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21 February 2006

Submission No. 98

Dr Alison Clegg
Inquiry Secretary
Standing Committee for Science and Innovation
House of Representatives
Parliament House
CANBERRA ACT 2600

Dear Dr Clegg,

Pathways to Technological Innovation Inquiry - Submission

The purpose of this submission is to comment on taxation aspects of the problem of technological innovation.

The submission draws on research for a report released in January 2006 by The Intellectual Property Research Institute of Australia, *Taxation Problems in the Commercialisation of Intellectual Property*[1].

Studies of the relationship between technological innovation and taxation laws often give significant attention to levels of government support for research and development (R&D). Tax incentives for R&D are not, however, the only area in which taxation laws exert influence on innovation. Also important is how the taxation system treats entrepreneurs in small start-up enterprises, how venture capital investment in small firms is taxed, how employee shares and stock options in entrepreneurial businesses are treated for income tax and capital gains tax purposes, and how the general tax law treats capital investment in intangibles.[2]

It is submitted that current taxation laws present significant impediments to IP originators in combining to form entrepreneurial enterprises, and in obtaining the necessary capital and labour, for the efficient commercialisation of IP. By 'commercialisation' is meant the activity by which the knowledge, ideas and inventions generated by research and development are converted into business assets capable of producing commercial revenues from marketable goods and services.

Taxation impediments to commercialisation of IP are an impediment to technological innovation. If the path by which innovations are taken from the R&D phase to successful commercialisation involves unnecessary additional tax costs and inefficiencies, investment in innovation will be discouraged, and diverted to investments – for example, investment in negatively geared residential property – where the taxation treatment is more favourable.

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1 IPRIA Report No.01/06. The authors of the report are Cameron Rider, Lillian Hong, Ann O'Connell, Miranda Stewart, and Michelle Herring, of the Tax Group at Melbourne Law School, The University of Melbourne.

2 OECD Directorate for Science, Technology and Industry, ***Entrepreneurship and Growth: Tax Issues*** (February 2002).

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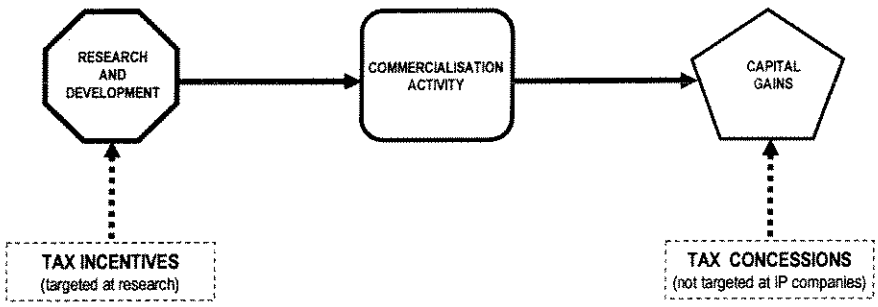
Problems in current structure of tax assistance regime

It is submitted that the current structure of tax assistance for commercial development of IP is limited and poorly targeted.

Tax assistance is given at the initial research and development phase in the form of the R&D concession. This offers companies a tax deduction, generally at a rate of 125%, for certain defined R&D expenses. Small companies can convert the deduction to a cash rebate under the R&D Offset scheme.

Tax concessions are also offered in the event of ultimate commercial success. The 'CGT discount' exempts 50% of capital gains of individuals from tax. The pooled development fund (PDF) and venture capital fund (VCF) schemes offer tax exemptions for gains on equity investments in small-medium enterprises.

However, no tax assistance is given for the critical intermediate phase of commercialisation activity – the activity by which concepts generated in the R&D phase are ultimately converted to business assets capable of generating commercial revenues.



The R&D concession is directed to systematic, investigative and experimental activity – research rather than commercial development. It excludes much commercialisation activity – for example, expenses associated with patenting inventions and marketing expenditures.

The general rationale for the R&D concession is that technological innovation is subject to high levels of business and investment risk, which tend to deter the market from providing socially desirable levels of investment in the absence of countervailing tax incentives. It is difficult to see why the same rationale does not extend to the equally high risk commercialisation phase of IP development.

In an October 2005 survey of R&D firms by the Department of Industry, Technology and Resources (***The R&D Tax Concession – Impact on the Firm. Report on a Survey of 116 Firms***), the following observation was made:

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"A final comment made across all firms, regardless of size, was that the attractiveness of undertaking R&D and claiming the R&D Tax Concession is affected by the daunting challenge of commercialising R&D results. A number of firms made the observation that without assistance to commercialise R&D and to take it to the market, the incentive for businesses to undertake R&D is weak, regardless of the level of government R&D support available".

