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1 What is Intellectual Property

Properly identifying and understanding early stage intellectual property is critical when it comes to planning for the future. The creation and development of intellectual property can happen fast and the accounting and taxation treatment associated with it can be complicated. In order to ensure the optimal business structure is in place to protect and maximise the value of any intellectual property, the hard work must be done up front.

This section will explore:

- When is intellectual property a CGT asset?
- When is intellectual property a depreciating asset under Division 40?
- Where does R&D expenditure fit?

Whereas it is usual accounting and taxation practice to identifying all items of intellectual property has merely being an intangible asset, not all items of intellectual property have the same all-embracing taxation characteristics.

There are specific taxation issues that need to be fully understood when we are dealing with intellectual property and the taxation implications. These issues can be best summarised in the form of three simple propositions which I set out below.

1.1 How to define intellectual property

I find it easiest, in a tax sense, to break down the definitional concepts sitting behind intellectual property into three guiding propositions, which for the purposes of this paper I have named the "*Guiding Propositions*".

GUIDING PROPOSITION 1: All forms of intellectual property rights are CGT assets.

Section 108-5(1) defines a CGT asset in the following manner:

> A ***CGT asset*** is:
>
> (1) any kind of property or
>
> (2) a legal or equitable right that is not property.

Goodwill is a CGT asset. Trademarks are a CGT asset. Brands, patent applications and other similar assets are all CGT assets. The question is are those assets also depreciable assets (see proposition 2 below)?

There are some assets that might seem to be CGT assets but are not. Taxation Ruling 98/3 provides that mining, prospecting and quarrying information (as distinct from the underlying right) is not a CGT asset and amounts received from the sale of such information will likely be taxed as ordinary income on the basis that:

> Mining, quarrying or prospecting information itself is not property. It lacks the characteristics, of being able to be transferred, that are found in property. It cannot be sold outright, it can only be dealt with or disclosed.

Costs incurred in developing CGT assets go to the relevant asset's cost base. If those assets are sold then any gain or loss is measured by reference to the proceeds and the asset's cost base. Where applicable, small business CGT concessions and/or the CGT discount may be applied to any capital gain.

Other CGT provisions may also be relevant to the creation of IP. For example section 104-35(1) of the ITAA 1997 provides that CGT event D1 happens if you create a contractual right or other legal or equitable right in another entity. This can be the case where a licence is granted for the use of intellectual property. CGT Event D1 and the granting of a licence is explored further in section 5 below.

GUIDING PROPOSITION 2: Some, but not all, forms of intellectual property are also depreciable assets

Certain types of intellectual property will have their taxation treatment governed by Division 40 of the ITAA 1997. The point to note is that not every type of intellectual property comes within Division 40.

That being the case, an understanding of the impact of the specific provisions within Division 40 that identifies certain intellectual property rights as a depreciating asset is a critical taxation issue.

Section 40-30 defines a "*depreciating asset*":

> A depreciating asset is an asset that has a limited *effective life and can reasonably be expected to decline in value over the time it is used, except:
>
> a) land or
>
> b) an item of *trading stock or
>
> c) an intangible asset, unless it is mentioned in subsection (2).
>
> These intangible assets are depreciating assets if they are not *trading stock:
>
> a) mining, quarrying or prospecting rights
>
> b) mining, quarrying or prospecting information
>
> c) items of *intellectual property
>
> d) *in-house software
>
> e) *IRUs
>
> f) *spectrum licences
>
> g) *datacasting transmitter licences
>
> h) *telecommunications site access rights.

The definition of intellectual property is provided by section 995 in the following manner:

> **Intellectual property**: an item of intellectual property consists of the rights (including equitable rights) that an entity has under a *Commonwealth law as:
>
> a) the patentee, or a licensee, of a patent or
>
> b) the owner, or a licensee, of a registered design or
>
> c) the owner, or a licensee, of a copyright.
>
> or of equivalent rights under a *foreign law.

The correct characterisation of the asset as “intellectual property” is important because:

- to the extent that there are capital costs associated with the creation of the of the Division 40 item of intellectual property, the costs incurred to create the depreciating asset, in accordance with subdivision 40-C, will form the basis of future depreciation claims in respect of the asset; and
- any transaction relating to the disposal or granting of a licence to use the intellectual property will be assessed pursuant to Division 40 (Subdivision 40-D) and accordingly assessable as a revenue transaction, not a capital gain (section 118-24).

This latter point has profound implications for the application of the small business CGT concessions and other CGT concessions for small business taxpayers which will be the subject of a later paper for this workshop.

ATO ID 2004/858 confirms the Commissioner’s that a trade mark is not a depreciating asset for the purposes of section 40-30(1). Accordingly any costs such as registration fees or legal costs incurred in creating or registering a trade mark cannot be amortised under Division 40.

GUIDING PROPOSITION 3: Software has its own rules

There are other special taxation treatment for certain items of intellectual property. For example “in house software” is defined for the purposes of Division 40 as:

> ***"In-house software"*** *is computer software, or a *right to use computer software, that you acquire, develop or have another entity develop:*
>
> *a) that is mainly for you to use in performing the functions for which the software was developed*
> *b) for which you cannot deduct amounts under a provision of this Act outside Divisions 40 and 328.*

The taxpayer is able to pursuant to section 40-450 to allocate amounts of expenditure incurred on the development of “in-house software” to a software development pool, if the taxpayer intends to use the software solely for the production of assessable income (“taxable purpose”). The amount of the deduction is calculated under section 40-455 rather than Subdivision 40-B.

In terms of the interaction between the in-house software rules and the depreciating asset definition, it is important to note that section 40-450 provides a deduction for expenditure on in-house software even if no depreciating asset has been developed.

1.2 R&D Expenditure

It is useful to comment briefly upon the relationship between intellectual property and the specific regime that exists (albeit ever-changing) for research and development (**R&D**) expenditure. It is sufficient to say that a refundable tax offset, if you can get it, is more beneficial than a straight out deduction.

Without embarking on a detailed examination of the current R&D regime, some of the key points to note regarding the interaction of the R&D rules and IP are as follows:

- A tax offset is generally available for expenditure on core R&D activities or in respect of the decline in value only of <u>tangible</u> depreciating assets used in R&D.
- Expenditure associated with "*patenting, licensing or other activities*" is specifically excluded from the definition of core R&D activities in section 355-25(2) of the ITAA 1997.
- Section 355-25(2) also excludes from the realm of eligible expenditure any costs associated with the development or modification of computer software for the dominant purpose of internal administration.

Any amount that can be deducted under the R&D rules (a notional deduction) is generally excluded from the cost base of a CGT asset pursuant to section 110-45 of the ITAA 1997 and also from the cost of depreciating assets.

Other requirements of the R&D regime that can have an important bearing on some of the structuring issues explored below is that the R&D must be conducted by a company and that the activities must be conducted in Australia.

2 What is Goodwill?

All intellectual property is an intangible asset of a business, however not all intangible assets of a business are intellectual property. This section will discuss some of the common misconceptions that blur the line between goodwill and intellectual property. It will briefly explore what the courts and the ATO have said about goodwill and why it is important to properly distinguish between goodwill and intellectual property.

2.1 Why do we care?

Perhaps the best reason why we should care about identifying and separating goodwill from IP is that the High Court decision in *FCT v Murry* 98 ATC 4585 tells us that for capital gains tax purposes on the sale of a business an allocation of the purchase price to goodwill is necessary. Goodwill is a CGT asset (and potentially subject to concessionary treatment) whereas certain IP may be a depreciable asset as outlined above and the sale of those items will result in a balancing adjustment event under Division 40.

Taxation Ruling TR 1999/16 adopts the reasoning in Murry regarding goodwill and provides the Commissioner's views on how goodwill might be allocated on the sale of a business, noting at paragraph 27 that:

> Goodwill is one CGT asset separate and distinct from other assets of the business such as plant, licences (whether exclusive or non-exclusive licences), statutory permits, quotas, entitlements, valuable contractual rights and items of intellectual property (for example, a trade mark, patent, copyright or registered design).

