



Taxation Problems in the Commercialisation of Intellectual Property

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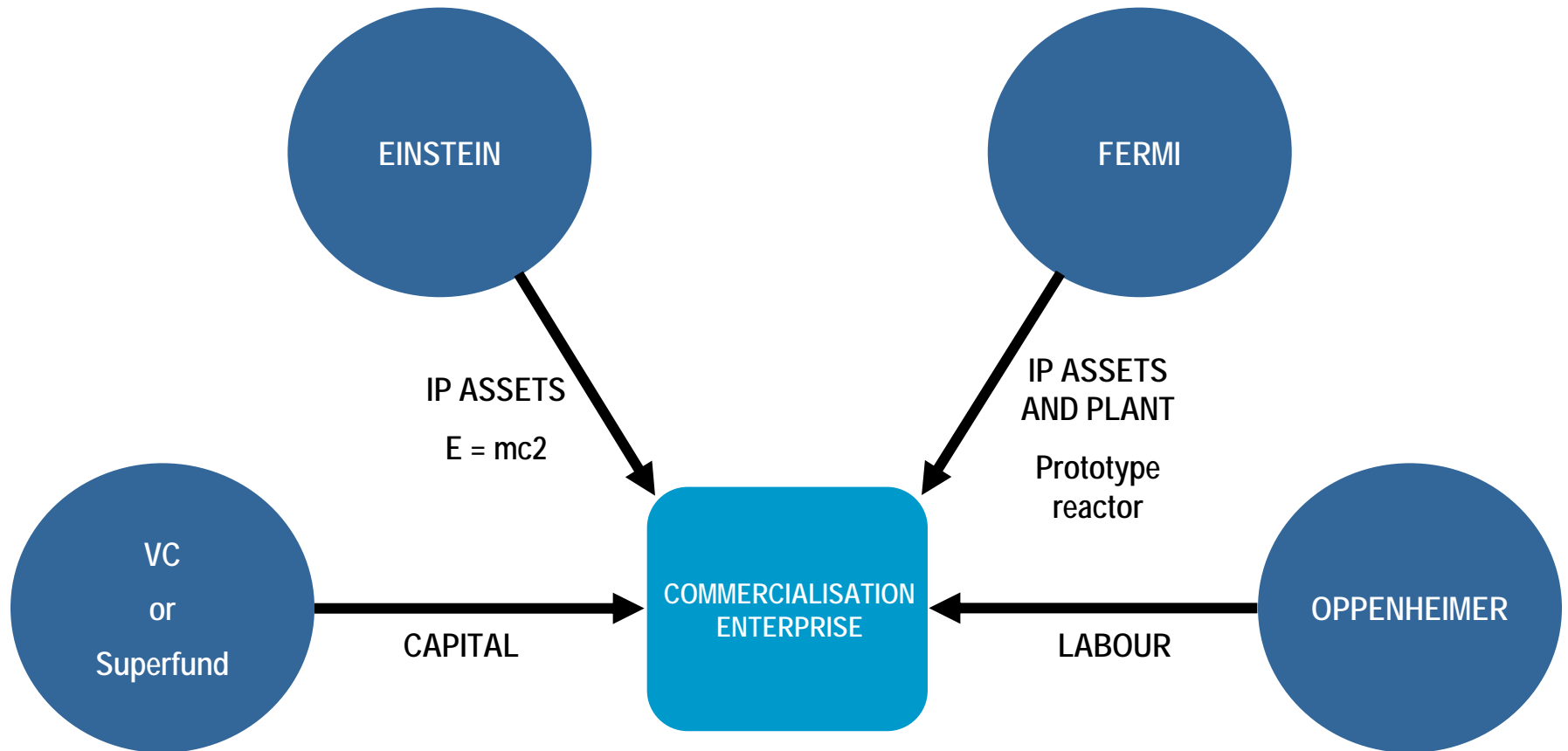
Intellectual Property Research Institute of Australia

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Report by Tax Group at Melbourne Law School

- ◆ Co-authors Lillian Hong, Ann O'Connell, Miranda Stewart and Michelle Herring
- ◆ Aims to identify tax problems which impede IP originators in combining to form an economic enterprise, and obtaining capital and labour, to commercialise IP



