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Review of the National Innovation System

Submission

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About this submission

This submission is in response to an invitation from the Review of the National Innovation System in February 2008. The submission focuses on tax law and policy relating to innovation and in particular on the tax issues associated with commercialization of innovation knowledge and intellectual property.

The Tax Group at the University of Melbourne published a report in 2006 under the auspices of the Intellectual Property Research Institute of Australia: *Taxation Problems in the Commercialisation of Intellectual Property* (IPRIA Report No. 01/06), by Cameron Rider, Lillian Hong, Ann O'Connell, Miranda Stewart and Michelle Herring. In that report, we concluded that Australia's income tax law has a clear tendency to inhibit the adoption of a spin-off company as a commercialization vehicle for intellectual property and that this, in turn, reduces the effectiveness of the Research and Development concession and the Capital Gains Tax concessions that exist in the income tax law, in stimulating investment in intellectual property.

This submission is based on our findings in the report, *Taxation Problems in the Commercialisation of Intellectual Property* (IPRIA Report No. 01/06), combined with conclusions from our more recent research in specific areas of tax law and policy. We can provide electronic or print copies of that Report or other cited research on request.

This submission discusses tax law and policy issues law relating to four aspects of the commercialization of intellectual property:

1. income taxation of spin off companies;
2. tax characterization and capital allowances for business intangible assets and knowhow;
3. venture capital investment funds; and
4. employee share ownership.

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B.Sc, LL.B (Hons), University of Sydney, Australia; LL.M (International Taxation), New York University Law School, USA. Associate Professor Miranda Stewart has many years experience on tax law and policy in the ATO, legal practice and academia. She is a Fellow of the Taxation Institute of Australia and a Director of the Australian Tax Research Foundation. She is a co-author of the report Taxation Problems in the Commercialisation of Intellectual Property (IPRIA Report No. 01/06); Income Tax: Text, materials and essential cases; Death and Taxes (2007, 2nd edition: Thomson) and the reference, Australia, in the International Guide to the Taxation and Regulation of Mutual Investment Funds and Their Investors (International Bureau of Fiscal Documentation: 2006, The Netherlands). She has published on Australian, United States and New Zealand venture capital tax concessions, on capital allowances for business assets including innovation assets and on a wide range of other tax law and policy topics in national and international refereed journals including the British Tax Review, Tax Law Review (US), Australian Tax Forum, Australian Tax Review, Journal of International Taxation. She consults with Greenwoods & Freehills.

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1. Taxation of spin-off companies for commercializing intellectual property

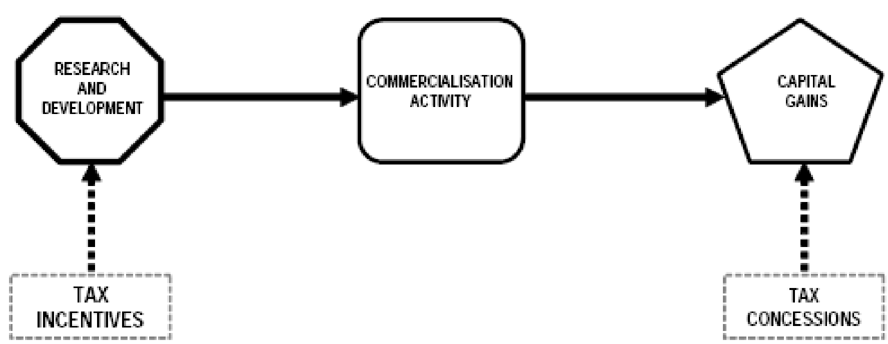
Our report, *Taxation Problems in the Commercialisation of Intellectual Property* (IPRIA Report No. 01/06), examined the tax issues for a company at the high risk stage of commercialization of intellectual property generated through research and development.

1.1 Losses in spin-off companies

A spin-off company with limited liability is the most desirable form in which to commercialise intellectual property. To receive the Research and Development tax concession, use of the limited liability company is required. A company is also the preferred form for investment by venture capital funds (see further below).

