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1 Introduction to types of IP

The focus of this session at the Tax Summit 2020 is upon tax issues with IP and Technology. Intellectual property is ever-present in a modern business. It may be the central focus of the business — as in the case of a tech start-up — or it may be part of the critical systems of an ordinary enterprise that has invested in a website, marketing, branding and software.

This presentation is split into discrete sections. Sections 1 and 2 of this presentation (by Aditi Rao) will address some of the fundamentals of intellectual property law and practice in Australia, itself a rich practice area of its own. Sections 3 and 4 (by William Calokerinos CTA) will then turn to the tax issues in detail. What follows in sections 1 and 2 are:

1. A basic and non-exhaustive introduction to some of the different legally protected forms of commonly encountered IP and intangibles: patents, copyright, trademarks, confidential information and bespoke statutory IP regimes;

2. A discussion of IP related commercial issues, informed by observations of the tech sector, and trends in voluntary licensing of IP.

What is intellectual property? Australian tax legislation has certain definitions that imply a fairly narrow conception of what is an "item of intellectual property". In the *Income Tax Assessment Act 1997 (*Cth) (**1997 Act**) the Dictionary in s.995 provides:

> ***intellectual property***: an item of ***intellectual property*** consists of the rights (including equitable rights) that an entity has under a *Commonwealth law as:
>
> (a) the patentee, or a licensee, of a patent; or
>
> (b) the owner, or a licensee, of a registered design; or
>
> (c) the owner, or a licensee, of a copyright;
>
> or of equivalent rights under a *foreign law.

Some explanation for this apparently arbitrary definition lies in its purpose: to inform what is an 'intangible depreciating asset' for the purposes of Div 40 of the 1997 Act. Such an item of intellectual property can be intangible depreciating asset under s.40(3)(2)(c). Software can also be an intangible depreciating asset if it is 'in-house software' under s.40(3)(2)(d), even though it is not defined as an 'item of intellectual property'. So in-house software is defined as follows:

> ***in-house software*** is computer software, or a *right to use computer software, that you acquire, develop or have another entity develop:
>
> (a) that is mainly for you to use in performing the functions for which the software was developed; and
>
> (b) for which you cannot deduct amounts under a provision of this Act outside Divisions 40 and 328.

Software generally attracts copyright protection, so it may also be an "item of intellectual property". Not everyone purchasing or using in-house software will be the owner of the copyright over that software (although they will probably be a licensee of some kind). The current approach allows taxpayers who simply buy and use in-house software to claim it as a depreciating asset, irrespective of whether the taxpayer is the owner or licensee of the copyright.

As will be seen, statutory protection of patents, copyright and registered designs are for a limited term, beyond which the relevant rights expire and the formerly protected intellectual property enters the public domain. Other kinds of "intellectual property" in the general sense, such as rights over circuit layouts and plant breeders' rights, are not depreciating assets under the tax law even though they are also conferred for a limited term. They are, however, likely to be CGT assets within the meaning of s.108-5 of the 1997 Act. Trade marks are also not a depreciating asset. Statutory trade mark protection can be renewed every ten years, and is potentially perpetual (provided that the criteria for validity continue to be met).

1.1 Patents

Patents can be fairly regarded as the strongest type of legal protection for intellectual property in Australia. A patent confers upon the owner a time-limited monopoly over an invention. The standard for the grant of a patent is correspondingly high. Patent rights are supposed to encourage invention. The basic theory is that patent rights are conferred in exchange for full public disclosure of the invention.

The Australian patent system has its roots in the mediaeval practice of English monarchs of making grants of privileges in "letters patent". This practice grew into a system of granting monopolies to favoured manufacturers, importers etc over the rights to specified trades, articles or practices. It is said that the grants were so abused by the Crown, to the great detriment of English trade, that eventually in 1623 Parliament enacted the *Statute of Monopolies*, abolishing any extant letters patent granting monopoly rights and prohibiting any future grants unless they were for "*the sole working or making of any manner of new manufactures*" and were granted "*to the true and first inventor*".

In Australia today, patents are governed by the *Patents Act 1990* (Cth) (**Patents Act**)[1]. There are two different kinds of patent under the current legislation:

- A **standard patent** which lasts for up to 20 years under s.67 (or up to 25 years for pharmaceutical substances: s.70).
- An **innovation patent** which lasts for up to eight years under s.68.

The system of patents is now administered by the Commissioner of Patents and Deputy Commissioners, public offices established by ss.207-208 of the Patents Act. The Patent Office itself is also established by s.205. These statutory offices are administered within IP Australia, a Commonwealth government agency.

[1] References to legislative provisions in this part ("1.1 Patents") are references to the Patents Act unless otherwise specified.

1.1.1 Rights conferred by a patent

A patent confers upon its owner a true proprietary monopoly right – the exclusive right to "exploit" the invention, as provided by s.13:

> (1) Subject to this Act, a patent gives the patentee the exclusive rights, during the term of the patent, to exploit the invention and to authorise another person to exploit the invention.
>
> (2) The exclusive rights are personal property and are capable of assignment and of devolution by law.
>
> (3) A patent has effect throughout the patent area.

The concept of exploitation, in relation to an invention, is the subject of an 'includes' definition in the Patents Act. It covers the following actions:

> (a) where the invention is a product—make, hire, sell or otherwise dispose of the product, offer to make, sell, hire or otherwise dispose of it, use or import it, or keep it for the purpose of doing any of those things; or
>
> (b) where the invention is a method or process—use the method or process or do any act mentioned in paragraph (a) in respect of a product resulting from such use.

Commonly, patented technology can be exclusively licensed to another entity (it may be a related entity or a third party). The exclusive licensee might then deal with commercialising the product, eg, via sale of products or non-exclusive licensing to customers. The unusual position of the exclusive license is recognised in the legislation: the exclusive licensee of a patent has the right to sue for infringement under s.120, in recognition of their special economic as well as legal interest in protecting their right to exploit the patent.

The patent has effect throughout the "patent area". The "patent area" is geographically limited to Australia and its continental shelf, and the waters and airspace above Australia and its continental shelf. There are some obvious shortcomings to having a geographically limited monopoly. However, this is mitigated somewhat by the ability to obtain international recognition of Australian standard patents under the Patent Cooperation Treaty (1970), once the Australian standard patent has been granted. This enables protection of the patented invention in any or all PCT Contracting States, which include most major markets (including the USA, most European states and the PRC).

1.1.2 Criteria for grant of a patent: what sort of inventions does a patent cover

The central concept of the Patents Act is that of the "patentable invention" in s.18. For a standard patent, a "patentable invention" is one that:

a. is a ***manner of manufacture*** within the meaning of the s.6 of the *Statute of Monopolies*;

b. When compared with the prior art base as it existed before the priority date of the claim:

    a. is ***novel***;

    b. involves an ***inventive step*** (or, in the case of an innovation patent – an '***innovative step'***: s.18(1A).)

c. is ***useful***;

d. was not ***secretly used*** (in the patent area) before the priority date of the claim by, or on behalf of, or with the authority of the patentee (or various others linked to the patent).

The general rule is that the "priority date" for a patent is the date on which the specification for the claimed invention has been filed.

Each of the key criteria is briefly discussed below.

Manner of manufacture

The essential question underpinning this criterion is whether the subject matter of the patent is suitable for patenting, using the language of the *Statute of Monopolies*. It can be helpful to think about patentable inventions generally falling into two basic categories - 'process' inventions or 'product' inventions. In Australia the Patents Act made no fundamental changes to the "manner of manufacture" concept, nor was there any attempt to codify or modernise the concept (cf. the broadly contemporaneous UK reforms which introduced a test of whether the invention is "industrially applicable"). Instead, by retaining the ancient statutory language of the *Statute of Monopolies*, Parliament chose to use an expression with a long history of judicial interpretation demonstrating its adaptability. This has had two notable consequences: one, through historical judicial development over centuries of economic and technological changes, the phrase has much greater scope and flexibility than the bare words, stripped of their context, would possess; and two, the courts have been able to continue this tradition of judicial development in response to changing conditions.

There is no better recent example than software patents. They are a particularly prolific field of development. It is not always easy to see how software might be a "manner of manufacture". However, as case law has developed, the key criterion for patentability of software is whether the substance of the software invention is a technological or technical innovation (which is patentable) or a business innovation (which isn't): *Research Affiliates LLC v Commissioner of Patents* [2014] FCAFC 150, *Commissioner of Patents v RPL Central Pty Ltd* [2015] FCAFC 177; *Encompass Corporation Pty Ltd v InfoTrack Pty Ltd* [2019] FCAFC 161; *Grant v Commissioner of Patents* [2006] FCAFC 120; conveniently summarised in *Aristocrat Technologies Australia Pty Limited* [2016] APO 49 at [35]. Is it also important for software patents to show that they are not a mere scheme, abstract idea, or mere information.