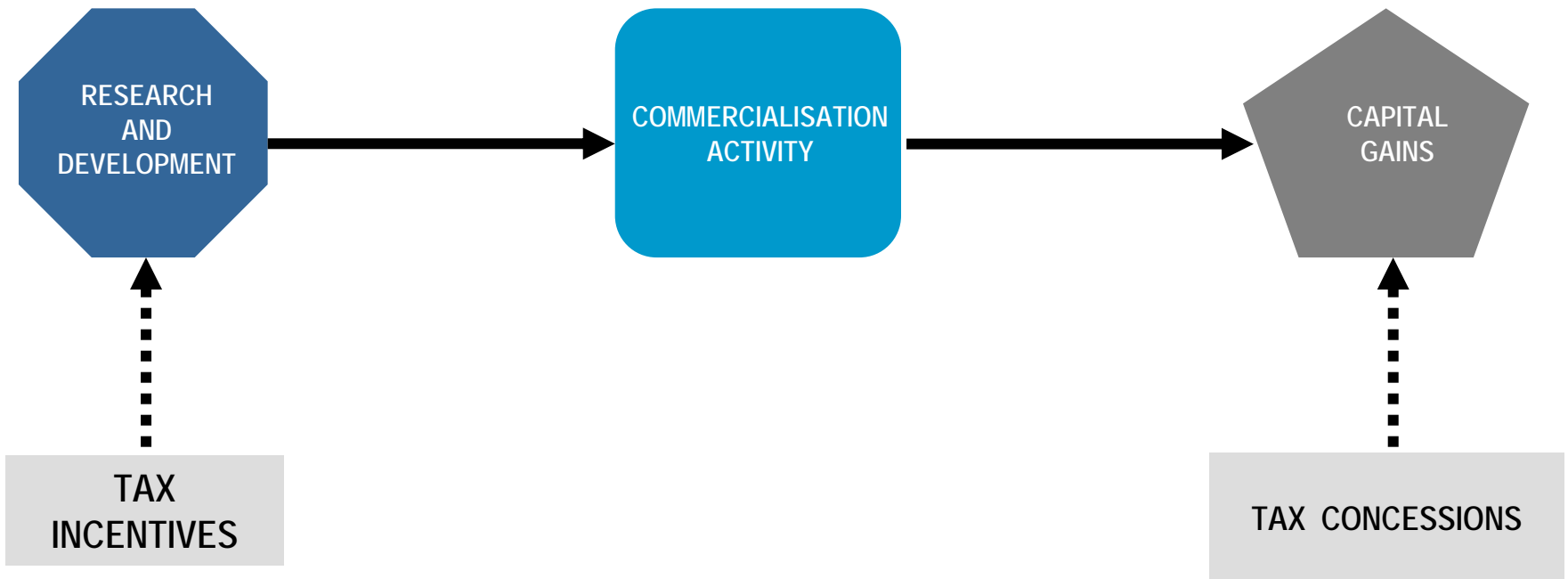


Tax assistance regime for IP

- ◆ Tax incentives for expenditure on *initial* R&D (125% deduction, etc)
- ◆ Concessional taxation of gains on *ultimate* success (CGT discount, PDF and venture capital exemptions)
- ◆ No tax assistance for *intermediate* phase of commercialisation activity itself