However, various features of Australia's income tax law combine to penalize a spin-off company as a commercialization vehicle. No tax concessions for companies apply at the start-up or commercialization stage. We argue that this reduces the effectiveness of both the Research and Development concession and the Capital Gains Tax concessions that exist in the income tax law, in stimulating investment in intellectual property. The current structure of tax assistance for intellectual property commercialization is illustrated in Figure 1 below.[1]

Figure 1: Structure of tax assistance for intellectual property commercialisation



Spin-off companies involved in commercialization activity are taxed at the company tax rate of 30 percent on profits. However, in the start-up and early stages of commercialization, a spin-off company is likely to have losses rather than profits. These losses can be carried forward by the company to be offset against profits in future years, although subject to significant limitations requiring that the company continues to be owned by a majority of the same shareholders or must carry on the identical business.

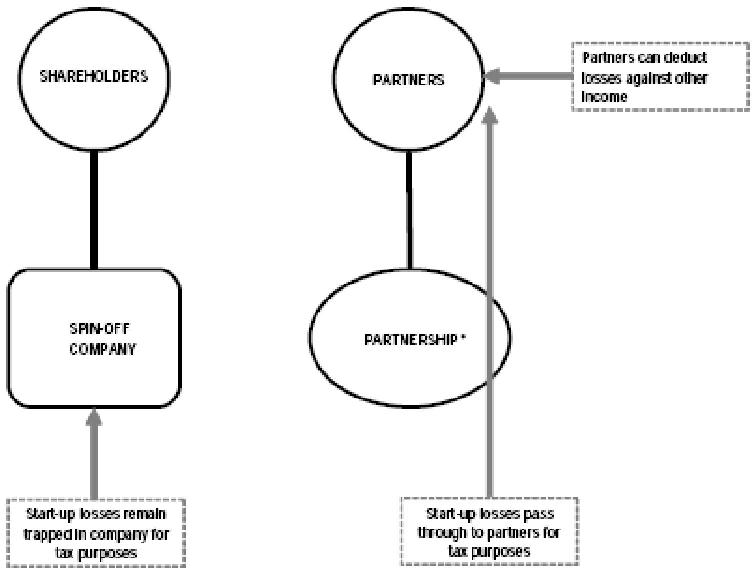
Tax losses are trapped inside the company and are unable to be allocated to shareholders to be utilized against other sources of income. This contrasts to the "fiscally transparent" or "flow through" taxation of a partnership or joint venture, which enables the ultimate owners to deduct losses in the business entity operations. A fiscally transparent structure may also be more attractive for a tax exempt investor when income is generated, as the income or capital gains

[1] Cameron Rider, Lillian Hong, Ann O'Connell, Miranda Stewart and Michelle Herring, *Taxation Problems in the Commercialisation of Intellectual Property* (IPRIA Report No. 01/06) (the ***IPRIA Report***), Figure 1, p. 1.

can be passed through and exempted in the hands of the investor. In a company, the income or capital gains are subject to company tax at 30 percent regardless of the tax exempt status of the owners.[2]

A comparison of the spin-off company with a fiscally transparent partnership is illustrated in the Figure below.[3]

Figure 5: Comparison of spin-off company to fiscally transparent partnership* in treatment of start-up losses



* Same treatment applies to unincorporated joint venture

The use of tax losses *is* available for commercialization activity carried out by large, established, profitable businesses operating in a company or a consolidated corporate group. This is because those losses can be offset against other profits generated by the company or corporate group. Thus, the income tax law creates a bias against commercialization activity by small or start-up enterprises rather than large businesses. This is a problem for innovation as research suggests that "innovation-led growth" is more likely to be generated through innovative small and medium enterprises rather than established large enterprises.[4]

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[2] Where a tax-exempt shareholder is endorsed as an eligible charity, it may be entitled to receive a refund of franking credits on payment of franked dividends from the company, enabling an exemption of the income. However, this applies only to a restricted list of tax-exempt organisations: s 207-115, Subdivision 207-E *Income Tax Assessment Act 1997*.

[3] IPRIA Report, above n 1, Figure 5, p. 11.