Another source of debate in the courts has been the issue of goodwill in a mining context and with regard to the impact it may have for non-residents under Division 855 and determining whether non-portfolio shares held in an Australian company are taxable Australian property.

Legislative changes addressing in part the issues raised by the *AP Energy Investments Ltd v FC of T* 2013 ATC 10-335 (with the Commissioner's appeal being rejected by the Federal Court in 2016) were originally announced in the 2013 Federal Budget. To the best of my knowledge these proposed measures were put on hold pending the outcome of the RCF line of decisions, but ultimately have not resurfaced.

The thrust of the proposed amendments was to take certain intangible assets, such as mining information and goodwill which are currently not considered taxable Australian real property, and treat them as taxable Australian real property provided they are attributable to taxable Australian real property such as the exploration and mining rights. According to the Government's press release, a number of foreign owned mining companies have been disposed of, and the foreign owner had not been taxed on the basis that the non-taxable Australian real property, including mining information, exceeded the value of the taxable Australian real property.

2.2 What is goodwill?

The “intellectual capital” of a business typically include a range of intangible assets. As identified above, these can include the obvious patents, trademarks, copyrights, brand names, logos, and other elements frequently lumped into the category of goodwill and that for a number of reasons are seldom valued individually.

Strictly speaking, intangible assets cover a wider range of assets than simply goodwill. They are identifiable, legally-owned and protected assets with quantifiable value. Examples of intangible assets include: trademarks, patents, names, logos, colours, software, databases, designs, trade secrets, technical know-how, license agreements and websites. Brand value is an intangible asset, for instance, whereas goodwill encompasses the less quantifiable good reputation of a company.

A company’s good reputation is a concept embedded in goodwill, but a company’s brand value may be a specific intangible asset that can be measured and valued (and potentially depreciated). In *Murry* the High Court noted at 23:

> From the viewpoint of the proprietors of a business and subsequent purchasers, goodwill is an asset of the business because it is the valuable right or privilege to use the other assets of the business as a business to produce income. It is the right or privilege to make use of all that constitutes ``the attractive force which brings in custom." Goodwill is correctly identified as property, therefore, because it is the legal right or privilege to conduct a business in substantially the same manner and by substantially the same means that have attracted custom to it. It is a right or privilege that is inseparable from the conduct of the business.

Under basic accounting principles, my understanding is that goodwill is, strictly speaking, the difference between the market value of a company and the total value of its tangible assets and liabilities. It is often measured as the amount exceeding a company’s quantifiable assets, leftover from accounting and valuation.

Difficulties arise when goodwill may also be calculated as an element of the value of a particular trademark. The question arises as to whether the value embedded in a trademark is different to the value embedded in the goodwill associated with that trademark?

In one sense, the value of goodwill is distinct from, but tied to, the value of a trademark. The value of the associated goodwill has the effect of strengthening a brand, which becomes useful when negotiating licences or royalties.

What is clear from the cases is that goodwill, although an asset, cannot be transferred separately to the underlying business. The Commissioner acknowledges this at paragraph 30 of TR 1999/16 (somewhat confusingly):

> Goodwill does not attach to assets of a business or to knowledge or information. Rather, it attaches to the business that uses the assets, knowledge or information. Proceeds of the sale of a business are reasonably attributed to the goodwill of the business and to the assets, knowledge or information.

The Commissioner in Taxation Ruling TR 98/3 also confirms that costs incurred in acquiring mining, quarrying or prospecting information (e.g., relevant exploration or prospecting expenditure) do not form part of the cost base of the goodwill for the purposes of calculating a capital gain on the disposal of the goodwill. This is on the basis that:

> 29. Another unique feature of mining, quarrying or prospecting information is that it does not attach itself to the goodwill of a mining business. As explained above, information can be and is often disclosed independently of the mining tenement or any other item of property forming part of a business. Information does not give its owner any monopoly to trade in a certain area that is the characteristic of the taxi licence considered by the Federal Court in *FC of T v. Murry* 96 ATC 4703; (1996) 33 ATR 206.
>
> 30. Goodwill is an accounting concept and is defined in Approved Accounting Standard ASRB 1013: 'Accounting for Goodwill', as meaning the future benefits from unidentifiable assets, i.e., those assets that are not capable of being both identified and specifically brought to account. In contrast to goodwill, mining or prospecting information arises from expenditure that has its own specific method of disclosure under accounting standards.

Suffice to say that an accurate identification of the goodwill of a business, which is necessary such that it can be valued or part of the sale price can be accurately apportioned to it, can be a difficult task fraught with uncertainty and difficult legal concepts.

2.3 What is the cost base of goodwill?

Once you have established that goodwill is a CGT asset and you have identified and valued it, in order to calculate any gain or loss arising on the sale of that goodwill it is necessary to consider whether it has a cost base.

In order to determine the cost base of goodwill you are required to distinguish between “purchase” goodwill and “internally generated” goodwill … just to keep things simple.

The Commissioner provides a useful (and in my view correct) explanation in Taxation Ruling TR 1999/16. In summary, he notes at paragraphs 53 to 58:

> 53. The cost base of goodwill purchased in an arm's length transaction includes money paid or required to be paid in respect of acquiring the goodwill and the market value of any other property given or required to be given in respect of its acquisition.
>
> 54. The cost base of internally generated goodwill does not include any expenditure incurred in the course of carrying on a business which has the essential character of a working expense of the business or a cost of the trading operations of the business. In any event, expenditure that you have deducted or can deduct might not form part of the cost base of your goodwill or your interest in goodwill.
>
> 55. The cost base of goodwill is separate and distinct from, and does not include, the cost base of other assets of a business - even business assets which are sources of goodwill.
>
> 56. If a taxpayer commences a business, or internally generates goodwill in an existing business, the cost base of the goodwill does not include any figure for the taxpayer's (that is, sole trader's or partner's) own effort in building up the goodwill. The value of services performed by an individual taxpayer personally are not included in the cost base of an asset.
>
> 57. The cost base of goodwill includes capital expenditure to the extent it is incurred to increase the value of the goodwill and is reflected in the state or nature of the goodwill when a CGT event happens (subsection 110-25(5)). It also includes capital expenditure to the extent it is incurred to establish, preserve or defend the taxpayer's title to, or right over, the goodwill (subsection 110-25(6)).

58. Costs incurred in acquiring knowledge or information - e.g., know-how, mining, quarrying or prospecting information, trade secrets and secret formulae - do not form part of the cost base of goodwill. Similarly, costs incurred in establishing and maintaining the get-up of a business and in developing work in progress do not form part of the cost base of goodwill

3 What are some of the key legal mechanisms that can be used to govern and protect the use of valuable intellectual property?

The realm of potential predators who lie in wait to pounce upon and steal your valuable IP are both numerous and very real. Protecting your IP and ensuring you have put in place the most robust legal mechanisms and structures as early as possible should be a core priority for any start up business.

Who am I protecting my IP from you may ask? Consider the following:

- Creditors – banks, non-bank lenders, related party loans and basically anyone who may have a secured or even unsecured interest over the assets of your business.
- Spouses – in the event of a marital breakdown what is the risk of control of the valuable IP assets passing or changing as part of any matrimonial property agreement or pursuant orders of the Family Court?
- Business partners and shareholders.
- Employees.

This section will cover some of the fundamentals in using and protecting valuable intellectual property in a business. This will include discussion around:

- Who should own the intellectual property?
- Identifying the risks?
- What type of entity should you use?
- What does an exit scenario look like for your business?
- How do you secure the assets?