Novelty

Novelty is to be assessed in accordance with the rather self-referential test in s.7(1): something is novel unless it is *not novel* in light of *prior art information* made publicly available in any of the ways identified in s.7(1). Prior art is discussed below.

Inventive step (or innovative step)

An "inventive step" is required for the grant of a standard patent. An invention is taken to involve an inventive step when compared with the prior art base, *unless* the invention would have been obvious to a person skilled in the relevant art in the light of the common general knowledge as it existed before the priority date of the relevant claim: s.7(2) and (3).

For an innovation patent, the inventive step requirement is reduced to a need for an 'innovative step'. An invention is taken to involve an innovative step when compared to the prior art base *unless,* to a person skilled in the relevant art in light of the common general knowledge as it existed before the priority date, it varies from the prior art information in a way that makes no "substantial contribution" to the working of the invention.

Useful

An invention is not 'useful' unless a **specific, substantial and credible use** for the invention is disclosed in the complete specification for the patent (as to specifications see below).

Secret use

Secret commercial use of the invention will generally disqualify it from being patentable. There are limited exceptions to disqualifying effect of secret use, including where the use is for the purposes of reasonable trial and experiment, use in the course of confidential disclosure, non-trading and non-commercial use etc: s.9.

Prior art base

The concept of "prior art base" is an important one and is defined in the Dictionary (Sched 1 to the Act), since the question of novelty and inventive step (or innovative step) is judged against the state of the "prior art base".

In general terms, the prior art base is comprised of any information in a publicly available document, and any information that is publicly available, anywhere in the world. Given the worldwide coverage of this concept, in cases challenging the validity of a patent it is not uncommon for evidence of prior art to come from far and wide, and be in any language.

These criteria impose high standards for the grant of a standard patent.

1.1.3 Applying for a patent

In the quest to create a patentable invention, a person may spend (or invest) huge sums of money over many years. The outcome of at least certain kinds of scientific/industrial research is inherently unpredictable and therefore involves risk. The tax treatment of expenditure on the development of a patentable invention, and the availability of incentive schemes, will naturally be of great interest to the taxpayer concerned.

However, developing a patentable invention is only the first step to acquiring patent rights.

Once there is a potentially patentable invention, the formal administrative and legal processes for the grant of patent must occur, with a filing fee or equivalent payable to IP Australia at each successive stage of the process. First, an application for a patent application must be made. It may be complete or provisional: s.29(2). The application must be accompanied by a "specification", again, either complete or provisional. A "specification" must comply with the requirements of s.40 and must fully disclose the invention in the manner there prescribed. A provisional specification does not, however, contain the comprehensive claims defining the invention that are required in a complete specification. The advantage of a provisional application is that it gives an additional 12 months within which the complete application and specification must then be filed.

Drafting of the claims and specification is usually the work of a patent attorney and is itself a highly specialised and expensive skill. The process of drafting and filing the claim for a patent is yet another cost centre for the aspiring patentee.

Once the application for the grant of a patent is complete, it is ordinarily published in the Official Journal of the Patents Office. This has the effect of public disclosure. At this stage, the patent has not been granted but only applied for. The next step involves the examination of the patent by a patent examiner in accordance with the Act and Regulations. IP Australia publishes the Australian Patents Office's *Manual of Practice and Procedure*, an administrative document that is intended to assist in this process. The application must be "accepted" if, on the balance of probabilities, the Commissioner is satisfied that the statutory criteria for a patentable invention are met: s.49(1). This decision must then then be published in the Official Journal. Following acceptance of the patent application, the actual grant of the patent can be opposed by any third party. If so a contested pre-grant opposition hearing will be held before the Commissioner, at which evidence can be adduced. The Commissioner may refuse to grant the patent if a ground of opposition is made out: ss.59-60. An appeal lies from this decision to the Federal Court: s.60(4). If there is no opposition to the grant of the patent or, or if opposition is unsuccessful, then, finally, the standard patent must be granted: s.61. As can be seen, the process of obtaining a patent be lengthy and expensive.

A mere patent application is not itself an "item of intellectual property", however, Rankine has commented that the application itself is a CGT asset since it comprises a "kind of property or legal or equitable right that is not property": subsection 108-5(1)) of the 1997 Act; and see Rankine, "*Tax through the bottom of a glass*", Div 40 Intellectual property, Tas Division 23-24 May 2013.

Ownership and assignment of patents

Only certain entities are entitled to obtain the initial grant of a patent. They are, under s.15:

a. the inventor of the invention;

b. someone entitled to be assigned the patent upon its grant (the entitlement might arise from the terms of an employment contract, for example);

or someone claiming through the title of such a person or the legal representative of their deceased estate.

Once granted, a patent is a form of intangible property and it may be sold, transferred, licensed, assigned, partially or fully, as with other intangible property.

1.1.4 Infringement

Armed with a patent, the patentee has the exclusive right to exploit the invention. This means the patentee can preventing others from making unauthorised use, importation, sale, etc, of the invention, and can sue for infringement of the patent if they do: s.120. This will likely involve expert evidence in the relevant field. It is important to bear in mind that the grant of a patent does not confer absolute validity upon the patent. The validity of a patent may be challenged in Court and a person sued for infringement may counterclaim for revocation of the patent on the grounds of invalidity: s.121. This may open up any number of questions, including novelty and inventive step having regard to the state of the prior art base. Given the breadth of material potentially forming the prior art base, such litigation can be wide-ranging and very expensive.

Remedies for patent infringement are wide-ranging, from destruction of infringing articles to an account of profits.

It is also worth noting that under ss.128-129A, Courts are empowered to grant relief against a person making unjustified threats of infringement proceedings. Remedies include declarations, injunctions, and even damages: s.128(1).

1.1.5 Defences and exemptions

A person sued for patent infringement may counterclaim for invalidity, as already noted. In addition there are a number of limited exemptions from infringement under the Patents Act, including:

- use of a patented invention on a foreign vessel/aircraft, if the vessel enters the Australian patent area only accidentally or temporarily: s.118;
- a limited exception for prior use: s.119;
- certain exemptions for acts for obtaining regulatory approvals of pharmaceuticals: s.119A), and non-pharmaceuticals: s.119B;
- for experimental purposes: s.119C.

1.2 Copyright

Copyright in Australia is governed by the *Copyright Act 1968* (Cth) (**Copyright Act**). It is a powerful but nonetheless more limited form of protection than patents. If the protection of invention is the value served by patent law, then in copyright law the value being promoted is originality.

1.2.1 The subject matter protected by copyright

The subject matters protected by copyright fall broadly into two categories:

- "Works" – ie the traditional forms of literary, dramatic, musical and artistic works;

- "subject matter other than works" – sound recordings, cinematograph films, TV and sound broadcasts etc, which are addressed in Part IV of the Copyright Act.

Software usually attracts copyright protection as a literary work.

1.2.2 The rights conferred by copyright

The rights conferred by copyright in relation to a "work" are, essentially the rights to reproduce and disseminate the work. In general terms, rights in relation to works are set out in s.31(1):[2]

(a) in the case of a literary, dramatic or musical work, to do all or any of the following acts:

(i) to reproduce the work in a material form;

(ii) to publish the work;

(iii) to perform the work in public;

(iv) to communicate the work to the public;

(vi) to make an adaptation of the work;

(vii) to do, in relation to a work that is an adaptation of the first-mentioned work, any of the acts specified in relation to the first-mentioned work in subparagraphs (i) to (iv), inclusive; and

(b) in the case of an artistic work, to do all or any of the following acts:

(i) to reproduce the work in a material form;

(ii) to publish the work;

(iii) to communicate the work to the public; and

(c) in the case of a literary work (other than a computer program) or a musical or dramatic work, to enter into a commercial rental arrangement in respect of the work reproduced in a sound recording; and

(d) in the case of a computer program, to enter into a commercial rental arrangement in respect of the program.

Copyright is not a true monopoly in the sense that a patent is. Copyright is protection against the use or copying of the actual protected work. If someone independently and innocently recreates a work by coincidence then there is no infringement.

The bundle of rights comprised in copyright are property rights.

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[2] References to legislative provisions in this part ("1.2 Copyright") are references to the Copyright Act unless otherwise specified.

1.2.3 Scope of copyright protection

As can be seen from s.31 itself, the amplitude of the right to reproduce depends on the importance or merit implicitly accorded to the *type* of work, or as being inherent in the *type* of other subject matter. Literary works are protected in a multitude of ways: against direct reproductions, adaptations, public performances, translations into other languages, dramatisations etc, whereas artistic works obtain much more limited protection. Protected matter that is not a traditional "work" will receive more limited protection again: see, eg, the regime for sound recordings, photographs and cinematograph films.