[4] Keuschnigg and Nielsen, "Public Policy for Start Up Entrepreneurship with Venture Capital and Bank Finance" in Kanniainen and Keuschnigg (eds), *Venture Capital, Entrepreneurship and Public Policy* (MIT Press, 2004), p. 221; see also Sandler, Daniel, *Venture Capital and Tax Incentives: A Comparative Study of Canada and the United States* (Canadian Tax Foundation: 2004); OECD Directorship for Science, Technology and Industry, *Entrepreneurship and Growth: Tax Issues* (Paris, 2002); OECD, "Promoting Entrepreneurship and Innovative SMEs in a Global Economy:

In some other jurisdictions, in particular in the US, an election is available to apply flow-through or "transparent" treatment to closely held limited liability corporations.[5] This was also recommended in Australia by the Asprey Committee Report of 1975.[6]

1.2 Contribution of intellectual property to spin-off companies

A company is a separate legal entity for tax purposes. Consequently, a contribution of assets to a company in exchange for shares is prima facie treated as a taxable transaction for the contributor at the time of the contribution. This means that a researcher who owns intellectual property and seeks to contribute it to a company in exchange for shares is likely to owe tax on the market value of the property at that time, even though no cash is received.

A limited rollover is applicable where the contributor owns 100 percent of the company shares and other conditions are satisfied.[7] However, a contribution to an existing company owned by other researchers or by investors seeking to commercialise the intellectual property is not eligible for the rollover. Furthermore, a recent draft ruling suggests that in some cases, the contribution of assets (or provision of services) to a company in exchange for shares may not always generate a deduction for the expenditure, or a cost of an asset that can be depreciated, in the hands of the company.[8]

Recommendations

It is recommended that the Review investigate the following possible reforms for taxation of spin-off companies:

1. Elective or automatic "flow through" (partnership) tax treatment be allowed for closely held companies.
    a. This flow through treatment could be general in application or could possibly be limited to companies that are seeking to commercialise intellectual property. For example, it could be limited to companies that have carried out registered research and development activities or have received a Start or other government grant for research.
    b. To prevent tax avoidance, the ability of a shareholder to deduct flow through losses could be limited to capital invested in the enterprise or in some other way.[9]
2. A relaxation of the stringency of the continuity of ownership and same business tests limiting carry forward of tax losses of companies engaged in commercializing intellectual property.
3. Provision of a rollover for contribution of intellectual property assets to a spin-off company so as to defer taxation until a future time.

Towards a More Responsible and Inclusive Globalisation" (2nd OECD Conference of Ministers Responsible for Small and Medium Enterprises, Istanbul, Turkey, June 3-5, 2004).

[5] This is available through the "S Corporation" regime and through elective flow-through treatment for limited liability partnerships (LLPs) and limited liability corporations (LLCs): Subchapter S, ss 1361-1378 US Internal Revenue Code (Title 26); US Treas. Reg 301.7701-1 through -4 ("check the box" regulations).

[6] Taxation Review Committee (Asprey Committee), *Full Report*, January 21, 1975, Chapter 16. See also the proposal for a flow through start-up company in Europe: Vermeulen, "Towards a new 'company' structure for high-tech start-ups in Europe' (2001) 8(3) *Maastricht Journal of European and Comparative Law* 233.

[7] Division 122-A and s 40-340 *Income Tax Assessment Act 1997*.

[8] Draft Tax Ruling TR 2008/D1.

[9] This kind of loss limitation rule already applies to Venture Capital Limited Partnerships: see Stewart, M, "Flow Through Taxation of Limited Partnerships: It's Time to Repeal Division 5A' (2003) 32 *Australian Tax Review* 171-195.

2. Income tax treatment of business intangible assets and knowhow

The research and development tax concession applies to the early research stage of innovation activities. However, the R&D concession does not cover high risk development or commercialization activity. More generally, for taxable companies, expenditure on intellectual property, knowhow and business intangible assets may not always be appropriately recognized in the income tax law.

Expenditure incurred by a spin-off company to develop or acquire intellectual property, scientific research or knowhow is deductible only if it can be brought within specific capital allowance rules in Division 40 of the *Income Tax Assessment Act 1997*. If it cannot be brought within these rules but a capital asset is generated, the acquisition cost will generally only be recognized on sale of the asset (for example, the cost of goodwill may be recognized on sale of the business). If the intellectual property (for example, trade secrets or confidential information) is not recognized as a capital asset at all, there is unlikely to be any recognition of its acquisition cost for tax purposes. Expenditure incurred by a researcher prior to commercialization will usually not be deductible.