3.1 Who should own the IP?

The tax regime generally leads towards a limited liability company as the vehicle of choice for the commercial development of IP assets. In particular the R&D rules and now the ESIC rules require a company to develop and hold the IP. Also given that many of the CGT concessions (in particular the 50% CGT discount) apply only to CGT assets – it may be preferable for any disposal to be of shares in a company rather than of the underlying IP assets, which for the reasons set out in this paper may not themselves be CGT assets. The employee share scheme rules in Division 83 of the ITAA 1997 also only apply to companies – which is relevant if shares and options are to be used to remunerate employees and key executives. Other considerations may include the eligibility requirements for investment and funding from VCLPs and ESVCLPs which generally require an investee company.

There are solid commercial reasons for using a company. It goes without saying that a company allows the original owners of the IP to undertake activity and develop the IP without being exposed to direct legal liability. It also means that equity and debt can be raised against the IP assets held in the company rather than the assets of the founders of owners themselves (subject of course to personal guarantees and collateral arrangements that may be required). A company also has a perpetual life.

To the extent that these incentives are not going to be utilised then the following alternative vehicles may be considered:

- *Trusts (both fixed or discretionary)* – trusts allow flow through treatment of any income and gains and unit trusts allow for interests in the trust to be bought and sold. However, some of the reasons why these entities may not be preferable is the restrictions on retaining and reinvesting any profits (trustees are generally taxed on the top marginal rate on any profits not distributed at the end of the year) and such vehicle are less likely to be attractive when raising capital or selling the business.
- *Partnerships or joint ventures* – this is the only alternative that would allow losses incurred by the entity to be utilised directly by the partners (which is useful if maintaining COT or SBT is likely to prove problematic in the future). The "cost" of this is the joint and several liability of the partners and the lack of flexibility (a change in the partnership terminates the old partnership).

These types of "fiscally transparent" vehicles may offer advantages to non-resident investors or tax-exempt investors who may not wish to pay corporate tax at 30% (or 27.5%) in Australia. However, unit trusts are generally an unfamiliar vehicle in a number of foreign jurisdictions – notably the US and in Asia.

3.1.1 Separating IP from the operating business

The first question usually to be asked by clients is whether IP should be owned in a separate entity to the operating business (to the extent there is one). Clearly for asset protection reasons this is preferable as it is a good idea not expose to key IP assets to claims or liabilities arising out of trading operations. However, housing IP in a separate company has an immediate compliance and cost effect – two companies instead of one, and the need to put in place legal arrangements governing both entities and how they deal with each other. For example, if IP is to be housed in a separate entity how is that entity to funded? Does there need to be a licence put in place between the two entities and on what terms?

The separate IP-owning entity can be established as a stand-alone entity with ownership different to the trading entity, or it could be established as a wholly-owned subsidiary. A separate entity may be preferable if the benefit of the IP is to accrue to a different set of shareholders than the trading operations. Founding owners may prefer this, however it can mean restructuring is necessary in the future if capital is to be raised (or the business is to be sold) and the new investors see the IP assets as fundamental to the value of the business. It also makes using employee share schemes difficult as they will usually be employed by the operating entity however the value may sit with the IP entity – there is not much incentive in being awarded shares in a company that doesn't have any value!!

To the extent it is a subsidiary of the trading entity then the asset protection benefits are destroyed as the shares in the IP company will be exposed to any claims or liability of the parent company.

Accordingly, this usually leads to a structure whereby an operating company and an IP company are incorporated as wholly owned subsidiaries of a single head company.

Likewise, it should be recognised that the security arrangements entered into with financiers can undo some of the benefits. A lender may require a personal guarantee from a founder or director. A lender may want to cross-collateralise the obligations of the actual borrower with other entities within the group, particularly if those other entities hold valuable assets which are required as security. A lender may take a floating charge over all assets of the head company which will include the shares in the IP company.

3.1.2 Consolidation

The formation of a tax consolidated group (and a GST Group) can ease the administrative burden of having three companies in a group but it also means that professional advice will be required. A valid tax sharing agreement will need to be in place to avoid joint and several liability of the members for the group tax liability (again to ensure the asset protection advantages of housing IP in a separate company are maintained).

The main benefits of this structure is that the resulting single 'taxpayer' (the consolidated group):

- has all income, losses and deductions of each group member treated as belonging to the one taxpaying entity;
- has any transactions between members of the group treated as internal activities between divisions of the one taxpayer, and ignored for tax purposes;
- can lodge a single tax return on behalf of the whole group, with any PAYG instalments also administered by the head company;
- can transfer assets from one business to another without any income tax consequences; and
- may be entitled to increased depreciation deductions once the entities consolidate, since the tax values of some assets are amended when an entity joins a group.

Without consolidation, each business would be taxed as a separate entity, and intra-group transactions (i.e. the licensing of IP from the IP company to the operations company) and debt and equity movements attract a tax consequence.

A tax consolidated group is not a cure all – a tax consolidated group is a tax fiction. Proper legal arrangements between the entities still need to be put in place to protect the IP in a legal sense – particularly in terms of licencing and funding.

3.2 Business partners and other investors

The main legal tools used to govern the relationship between co-owners of IP will depend upon the type of entity being used to hold the IP:

- *Companies* – the constitution and a shareholders agreement

- *Unit trusts* – the trust deed and a unitholders agreement
- *Discretionary trusts* – the trust deed
- *Partnerships/JV* – a partnership or JV agreement

These agreements usually provide a number of important mechanisms that can be relied upon to protect the control over assets in the entity:

- pre-emptive rights;
- composition and control of the board;
- restrictions on transfer;
- “tags” and “drags”; and
- insolvency events/events of default.

One of the difficult issues that can be encountered is dealing with founders who have either exited the business and who still hold shares, or founders who are still with the business but have not performed or contributed in line with original expectations. In such cases it may be undesirable for such persons to continue to hold shares (or as many shares) in the company. There are a number of mechanisms I have seen that seek to deal with this ranging from provisions in the constitution allowing for shares to be cancelled to “blossoming” or “flowering” share schemes which seek to convert restricted classes of shares to ordinary shares upon the attainment of certain KPIs or events.

There is a separate paper on employee incentive arrangements, but briefly the ‘blossoming’ is a form of vesting and the terms can be drafted so as to reflect the economic arrangement between the founders. For example, the number of ordinary shares which each founder holds following a trigger event can be adjusted (in a formula) to take into account variables. For example, the number of ordinary shares could be greater in circumstances where one of the other founders does not satisfy the relevant hurdle.

Some of the more important tax considerations under these arrangements are as follows:

- *Value shifting* - the shares may be significantly more valuable on the occurrence of the ‘trigger event’, the direct value shifting provisions require consideration. For example, the variation may result in a decrease in the market value of the existing ordinary shares and the decrease may be ‘reasonably attributable’ to the increase in the market value of the ‘flowered’ shares.
- *Conversion* - CGT event C2 happens if the ownership of an intangible asset ends by the asset, if it is a “convertible interest”, being converted. The conversion mechanism could occur by the converting share first being split to the required number, and then the rights of the converting share being varied so that the rights attaching to the converting share will, at the time of conversion, be equivalent to the rights attaching to the ordinary shares. It could then be argued that the conversion does not take place by way of a cancellation, buy-back or redemption.
- *Ordinary income* - to the extent that the blossoming shares are held by an employee (or an associate of an employee) and any increase in value of the flowered share is linked to the employee’s personal exertion (e.g. minimum term of employment or performance hurdles), then

it could be argued that the enlargement of the rights on the ‘trigger event’ may represent ordinary income in the hands of the employee (e.g. by virtue of section 21A as a ‘non-cash business benefit’).

3.3 Employees

The key to protecting IP from employees starts with ensuring appropriately drafted IP clauses are included in employment agreements (or contracting agreements).