Notwithstanding the need for originality, it is often said that copyright does not protect ideas, but only the form in which those ideas are expressed. This is in contrast to patents, which do protect ideas – at least so far as they are manifested in a manner of new manufacture under the Patents Act.

Several different kinds of copyright can exist concurrently in a single article. To take the example of a sound recording of an original musical composition, copyright protection subsists in relation to the musical work. The unique sound recording of a performance of the work will also attract concurrent copyright as a sound recording protected by the Act. To make commercial use of that sound recording, one would need licences both from the owner of the copyright in the musical work and from the owner of the copyright in the sound recording.

1.2.4 Term of protection

The term of protection for copyright in works is generally the life of the author/creator plus 70 years (s.33). The terms of protection for other subject matter will vary. Following recent reforms to the term of copyright, the Australian government has published a handy ready reckoner of copyright terms for all manner of works and other subject matter under the Act.[3]

1.2.5 Criteria for protection

In Australia, no formalities for registration of copyright are required. Copyright automatically subsists in subject matter that meets the statutory criteria. The copyright symbol - © - is not required, but it is always a good idea to have it as a clear assertion of rights.

The criteria for protection of a work/subject matter under the Copyright Act includes:

- There must be some nexus to Australia. Broadly, one of the following should be met:
    - the author or maker must be a "qualified person", ie a natural person who is Australian citizen or resident, or a body incorporated under a State or Commonwealth law; or
    - the work (or other subject matter) must be first published in Australia, or,
    - for some types of subject matter, the subject matter was made in Australia.

[3] https://www.communications.gov.au/copyright/duration-copyright

- The work or other subject matter must be "original". The threshold for originality is not particularly high when compared to the test of novelty or inventiveness in patent law. The work does not necessarily have to be especially creative or meritorious. If the creation of the work/subject matter involves a non-trivial degree of skill or labour on the part of the author/creator, this will often suffice. A compilation or arrangement may attract copyright even if its individual components do not meet the test of originality or skill. But if so, there should still be some independent intellectual effort involved in the making of the compilation: *IceTV Pty Ltd v Nine Network Australia Pty Ltd* (2009) 239 CLR 458 at [33]. It is essential that the work/subject matter was created by the author and not copied from elsewhere.

- To attract copyright, the work or other subject matter should have been reduced to a material form.

There are now a range of rights that are less than copyright, such as rights in live unfixed performances, which do now attract limited protection: Copyright Act: Pt XIA.

In addition to traditional copyright, authors and creators now have "moral rights" over works; broadly, these rights are the right of attribution and the right of integrity. They are not traditional property rights.

1.2.6 Infringement

As a general rule, copyright in a work will be infringed where there is a "substantial" degree of copying (sometime framed as "substantial similarity") between the allegedly infringing work and the original. The infringing work must in some way have been derived from the original. If it was truly independently created then it is not an infringement. Usually, access to the original work is enough to indicate some form of derivation.

Readers may be familiar with the "Down Under" case, *Larrikin Music Publishing Pty Ltd v EMI Songs Australia Pty Ltd* [2010] FCA 29 (Jacobson J); on appeal *EMI Songs Australia Pty Ltd v Larrikin Music Publishing Pty Ltd* (2011) 191 FCR 444. What was in issue was flute "riff" lasting only few seconds, that was melodically the same as the opening two bars of the song "Kookaburra sits in the old gumtree", first published in a 1934 Girl Guides publication. This was held to satisfy the substantiality test. The decision is of significance for the music industry and confirms that licensing is required for 'sampling' and use of musical 'hooks' referencing other musical works.

Where infringement is shown, again, available remedies are broad. In the case of the copying in *Down Under*, a small proportion of the royalties for that song was ordered to be paid to the owner of the copyright in "Kookaburra sits in the old gumtree".

1.2.7 Defences and exceptions

There are a number of well-known defences or exceptions to infringement, including:

- Fair dealing for the purpose of research or study: s.40;

- Fair dealing for the purpose of criticism or review: s.41;
- Fair dealing for the purpose of parody or satire: s.41A;
- Fair dealing for the purpose of reporting news: s.42;
- Reproduction for the purposes of judicial proceedings or professional advice: s.43.

The Copyright Act creates a large number of other situation-specific defences or exceptions to infringement.

1.3 Registered Designs

Registered designs are governed by the *Designs Act 2003* (Cth) (**Designs Act**).[4] This regime is concerned with the protection of new ‘designs’ of ‘products’. That is, the **new and distinctive** visual **overall appearance** of a product resulting from one or more **visual features** of the product: s.5. See also the definition of “product” in s.6 which, broadly, means any manufactured or hand-made thing, but must generally be of a definite specifications/dimensions (or at least, having definite proportions).

What is a visual feature? It includes shape, configuration, pattern and ornamentation; it may but need not serve a functional purpose; it does not include the feel of a product or materials used: s.7.

1.3.1 Criteria for registration of design

A design is registrable if it is new and distinctive when compared with the prior art base for the design as it existed before the priority date of the design: s.15(1). The concepts of prior art and priority date are similar to those under the Patents Act (discussed above). A design is new if it is not identical to some prior art. The test for distinctiveness from another design (or rather, lack of distinctiveness) is whether it is “substantially similar in overall impression”. This is both the test for **registrability**, and for **infringement** (discussed below). Section 19 sets out the factors to be considered in this comparative exercise. Interestingly, s.19(1) requires that more weight be given to similarities than differences –it was thought that, under earlier legislation, too much weight was given to minor differences.

1.3.2 Rights conferred by registration

The Designs Act grants monopoly rights to the owner of a registered design. Rights granted include: the right to make or offer the “product” embodying the registered design; to import such a product for sale or use for any trade or business; to sell, hire, dispose of, such a product, to keep such a product for such purposes, or to authorise any person to do such things: s.10. The rights are personal property rights: s.10(2), subject to the Designs Act, and can be assigned: s.11, or otherwise dealt with: s.12, by the registered owner.

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[4] References to legislative provisions in this part (“1.3 Registered Designs”) are references to the Designs Act unless otherwise specified.

1.3.3 Applications for registration

Registration must be applied for under s.21 and Chapter 3 of the Designs Act.

A design application must meet minimum filing requirements for disclosure of the design. Only certain persons can be registered as owner/s of the design. The creator of the design is one such person: s.13(1)(a). The employer of the designer is presumptively permitted to be registered, unless the contract between employee and employer provides to the contrary: s.13(1)(b)). A person who derives title from such a person is also eligible to be registered: s.13(1)(c), such as an assignee. Co-ownership is permitted.

The term of protection under the Designs Act is maximum of 10 years: s.46.

Unlike standard patents, no mandatory examination of the design occurs prior to registration. Registration occurs after a formalities check: s.39. However, an examination and certification of the design under s.67 must be carried out before the owner can bring infringement proceedings under s.73. The cost of examination can thus be deferred.

1.3.4 Infringement

A person who without authority makes a product embodying a registered design, or otherwise deals in such a product in a way that fall within the other exclusive rights of the owner, may be liable for infringement of the design: s.71(1). Parallel imports of products made under a licence from the registered owner do not infringe: s.71(2).

The test for infringement is whether the allegedly infringing design is identical or substantially similar in overall impression to the registered design: s.71(1)–(3). This is the same test as the test for registrability in s.19.

As noted above, infringement proceedings may only be brought once the design has been certified and has been substantively examined: s.73. The examination and certification process is not conclusive; and any claim for infringement may be met with a counterclaim alleging invalidity: s.74.

A person makes or offers to make the design will have committed a **primary infringement**: s.75(2)(a). "**Secondary infringement**" refers to infringement by a person dealing in infringing designs: s.75(2)(b) (eg, retailers selling a product).

The type of infringement alleged is important because, along with the degree of knowledge of the infringer, it affects the scheme for remedies available under s.75, discussed next.

1.3.5 Defences, exceptions and mitigation

There is a defence known as the "repair defence" in s.72, the purpose of which is to ameliorate the anti-competitive effect of the monopoly in the after-sales market for certain kinds of spare parts. Car parts are a classic example. By way of a broad oversimplification, s.72 allows the creation and supply of components by competitors of the registered owner for the purposes of repair of a complex product. In such a case, there must be use of the component product for a "repair" that restores the overall

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appearance of the complex product that is under repair. The defence does not protect enhancement of the appearance of the product, only restoration of that appearance.