The capital allowances regime for intellectual property provides the following depreciation rates:

Table: Effective life of certain intangible depreciating assets (s 40-95(7))

Item	For this asset:	The effective life is:
1	Standard patent	20 years
2	Innovation patent	8 years
3	Petty patent	6 years
4	Registered design	15 years
5	Copyright (except copyright in a film)	The shorter of: (a) 25 years from when you acquire the copyright; or (b) the period until the copyright ends
6	A licence (except one relating to a copyright or *in-house software)	The term of the licence
7	A licence relating to a copyright (except copyright in a *film)	The shorter of: (a) 25 years from when you become the licensee; or (b) the period until the licence ends
8	*in-house software	2 1/2 years
9	*Spectrum licence	The term of the licence
10	*Datacasting transmitter licence	15 years
11	A *mining, quarrying or prospecting right relating to *mining operations (except obtaining *petroleum or quarry materials)	The life of the mine or proposed mine or, if there is more than one, the life of the mine that has the longest estimated life
12	A *mining, quarrying or prospecting right relating to *mining operations to obtain *petroleum	The life of the petroleum field or proposed petroleum field
13	A *mining, quarrying or prospecting right relating to *mining operations to obtain quarry materials	The life of the quarry or proposed quarry or, if there is more than one, the life of the quarry that has the longest estimated life
14	*Telecommunications site access right	The term of the right

Division 40 of the *Income Tax Assessment Act 1997* also provides a deduction for capital 'project expenditure' (s 40-830) and for capital 'business related costs' (s 40-880). These provisions are stated to apply to capital expenditures on, among other things, seeking to obtain a right to intellectual property, or on intangible assets in relation to the business. However, it is unclear how far these provisions go in allowing amortization for tax purposes of all business intangibles that might be developed by a spin-off company.

Australian tax treatment of intellectual property and other business intangibles falls short of the accounting treatment in terms of the range and coverage of these kinds of business assets (Accounting Standard AASB 138 *Intangible Assets*). It also differs from the tax treatment in the United States, in particular, where amortization of business intangibles and knowhow is generally allowed over a period of 15 years.[10]

Recommendations

It is recommended that the Review investigate the following possible reforms for taxation of spin-off companies:

1. A full review of the tax treatment of business intangibles in the Australian income tax, to ensure that all innovation intangibles are properly and systematically accounted for and to remove uncertainties for businesses seeking to commercialise intellectual property.
2. A possible expansion of the R&D tax concession to cover the development or commercialization phase.
3. Review of the R&D concession recapture rules to ensure that these are not operating to discourage development or commercialization.

3. Taxation of venture capital investment funds

Australia has a Venture Capital Limited Partnership (VCLP) regime that is designed to encourage foreign venture capital investment in Australia by providing tax concessions to investors that make "eligible venture capital investments" (ie, investment in shares or options in unlisted Australian resident companies that satisfy specified value, location, activity and other requirements).[11] In 2007, the government expanded this regime to cover Early Stage VCLPs.

The VCLP regime applies to investments made through limited partnerships that are registered as VCLPs or Australian Funds of Funds ("AFOFs"). Venture Capital Management Partnerships ("VCMPs") may be general partners in such partnerships. It also applies to direct investments made by "eligible venture capital investors" (ie registered tax exempt foreigners that are resident in certain countries). The VCLP and ESVCLP regimes provide three forms of tax concession:

1. Unlike other limited partnerships, which are taxed as companies under Div 5A of Pt III of the ITAA 1936, VCLPs, ESVCLPs, AFOFs and VCMPs are taxed as ordinary partnerships. Income and capital gains as well as revenue and capital losses, therefore "flow through" to the partners rather than being trapped in the partnership.

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[10] For a detailed discussion of these issues, see our IPRIA Report, above n 1; Stewart, M, "Capital Allowances for Depreciating Assets: A Successful Reform?" in Lehmann, G (ed), *Business Tax Reform: Meet the Critics* (2007, Australian Tax Research Foundation Conference Series No. 24), p 217 , especially pp. 237-248

[11] *Venture Capital Act 2002 (Cth)* as amended; various provisions in Division 118 and Division 51 of the *Income Tax Assessment Act 1997*. See further Stewart, M (2006) 'Venture Capital Tax Reform in New Zealand and Australia' Part 1 17(6) *International Taxation* 40-55; Part 2 17(10) *International Taxation* 42-54.