When employees create original works as part of their job the copyright will usually belong to the employer. However, it is best practice to include specific clauses regarding IP and confidentiality in their employment agreements. Similarly, if contractors are engaged in a business, their contract should clearly outline how copyright or IP is to be dealt with, and if necessary, assigned to the business immediately upon creation.

There is also the issue of remunerating employees if a business is considering using shares or options as an alternative to cash. Consideration must be given to whether or not it is a good idea for employees to hold shares or options in an entity which holds the IP and what protections can be put in place if they will hold such shares or options. There are a range of employee remuneration trust schemes that are (rightly) subject to a very high level of ATO scrutiny (and a draft ruling) but that can be used to “warehouse” and control interests in the company. Alternately different classes of shares or trading restrictions and buy back rights can be used to protect the company and the other shareholders, particularly in the case of “bad leavers”.

4 How do you optimise your structure for both IP protection and retaining access to any concessions, grants or incentives that may be available?

All the best planning in the world does not avoid a need to understand the interaction of business planning with the structure of the various grants and incentive schemes available. Often these funding schemes will have certain requirements that will necessitate a certain structure.

In general, a grant or subsidy received in the ordinary course of business will be treated as ordinary taxable income. At a policy level this is less than ideal because 30% of any grant received (particularly from a state) is passed back to the federal government in the form of tax. The timing issues, explored later in this paper, means there may not always be sufficient deductions available to offset any grant income.

Annexure A to this paper sets out a summary of most of the relevant Federal and State incentive schemes that may be worth considering.

This section will explore two examples, based on real examples, of when the optimal structure for legal and tax reasons may not be suitable if a specific grant or incentive is being sought. The two examples are:

- Early stage innovation companies (**ESICs**)
- Co-operative research centre projects (**CRCPs**)

Choosing the right structure which provides the optimal tax outcome, legal protections and also ensures that your business is eligible for the necessary grants and incentives is the nirvana for planning and “protecting the recipe”. Unfortunately, it is often impossible to tell until sometime into the lifecycle of a business the exact direction it may be going or to predict opportunities that will arise.

There is no substitute for obtaining a thorough understanding of the terms and conditions of any grants and incentives that are important and seeking specialist advice at an early stage where practicable.

4.1 ESICs – The Holding Company Issue

It is now over 2 years since the tax incentives for ESICs in Division 360 of the ITAA 1997 were introduced. In that time, we understand that around 100 private rulings have been issued by the Commissioner, with at least 8 companies receiving unfavourable rulings and failing to qualify as ESICs. However, many more applications have been withdrawn by applicants for various reasons, including the Commissioner's refusal to rule.

This might lead one to ask whether the rules are operating as intended or whether the level of uncertainty in how these provisions are meant to apply have led many astray. One of the nuanced issues that I have found to be a significant roadblock for companies aiming to qualify as ESICs is how the rules apply to group company structures. The issue has also been recognised by the Commissioner of Taxation in his discussion paper entitled *'Do the early stage innovation tests need to be satisfied by the company that issues shares to investors'* (Policy Paper).

The background and explanation of the ESIC rules has been well-covered elsewhere and it is not necessary for present purpose to delve into the operation of the rules to highlight the issue I want to bring attention to.

Broadly speaking, the incentives will be available for investments where the company is both:

- *'early stage'*, determined against criteria related to expenditure, assessable income, stock exchange listing and incorporation; and
- *'innovative'*, determined by allowing the company to self-assess against either a principles-based test or a points-based gateway test, or by receiving a ruling from the ATO.

The principles based test requires that (emphasis added):

- ***the company*** is genuinely focussed on developing for commercialisation one or more new, or significantly improved, products, processes, services or marketing or organisational methods; and
- the business relating to those products, processes, services or methods has a high growth potential; and
- ***the company*** can demonstrate that it has the potential to be able to successfully scale that business; and
- ***the company*** can demonstrate that it has the potential to be able to address a broader than local market, including global markets, through that business; and
- ***the company*** can demonstrate that it has the potential to be able to have competitive advantages for that business.

4.1.1 What's the issue?

For an investor to receive the benefits afforded to it under the ESIC regime it is clear on the face of the provision that the company issuing the shares to the investor must also be the company that meets the above criteria.

It is also apparent that in each of the abovementioned tests, the focal entity is 'the company'. In other words, the company that is seeking to qualify as an ESIC must, arguably, be the company that is actually carrying on the innovative activities (or holding the relevant rights). Whilst somewhat controversial, this is certainly the Commissioner's current view (see below).

If correct, then any holding company structure is likely to fall foul of the rules. This is because in a group structure, the relevant entities that hold assets and carry on activities are generally the subsidiaries and not the company in which investors will acquire shares (ie the head company).

Choosing the right operating entity and holding structure of course involves striking a fine balance between several factors which are outlined further below - including asset protection, tax minimisation, control, setup cost, compliance costs, access to capital, employee ownership, suitability for offshore expansion and loss preservation.

However, for businesses of the kind that these provisions are targeting, for the reasons set out above one might expect to see in many situations a multitier holding structure. This ensures that any valuable intellectual property that is being developed is not exposed if the operating entity enters into insolvency.

The objective of the ESIC rules, as stated in the original policy discussion paper, 'Tax incentives for early stage investors', released in February 2016 (2016 Discussion Paper) was:

> … to encourage investment into Australian innovation companies (innovation companies) at earlier stages, where a concept has been developed, but the company may have difficulty accessing equity finance to assist with commercialisation.

The 2016 Discussion Paper did not indicate that the rules should be read down as applying to single company structures or your 'garage style' start-ups. In fact, these types of entities are unlikely to be at a stage where they are sophisticated enough to attract angel funding.

Instead, the proposed policy setting in the 2016 Discussion Paper was that smaller ventures could be targeted by including gateway provisions. These gateway provisions now find form in the 'early stage limb', which explicitly acknowledges that subsidiaries are to be taken into account when applying the monetary threshold tests in the 'early stage limb' (see subsections: 360-40 (1)(a)(ii), 360-40(1)(b), and 360-40(1)(c)). These subsections allow for the ESIC to have a layered structure with 100% owned subsidiaries. However, the legislation never envisaged the ESIC, itself, being a 100% owned subsidiary. Changes to recognise that the ESIC may be the holding company and not a wholly owned subsidiary are necessary if the legislation is to work as intended.

4.1.2 The ATO view?

Shortly after the introduction of the ESIC rules, the ATO created a discussion page on its Let's Talk website. In March 2017, a number of discussion papers were released, including the Policy Paper, in which the Commissioner expressed the following view in "*ESIC company level tests*" paper:

> [principle-based innovation test] … It seems to us that subparagraph 360-40(1)(e)(ii) applies to the same 'company' referred to in the other four elements of subsection 360-40(1) but, employing a broader term, also encompasses those activities which it directs other entities to conduct.
>
> All of the items in the 100 point innovation test make reference to 'the company'. When section 360-45 is read with paragraph 360-40(1)(e), it is apparent that these references are to the same company that met the requirements in the other four paragraphs in subsection 360-40(1) … the actions of a 100% subsidiary may assist a potential ESIC in satisfying the innovation limb where they are performed for or on behalf of the potential ESIC. Whether this is so will depend on the facts in each case. The actions of a 100% subsidiary are not for or on behalf of a potential ESIC merely because the potential ESIC stands to benefit from them by virtue of its share ownership.
>
> … the single entity rule [section 701-1] only has effect for head company and entity core purposes [which] do not include determining the income tax consequences for an investor under Subdivision 360-A.

Whether the 'the actions of a 100% subsidiary are being performed for or on behalf of the potential ESIC' will depend on the facts in each case. However, in our experience, the Commissioner would be unlikely to accept that a simple holding structure without any other contractual arrangement in place would satisfy this requirement. We also understand that the Commissioner is choosing not to rule on the matter.

This has left many potential ESICs to either self-assess their position or simply give up. This outcome is a far from ideal.