As with most types of IP litigation, the Court has a wide discretion over remedies. Typically these may include injunctive relief and damages or an account of profits: s.75(1). Under s.75(2), the Court may refuse or reduce the quantum of monetary relief (damages or account of profits) in certain legislated circumstances. In a case of **primary infringement**, this discretion is enlivened if:

- at the time of infringement, the defendant was not aware that the design was registered, ***and***
- before that time, the defendant had taken all reasonable steps to ascertain whether the design was registered. This would usually require the defendant to have searched the Register of Designs.

The defendant bears the onus of proving these matters.

In a case of secondary infringement, the discretion to reduce or refuse a monetary award is enlivened if the defendant proves that at the time of infringement the defendant was not aware, and could not reasonably be expected to have been aware, that the design was registered.

The Court has a further statutory discretion to award such additional damages as it considers appropriate having regard to the flagrancy of the infringement and all other relevant matters: s.75(3).

Where the product or packaging bears a sign indicating that the relevant design is registered, this is prima facie evidence that the defendant was aware that the design was registered: s.75(4).

1.3.6 Relationship to copyright

There is an obvious potential overlap with copyright, in particular, copyright in artistic works. However, in Australia, it is unsafe to assume that a design which is an artistic work will have concurrent copyright protection. Under ss.74-77 of the Copyright Act, certain kinds of concurrent statutory protection is prohibited for designs that are, or could have been, registered. The general policy in successive legislation has been to encourage the registration of industrially applicable designs, by (amongst other things) removing copyright protection from some kinds of artistic works. A failure to register a registrable design may in some circumstances result in no protection at all: *Burge v Swarbrick* (2007) 232 CLR 336.

1.4 Trademarks

Registered trademarks are governed by the *Trade Marks Act 1995* (Cth) (**Trade Marks Act**).[5] As noted, they are not depreciating assets. The protection of a trade mark is potentially perpetual, subject to the criteria for validity being satisfied.

[5] References to legislative provisions in this part ("1.4 Trade Marks") are references to the Trade Marks Act unless otherwise specified.

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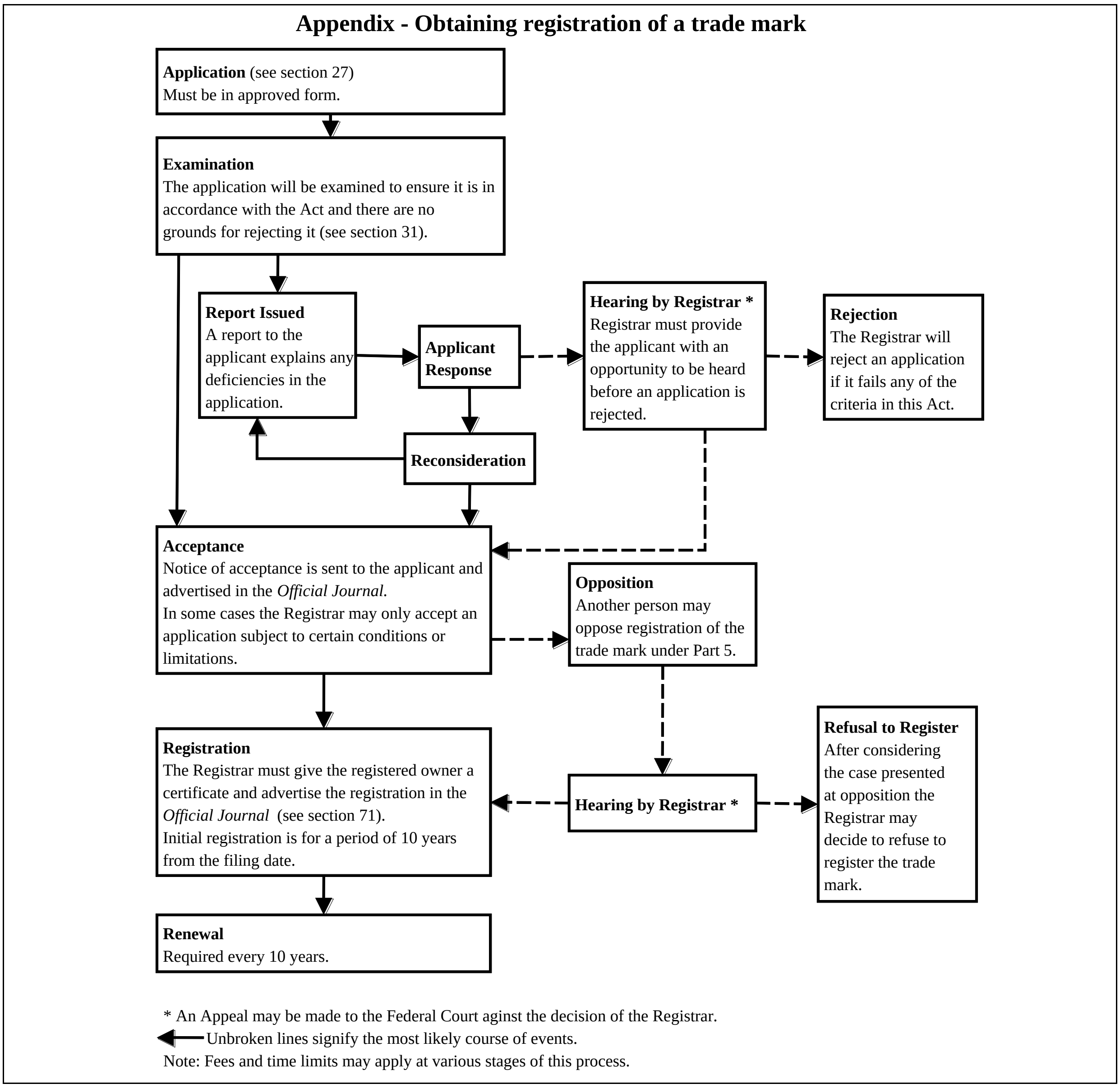
1.4.1 Process for registration

A registered trademark must be applied for under s.27. The process for registration is helpfully represented in a flow chart accompanying the Trade Marks Act:



As can be seen, there is an initial examination by the Registrar of Trade Marks: s.31. The examination may result in acceptance of the mark. If there are concerns about the mark there may be a hearing before the Registrar to determine whether the mark will be accepted or rejected: s.33(4), and the outcome may be the subject of appeal to the Federal Court or the Federal Circuit Court: s.35. If the application passes examination, the proposed registration will be advertised in the Official Journal: s.34(b). At this stage, another person may oppose registration: s.52. If so, there will be an opposition proceeding before the Registrar: s.54, at which the Registrar may decide to accept or refuse registration of the trade mark: s.55. Again, an appeal lies to Federal Court or Federal Circuit Court: s.56.

1.4.2 Criteria for registration

The trade mark sought to be registered must be a “trade mark” within the meaning of s.17 of the Trade Marks Act. That is must be a “sign” used or intended to be used to distinguish goods or services dealt with or provided by one person, from those of another person. Registration is not limited to visual signs. There is an expansive inclusive definition of “sign” in s.6. A sign may be or may be a combination of “any letter, word, name signature, numeral device, brand, heading, label, ticket, aspect of packaging, shape colour, sound or scent”.

The sign must then:

- be distinctive: s.41;
- not be deceptive or confusing due to similarity to another unregistered mark (s.60) or some other misleading quality: s.43;
- not be too similar to another registered trade mark for the same or similar goods or services: s.44.

Distinctiveness

The concept of distinctiveness is where much of the debate arises, and can lead to fine judgments being drawn. A trade mark cannot be a generic, functional or purely descriptive. However distinctiveness may be inherent or acquired through use. The trade mark is supposed to be a badge of origin, distinguishing the person from whom the goods or services originate. Section 41 sets the standards for distinctiveness.

Under the current Act, the trade mark does not need to be wholly separate from the goods themselves. For example, a shape can be trademarked in respect of a biscuit, the Coca Cola bottle design or the shape of Life Savers mints. Nonetheless a shape cannot be a usual, functional or inherent shape that other traders would expect to be able to use. In *Chocolaterie Guylian NV v Registrar of Trademarks* (2009) IPR 13 a seahorse shaped chocolate was refused registration as it was a representation of a real creature which other chocolatiers would reasonably expect to be able to use. In contrast, candies and chocolates of made up or ‘fanciful’ creatures have received protection on other occasions. Harley Davidson spent many years unsuccessfully seeking to trademark the sound of their motorcycle engine in the USA. It failed because the engine sound was deemed insufficiently distinctive to the brand.

Used or intended to be used

A trade mark cannot be kept idle, or it will be liable to expungement: ss.92-105. If there is no intention to use the trademark, or but it is being registered for a collateral purpose, it may be refused registration: *Imperial Group Ltd v Phillip Morris* [1980] 1 FSR 146.