2. Eligible venture capital investors are exempt from tax (and are not entitled to revenue or capital losses) arising from the disposal of eligible VC investments.

3. General partners of VCLPs and AFOFs benefit from capital gains tax treatment in respect of a "carried interest" gain derived by them in a VCLP, AFOF or VCMP. VC managers who are individuals are, therefore, eligible for the 50 percent CGT discount.

The VCLP and ESVCLP regimes are still at early stages of operation. It is important for the government to continue to monitor these regimes to ascertain whether they are effective in bringing new capital investment into spin-off companies seeking to commercialise intellectual property. The cost to revenue should also be accurately estimated, if possible.

Recommendations

The Review seek to ascertain the effectiveness of the VCLP and ESVCLP regimes in bringing new capital into commercialisation of innovation in Australia. In particular, the Review should investigate:

1. The take-up of the ESVCLP structure, which is intended to target early stage investments;

2. The effectiveness and cost to revenue of the "carried interest" tax concession for venture capital managers;

3. The effectiveness or not of the various limitations on VCLP and ESVCLP structure, investment, employment and operation.

4. Employee share ownership

A spin-off company will commonly seek to reward researchers with employee shares in the company, enabling them to continue to be involved and reap any rewards of the intellectual property they have created. This enables spin-off companies which are cash-poor to retain and compete for talented researchers and managers.

Under Australian tax law, the issue of shares to an employee will be taxed as the equivalent of cash salary unless the share issue satisfies a restrictive set of conditions. Div 13A of the *Income Tax Assessment Act 1936* contains the rules for the taxation of shares or rights provided under an employee share scheme. The Division does two things: it identifies a taxing point and valuation mechanism for shares or rights provided in these situations. Secondly, it provides two concessions where shares or rights are provided. Those concessions are either a $1000 per annum exemption or a deferral of tax for up to 10 years. There are a number of problems in the use of the tax concessions as a tool for regulating employee share schemes.

The report, *Shared Endeavours* made a number of recommendations to ease some of the requirements for qualifying shares and rights, particularly to facilitate the use of employee share schemes in 'sunrise enterprises'.[12] The Government, however, did not support any of these recommendations.[13]

[12] SHARED ENDEAVOURS, Nelson Report on Employee Share Ownership (2003) §§ 4.129, 4.130, 4.142, 4.153, 4.164, 4.176, 4.182, 4.198 (Recommendations 32–9).
[13] Press Release, Peter Costello, Treasurer, Government Response to Nelson Report on Employee Share Ownership (Mar. 27, 2003), *available at*

4.1 Cost and complexity

If an employer wishes to offer shares to employees it must comply with regulatory requirements in the *Corporations Act 2001* (Cth) designed to provide information to investors. Although ASIC has provided conditional relief from disclosure requirements for employee share schemes, the preconditions for accessing this relief can be quite difficult to satisfy. Employers and employees also need to consider the detailed taxation requirements. As already noted there are different consequences depending on what is offered, on what terms the offer is made and a range of other structural issues. For these reasons start-up costs for employers can be very high.

Further, legal drafting of employee share documents is expensive as they must be precise (for tax purposes) and helpful for employees (in plain English). There are also costs of educating the administrators – for example, those in human resources or in the company tax group and legal groups. Standard or 'off the shelf' plans invariably fall foul of the tax rules with serious consequences. There are added costs if binding tax rulings are sought, which is common but often unnecessary.

On-going costs of administering an employee share plan can be high especially if an external administrator is used. Also, there may be costs associated with obtaining external advice for unique employee circumstances that continually arise. Educating employees (both administrators of the plans and participants) and responding to queries especially if they are not commercially literate can also be costly. Furthermore there is a need to review plans and documents each time an offer is made given the rapid and numerous changes in tax law.

4.2 Inflexibility

A 'one-size fits all' approach to employee share concessions is increasingly inappropriate to meet the emerging diversity and flexibility of work practices across the spectrum from small start-up companies in sunrise industries to large listed companies with transnational workforces. There are conceptual problems in treating an individual involved in an intellectual property commercialisation who receives shares in exchange for their labour in the same way as an employee who receives fixed cash salary regardless of the fortunes of the enterprise.Such persons are more like at-risk investors and should receive the tax treatment available to investors.