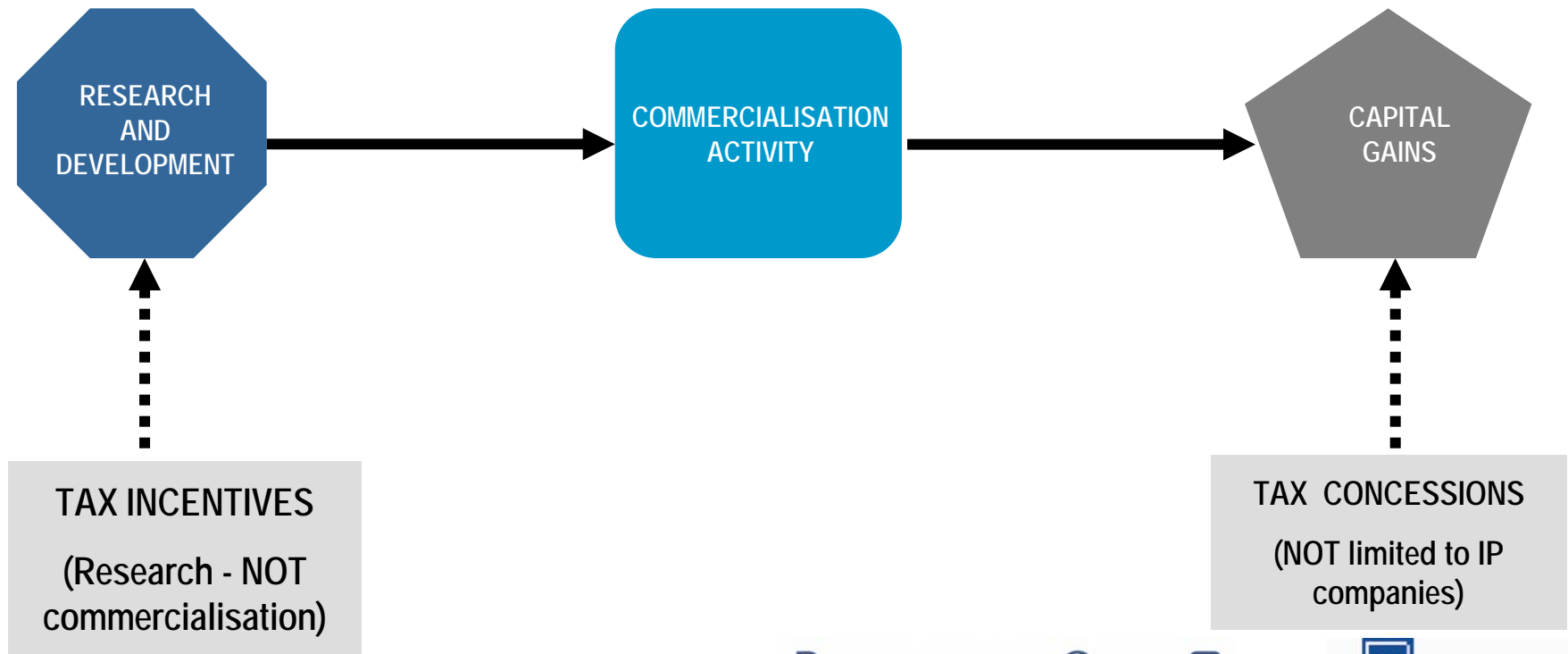


General scheme of tax assistance for IP development



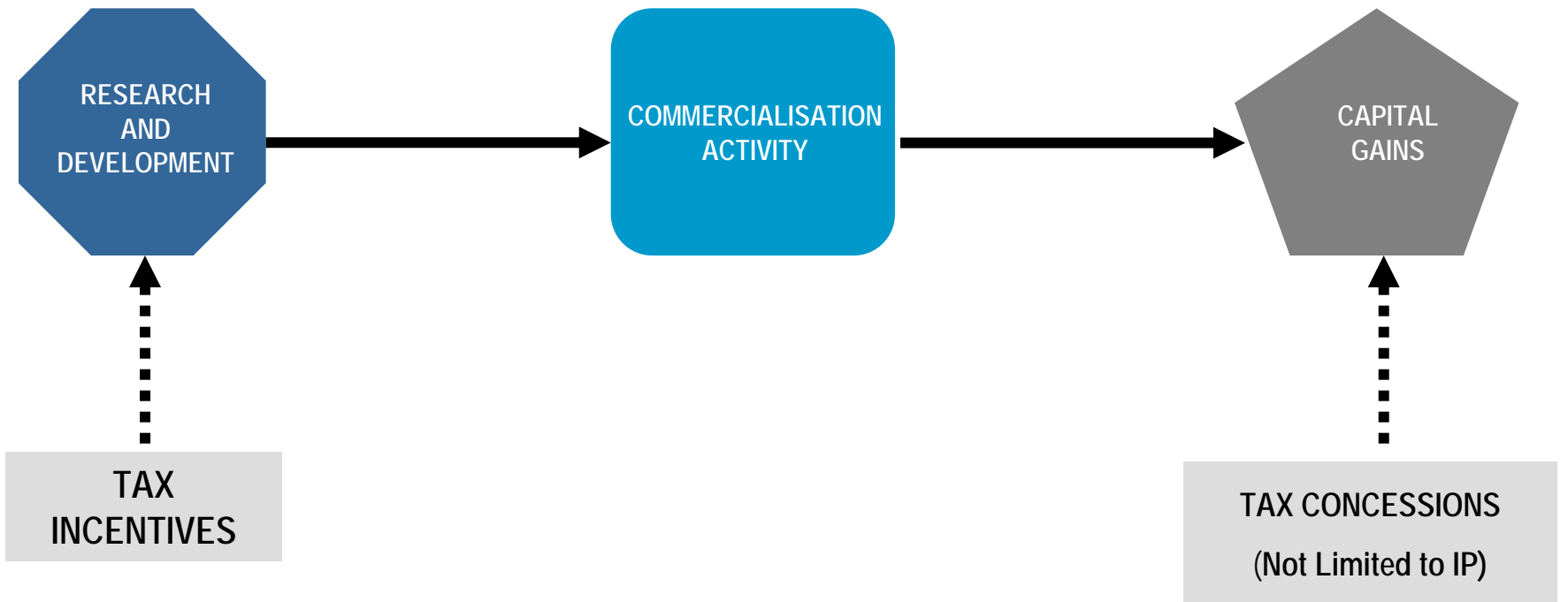


Only IP specific tax assistance is R&D concession
Focus on research, not commercial development
Concessions for gains not targeted at IP



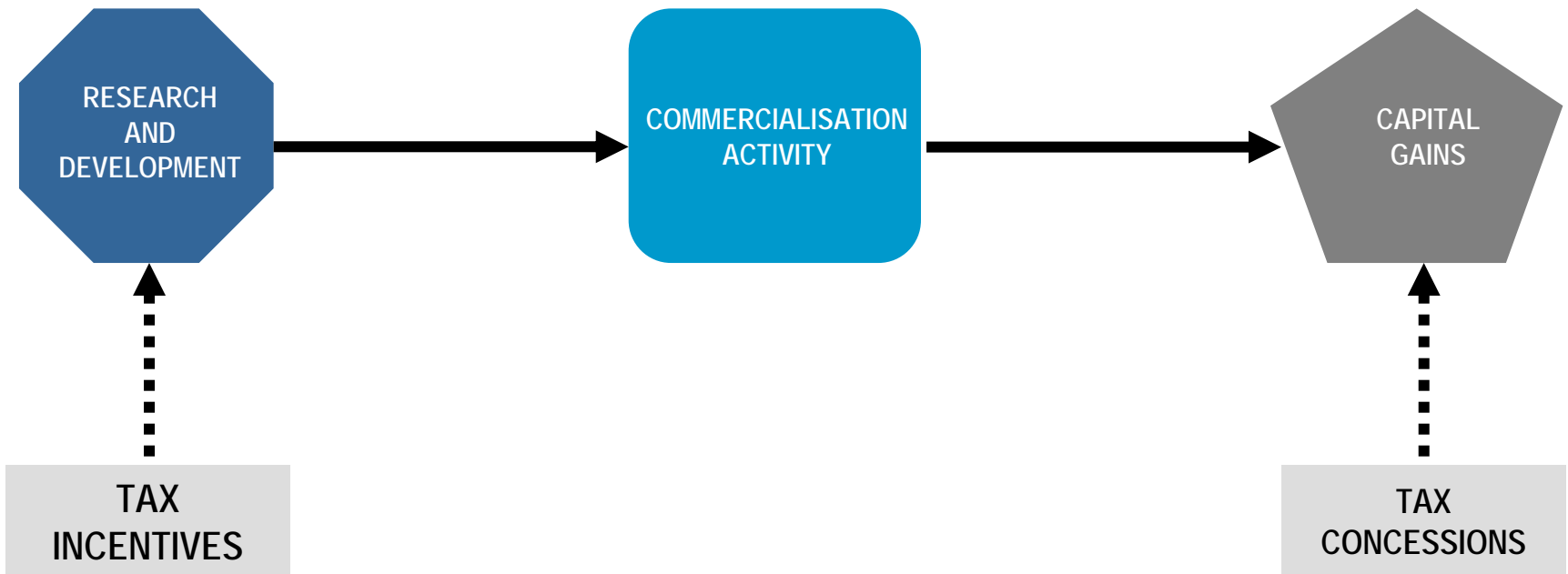


Rationale for R&D tax incentives is that high risk deters market from providing socially desirable levels of investment in IP