4.1.3 Legislative changes - has the issue been resolved?

In February this year, the Government introduced the *Treasury Laws Amendment (2018 Measures No 2) Bill 2018* into Parliament. The Bill included a number of measures in relation to ESICs that are largely integrity focused. The Bill also introduces a new requirement that an ESIC must be an Australian resident.

A new note to section 360-40(1) provided:

> For the purposes of paragraph (e), one way a company can demonstrate something is by engaging the services of another entity.

The Explanatory Memorandum provides further colour to the above (at paragraph 2.54):

> Under paragraph 360-40(1)(e), to be an early stage innovation company, a company has to engage in certain activities or hold certain interests. The amendment includes a note to clarify that, under the general principles of agency, this can include the company engaging other entities to hold these things or perform activities for it, or on its behalf.

It would seem that the new note is intended to deal with the Commissioner's position in the Policy Paper, but it is questionable whether it will operate as expected. In the context of a corporate group, it is unlikely that any internal group services (or rights held) by a subsidiary are 'for or on behalf of a head company' and generally speaking a subsidiary would not be viewed as an agent of its parent. Such a position would be inconsistent with the separate entity principle. The more likely scenario is where the company engages a third party service provider, but this is of little assistance in the context of a corporate group where intellectual property is held by one subsidiary and operations are performed by another.

Some commentators have suggested that a company can undertake a restructuring, potentially under the small business restructure rules in Division 328G, to fall within the relevant requirements. Any such manipulation of the tests needs to be carefully considered in light of the potential application of the general anti-avoidance rules in Pt IVA of the ITAA 1936.

4.2 Co-operative research centre projects (CRCPs)

One of the best examples of the complexities and competing drivers that can exist in a structuring sense is the CRCP program. This program, administered by Innovation and Science Australia and its “CRC Advisory Committee”, is designed to support industry-led collaborations between industry, researchers and the community. It aims to link researchers (predominantly universities) with industry to focus on research and development towards use and commercialisation. In particular it aims to:

- improve the competitiveness, productivity and sustainability of Australian industries, especially where Australia has a competitive strength and in line with government priorities

- foster high quality research to solve industry-identified problems through industry-led and outcome-focused collaborative research partnerships between industry entities and research organisations
- encourage and facilitate small and medium enterprise (SME) participation in collaborative research.

My actual experience is that the conditions and eligibility requirements are such that there is, at the end of the day, very little encouragement to SMEs to participate. I have had clients who have unsuccessfully tried to navigate the program without seeking expensive legal advice.

The overarching CRC Program offers support to industry, research and the community through two elements:

- *Cooperative Research Centres (CRC) grants* – to support medium to long term industry-led collaborative research, up to 10 years.
- *Cooperative Research Centres Projects (CRC-P) grants* – to support short term, industry-led collaborative research, up to 3 years.

More details on the program can be found in Annexure A, but for the purposes of this section of the paper I have simply summarised some of the issues that I have experienced in terms of trying to adapt an existing structure so as to fit within the requirements of the program.

4.2.1 Potential issues

One of the key requirement is for the lead participant under a CRC-P project to receive the project contributions (either the CRC-P grant or the participants' cash contributions). This means the early identification of the correct entity as the applicant is important. It is incredibly difficult down the track to change entities or applicants should, for example, a new jointly owned entity be desired as the vehicle which receives the contributions. The "project" has to be run by the applicant which can create issues with control and managing the other parties.

Managing the ownership and use of IP rights belonging to other parties in the venture/partnership can be difficult. The ownership rights to any IP developed under the project needs to be carefully considered along with which of the parties has the commercialisation rights. How to divide up the spoils effectively. If one of the parties, generally the applicant and funding entity is required to actually manage the project then there may need to be management fees paid. Again the funding of these fees can be contentious.

A number of legal agreements will be required, for example:

- *A Funding Agreement* – this will include standard terms and conditions and schedules which address specific activities and funding.
- *A Participant Agreement* - all Participants in a CRC must contribute resources to the CRC. The total of these resources including cash and in-kind, tied and untied, must at least match the amount of funding sought from the Program over the funding period

- *A Licensing Agreement* – this will govern the use of any pre-existing IP that is “contributed” by any of the parties and will set out the relevant terms and conditions.

The interaction of the CRC and CRC-P program and the R&D regime is complex. There are specific rules in the R&D provisions which delineate between the government funding piece (as opposed to industry party’s own funding contributions) that exclude contributions from being eligible for the R&D notional deduction (see section 355-380 of the ITAA 1997). A careful examination of which entities are entitled to notional deductions can impact on which entity should be the lead applicant, and the agreements noted above need to provide for the correct flow on IP rights resulting from the R&D being conducted.

5 What are some of the tax issues associated with IP that you need to be aware of during the lifecycle of a business?

This section of the paper will explore the taxation consequences of several key events that may happen to intellectual property over its lifetime.

5.1 Costs incurred in creating or developing intellectual property

In the first instance it is necessary to characterise the nature of the expenses and to determine the correct tax treatment of that expenditure by reference to the following facts and circumstances:

- The purpose of the expenditure and the benefits to the business of the expenditure?
- Does the outcome of the expenditure have an expected enduring benefit to the business?
- Does the outcome of the activities and expenditure result in some intellectual property rights?
- Is it anticipated that the expenditure will create future economic benefits for the business?

5.1.1 Capital v revenue

The character of any item of expenditure relating to IP is must be first considered in the context of section 8-1 ITAA 1997. The distinction expenditure of a capital or revenue nature is well known and the decisions in *Colonial Mutual Life Assurance Society Ltd v FCT* (1953) 89 CLR 428 and *Sun Newspapers Ltd & Associated Newspapers Ltd v FCT* (1938) 61 CLR 337 remain instructive in this regard.

The oft-cited passage of Dixon J from Sun Newspapers at 61 observes that:

> … the distinction between expenditure and outgoings on revenue account and on capital account corresponds with the distinction between the business entity, structure, or organization set up or established for the earning of profit and the process by which such an organization operates to obtain regular returns by means of regular outlay, the difference between the outlay and returns representing profit or loss.

This principles and the three central considerations outlined by Dixon J remain as relevant to expenditure connected with the development of IP as they do for any other expenditure. Namely that one must consider:

- the character of the advantage sought, and in this its lasting qualities may play a part;
- the manner which it is to be used, relied upon or enjoyed, and in this and under the former head recurrence may play its part
- the means adopted to obtain it; that is, by providing a periodical reward or outlay to cover its use or enjoyment for periods commensurate with the payment or by making a final provision or payment so as to secure future use or enjoyment."

With regard to the creation of IP, the key consideration is usually the distinction between the "profit yielding subject" and the "profit-making process".

Where the taxpayer's purpose is to innovate some new product, or to design a new process for a different business and in so doing the expenditure can be said to create a new IP asset, it is more likely the expenditure will be capital. Whereas if the new IP asset is an incidental product of the usual operating process then the expenditure in relation to the creation of IP is more likely to be revenue.

The decision in *Goodman Fielder Wattie Ltd v FCT* 91 ATC 4438 provides a useful example of the application of the principles from Sun Newspapers in an IP context. For example, Hill J states:

> "The judgment in the Sun Newspapers case makes it clear that it is necessary to consider carefully the nature of the business which is carried on, so as to be able to distinguish between recurrent expenditure, that is to say ``expenditure which is made to meet a continuous demand'' (per Rowlatt J in Ounsworth v Vickers Ltd [1915] 3 KB 267 at 273) and that expenditure which is made once and for all. A pharmaceutical company, the business of which includes continuing research and development as part of the continuous or constant demand for expenditure in its business, does not each time that expenditure is incurred make an outlay of capital or of a capital nature. Its business, when properly analysed, includes its research and development, at least in the ordinary case. No doubt, there are matters of degree involved, and in a particular case the research and development may be concentrated on a product so far removed from the day to day products of the taxpayer, that the expenditure cannot be properly seen as part of its working expenditure."