The limited terms on which employee share scheme tax benefits may be provided and the limited component of overall remuneration which they can provide, also reflect an outdated view of the appropriate taxation treatment of labour income.

4.3 Stringency of requirements to access concessions in Division 13A

The qualifying rules for the two concessions in Division 13A may be too strict and have the effect of constraining the growth of employee share ownership in Australia. Companies who cannot or are unwilling to issue ordinary shares to employees are unable to access the concessions in Division 13A. This is more likely to be the case where the company is small and control is highly valued by the owners.

Limiting the availability of the concessions under Division 13A to employees who hold a legal or beneficial interest in more than 5 percent of the shares in the employer, or are in a position to cast, or control the casting of, more than 5 percent of the maximum number of votes that may be

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http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2003/014.htm&pageID=003&min=phc&Year=2003&DocType=0.

cast at a general meeting of the employer, may be problematic for smaller businesses. It also prevents employee buyouts from occurring under Division 13A.

The requirement that the scheme or another scheme be available to 75 percent of permanent employees is also problematic for start-up companies with a small number of employees. It should be noted that the Commissioner does have discretion to determine that the condition has been satisfied[14] and it may be that, in the case of a new company, the Commissioner would do so if the scheme was open to 75 percent of current employees. The reference to permanent employees as full or part-time employees with at least 36 months service makes this condition impossible to satisfy for start-up companies. It may, however, be possible to obtain the deferral concession which is often seen as a more attractive option for providing executive remuneration.

4.4 The $1000 tax exemption

The $1000 tax exemption available under Division 13A has been criticised for being too low. According to Price, for example, it 'equates to the bare minimum of employee ownership.'[15] In submissions to the Nelson Committee, a number of companies and accountancy firms argued that the threshold was too easily exceeded, particularly where employees are given the opportunity to participate in both share and option plans.[16]

These arguments were rejected by the Treasurer, who argued that the Government had already doubled the exemption (from $500 to $1000) and that indexing the concession would be anomalous, given that neither personal income tax scales or the income free threshold are indexed.[17]

4.5 Capital Gains Tax treatment

An aspect of the current taxation treatment of employee shares that has attracted considerable criticism is the extent to which employee share schemes should attract the CGT discount treatment for capital gains. Price has argued that there is a 'glaring inconsistency' in the taxation treatment of plans under Division 13A in which tax-exempt plans attract CGT discount treatment but tax-deferred plans do not.[18]

Shared Endeavours recommended that all employee share schemes should have the capital gains tax concessions afforded to superannuation and other tax-advantaged investment savings vehicles.[19]

4.6 Potential for Abuse

Wariness of policy reform on employee share ownership in the past has been attributed in part to the fear of the Treasury of tax abuse.[20] The lack of published information relating to the number, structure and incidence of employee share plans makes it difficult to identify particular types of abuses but this is an area that certainly requires more attention.

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[14] S 139CD(5) *Income Tax Assessment Act 1936.*
[15] Geoff Price, *Employee Ownership: Reform Opportunity Lost?*, KEEPING GOOD COMPANIES*,* July 2003, at 331.
[16] *See* SHARED ENDEAVOURS, above n 12, at 152–55.
[17] *Id.* at 154.
[18] Price, above n 15, at 330.
[19] SHARED ENDEAVOURS, above n 12, § 4.67 (Recommendation 27).
[20] Price, above n 15, 453, at 331.

Recommendations

1. The Review investigate whether and how employees who invest their intellectual capital in IP start-ups can be treated in the same way as other investors in the enterprise: no taxation of gains until they are realised on sale of the shares, and capital gains tax concessions should apply.

2. The Review should examine the US tax treatment of employee shares in venture capital investee companies. Evidence suggests that this may have operated as a significant subsidy to innovative growth companies in the US.[21]

3. Data on employee share ownership in small companies be collected so as to investigate the effectiveness of this policy option.

[21] Gilson and Schizer, "Understanding venture capital structure: A Tax Explanation for Convertible Preferred Stock" (2003) 116 *Harvard Law Review* 874.