1.4.3 Rights conferred by registration

Section 20 confers a limited statutory monopoly upon the owner of a registered trade mark. The registered owner has the exclusive right to use the trade mark, and to authorise the use of the trade mark, in relation to the goods / services for which it is registered.

1.4.4 Infringement

Under s.120 the registered owner has a statutory right of action against unauthorised use of the trade mark "as a mark" in relation to the relevant goods and services. In certain circumstances, this right extends to use in relation to other goods. Again, fine judgments may be involved. Use of a trade mark in searchable metadata or purchase of a mark a Google Adword (being a competitor's mark) has been held not to be use "as a mark": *Veda Advantage Ltd v Malouf Group Enterprises* (2016) 241 FCR 161. Yet use of a trade mark in certain software source code did constitute trade mark use as it influenced search results and was visible in certain respects: *Accord Australia v LIV Pty Ltd* (2017) 124 IPR 264. Often the crucial question is whether the mark is being used merely descriptively. In cases of alleged counterfeiting, a rule of thumb is often to ask whether the mark is being use for some purpose *other* than as a badge of origin.

In some instances, trade mark protection will extend beyond the relevant goods and services to:

- use of the mark in in *related* good or services: s.120(2).
- use on *unrelated* goods or services, but only for "well known" marks: s.120(3) and (4). Marks such as Coca-Cola, Cadbury, Nike, etc spring to mind.

1.4.5 Defences and exceptions

There are a range of carve-outs and defences which will not be discussed in detail here, but can include:

- Uses in good faith of a personal or business name or of some descriptive or informative terminology denoting quality, kind, purpose, origin. Eg in *Australian Postal Corporation v Digital Post Australia* (2013) 105 IPR 1, the respondent's chosen name "Digital Post Australia" was held to be descriptive of its services without seeking to leverage any association with Australia Post.
- Prior use.
- Generic trade marks: s.24, where a brand name or mark has come to denote a generic class of goods of services. In this instance, a brand has become too successful for its own good; it has come to embody the generic article. History is replete with such brands: hoover, biro, kleenex, walkman, esky, jacuzzi, band-aid, xerox – and perhaps nowadays 'google' to mean internet search.

1.4.6 Alternatives to registration

Trade marks can be protected at common law, generally via the tort of passing off. To prove a common law trade mark the claimant must prove:

- the existence of a reputation in a distinct aspect of goods or business;
- a misrepresentation by the defendant (ie a deceptive use or deceptive similarity of the mark) and
- damage.

The business reputation is something akin to goodwill. By contrast if a trade mark has been registered, the owner has an automatic right and protection of the use of the mark in relation to the goods or services for which the mark has been registered. Registration therefore confers some quite tangible advantages.

1.5 Confidential information and trade secrets

In some cases, protection of IP may not be suited to the 'disclose and defend' model of patents etc, which requires substantive disclosure of the details of the invention or other IP. There may be many reasons for this. For example in practical terms, infringement may be too hard to prevent or eradicate. In such cases a business may choose to keep the key details of their product secret. This would be achieved by strictly controlling the personnel who can know this key information, requiring confidentiality agreements, and putting in place various technological or professional security to prevent copying, theft or misuse. It is self-evident that if a trade secret gets out, the consequences for a business may be dire. Accordingly, while is not the occasion for a detailed treatise on the law of confidentiality, we would be remiss not to make brief mention of it.

A person whose confidential information disclosed or used against their wishes may have an action at law or in equity against the person who has taken that information and, potentially, anyone who has received that information or may make use of it. Obligations of confidence may derive both from contract and general principles of equity. In the case of the equitable cause of action, equitable remedies will be available, including injunctive relief and gain-stripping remedies such as an account of profits (or even a constructive trust).

In *Optus Networks Pty Ltd v Telstra Corporation Ltd* (2010) 265 ALR 281 at [39] Full Federal Court conveniently summarised the four elements of the equitable cause of action:

- The information must have the necessary "quality of confidence";
- The information must be sufficiently identifiable and specific;
- The information was imparted in circumstances importing an obligation of confidence (this can also be satisfied where the information was obtained by surreptitious, tortious or illegal means);
- There is actual or threatened misuse of the information without the owner's consent.

In this type of case, at least, the information itself may sometimes be seen as a type of property: “equity regards information as akin to property and grants or withholds relief accordingly”: *Darvall McCutcheon v H K Frost Holdings* (2002) 4 VR 570 at [56], although this proprietary theory of confidential information is but one of many. It may suffice to note for present purposes that the action is be deployed against ex-employees who have “stolen” not only sophisticated IP, but also more mundane assets such as customer databases and other information that, on its own, is not inherently confidential but is nonetheless very valuable. Typically, the aggrieved claimant may have a number of concurrent causes of action for breach of contract, breach of fiduciary duty, breach of confidence and the enforcement of a lawful restraint of trade.

1.6 Other types of IP

Other types of IP in Australian law include sui generis statutory regimes, such as the *Circuits Layout Act 1989* (Cth) and the *Plant Breeders Rights Act 1994* (Cth). Besides these, there are business assets commonly grouped together with IP, that might also be seen as part of the get up (“look and feel”) and goodwill of the business, such as customer databases, internet domain names etc.

1.6.1 Circuit Layouts Act 1989

The *Circuit Layouts Act 1989* (Cth) (**CL Act**) provides protection for “eligible layouts” (ELs) of integrated circuits. A circuit layout is defined to mean “a representation, fixed in any material form, of the three dimensional location of the active and passive elements and interconnections making up an integrated circuit”: s.5 of the CL Act. A brief synopsis of the regime was given by Northrop J in *Centronics Systems Pty Ltd v Nintendo Co Ltd* (1992) 39 FCR 147 at 147-8:

> The Act contains many technical expressions, but in essence EL rights are rights conferred on the owner of an original circuit layout which can be described as the drawing of a plan, in a material form, for an integrated circuit, the purpose of which is to perform an electronic function and being a circuit in which the active and passive elements, and any of the interconnections, are integrally formed in or on a piece of material. An integrated circuit is the device made in accordance with a circuit layout. Thus, there is a similarity between the drawings of a plan prepared by an architect for the construction of a building and a circuit layout prepared for the construction of an integrated circuit. The EL rights apply both to the circuit layout and to an integrated circuit made in accordance with the circuit layout. Integrated circuits form part of electronic equipment such as computers and electronic games.

This legislation broadly follows the model of the Copyright Act: protection arises automatically and is not dependent upon registration. The layout must have been made by an eligible person or was first commercially exploited in Australia or another eligible jurisdiction: s.5, 8, CL Act. The eligible layout should be original: s.11 CL Act. The owner of the rights in the electronic layout is its maker (ie the person who first “fixed it in a material form”), or the employer of the maker: s.16, CL Act.

By s.17 of the CL Act, the owner of the EL rights has the exclusive rights to copy the layout, directly or indirectly, in a material form, to make an integrated circuit in accordance with the layout or copy, and to exploit the layout commercially in Australia. As with copyright, these are anti-copying rights rather than full monopoly rights.

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1.6.2 Plant Breeders Rights Act 1994

The *Plant Breeders Rights Act 1994* (Cth) (**PBR Act**) creates another bespoke statutory scheme for intellectual property rights called plant breeders rights (**PBR**), in relation to “new plant varieties”. The owner of PBR in relation to a plant variety obtains certain exclusive rights in relation to “propagating material” of that variety.

The scheme is derivative of the regime for patents, with administrative processes required for applications for PBR: s.24, priority dates: ss.28-29, objections: s.35, grant and registration of PBR: ss.43-46, and so on. This statutory regime is in addition to the patent regime: plant technology can also be patented if it meets the stricter thresholds for patentability.

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2 Common legal aspects of exploiting and protecting valuable IP

The reader may by now have a sense of the different levels of expenditure that might be involved in securing different kinds of IP rights. Standard patents are a potentially very expensive form of intellectual property, not only in terms of research and development, but also in terms of registration and protection. On the other hand while registering a design involves some expense, the process is far more streamlined compared to patents and certain costs can be deferred.

Nonetheless the model for commercialisation and structures for intellectual property businesses is broadly similar regardless of whether the property is a patent, registered design, copyright or some other form of statutory IP.