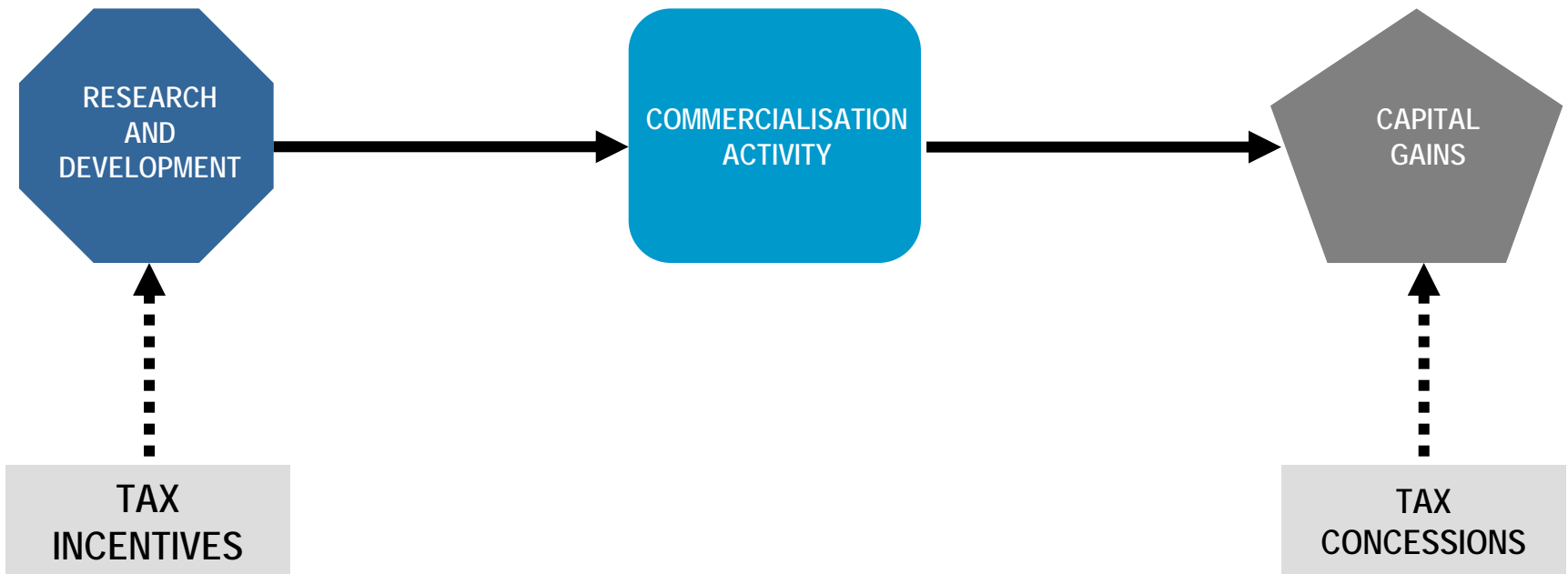


Same rationale would support tax assistance for actual IP commercialisation activity: subject to same high risk



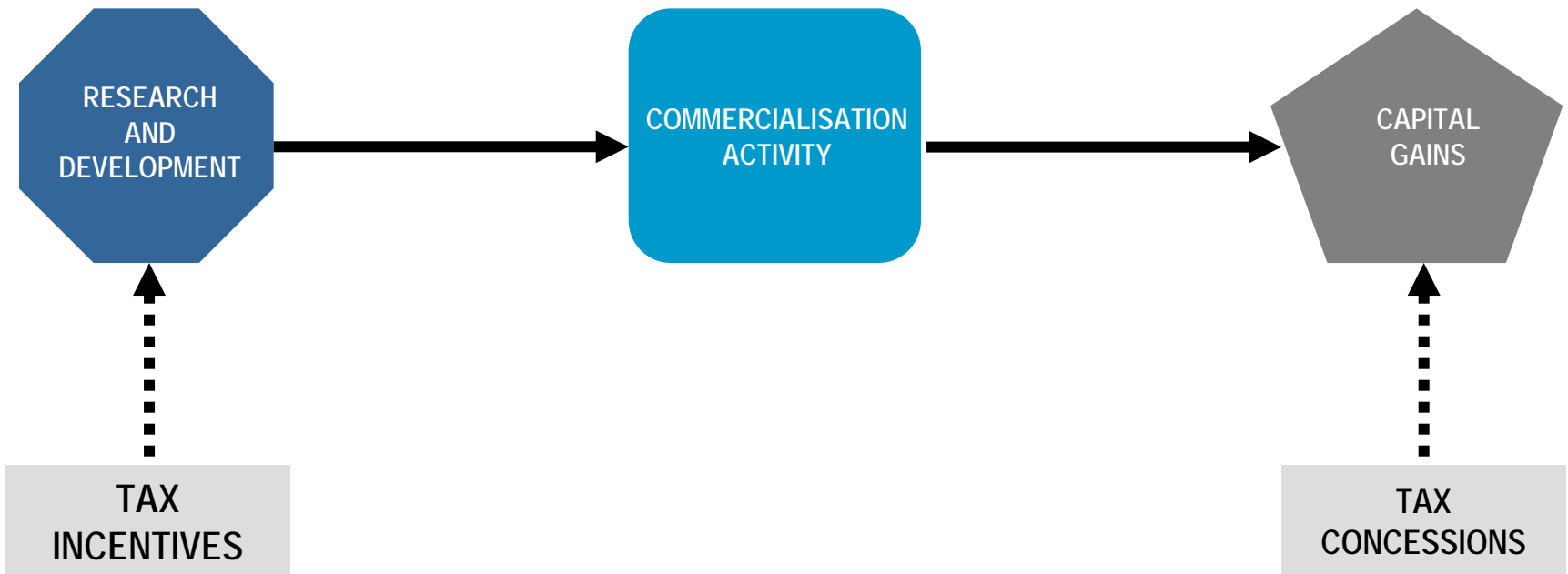


R&D incentives will be ineffective if interaction with ordinary tax law treatment of IP commercialisation is inefficient