And relevantly:

> A company engaged in an enterprise involving new technology such as the applicant, where the nature of its activity requires as part of its business ongoing research into product development incurs expenditure which is recurrent, expenditure which is part of the regular cost of its trading operations. That expenditure is, to adopt the words of Dixon J in Sun Newspapers, part of the process by which the organisation (being an organisation where research is part of its business activity) operates to obtain regular returns by means of regular outlays.

The Commissioner has finalised a public ruling (TR 2016/3) in respect of the deductibility of expenditure on a commercial website. It contains some useful guidance on some of the principles summarised in this paper in the context of website development.

Generally speaking it is very difficult to get a revenue deduction for expenditure associated with the creation of IP and so a taxpayer must normally look to the R&D provision s(to the extent they apply) or to Division 40 for relief.

5.1.2 Blackhole expenditure

There is potentially some scope for section 40-880 to apply to expenditure connected with IP assets that are perhaps are neither a Div 40 depreciating asset nor a CGT asset. For example, it is generally accepted that information itself is not property and therefore not an asset.

In ATO ID 2009/3 the ATO considered the application of section 40-880 to the price paid to acquire a business of franchising and whether some part of the purchase price represented capital expenditure on acquiring confidential information, trade secrets and know-how. The Commissioner formed the view that section 40-880 could not apply on the basis that:

> The confidential information, trade secrets and know-how described in the sale contract refers to the ideas and concepts upon which the business format was developed. Those ideas and concepts are, in effect, embedded and preserved in the

> documents and other subject matter which give expression to the business format (they may also be reflected in patents and registered designs).

So it would seem that caution must be exercised when potentially using section 40-880 as a "provision of last resort" in the context of IP.

5.1.3 R&D Expenditure

A brief explanation of the R&D rules has been provided above and these rules are clearly relevant when a taxpayer is determining the tax treatment of expenditure incurred on IP.

Again, these rules will only be relevant to the extent a company is being used to develop IP.

5.2 Granting a licence and how do the terms of that licence impact the tax treatment?

If you grant or assign an interest in an item of intellectual property, you are treated as if you had stopped holding part of the item. You are also treated as if, just before you stop holding that part, you had split the original item of intellectual property into two parts, the part you stopped holding and the rest of the original item. You determine a first element of the cost for each part.

This treatment applies if a licence is granted over an item of intellectual property. To this extent, the treatment of intellectual property is different from other depreciating assets. The granting of a licence in respect of other depreciating assets would result in CGT event D1 (about creating contractual rights) happening.

5.2.1 Operation of Div 40 and CGT event K7

The 'balancing adjustment' rules will apply first in relation to any 'disposal' of IP that is a depreciating asset and the CGT rules (specifically CGT event K7) will only have residual application, for example, where the IP was used for used partially for non-taxable purposes. Additionally, it should be noted that CGT event K7 takes precedence over other CGT events that also amount to a balancing adjustment event in respect of a depreciating asset.

The licence of IP will generally trigger a balancing adjustment under Div 40 and CGT event K7 for due to the operation of section 40-115(3) of the ITAA 1997. The effect of a balancing adjustment is that it will include an amount in assessable income (of the grantor) to the extent that the 'termination value' (proceeds) exceeds its 'adjustable value' (which is the cost of the asset less its decline in value over time) – if a loss is made a deduction may be allowed.

The 'termination value' to be ascribed to the IP will reflect the amount being paid for the grant of the licence (where applicable). The amount paid in respect of the grant of the license should be distinguished from any ongoing licence fee.

It is important to note that the Div 40 market value substitution rule in item 6 of the table in s 40-300(2) may apply where there is at least one other party to the arrangement with whom the grantor did not deal at arm's length. Where the parties to the license are related there may be a risk that, in the absence of arm’s length terms, the parties could be viewed as not dealing with each other at arm’s length and a market value may be substituted for the termination value. In such circumstances a valuation would be required to determine the question of the value of the granting of the licences.

Additionally, any potential ‘non-cash benefit’ that may arise under item 4 in the table in s 40-305(1)(b) of the ITAA 1997, potentially for the right to receive the licence fee payments, should be nil because it should be correctly viewed as ordinary income and not as amounts received under item 4 in respect of the grant of the licences.

These provisions are relatively untested and there is a general lack of commentary or guidance on their application. I suspect in practice they are not often considered. The above views are supported by the Commissioner’s position in ATO Interpretative Decision ATO ID 2006/167 and Private Binding Ruling PBR 63585, which both involved a 50% licence fee for IP under a related party licence. In ATO ID 2006/167, the Commissioner relevantly decided:

> A balancing adjustment occurs upon company A entering into a licence agreement with company B. The licence permitted company A to exploit, in a foreign jurisdiction, the technology, patents and know-how owned by company B in an invention. Under the licence company A was obliged to pay 50% of the revenue it earned from exploiting all of the technology patents and know-how owned by company A in the foreign jurisdiction. The royalty is payable monthly in arrears and was negotiated at arm's length. Company A was not required to pay any amount either as prepaid royalties or as consideration for entering into the licence agreement.
>
> …
>
> Company A does not pay an amount for entering into the licence agreement, and the royalties do not contain any embedded capital amount. Therefore, whilst the right to the royalty is 'property' for the purposes of the definition of a 'non-cash benefit' as it relates to item 4 in the table in paragraph 40-305(1)(b) of the ITAA 1997, it is not property the taxpayer is taken to have received under section 40-305 of the ITAA 1997 for the asset.

5.2.2 Licencing to offshore parties

Granting licences to offshore parties gives rise to a number of further issues that should be considered:

- *Withholding taxes* – does the jurisdiction of the licensee impose withholding tax on royalty payments to an Australian licensor? If so what is the rate and is there a double tax treaty in place that might operate to reduce that rate? Will a foreign income tax offset be available in Australia in respect fo the withholding tax paid?
- *Transfer pricing* – to the extent that the parties are related or not dealing at arm’s length, what is the appropriate arm’s length royalty to be charging for the use of the IP?
- *Enforcement* - what is the level of comfort that any breach of the terms of the licence can be effectively enforced in the foreign jurisdiction? What should be the governing law applying to the licence agreement?

5.3 Depreciating assets – Division 40

To the extent that IP falls within the definition of a depreciating asset the capital cost of developing such assets can be written off and a deduction claimed pursuant to Division 40.

In the 2017 Budget the Federal Government announced changes to the way businesses depreciate intangible assets, a change that will deliver significant benefits for intangible assets acquired after 1 July 2016 (if it receives Royal Assent).

Under the existing rules taxpayers are required to depreciate qualifying intangible assets (such as patents, registered designs, software, etc) at a prescribed statutory rate, a rate that does not necessarily take into account the economic life of that asset. Examples include 20 years for a standard patent, 15 years for a registered design and 25 years for copyright.

5.3.1 Self-assessing effective lives

Draft legislation (which was introduced into the lower house of Federal Parliament in March 2017 and passed on 22 June 2017) will enable businesses to self-assess the tax effective life for intangibles acquired after 1 July 2016. This significant change to the current tax laws will deliver a cash flow advantage (through an increased tax expense) to businesses acquiring intangible assets, while also reducing the cost of investing in this type of asset. The draft legislation had not yet been passed by the Senate as at the time of the writing of this paper.

In the initial start-up phases of a business the tax shelter provided by such depreciation deductions will be limited to the assessable income, if any, being derived by the company. This may result in tax losses to be carried forward subject to satisfaction of the continuity of ownership test or the same business test – both of which can be challenging for start-up enterprises that will be seeking an injection of new capital and the nature of whose business may change as it matures.

It should also be remembered that to the extent that a company does generate profit that is "tax-sheltered", then to the extent that the profit is distributed by way of an unfranked dividend to shareholders then the value of any depreciation cover is effectively reversed.