It is also important to note that the CGT, PDF and VCF concessions are not targeted at IP development. They apply to investments in companies carrying on almost any kind of business, including mature operating businesses. The CGT concession also applies to property investment. Thus investors can obtain these concessions for investments with much shorter time frames to completion, and much lower risk profiles, than IP commercialisation. It follows that these concessions provide only a very weak incentive for investment in IP.

Government assistance for the commercialisation phase is limited to competitive grants schemes, such as COMET (commercialising emerging technologies). These schemes can hardly be regarded as providing businesses with a secure structure of assistance for commercialisation. No rational business plan can be based around the contingencies of competitive grant schemes. It is absurd to expect that businesses will be persuaded to embark on long-term commercialisation projects on the basis that, when they need capital, they might be able to obtain it from grant applications made under limited, highly competitive grant schemes.

Tax assistance regimes compel use of companies

Another problem is that the existing tax assistance regime compels use of an incorporated company as the business vehicle for IP development.

The R&D concession is only available to companies; it is not available to individuals, partnerships, unincorporated joint ventures or trusts. Hence it requires use of a company if the concession is to be accessed.

The CGT discount applies to shares in companies, but not direct interests in IP assets such as patents, copyrights, designs and know-how. Such assets are deemed by the tax law not to be CGT assets. Hence, to access the CGT discount it is necessary to hold IP assets through a company, and aim to realise gains by selling the shares in the company rather than the IP assets themselves.

The PDF and VCF concessions operate by offering tax exemptions to funds investing patient equity in shares in companies operating small-medium enterprises. They do not extend to equity investments in partnerships or trusts, or loans to individuals. Hence enterprises wishing to attract this patient equity investment must organise as companies.

In short, the tax assistance regime assumes IP originators will adopt a corporate structure, and contribute IP assets, labour and capital to a start-up company in exchange for shares.

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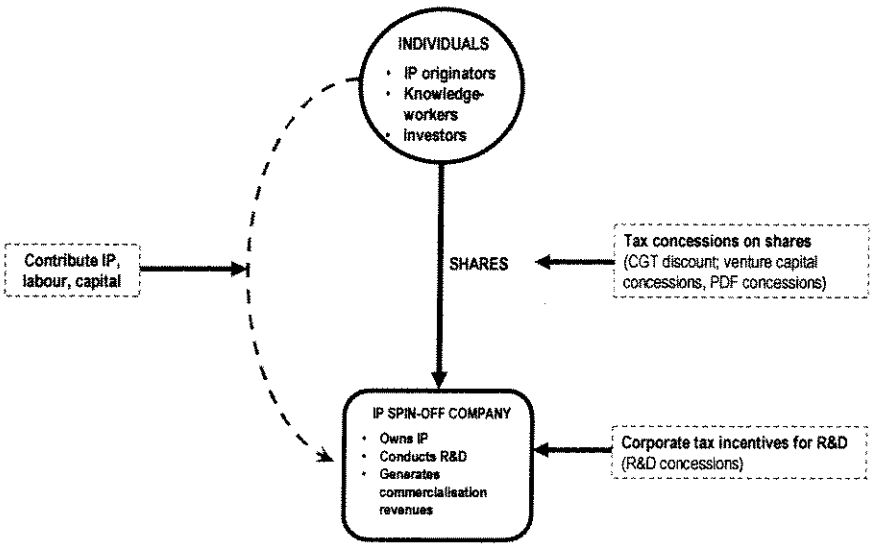

An incorporated company is a sensible business structure from a commercial perspective, not least because it offers investors the protection of limited liability. However, from the perspective of a start-up IP enterprise, as discussed below, it is the least efficient tax structure. The problems all derive from the fact that, for taxation purposes, the company is treated not as an economic partnership, but rather as an entity separate from its owners.

Problems on the contribution of IP assets to companies

One problem area with the use of a company for start-up commercialisation activity concerns the transfer of IP assets by the IP developers to the company.

As noted above, a company and its shareholders are treated as separate entities. This means that, for taxation purposes, the transfer of the IP assets to the company in exchange for shares is treated as an outright sale of the IP assets (by the owners) at the assets' market value. Hence, on formation of the start up company, the IP developers face an immediate and potentially significant tax impost: tax on a deemed sale of their IP assets. Moreover, since the tax impost will be based on the market value of the IP assets, and their market value will in turn be based on their potential future cash flows, the tax system is seeking here to tax unrealised gains - the present value of future, contingent profits of the enterprise.