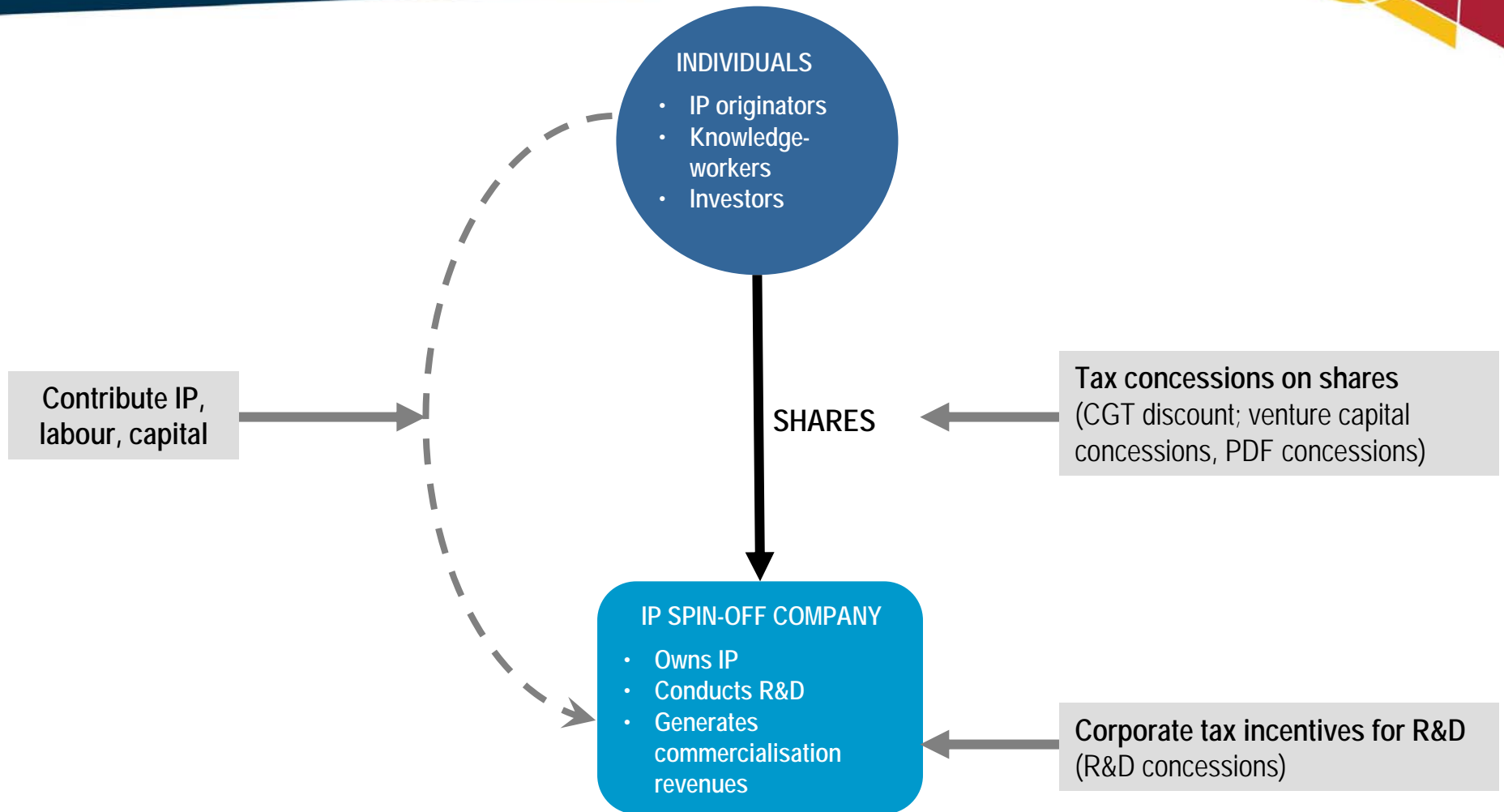
Important to ensure interaction of ordinary tax law with tax assistance regime permits efficient IP commercialisation activity





Tax concessions require companies

- ◆ **R&D concession** is limited to **companies** (not available to individuals, partnerships or trusts)
- ◆ **CGT discount** treatment does not apply to IP assets (patents, copyright, designs, know-how): but does apply to **shares in a company owning IP**
- ◆ **PDF** and **venture capital concessions** require equity capital to be invested in **companies**





Company is preferred commercially

- ◆ **Company** allows limited liability: also flexible and familiar form
- ◆ **Partnership** has unlimited joint and several liability: only partly mitigated if structure as **unincorporated joint venture**
- ◆ **Trust** allows limited liability (but unfamiliar form to overseas investors)



Company is least tax efficient commercialisation vehicle

- ◆ Taxed as an entity separate from its owners
- ◆ Contribution of IP assets to company is a taxable event
- ◆ Issue of employee shares is a taxable event
- ◆ Start-up losses are trapped in the company: no value to owners and investors
- ◆ Unfavorable outcomes for tax exempt investors



Contribution of assets

- ◆ Transfer of IP assets to company in exchange for shares **is prima facie taxable as a sale of the IP at market value**
- ◆ Rollover relief for individual transferring IP to wholly-owned company
- ◆ Rollover relief for partnership/trust transferring IP to wholly-owned company
- ◆ **No general rollover relief** for exchanging IP assets for shares in jointly owned company



