AIC Australian Institute for Commercialisation

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AIC BRIEFING NOTE

Taxing the mind: time for reform?

In the current debate on tax reform in Australia, a place must be found for reform of intellectual property (IP) taxation. How a country taxes its intellectual production has long term effects on its economic and social development.

Current tax law seeks to stimulate the creation of IP by offering companies a concession for R&D at the research phase. Shareholders are also offered various capital gains tax concessions for gains finally realised if and when the commercialisation is successful.

However, during the critical intervening development phase, there is no meaningful tax assistance to help convert a research idea that has potential into a marketable product capable of generating commercial revenues. This is despite the development phase being both high-risk and cash-intensive, and of critical importance to the development of a knowledge economy.

The situation is worse for start-ups looking to move through the commercial development phase. Existing tax law effectively prevents tax relief for losses flowing through to the owners of a start-up company, even though they bear the economic cost of those losses.

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. Instead, its commercial activity, and the R&D, will inevitably depart to overseas jurisdictions with more favourable tax regimes.

The Australian Institute for Commercialisation (AIC) has been working with the Intellectual Property Research Institute of Australia (IPRIA) to promote their report 'Taxation Problems in the Commercialisation of Intellectual Property'. This report has identified significant flaws in the current tax regime for IP, particularly the incentives it gives for start-up enterprises.

During February, around 300 people attended seminars sponsored by the AIC, IPRIA, and Price Waterhouse Coopers in Brisbane, Sydney, Canberra and Melbourne to:

- gain an insight into the taxation impediments to commercialisation of IP
- hear proposals for reform to address these issues
- be provided with some guidance on best practice for managing IP commercialisation under the current system.

The seminar keynote speaker was Prof. Cameron Rider, professor of taxation law at the University of Melbourne and author of the IPRIA report. . He noted that although both the production of IP and any ensuing capital gains receive favourable tax treatment, the vital stage of **commercialisation** of IP is actually penalised in a number of ways:

1. The transfer of IP into a company structure is treated as a sale of the IP and is a taxable event to the contributor of the IP. Tax is calculated on the value of the shares received in exchange for the IP i.e. unrealised future gains are assumed based on the present value of highly contingent future cash-flows;

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2. Employee shares are an essential element of incentivisation in a start up company, but are taxed in the hands of the employee as income, even though the shares may not be marketable when awarded and there is no present cash flow;

3. Start up losses are typical for growth companies, but these losses are quarantined and do not flow through to the investors, until future profits are realised. These profits then become taxable unfranked dividends on distribution. Furthermore, because additional capital is often required, the entity will fail the continuity of ownership test and tax losses are unusable.

4. There is no depreciation tax write-off for the capital cost of know-how, confidential information, trade marks or trade secrets, even though these may represent IP as important as patents or copyright (which can be written off).

Such issues, which do not exist in more favourable international jurisdictions, are bypassed today through complex structures that add cost to the commercialisation of IP, and have created a wealthy, but essentially parasitic advisor and consultancy community. They increase the effective tax rate on IP investment, divert capital to non IP investment which do not suffer such penalties, undermine the R&D tax concession, and ultimately encourage relocation of commercial IP activity to more favourable overseas jurisdictions. If Australia is to seriously encourage the creation of new industries and participate fully in the knowledge economy, some simple reform steps must be taken.

There are several possible reforms. Firstly, as in the US, it should be made possible for limited liability companies to elect to be taxed on the same basis as partnerships.

Second, there should be a general 'tax rollover relief' for contribution of assets in exchange for equity in an enterprise, to prevent taxation of unrealised gains at the establishment of start-up companies.

And third, employees who invest their intellectual capital in IP start-ups should be treated on the same footing as other investors in the enterprise. That is, there should be no taxation of gains until they are realised on sale of the shares, and then CGT concessions should apply.

Following the seminars IPRIA made a submission to the Pathways to Technological Innovation Parliamentary Inquiry and the AIC has written to the Federal Treasurer. IPRIA is continuing its work on the development of an appropriate taxation regime for IP. This will involve:

- Cost-benefit analysis of the proposed reforms for the economy

- Examination of how the proposed reforms fit within the overall innovation system to ensure that reforms in one area don't create impediments in other areas (eg: examination of interaction between incentives of grant programs and taxation reform)

- Ongoing consultation with affected groups to prioritise reform in those areas that are impacting most heavily on organisations.

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