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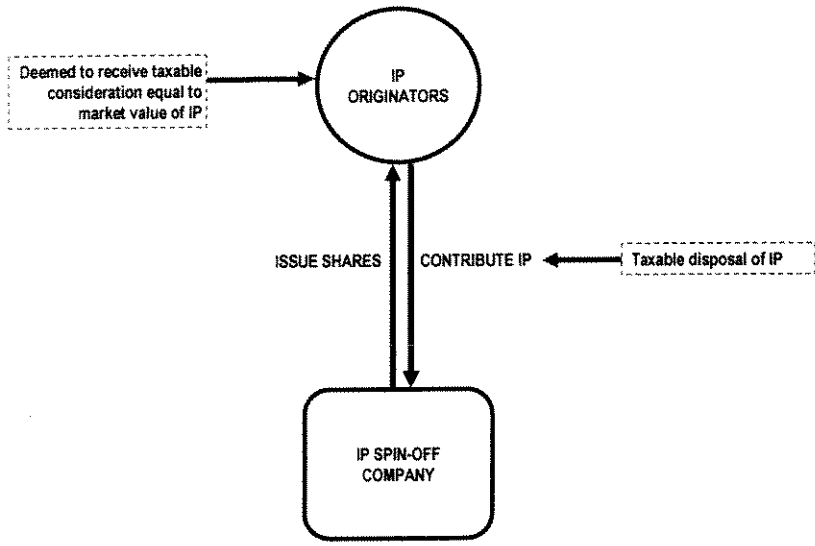

The tax system provides some 'rollover relief' to exempt the contribution of assets from tax in certain limited cases – namely where an individual transfers assets to a company wholly-owned by the individual, or a trust or partnership transfers assets to a company wholly-owned by the trust or partnership. There is, however, no rollover relief where multiple owners of different IP assets wish to combine their assets in a jointly-owned company.

It is submitted that the tax law should be amended to extend rollover relief to the case where multiple owners of different IP assets transfer their assets to a jointly-owned company in exchange for shares in the company.

Problems with employee equity participation

A second problem area concerns employee participation in IP start-up companies.

Use of employee shares is a critical tool for start-up companies, which are cash-poor and cannot use cash salary to compete for talented personnel. However, an employee share received in lieu of salary in an IP start-up will generally be taxed as the equivalent of cash salary. Tax will be based on the market value of the shares. Since the market value of the shares will be based on the potential future cash-flows of the company business, the tax system is again seeking to tax unrealised gains - the present value of future, contingent profits of the enterprise.

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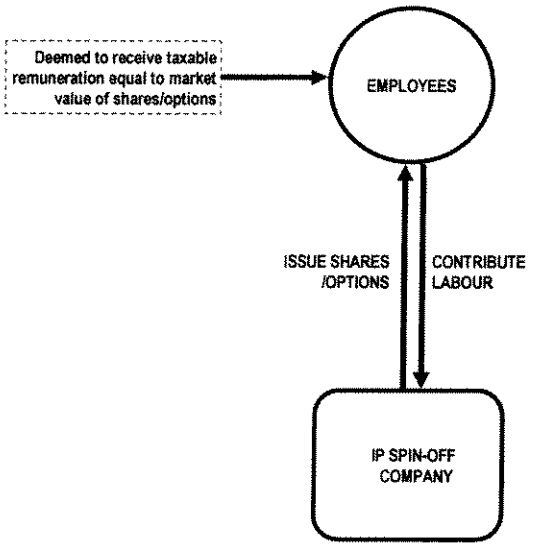

While some employee share tax concessions exist under current law (in Division 13A of the *Income Tax Assessment Act 1936*), they are limited in scope and not easily accessed by IP start-ups. One concession is a tax exemption limited to $1,000 of share value. Another concession defers the time of taxation to when the shares are sold, but only if certain onerous conditions are met, the shares are offered to most employees and employee shares are limited to a small percentage of the total share capital.

This means employees in IP start-ups are generally left subject to the risk of up-front taxation on the 'paper gains' represented by their holding of employee shares.

It is submitted that tax laws should be reformed so that employees who invest their intellectual capital in IP start-ups in exchange for shares are not taxed, unless and until they make real gains on the actual sale of the shares.

Lack of tax relief for start-up losses

A third problem with use of the company form concerns tax relief for the start-up losses, which an IP commercialisation enterprise will invariably generate.

The tax law treats the losses as being trapped in the company, rather than flowing through to the owners, even though they bear the economic cost of those losses. This effectively denies the owners tax relief for the losses. It thus discourages investment in IP companies, particularly as compared to alternative investments - such as, say, a negatively geared residential investment property - where current law allows owners to immediately deduct the start-up losses against their other income.