2.1 Outright sale

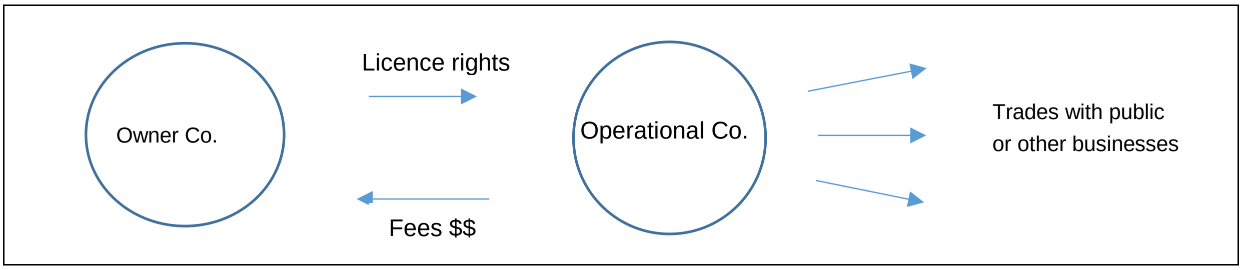
Outright sale of the IP is one option for commercialisation, and is a common successful 'exit' for entrepreneurs in tech start-ups. This is often the model for a tech start up: the desired exit is for the founders and key employees of the start-up to sell the technology to a large existing player. The start-up's novel IP would likely make up the bulk of the company's valuation.

The research and development phase of an intellectual property business will likely have occurred through a corporate structure (that could take advantage of the Australian R&D incentive scheme). Additional funding will often include some combination of venture capital or other outside investment. Founders of a start-up and investors will likely be substantial shareholders and option-holders. The sale of the IP can therefore occur through the purchase of shares in the entity that owns the IP.

2.2 Entities: separation of ownership and operational entities

Within a corporate group it is not uncommon for the entity owning the IP to be separate from the entity conducting the operational part of the business. In this model, the owner would then grant a licence to the operational entity, in exchange for payment of licence fees (royalties). This has the attraction that the valuable intellectual property itself is somewhat shielded from operational risks and liabilities.

It also means that there can be income in the form of royalties/licence fees to the owning entity and conversely payment of royalties / licence fees by the operational entity:



The tax aspects of such arrangements may be addressed in another part of this presentation/paper. A host of additional issues arise where one of these entities is an offshore entity.

2.3 Tangling with patents

Patent portfolios are regarded as extremely valuable forms of IP. In some tech companies they are the most prestigious and perhaps only significant asset. Some tech companies' main business is simply to generate patents. On this model the patent owner might exclusively licence the patent to some arms length third party to exploit commercially in return for a royalty-based income stream. Alternatively, the patent may simply exist in a passive portfolio without being exploited.

Presumably the business model in such a case requires the entrepreneur to be vigilant for new products that might infringe their existing (albeit largely unexploited) patent. This approach differs from conventional expectations because no owner or licensee will have invested money in making practical commercial use of the patented invention. Conversely, however, if the invention was not a real or workable invention at the time of the claimed patent, it would be vulnerable to a counterclaim for invalidity. The claimant would also need to be mindful not to make unjustified threats of infringement proceedings.

On the other hand, the cost of ownership of a patent, including the associated administrative costs, is high. Time and money must be invested on the preparation of specifications and claims. Even with such investment, there is always a risk that with the benefit of hindsight (ie during the course of infringement proceedings!), the specification has not captured precisely what the entrepreneur might have wished it did. Meanwhile the public nature of patent specifications means that the technology in question is not a trade secret, and therefore potentially vulnerable to reproduction. How is one supposed to protect something like, eg, software in a world where the initial production is arduous but infinite copying of it is really easy? Even for pharmaceuticals, if there is an industrial facility available for manufacture, infringing reproduction is relatively easy in comparison to initial research and development. With a sufficiently large legal budget, some entities develop and maintain fearsome reputations for defending their IP. That reputation itself may deter some potential infringers. This might be combined with a campaign warning the public (ie the consumers) about the dangers of counterfeit products. But these measures are suggestive of an eternal "arms race" between patentees and infringers without any definite end.

Given the costs of patent ownership and ongoing protection, one common issue is that it may simply not be feasible for small (tech or other) start-ups. A well-funded venture capital backed company will be more likely to treat patenting as a key part of their IP. However, even if costs are not an issue, unless the business is willing to make the key details of the invention public, it may be more realistic to avoid the arms race entirely and keep knowledge of key innovations, such as innovative software, a trade secret, simply because it is otherwise impossible to prevent functional reproduction of the invention, whatever legal rights there may be. The 'trade secret' route has its own risks – for example, leaks, hacking, or reverse engineering of a software product, or where third-party labs can analyse the contents of commercially available chemical/pharmaceutical products. If that occurs, the owner potentially has copyright protection to fall back upon, as well as the law of confidentiality – provided that the culprits can be identified and sued in a suitable jurisdiction. In the case of software, as noted, copyright does not protect ideas but only the expression of ideas. If the invention is recreated using very different software code and architecture, there may be no copyright infringement. However a patent would give some protection to the underlying invention

Conversely, widespread ownership of patents by a firm can present issues for their smaller competitors and other businesses. Especially in the start-up phase, the burden of *defending* a patent lawsuit brought by a well-resourced existing player might be unsustainable. Firms (even large firms) may therefore put in place strategies for mitigation – eg, it may be a policy that employed inventors should not read patents relating to their field. The rationale is that it will reduce the risk of copying. Even if the worst happens and they are found to have infringed a patent, deliberate infringement of a patent by the inventor is generally thought to be worse than innocent infringement in most jurisdictions where litigation is likely to be brought. At least some of this reasoning is likely to have been influenced by If a claimant can show an evidentiary chain suggestive of knowing infringement, damages may be increased significantly.

2.4 Licensing IP

Selling a new physical device into each home is perhaps the classic model of commercialising an invention. However licensing of IP to other people is an increasingly common way of commercialising proprietary IP. Again, typically this is encountered in software.

2.4.1 Buy and install model

The historical model of licensing software was where a person or business bought outright the right to install and run software at home, or in the business, on a computer or number of computers. The software may or may not have been updated, but the licence was not time limited in any meaningful way.

2.4.2 Subscription model

Many businesses now adopt a subscription model, in preference to the buy and install model. Here, the customer pays a recurring (usually monthly or yearly) fee. In theory, in return, the customer gets the benefit of regular updates and improvements to the software product. If the recurring fee is not paid the software licence terminates.

2.4.3 Open source software

A very different kind of software licence is 'open source' licensing. The IP here is made public, meaning that the source code of the software is 'open'. The GNU Public Licence (GPL) is the best known example of an open source licence although it is only one of many. The licence attaches to publicly available code and governs its use. The GPL allows anyone to be to work with the software internally and to, alter and improve it. But this is subject to certain conditions, such as a condition that the licensee must, in turn make public whatever software they produce from the original open source work. The volume of useful software that is open source is huge. Companies often do make use of open source software (and can get into trouble for breaching open source software licences).

2.4.4 Software as a service

Most traditional licences assume that a user will be running the software on their own computer. A new model of software enabled by the growth in Internet "cloud computing" platforms is where the software itself is a service. That is, the customer purchases the right to direct the service provider to call a software function (on the provider's own computers) and return the result to the customer. On this model, the customer might licence the right to make, say, 30,000 function calls per month within their subscription with the service provider. The model is capable of exploiting loopholes in conventionally drafted "buy and install" licences. According to this model:

- the service provider is the "user" of the software, ie, they are running the software on their own private computer pursuant to a licence granted by the owner of the software;
- the customer may be in a subscription-based relationship with the service provider, who may well not be the owner of the software;
- Therefore there is no direct relationship between the customer and the owner of the software. The customer is not running the software and does not pay the software owner;

Depending upon how the licence is drafted, the owner may find themselves remunerated for just the one software "user" notwithstanding its much wider commercial application. They may find that instead of thousands of customers purchasing their own individual software licences, they have been replaced by a small number of service providers aggregating their service for lower cost. The owner of the original software will only be remunerated according to the terms of their licence with the service provider. They can only hope that they have had the foresight to draft a licence does not have a loophole exploitable in this way.

3 IP under Tax Law

Acknowledgement

Parts 3 and the Annexure (Part 4) of this paper has been prepared for the purposes of the Taxation Institute of Australia's (TIA) Tax Summit 2020 conference and seeks to update the discussion at previous TIA conferences.

The following three papers were delivered at previous conferences, and the authors of this paper gratefully acknowledge the assistance provided by the below three papers

1. 26th Noosa Tax Intensive - *Plenary 2: Protecting the Recipe* - Written and Presented by Mr Clint Harding, CTA (2018) – QLD Division

2. 20th Annual Tax Intensive Retreat: *Intellectual property, goodwill and taxation* - Written and Presented by Mr Domenic Carbone (2012) – NSW Division

3. 10th October 2006 SA Division - *Intangibles – Tax Tips and Traps* - Written and Presented by Mr Sean van der Linden (2006) – SA Division

(all the above papers are also available for purchase through the TIA website).

