Tax Aspects of Commercialising Intellectual Property

In this second article in a series of three dealing with various tax aspects of IP, we examine the tax implications of exploiting existing IP assets through licensing, sale and use. The first article examined the tax treatment of costs incurred in creating or acquiring IP assets and our final article will consider the tax implications of locating your IP assets offshore.

Exploiting Intellectual Property

IP is generally exploited in one of three ways:

a. through use in operating a commercial enterprise, either by the owner of the IP or in a joint venture arrangement;
b. through the grant of a short or long term license to another party in relation to the use of the IP; or
c. through its sale or assignment to another party.

Whilst the method of exploitation is usually driven by commercial and legal considerations, the tax treatment of the income arising from the transaction is a contributing factor worthy of careful consideration.

Income from R & D Activities

Companies that have incurred expenditure on R&D activities and have claimed or were entitled to claim a concessional deduction under the R&D provisions will be assessable on amounts received or receivable "in respect of the results of" those R&D activities.

It is important to note that:

a. these provisions apply irrespective of whether the receipt is on capital or revenue account. Accordingly, amounts which would ordinarily be capital in nature and subject to concessional CGT provisions may be caught, resulting in an increase in tax payable e.g. a portion of the consideration received for the sale of a business which has R&D results;
b. the term "results" is not defined and should be taken to include IP developed through R&D activities;
c. these provisions apply not only where a company has claimed R&D deductions but also where they were entitled to claim such deductions, *even if such claims have not been made*;
d. the amount assessable under these provisions is not limited to the amount of prior year R&D deductions.

TIP: *Any company engaged in R&D activities needs to consider these provisions, even if they are not claiming the concessional R&D deductions.*

These R&D provisions have broad application and would generally include receipts arising from:

- fees from granting access to, or granting the right to use, those results – such as granting a license to use IP developed through R&D activities;
- the disposal of IP developed through R&D activities; and
- the disposal of core technology.

Licensing of Intellectual Property

In our first article we discussed the annual depreciation deductions available for IP capital assets under Division 40 of the 1997 Tax Act.

Division 40 provides that the grant or assignment of an interest in an item of IP (including the granting of a license) will be treated as a part disposal of the item of IP. The owner of the IP is taken to have split the asset into two parts and disposed of the part subject to the grant or assignment.

This gives rise to a "balancing adjustment", being the difference between the adjusted value of the IP asset disposed of and the consideration received. This balancing adjustment can either be assessable or deductible, depending on the result of the calculation.

Two resulting issues arise:

a. There are no guidelines within Division 40 as to how to apportion the adjusted value of the original asset between the realised and unrealised interests in the IP. The example given of apportionment based on relative market values is not easily applied to IP. This can give rise to uncertainty as to the correct method to use, which will depend on such factors as whether the license is exclusive or not, whether reasonable royalties are paid and the term of the license.
b. Whilst any up-front or capital payment will clearly form part of the "consideration" for the purpose of the balancing adjustment calculation, it is conceivable that ongoing royalty payments and the market value of other non-cash benefits or contingent amounts could also be included. This raises the possibility of double taxation on such receipts, which would also ordinarily form part of assessable income when received.

TIP: *Balancing adjustments arising on granting licenses over IP assets are easily missed but may have significant tax consequences.*

As a general rule, receipts under any arrangement where the ownership and benefits of the IP are retained by the recipient would be classified as being revenue in nature. This would typically include royalty payments, but has also been found to include payments for sharing know-how and supplying information and expertise.

It is also worth noting that where licenses are granted to non-residents, the resulting payments will generally be treated as royalties and be subject to royalty withholding tax. As the resulting foreign tax credit does not give rise to imputation credits for corporate taxpayers, this effectively reduces the after tax returns for shareholders in those companies.

For this reason, license agreements may be drafted to include the provision of various rights and services which do not constitute "royalties" and accordingly are not subject to withholding taxes.

Particular care must given where licensees of IP are given an option to purchase the IP at the end of the license. In certain limited circumstances, this may impact on the ability of the licensor to claim deductions for the decline in value of the IP during the period of the license, if it is determined that the licensee has become the "holder" of the IP.

Sales of Intellectual Property

The disposal of IP assets comprising patents, registered designs or copyright will generally be treated under the Division 40 balancing adjustment rules rather than the CGT provisions, unless the IP has not been used for the purpose of producing assessable income at some time.

Disposals of other forms of IP may fall within the CGT provisions if those assets meet the definition of a "CGT asset".

This distinction can result in significant tax consequences for the non-corporate sellers of IP:

a. Disposals subject to Division 40 will not have the benefit of the CGT discount – the full gain made on a balancing event under Division 40 is taxable;
b. Disposals subject to Division 40 do not have access to the small business CGT concessions;
c. Gains under Division 40 cannot be offset against accumulated capital losses.

Considerable planning is required in order to correctly maximise the tax treatment of gains or losses made on the disposal of IP assets:

- Opportunities may exist to exclude IP assets from the scope of Division 40 and therefore bring them within the scope of the more general CGT provisions – this would particularly be the case where there is an expectation that the value of the IP asset will increase over its life.
- Not all IP assets will have been used for the gaining or producing of assessable income. Some IP assets may be developed with no express intended use, whilst others may have specific uses in overseas markets which give rise to exempt income in Australia. The disposal of such assets may be structured to give rise to capital gains (as opposed to balancing adjustments under Division 40), thus opening up access to the CGT concessions.
- Bundles of IP assets, such as patents, trademarks and confidential information, which are used or dealt with together, give rise to particular difficulties and opportunities in segregating the tax treatment of the individual components.

Conclusion

We have touched briefly on some of the tax pitfalls which face taxpayers in seeking to commercialise intellectual property.

Significant opportunities exist, with careful planning, to maximise the returns available from intellectual property and to protect the value of these important assets from unnecessary exposure to income tax.

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