When the losses are trapped in the company, the company must seek to 'carry-forward' the losses and use them as deductions against the company's future profits, if and when they emerge. But to carry-

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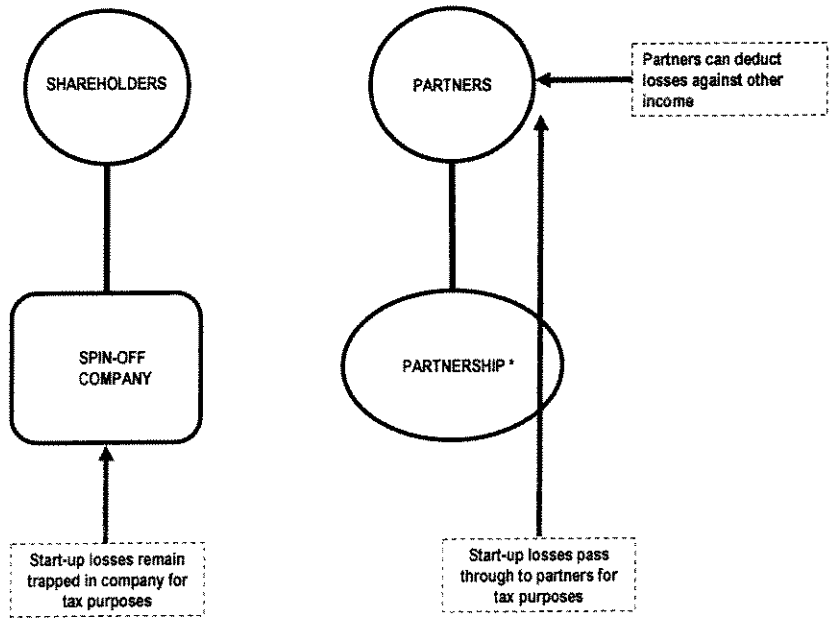
forward losses, a company must also meet additional tests which are very difficult for an IP start-up to satisfy. One test is a continuity of ownership test (COT), which requires the company to maintain the same majority shareholders at all times – which is difficult as start-up companies need to be able to raise fresh equity investment to fund development. An alternative test is the same business test (SBT), which requires that the company maintain exactly the same business at all times – again difficult for a start-up enterprise which needs to be flexible in its business development.

And if the start-up company does manage to carry-forward and use its start up losses as deductions against future profits, a further problem will then emerge. If the profits are sheltered from tax by the losses, when the untaxed profits are distributed as dividends, they will be received by the shareholders as unfranked dividends, fully taxable at marginal tax rates.

The overall result is that, for start-up IP companies, the value of tax relief for start-up losses is effectively nil.

By contrast, a partnership offers a better tax structure for start-up losses than a company. When a partnership is used, the tax law treats start-up tax losses as flowing through directly to the partners, and can be deducted immediately against their other income. The same applies for unincorporated joint ventures.



Consideration should be given to reforming the tax law so that, as in the United States, closely held limited liability companies can elect to be taxed as partnerships.

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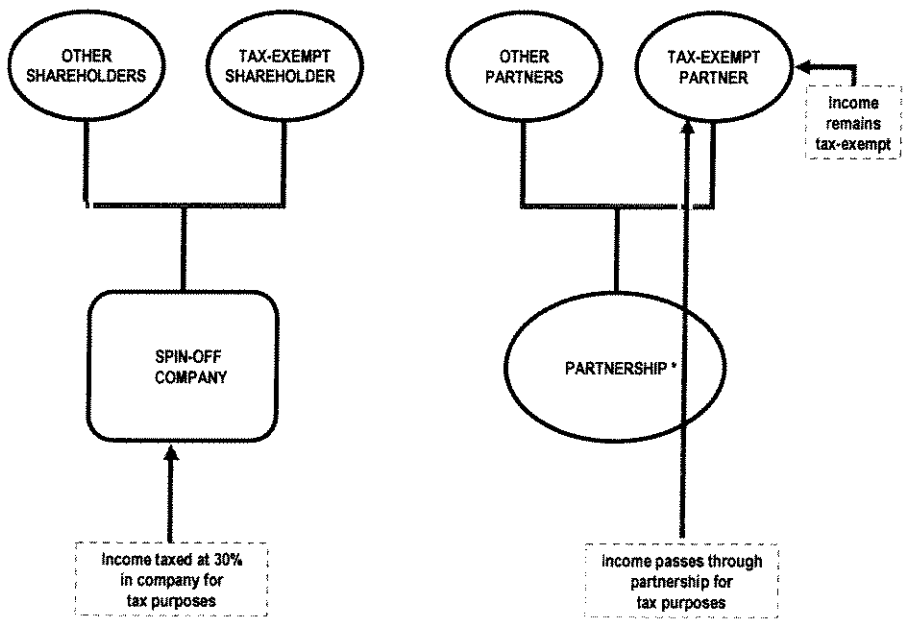
Problems for tax exempt investors