Introduction

In today's sophisticated world, it is exhilarating to think that businesses can capture the opportunity to create extra wealth just by identifying and managing their intellectual property (**IP**) – their IP – and leveraging it to their commercial advantage. There is a recurring correlation between innovation and the registration of intellectual property, yet many businesses are unaware of what may constitute IP, and how they can go about protecting, monetising it and dealing with the vast tax implications that arise.

IP can play fundamental role in the sustainability and growth of a business. While many companies work hard to develop, protect and monetize their IP, they often fail to integrate savvy IP tax planning into their efforts. What senior management doesn't know about the tax implications of intangible assets like IP can really hurt them or, conversely, present value-creating opportunities that can be seized if recognized and leveraged accordingly.

Integrated savvy IP tax planning is fundamental to sustainably growing business. Part 3 Section of the paper below discusses:

- the taxation consequences which follow when dealing with IP assets that include discussion relating to capital gains tax (CGT) and capital allowances treatment under Division 40 of the Income Tax Assessment Act 1997 (Cth) (the **ITAA 1997 (Cth));**

- the taxation consequences which follow when dealing with IP assets in A New Tax System (Goods and Services Tax) Act 1999 (**GST Act**);

- The tax issues for Early Stage Innovation Companies (ESIC) under Division 360 of the ITAA 1997 (Cth);
- Other areas of tax law, including inter alia, deductions, disposals, CGT, research and development (**R&D**) deductions, black-hole deductions[6] and a recent seminal High Court of Australia case on goodwill is critically discussed.

3.1 Methodology

It is important to approach the topic in a methodical manner. The best approach (in the authors' view) is to break the topic up as much as possible. As a suggestion, it is useful to consider the following approach:

a. Identify all the relevant material **legal definitions** that should be properly considered;

b. Identify all the relevant material **tax propositions** (supported by authority) that should be properly considered;

c. Identify the material relevant facts (or material factual assertions) that should be properly considered[7]; and

d. Undertake the relevant research; and

e. Validate the tax propositions (arguable view of the law); and

f. Apply the tax propositions (or tax principles) to a robust set of material facts and draw reasonable conclusions (or inferences).

("**the methodology to apply tax IP law**")

The Part 3 of the Paper will commence by analysing and understanding the relevant legislative definitions.

3.1.1 Definitions

IP is a defined term in the ITAA 1997 (Cth)

The Dictionary in s995-1(1) of the *ITAA 1997 (Cth)* defines IP as:

> ***intellectual property***: an item of ***intellectual property*** consists of the rights (including equitable rights) that an entity has under a *Commonwealth law as:
>
> (a) the patentee, or a licensee, of a patent; or

---

[6] Section 40-880 in the *ITAA 1997 (Cth)* - Business related costs.

[7] In a real world, this would include an assessment of the evidence – see the paper written by Mr William Calokerinos in December 2019 Taxation In Australia relating to the Reliability of Evidence in Tax Disputes.

(b) the owner, or a licensee, of a registered design; or

(c) the owner, or a licensee, of a copyright; or of equivalent rights under a *foreign law.

The statutory definition of IP in the *ITAA 1997 (Cth)* is important for the following two reasons:

- firstly, to the extent that there are capital costs associated with the creation of the of the Division 40 item (depreciating assets) of intellectual property, the costs incurred to create the depreciating asset,[8] will form the basis of future depreciation claims in respect of the asset; and

- any transaction relating to the disposal[9] or granting of a licence to use the intellectual property will be assessed as a balancing adjustment pursuant to Division 40 (Subdivision 40-D[10]) and accordingly assessable as a revenue transaction, not a capital gain.[11]

Other useful definitions in the *ITAA 1997 (Cth)*

There are other useful definitions in the *ITAA 1997 (Cth)* to consider:

- The definition term of *CGT assets* in the *ITAA 1997 (Cth);*

- The definition term of *depreciating assets* in the *ITAA 1997 (Cth);*

- The definition term of *core Research and Development* (R&D) activities in the *ITAA 1997 (Cth);*

- The definition term of *in-house software* in the *ITAA 1997 (Cth).*

The four definitions are defined usefully defined below.

CGT Asset

Section 108-5(1) of the *ITAA 1997 (Cth)* defines a CGT asset in the following manner:

A ***CGT asset*** is:

(a) any kind of property or

(b) a legal or equitable right that is not property.

---

[8] In accordance with subdivision 40-C of the *ITAA 1997 (Cth)* – Cost.

[9] Stop holding the depreciating asset.

[10] In accordance with subdivision 40-D of the *ITAA 1997 (Cth)* – Balancing Adjustments.

[11] Section 118-24 of the ITAA 1997 (Cth) disregards the capital gain or capital loss. Remember that section 118-24(1) of the *ITAA 1997 (Cth)* will not apply if (a) a * capital gain or * capital loss you make from * CGT event J2 or * CGT event K7 happening; or (b) a * depreciating asset for which you or another entity has deducted or can deduct amounts under Subdivision 40-F or 40-G.

Section 108-5(2) of the *ITAA 1997 (Cth)* further defines, to avoid any doubt, a CGT asset as being:

(a) part of, or an interest in, an asset referred to in subsection (1);

(b) goodwill or an interest in it;

(c) an interest in an asset of a partnership;

(d) an interest in a partnership that is not covered by paragraph (c).

Broadly, it can be said that all forms of IP rights are properly characterised CGT assets and hence IP assets such as goodwill, trademark, brands, patent applications and other similar IP assets, are all properly characterised as CGT assets in tax law.

The costs incurred in developing CGT assets go to the relevant asset's cost base.

If those CGT assets are sold and disposed of, then any gain or loss is measured by reference to the proceeds and the asset's cost base. Where applicable, small business CGT concessions[12] and/or the CGT discount[13] may be applied to any capital gain.

Other CGT provisions may also be relevant to the creation of IP. For example, section 104-35(1) of the *ITAA 1997 (Cth)* provides that CGT event D1 occurs if you create a contractual right or other legal or equitable right in another entity. This can be the case where a licence is granted for the use of intellectual property.

It therefore follows with the following question – can a CGT asset also be a depreciating asset under the ITAA 1997 (Cth)? The answer is yes to that question.

Depreciating Asset

A limited number of types of IP assets will have their taxation treatment governed by *Division 40* of *ITAA 1997 (Cth)*. The question is – which ones?

The application of this division is important due to the identification of certain IP rights as being a depreciating asset. Sub-sections 40-30(1) and 40-30(2) of the *ITAA 1997 (Cth)* defines a "*depreciating asset*":

(1) A **depreciating asset** is an asset that has a limited *effective life and can reasonably be expected to decline in value over the time it is used, except:

a. land or

b. an item of *trading stock or

c. an intangible asset, unless it is mentioned in subsection (2).

[12] Division 152 of the *ITAA 1997 (Cth)*.
[13] Section 115.5 of the *ITAA 1997 (Cth)*.

(2) These intangible assets are depreciating assets if they are not *trading stock:

d. mining, quarrying or prospecting rights

e. mining, quarrying or prospecting information

f. **items of *intellectual property**[14]

g. *in-house software

h. *IRUs

i. *spectrum licences

j. *datacasting transmitter licences

k. *telecommunications site access rights.

The definition of **intellectual property** in section 40-30(2)(c) in the *ITAA 1997 (Cth)* above is a defined term within the *ITAA 1997 (Cth)* from the Dictionary.

The following assets are depreciating assets in the ITAA 1997 (Cth):

- mining, quarrying or prospecting rights
- mining, quarrying or prospecting information
- **items of *intellectual property**
  - the patentee, or a licensee, of a patent; or
  - the owner, or a licensee, of a registered design; or
  - the owner, or a licensee, of a copyright; or of equivalent rights under a *foreign law
- *in-house software
- *IRUs
- *spectrum licences
- *datacasting transmitter licences
- *telecommunications site access rights.

Importantly, the following assets <u>will not be</u> *depreciating assets* in the *ITAA 1997 (Cth)*:

- **Trademarks** – a trademark is not a depreciating asset, and hence costs attributing to registration fees or legal costs incurred in creating or registering a trademark cannot be amortised under *Division 40* of the *ITAA 1997 (Cth)*.[15] It is important to remember that the definition of IP in tax does not include trademark.

- **Business related costs transferring and establishing rights to IP** - business transfer arrangements that are confidential and used to establish confidential franchise rights are a capital asset. These costs are capital in nature and cannot be amortised under *Division 40* of

[14] See the Dictionary section within section 995.1 of the *ITAA 1997 (Cth).*
[15] See ATOID / 2004/858.

the *ITAA 1997 (Cth)* and cannot be deducted as a Black-hole expenditure under sections 40-880(5)(a) and 40-880(5)(f) of the *ITAA 1997 (Cth)*. [16]

So, what are the key R&D expenditure terms in the ITAA 1997 (Cth) should we also be aware? It is helpful to note briefly the inter-relationship between IP and the specific regime that exists for R&D expenditure.