5.3.2 Interaction with the R&D rules

IP - Acquired Assets

Division 40 sets out entitlement to deductions for certain types of capital expenditure. In particular, section 40-30 states:

> (1) A depreciating asset is an asset that has a limited *effective life and can reasonably be expected to decline in value over the time it is used, **except**:
>
> …
>
> > (c) an intangible asset, **unless** it is mentioned in subsection (2).
>
> (2) These intangible assets are depreciating assets if they are not *trading stock:

(c) items of *intellectual property;

However, to be entitled to a deduction for the cost of a depreciating asset during an income year section 40-25 sets out certain requirements. Subsection 40-25(2) provides that any deduction must be reduced to the extent that the asset is not used for a *taxable purpose*. Subsection 40-25(7) states that a *taxable purpose* is:

(a) the *purpose of producing assessable income; or

...

Note 2 to subsection 40-25(7) states:

When this Division notionally applies under section 355-310 (about depreciating assets used for R&D activities), the taxable purpose is sometimes only the purpose of conducting R&D activities.

It should be noted that entitlement to a notional deduction under paragraph 355-100(1)(b) only arises in relation to tangible depreciating assets. Therefore, any entitlement to a deduction for *acquired* IP will only arise upon satisfaction of the requirements of Division 40.

IP - Internally Generated Assets

R&D expenditure incurred by the Vendor in the **creation** of IP, for example a patent, will generally have been deducted under Division 355 (such as researcher salaries). Expenditure that has been notionally deducted (under Division 355) cannot be taken into account in working out a deduction under any other Division of the Act (see section 355-715).

Some expenditure associated with the generation of IP such as a patent is specifically excluded from being deducted under Division 355 (see paragraph 355-25(2)(e)). Expenditure that is specifically excluded from deduction under Division 355 will form part of the cost of such an asset for the purposes of Subdivision 40-C.

This means that internally generated assets which are IP (such as patents), will only be taken into account under Division 40 once they are held for a taxable purpose (see paragraph 40-25(7)(a)). Further, the tax cost of such assets will be limited to specific costs associated with the creation of the patent (such as registration costs, legal fees).

5.4 Sale of IP assets

5.4.1 Is the profit from the disposal of IP Assets ordinary income?

Going back to base principles, section 6-1 of the ITAA 1997 provides that an amount of assessable income received by a taxpayer will have its basis as either:

- ordinary income (section 6-5), or
- statutory income (section 6-10).

An amount which is ordinary income cannot also be statutory income, and vice versa (see, subsection 6-1(5)).

For the sale of IP assets to constitute ordinary income it would need to be *income according to ordinary concepts* (subsection 6-5(1)). The concept of what is income according to ordinary concepts is not free from difficulty, but generally it is expected that the receipt will have characteristics such as periodicity, recurrence and regularity (see, the Full High Court decision in *FC of T v Dixon* (1952) 86 CLR 540; 10 ATD 82). The notion of income according to ordinary concepts was arguably broadened by the High Court in *FC of T v The Myer Emporium Ltd* (1987) 163 CLR 199; 87 ATC 4363 (*Myer*), where a lump sum receipt from an isolated transaction was assessed as ordinary income (under subsection 25(1) of the ITAA 1936) as a profit resulting from a profit making scheme.

Prior to the decision in *Myer*, and the introduction of a comprehensive capital gains tax regime in Australia, the jurisprudence from both the United Kingdom and Australian courts in relation to the income tax consequences of dealings in 'know how' and IP was far from certain, and the Australian cases in particular, are reasonably limited in number. One of the key considerations was traditionally whether the vendor has parted with something or restricted its operation in some way, or whether it has merely exploited its know-how in the course of carrying on its business.

In *Case* W10, 89 ATC 182 an Australian company that dealt in the development of veterinary products developed an uncontaminated breeding stock of a particular species. In order to ensure the preservation of the stock from contamination or disease it entered into a contract with an international firm, which would also maintain this particular species in another jurisdiction. If either source became contaminated each could draw on the other to 'purify' their stock. The Australian company was paid a lump sum amount for the supply of its expertise and technical knowledge. The Commissioner assessed the taxpayer on the basis that the sum was ordinary income and as a royalty.

In upholding the Commissioner's assessment, the AAT considered the dicta of Lord Denning in *Evans Medical Supplies Ltd v Moriarty* (1957) 37 TC 540 (at 186), and found that the taxpayer did not come within the scope of the reasoning in *Evans Medical Supplies* and that the transaction - even though isolated - constituted assessable income according to ordinary concepts.

Conversely, in *Kwikspan Purlin System Pty Ltd v FC of T* 84 ATC 4282, the taxpayer (a company) owned a patented system. The taxpayer received lump sum payments for granting several companies the exclusive right to use the system in different parts of Australia.

The Queensland Supreme Court held that the taxpayer was not in the business of dealing in patents, and the lump sum payments were merely capital receipts resulting from the realisation of an asset.

As discussed previously, *Myer* determined that where the taxpayer is carrying on a business, and the circumstances give rise to an inference that the taxpayer's intention was to profit, the profit will be income even if the transaction was extraordinary judged by reference to the ordinary course of the taxpayer's business.

The fact that such a 'gain is made as the result of an isolated venture or a "one-off" transaction' does not preclude it from being properly characterised as income. If the Commissioner were to regard the profit which arises as a consequence of the disposal of the vendor's IP Assets as the result of a profit making undertaking or plan (in the form of the entire R&D project), paragraph 15-15(2)(b) of the ITAA 97 may operate to exclude any profit from that disposal being included in assessable income on that basis. However, as noted above, depending on the specific facts and circumstances it could be still be ordinary income. In my view this would be a rare outcome, but nevertheless one that should be considered.

5.4.2 Capital gains tax

Having determined that the profit from the sale of IP Assets is not ordinary income, the other basis for inclusion in assessable income is via specific statutory provision, that is, as statutory income.

The primary regime under which an amount received by a taxpayer will be included in their assessable income (i.e., statutory income) is the CGT regime set out in Chapter 3 of the ITAA 1997.

I have discussed the starting point for the application of the CGT provisions above, namely the identification of a CGT asset pursuant to section 108-5.

Subsection 100-20(1) of the ITAA 1997 stipulates that you only make a capital gain or loss if a CGT event happens. The disposal of IP Assets by a vendor (outside of a tax consolidated group) will trigger CGT event A1 as there will be a change in the legal and beneficial ownership of the IP Assets. The time the CGT Event happens will be the time when the contract to dispose of those assets is entered into (see paragraph 104-10(3)(a)).

Subsection 102-5(1) provides that your assessable income includes any net capital gain for the income year. Consequently, in the absence of any exception or exemption, the vendor will need to include the net capital gain from the disposal of its IP Assets.

The gain will be calculated by reference to the capital proceeds received in respect of the sale and the market value substitution rules may apply in a variety of circumstances, including where the sale of the IP is for consideration less than the market value and the parties are not acting at arm’s length.

5.4.3 Depreciating Assets

Ordinarily the sale of depreciating assets will constitute a balancing adjustment event and any resulting profit or loss included as income or a deduction in the taxpayer’s return. However, as noted above, there is an at-times difficult relationship between Division 40, the CGT rules and the R&D rules in Division 355. These difficulties can extend through to determining the treatment of any sale proceeds apportioned to IP.

Acquired IP Assets

Where the Vendor's activities in respect of acquired IP are not being carried out for an ordinary *taxable purpose* under Division 40 (they are not being carried out for the purpose of producing assessable income), nor do they satisfy section 355-305 (see, paragraph 355-305(1)(b)), any IP acquired by the Vendor which is disposed of will not give rise to a balancing adjustment event.

This means that the anti-overlap provision, subsection 118-24(1), has no application. Consequently, the disposal of acquired IP by Vendor would be taken into account via the general CGT provisions (CGT event A1).