Einstein
Fermi

Deemed to receive taxable
consideration equal to
market value of IP



ISSUE SHARES

CONTRIBUTE IP

Taxable disposal of IP

Taxing
unrealised
gains



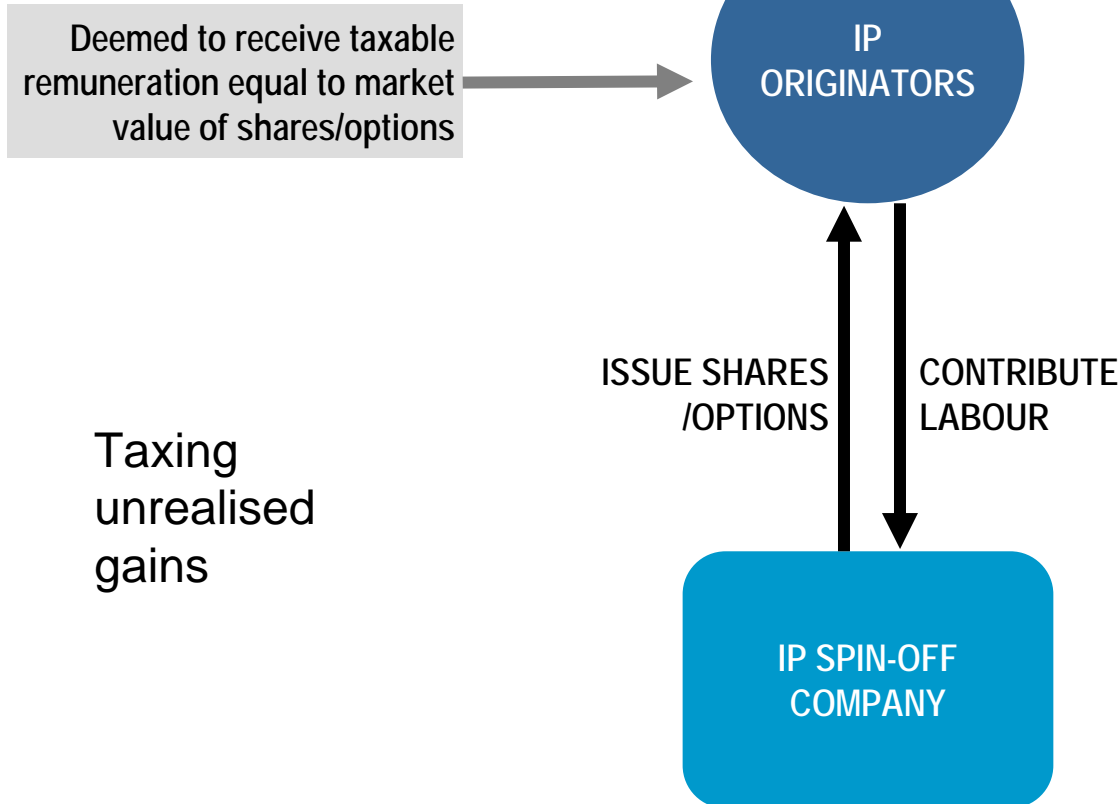


Problems with employee shares

- ◆ Employee shares critical for IP start-ups to counter cash-flow limitations
- ◆ Tax law treats shares as taxable salary
- ◆ Assumed to be equivalent to cash
- ◆ Division 13A concessions difficult to attract for start-ups: also expensive compliance costs and withhold benefit of CGT discount



Oppenheimer



Taxing unrealised gains



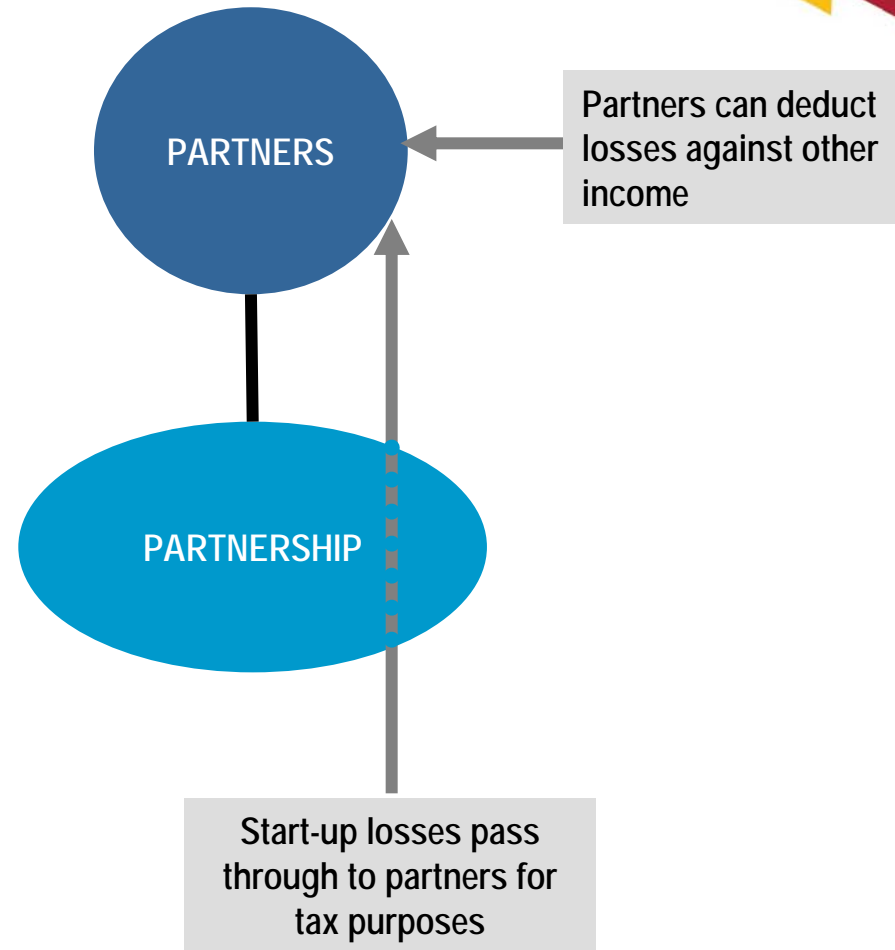
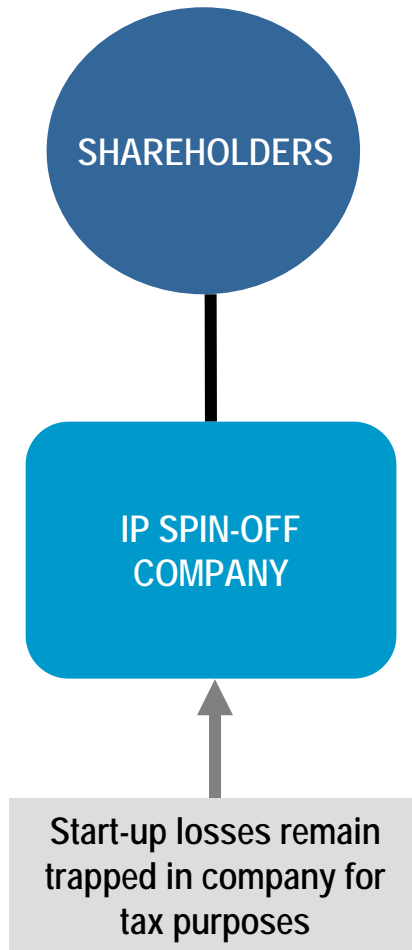
Start-up losses trapped in company