A fourth problem with the use of companies concerns the position of tax-exempt investors, such as public research institutions and charitable funds, or overseas pension funds.

A start-up company is taxable on the income it earns at the company tax rate – 30%. Hence, use of a company means that tax exempt investors effectively lose the benefit of their tax-exempt status on their share of the income. Relief is offered in limited cases only, by way of refundable imputation credits if the taxed profit is paid to certain types of tax exempt institution as a franked dividend.

By contrast, a partnership offers a better tax structure for tax exempt investors than a company. When a partnership is used, the tax law treats income of the enterprise as flowing through directly to the partners, meaning that the share of income of the tax exempt investors remains tax exempt in their hands. The same applies for unincorporated joint ventures.



A 'flow-through' treatment of income to tax exempt investors would also apply to use of a unit trust, provided that less than 20% of the units are held by tax exempt bodies (or else the unit trust is taxed as a company on the income). Hence unit trusts are often adopted for this reason. However, trusts do not allow similar flow-though treatment of start-up losses – rather the losses are trapped in the trust in the same way as they are trapped in a company.

These considerations also support reforming the tax law so that, as in the United States, closely held limited liability companies with tax exempt investors can elect to be taxed as partnerships.

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Problems with companies as commercialisation vehicles undermine existing tax assistance regime

Given it is necessary to use companies to access the R&D concession, and the CGT discount and PDF and VCF concessions, it can be seen that the effectiveness of these concessions is necessarily undermined by the tax costs and inefficiencies associated with the use of the company form for start-up commercialisation activity. This, it is submitted, leads one to the conclusion that removal of the tax inefficiencies associated with the company form will have significant flow-on benefits in relation to the R&D concession, and the technological innovation it is intended to stimulate.

Other problems – tax deductions for IP commercialisation expenses

The problems outlined above for start-up commercialisation companies are made worse by the fact that current tax law fails to provide a coherent regime of tax depreciation deductions for the capital cost of investment in IP assets and their commercial development.

The depreciation regime only recognises patents, copyrights and registered designs as depreciating assets – and only allows their cost to be depreciated over long fixed periods rather than by reference to their actual useful life. The depreciation regime does not explicitly recognise other IP assets such as know-how, trade secrets and confidential information. Neither does it explicitly recognise marketing goodwill, brand names or trade marks.

This puts Australia at a disadvantage relative to other tax jurisdictions, such as the UK or the US, which have comprehensive depreciation relief for all forms of intangible investment. While some relief in Australia might be found in draft legislation, now before Parliament, allowing deductions spread over 5 years for so-called 'black-hole' expenses not otherwise recognised by the tax law, these provisions are not directed at IP assets and still leave important discrepancies in the taxation treatment of different forms of IP investment.

It is submitted that Australian taxation law needs to adopt comprehensive depreciation relief for all forms of intangible investment.

Do these tax problems matter?

Some might argue that careful tax-planning can mitigate some of the problems outlined above. But tax-planning necessarily involves compromises, and subjects participants to the risk of arrangements being challenged by the Commissioner of Taxation under anti-avoidance provisions such as Part IVA of the Income Tax Assessment Act 1936. It also leads to more costly, complicated and inflexible business structures, which divert time and resources away from actual IP development.

More importantly, these tax problems increase the effective rate of taxation on investment in IP commercialisation, and so discourage such investment. They divert investment capital to other business and investment activities which attract more favourable tax treatment – such as negatively geared residential property. As such, they also undermine the R&D concession, as well as the PDF and VCF concessions.

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Unless taxation laws provide a favourable environment for the commercial development of IP, a country will find it difficult to generate socially desirable levels of scientific research and technological innovation. IP, being intangible, and the activities associated with its development, being the province of skilled intellectual labour, can be relocated from Australia to overseas jurisdictions relatively easily. If Australian taxation law provides unfavourable treatment to commercial development of IP, then business investment in IP will inevitably depart to overseas jurisdictions with more favourable tax regimes, and the associated research and development activity will follow.

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Yours sincerely

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