrently reducing the welfare bill. PwC in the UK estimated that a fifth of the new jobs created as a result of the R&D Incentive alone would result in a reduction in welfare claims by \$5,000 per case<sup>9</sup>. Introducing the AIM Incentive to cover commercialisation of IP could result in a dramatic enhancement of Australia's economy.

All of the stated benefits would help create a stronger national economy that is more resilient to change and provides a platform for greater innovation and development to protect the needs of Australians in the coming years. As a nation, we cannot afford to lose our remaining manufacturing skills and capabilities. Innovation and manufacturing need to be nurtured, so that they can once again excel and form robust pillars of the Australian economy.



# Final thoughts

Manufacturing and innovation have a proud history and, if supported, a transformational impact on the future of Australia's economy. They offer opportunities for many Australians to pursue their dreams, due to the diversity of skills and people required to operate in different industries.

In the past decade alone, manufacturing has gone from being Australia's second largest industry employer to the fourth and the unemployment rate for people who hold Certificate I/II qualifications is 9.9%<sup>10</sup> - nearly double the current national unemployment rate.

The introduction of the AIM Incentive would provide the optimal policy framework in which to turn Australian ideas into locally manufactured products.

The AIM Incentive would not only safeguard manufacturing jobs, help retain our IP and facilitate

innovation; it would also contribute to Australia maintaining a robust, broad-based economy. Innovation that emerges from our knowledge and manufacturing sector also fuels growth within the service sector, because intermediary goods - the machines used by services - drive service sector productivity. In the United States, for example, every dollar of manufacturing output requires 19 cents of services<sup>11</sup>. And in some manufacturing sectors, more than half of all employees work in service roles - such as R&D engineers and office support staff.

The time has come for Australia to leverage its skills in innovation and become a leader in manufacturing once more. Let us not wait for the next 85,600 jobs to be lost, or for the "patent box" concept to become a global norm. Let us be one of the first to enact a policy that supports the companies that are contributing to our broad-based economy with new and sustainable innovations.

# End notes

1. Harvard Business Review, 'Does America Really Need Manufacturing?'
2. Daily Telegraph, 'Budget 2012: GlaxoSmithKline to invest £500m in UK and create 1,000 jobs after cut in patent profits tax'
3. Prime Minister's Manufacturing Taskforce, Report of the Non-Government Members Manufacturing: Positions, Pressures and Prospects'
4. Ibid
5. IP Australia website
6. Australian Bureau of Statistics - Schools, Australia - 4221.0
7. Australian Bureau of Statistics 2013 labor Statistics Brief. Catalogue No. 6104.0
8. Prime Minister's Manufacturing Taskforce, Report of the Non-Government Members, 'Manufacturing: Positions, Pressures and Prospects'
9. PWC, 'R&D tax relief - an economic study, 2011'
10. Australian Bureau of Statistics 2013 labour Statistics Brief. Catalogue No. 6104.0
11. The McKinsey Global Institute, 'Manufacturing the future: the next era of global growth & innovation'.
12. Deloitte, '2014 Global Survey of R&D Tax Incentives'

## **List of Countries that currently have a patent or innovation box regime:**

Belgium, China, France, Hungary, Ireland, Luxembourg, The Netherlands, Spain, Switzerland, United Kingdom.

## **List of Countries that currently have an R&D tax incentive:**

Australia, Austria, Belgium, Brazil, Canada, China, Czech Republic, France, Hungary, India, Ireland, Israel, Italy, Japan, Malaysia, Mexico, Netherlands, Poland, Portugal, Russia, Singapore, South Africa, South Korea, Spain, Turkey, United Kingdom, United States.

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