- ◆ Tax relief for start-up losses critical to IP investment evaluation decisions
- ◆ If use company, start-up losses are trapped – do not flow through to owners
- ◆ Can only use if company makes future profits (and subject to COT or SBT)
- ◆ Profits will then become taxable unfranked dividends on distribution



Partnership or unincorporated joint venture preferred vehicle for start-up losses

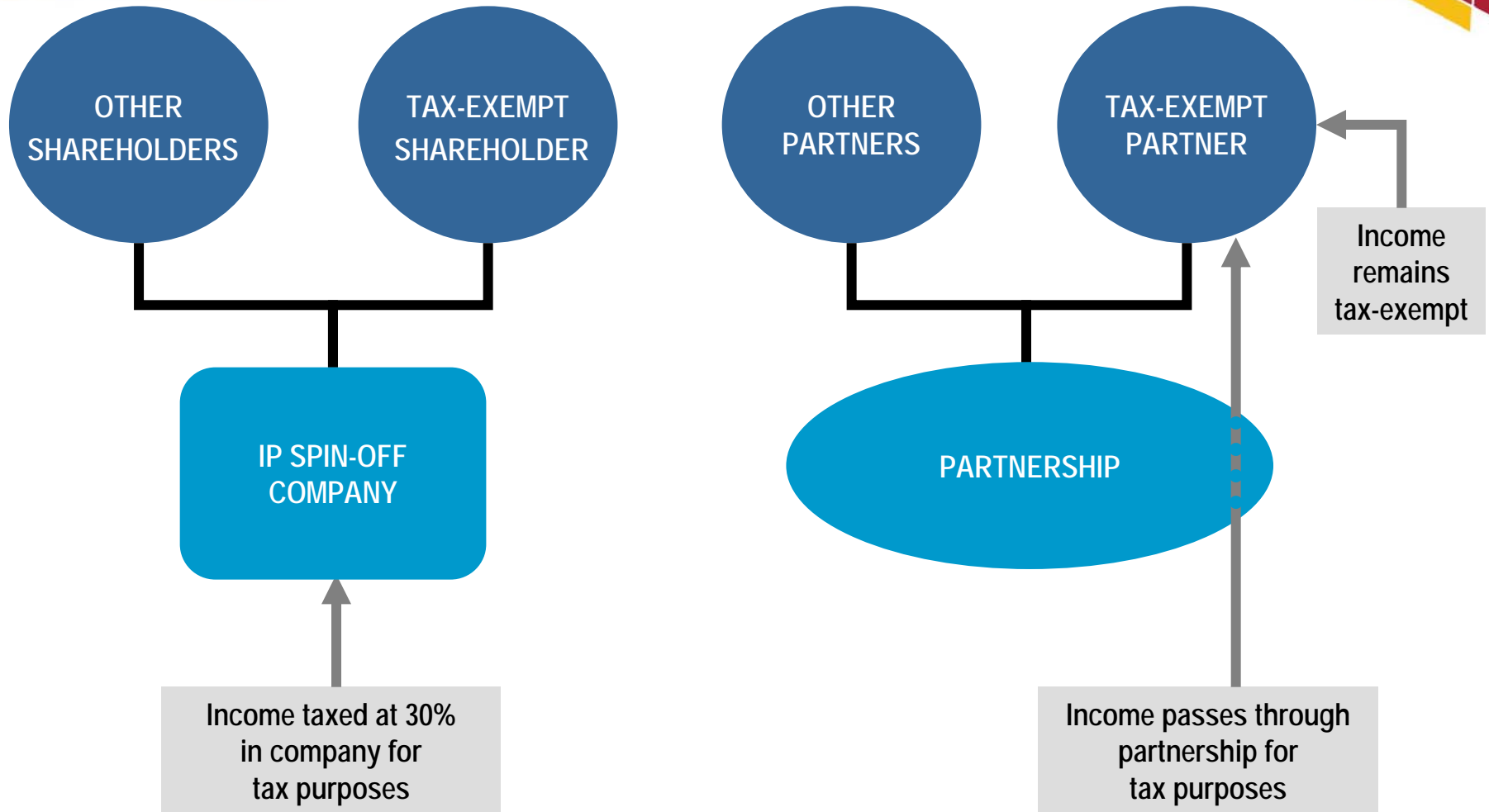
- ◆ Partnership allows losses to flow through immediately to owners
- ◆ Unincorporated joint venture has same effect
- ◆ More tax efficient for start-up enterprise