Internally Generated Assets

Again, where the Vendor does not hold these assets for such a purpose, and they are *intangible* assets which are not eligible to have their cost notionally deducted under Division 355, the disposal of internally generated assets will be subject to the general CGT provisions. That is, the disposal of internally generated IP by the Vendor would be taken into account via the general CGT provisions (CGT event A1).

5.4.4 Disposal of R&D results

An often overlooked provision is section 355-410 of the ITAA 1997 that operates as an integrity provision to ensure statutory revenue treatment for amounts received by an R&D entity relating to the results of R&D activities. Importantly, this includes amounts received from the granting of rights to the results under a license.

The facts set out in ATO ID 2015/4 provide a useful example of how this provision can in practice provide what might be an unexpected outcome when a taxpayer receives a lump sum that on the face of it may seem to be capital in nature:

> The taxpayer is an R&D entity within the meaning of section 355-35 of the ITAA 1997. The taxpayer incurs R&D expenditure on various Innovation Projects and claims the tax offset under section 355-100 of the ITAA 1997. The taxpayer also undertakes Innovation Projects for which it is not entitled to any tax offset under section 355-100 of the ITAA 1997. The taxpayer owns the intellectual property (IP) developed or related to all of these Innovation Projects.
>
> Company A and the taxpayer enter into a Licence Agreement in respect of the taxpayers Innovation Project IP pursuant to which Coy A makes a buy-in payment of $1 million to the taxpayer. This payment is for the grant of an exclusive, perpetual, royalty free, fully paid up licence by the taxpayer to Company A allowing Company A to access the results of the taxpayer's Innovation Project activities and use and exploit the Innovation Project IP owned by the taxpayer and identified in a schedule to the Licence Agreement.
>
> The Innovation Project IP that is the subject Licence Agreement (as identified in a schedule to the Licence Agreement) includes those that were developed from the taxpayer's R&D activities for which a tax offset was claimed under section 355-100 of the ITAA 1997 and those developed from activities for which the taxpayer had no tax offset entitlement under that section.

Whether the IP in question is a depreciating asset or a CGT asset will potentially impact upon the outcome but the provision needs to be carefully considered. Section 355-410(b) includes as a “results amount”:

> An amount from *disposing of a CGT asset, or from granting a right to occupy or use a CGT asset, where the disposal or grant resulted in another person acquiring a right to access or use any of those results.

A clear example of the application of section 355-410 in a disposal context could be the disposal of IP assets under an asset purchase agreement where the assets in question were not also Division 40 assets.

The amount assessable is generally the amount received or receivable. However, where the amount is from disposing of a CGT asset that is a depreciating asset, or from granting a right to occupy or use such an asset, the assessable income amount is the amount received or receivable less the cost of the asset (just before the disposal or grant).

Where the amount is from disposing of a CGT asset that is not a depreciating asset, the amount assessable is the amount received or receivable less the cost base of the asset (just before the disposal or grant).

5.4.5 Anti-overlap provisions

There are a number of the anti-overlap provisions that could have application in determining how much (if any) capital gain is included in a vendor's assessable income. The relevant ones are:

- section 118-20 - Reducing capital gains if amount otherwise assessable;
- section 118-24 - Depreciating assets, and
- section 118-35 – R&D

Exemption - Section 118-20

Paragraph 118-20(1)(a) provides:

> (1) A *capital gain you make from a *CGT event is **reduced** if, because of the event, a provision of this Act (outside of this Part) includes an amount (for any income year) in:
>
> (a) your assessable income or *exempt income; …

The provision only provides for a reduction in the capital gain that is to be included in a taxpayer's assessable income. Therefore, the Vendor would still be required to include a capital gain in its assessable income if no other provision of the Act (outside of Part 3) included an amount in assessable income. Further, the provision also leaves open the operation of the CGT provisions if that other provision does not fully include that relevant amount in the Vendor's assessable income (for example of IP that is also a depreciating asset is not used wholly for income producing purposes).

Exemption - Section 118-24

Paragraph 118-24(a) provides:

> (1) A *capital gain or *capital loss you make from a *CGT event (that is also a *balancing adjustment event) that happens to a *depreciating asset is **disregarded** if the asset was:
>
> (a) an asset you *held; …

As discussed under the heading 'Depreciating Assets', this specific provision will not operate in relation to the disposal of any of the vendor's IP Assets which are either acquired depreciating assets, or internally generated depreciating assets.

Exemption - Section 118-35

Section 118-35 allows a taxpayer to disregard a capital gain or loss where the amount included is included in assessable income under section 355-410. The section provides:

> **Disregard** a *capital gain or *capital loss from a *CGT event if an amount is included in your assessable income in any income year under section 355-410 (about disposal of R&D results) because of that CGT event.

5.5 Offshoring IP

There are numerous tax implications that arise from any decision to transfer IP to an entity that is outside of Australia. There is generally no rollover that may apply in circumstances where IP is transferred for an Australian company to a “spin-of” company in another jurisdiction. Thus, to the extent that the IP has a market value greater than its cost, the tax implications outlined above for disposing of IP will apply.

There are number of issues that require consideration before a decision to offshore IP is made. These include:

- *Transfer pricing* – the sale of the IP any subsequent licence back to the vendor will need to have regard to these rules which generally require an arm’s length price to be charged.

- *Diverted profits tax & Pt IVA* – the DPT is only relevant to entities qualifying as significant global entities, but where it applies then care needs to be taken that the offshoring does not fall foul of these rules. In all circumstances Pt IVA must be considered and the commercial purposes for the offshoring properly considered and documented.

- *Foreign taxes and withholding taxes* – what foreign tax will be payable on royalty income derived by the offshore IP company? What withholding taxes will be payable in Australia on licence payments to the IP company? Will a foreign income tax credit be available in the foreign jurisdiction for any withholding tax and can it be utilised?

- *Funding the acquisition* – how will the foreign company pay for the acquisition of the IP? Will it be debt funded or equity funded? If it is debt then does the foreign jurisdiction have thin capitalisation rules that put a ceiling on interest deductions? What is the appropriate interest rate to be charged on any loan (having regard to the transfer pricing rules noted above) Do the debt/equity rules potentially apply?

- *Controlled Foreign Company rules* – these rules apply to bring to tax on an accruals basis passive income generated by Australian-controlled foreign companies holding non-active business assets. The use of IP assets to generate royalty income will generate be considered as “passive income”

- *Repatriation of profits* – will this be done by way of dividends and will those dividends be non-assessable non-exempt income pursuant to Subdivision 768-A or section 23AI (to the extent the CFC rules apply and the income has been previously attributed)? Will there be a management agreement, service agreement or some form of costs contribution agreement in place between the entities? Are payments made by the foreign company deductible? What withholding taxes will apply to dividends?

- *Franking credits* – what is the effective rate of tax for any profits ultimately repatriated to shareholders of the company? To the extent that dividends are paid by a foreign company they will not be franked and a shareholder will generally not get a foreign tax offset in respect of any income tax paid by the foreign company. Likewise any dividends paid to an Australian holding company (which will be NANE) and then paid out to Australian shareholders will be unfranked.

- *Sale of the offshore entity* – the participation exemption Subdivision 768-G of the 1997 Act applies only to the extent that the non-portfolio interests in the foreign subsidiary can be traced to active assets of that company. For the reasons outlined above, it is generally difficult to categorise IP as an active asset.

Finally, the comments above regarding goodwill and IP are particularly relevant when considering whether it is possible in a legal sense to transfer IP. In *FCT v Just Jeans Pty Ltd* 87 ATC 4373 held that unregistered trademarks and brands cannot be validly assigned except in conjunction with a transfer of the underlying business to which the goodwill attaches. The decision is arguably at odds with that in *Murry* but nevertheless caution should be exercised when identifying what IP is being offshored.