Tax-exempt investors

- ◆ Company form problematic when profits earned
- ◆ Profits taxable at company level
- ◆ So tax exempt status prima facie wasted
- ◆ Limited relief through imputation credit refunds
- ◆ Partnership or unincorporated joint venture preferred form





Limited tax relief for IP commercialisation expenses

- ◆ Can only write-off capital cost of patents, copyright and registered designs
- ◆ No write-off for capital cost of know-how, confidential information, trade secrets
- ◆ No write-off for capital cost of trade marks, brand names, goodwill



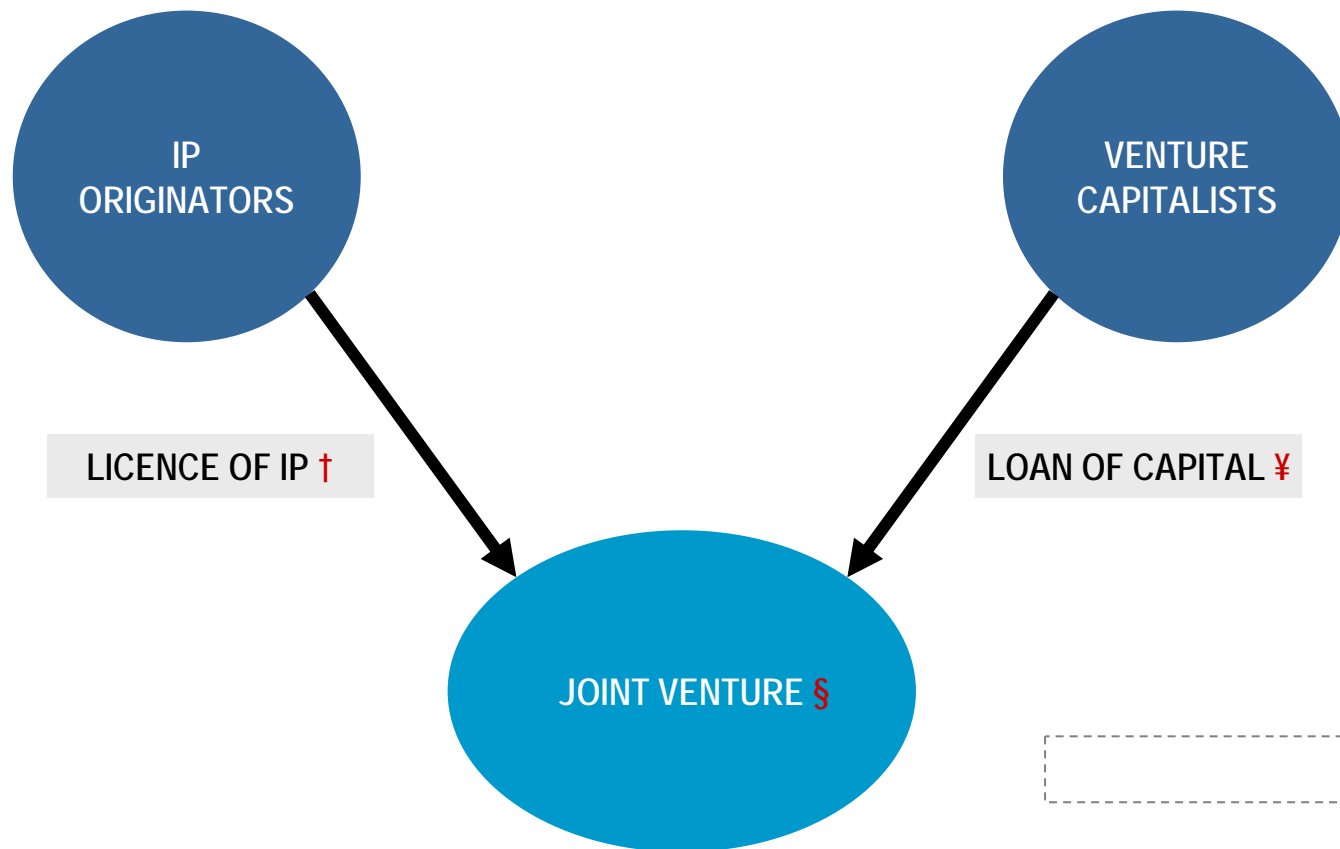
Do these tax problems matter?

- ◆ Increase effective tax rate on IP investment: divert capital to non IP investment
- ◆ Encourage relocation of commercial IP activity to more favourable overseas jurisdictions
- ◆ In turn encourage movement of initial R&D to those overseas jurisdictions
- ◆ Undermine R&D and CGT concessions



Solutions – Tax planning?

- ◆ Careful tax-planning can solve some problems on a case by case basis
- ◆ But involve compromises
- ◆ Subject to Part IVA risk
- ◆ Divert resources from IP development
- ◆ Discourage overseas investment





Solutions – tax reform

- ◆ Rollover relief for contribution of IP assets to company in exchange for shares
- ◆ Allow start-up companies to elect to be taxed as partnerships
- ◆ No tax on employee shares unless and until capital gains realised by sale of shares
- ◆ Comprehensive tax write off rules for all forms of IP and IP development expenses



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Available from IPRIA