Experiential R&D activities and Core R&D activities

A limited number of types of IP assets will have their taxation treatment governed by *Division 355* of *ITAA 1997 (Cth)*. It is useful to comment briefly about the specific regime that exists for R&D expenditure.

Our starting point is to consider what activities are defined within the *ITAA 1997 (Cth)*?

Sections 355-25(1) and 355-25(2) of the *ITAA 1997 (Cth)* defines a "*Core R&D activities*":

(1) **Core R&D activities** are experimental activities:

(a) whose outcome cannot be known or determined in advance on the basis of current knowledge, information or experience, but can only be determined by applying a systematic progression of work that:

(i) is based on principles of established science; and

(ii) proceeds from hypothesis to experiment, observation and evaluation, and leads to logical conclusions; and

(b) that are conducted for the purpose of generating new knowledge (including new knowledge in the form of new or improved materials, products, devices, processes or services).

(2) However, **none of the following activities are core R&D activities** :

(a) market research, market testing or market development, or sales promotion (including consumer surveys);

(b) prospecting, exploring or drilling for minerals or * petroleum for the purposes of one or more of the following:

(i) discovering deposits;

(ii) determining more precisely the location of deposits;

(iii) determining the size or quality of deposits;

(c) management studies or efficiency surveys;

(d) research in social sciences, arts or humanities;

(e) commercial, legal and administrative aspects of patenting, licensing or other activities[17];

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[16] See ATOID / 2009/3.

[17] These categories section 355-25(2)(e) of the *ITAA 1997 (Cth)* are defined as IP within the Dictionary. So the tax law definition of IP is excluded as core R&D activities.

(f) activities associated with complying with statutory requirements or standards, including one or more of the following:

(i) maintaining national standards;

(ii) calibrating secondary standards;

(iii) routine testing and analysis of materials, components, products, processes, soils, atmospheres and other things;

(g) any activity related to the reproduction of a commercial product or process:

(i) by a physical examination of an existing system; or

(ii) from plans, blueprints, detailed specifications or publically available information;

(h) developing, modifying or customising computer software for the dominant purpose of use by any of the following entities for their internal administration (including the internal administration of their business functions):

(i) the entity (the developer) for which the software is developed, modified or customised;

(ii) an entity * connected with the developer;

(iii) an * affiliate of the developer, or an entity of which the developer is an affiliate.

Note that expenditure associated with "*patenting, licensing or other activities*" is specifically excluded from the definition of core R&D activities in section 355-25(2)(e) of the *ITAA 1997 (Cth)*. The importance of properly characterising your activities will affect your eligibility to claim the R&D tax offset and this depends on where you are conducting your R&D activities and, importantly, what those activities are.

In-house software

Software will have its own rules within the tax law.

The Dictionary in s995-1(1) of the *ITAA 1997 (Cth)* defines In-house software" as:

"In-house software" is computer software, or a *right to use computer software, that you acquire, develop or have another entity develop:

(a) that is mainly for you to use in performing the functions for which the software was developed; and

(b) for which you cannot deduct amounts under a provision of this Act outside Divisions 40 and 328[18].

The amount of the depreciation deduction is calculated under section 40-455 of the *ITAA 1997 (Cth)* rather than Subdivision 40-B of the *ITAA 1997 (Cth).* Noting that, in accordance with general

[18] If you are a Small Business Entity within Division 328 of the ITAA 1997 (Cth) you can put assets within a single pool of assets.

deduction tax law principles, there must a taxable purpose to the software pool of assets for the depreciation pool to apply.[19]

The taxpayer may apply section 40-450 of the *ITAA 1997 (Cth)* to allocated amounts of expenditure for "*in-house software*" incurred as a software development pool, provided that the taxpayer intends to use the software solely for the production of assessable income ("**there is a taxable purpose**").

Section 40-450 of the *ITAA 1997 (Cth)* is applied to calculate and determine *Software Development Pools* are as follows*:*

> (1) You may choose to allocate amounts of expenditure you incur on * **in-house software** in an income year to a **software development pool** if it is expenditure on developing, or having another entity develop, computer software.
>
> Note: You cannot allocate expenditure on in-house software to a software development pool if it is expenditure on acquiring computer software or a right to use computer software.
>
> (2) Once you choose to create a software development pool for an income year, any amounts of the kind referred to in subsection (1) you incur after the pool is created (whether in that income year or a later one) must be allocated to a software development pool.
>
> (3) However, an amount of expenditure on * in-house software can only be allocated to a software development pool if you intend to use the software solely for a * taxable purpose.
>
> (4) **You must create a separate software development pool for each income year for which you incur amounts of the kind referred to in subsection** (1).

3.1.2 Broad Tax Propositions

The second step in our methodological approach to understand this topic is to identify the relevant broad tax propositions which are respectfully put as follows:

1. PROPOSITION ONE - All forms of IP rights are CGT assets
2. PROPOSITION TWO - Some forms of IP property are also depreciable assets[20].
3. PROPOSITION THREE - Be aware of the specific regime of R&D – to be discussed below.
4. PROPOSITION FOUR - Remember that Software has specific rules for depreciation.

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[19] Section 8-1 of the *ITAA 1997 (Cth).*

[20] Items of IP consisting of a patent, a registered design or copyright will therefore be depreciating assets and subject to the Capital Allowance rules in Division 40 of the *ITAA 1997 (Cth)*. These rules provide, inter alia, for specific deductions: (i) under section 40-25 of the *ITAA 1997 (Cth)* equal to the decline in value of a depreciating asset held for a taxable purpose during an income year, and (ii) for balancing adjustments to be made under section 40-285 of the *ITAA 1997 (Cth)* to taxable income if a depreciating asset stops being so held.

5. PROPOSITION FIVE - An IP asset that is an item of IP within the *ITAA 1997 (Cth)* definition is also a "*depreciating asset*" as defined in section 40-30 of the *ITAA 1997 (Cth)* if it is not "*trading stock*".[21]

The next section of the paper considers firstly whether expenditure could be on revenue account via an outright deduction.

3.2 Outright revenue deduction? – Expenditure for the creation of IP

3.2.1 Capital v Revenue

The character of any item of expenditure relating to IP is must be first considered in the context of section 8-1 *ITAA 1997 (Cth)*. This is because the consideration of an outright deduction should be the first consideration, as a preliminary assessment, as it is highly desirable to most taxpayer circumstances.

The first step is to consider the creation of IP assets – is the expenditure properly characterised as "*profit yielding"* and hence on capital account or properly characterised "*profit-making"* and hence on revenue account. How does a taxpayer make that distinction and when is an expenditure deductible pursuant to the general deduction of section 8-1 *ITAA 1997 (Cth)*?

As a broad proposition, where a taxpayer's purpose is to innovate various new products, or to design a new process for a different business and in so doing the expenditure can be said to create a new IP asset, it is more likely the expenditure will be capital. Whereas if the new IP asset is an incidental product of the usual operating process of a business and there is a nexus with the expenditure in relation to the creation of IP, the expenditure is more likely to be revenue.

The following thought process is instructive:

1. What is character of expenditure? What the advantage is sought? What are the lasting qualities that expenditure may play a part? and

2. What is the manner which the expenditure is to be used, relied upon or enjoyed? Is there recurrence? And

3. What means has been adopted to obtain the expenditure? Is there a periodical reward or outlay to cover its use or enjoyment? Is there a secured future use or enjoyment?

[21] Defined in section 70-10 of the *ITAA 1997 (Cth)* to include "anything produced, manufactured or acquired that is held for purposes of manufacture, sale or exchange in the ordinary course of a *business".

3.2.2 Seminal Case Law

Sun's Newspaper case

The relevant legal principles for the distinction between expenditure of a capital or revenue nature is well known with the High Court of Australia decision in the *Sun's Newspaper case,*[22] and this case remain instructive in this regard.

Dixon J in the *Sun Newspapers* judgment at page 61 opined the following ('***emphasis added***'):

> … **the distinction between expenditure and outgoings on revenue account and on capital account** corresponds with [1] the distinction between the business entity, structure, or organization set up or [2] established for the earning of profit and the process by which such an organization operates to obtain regular returns by means of regular outlay, the difference between the outlay and returns representing profit or loss.

Colonial Mutual Life Assurance case

The High Court of Australia decision of *Colonial Mutual Life Assurance* case,[23] the Court considered the question raised as to whether or not the taxpayer company was entitled to deduct from its assessable income of the accounting period ended 31 December 1942 a sum of 1,100 pounds paid by it – the Court determined the view was a simple "*no*" to that question.

Fullagar J (the plurality judgment) in the *Colonial Mutual Life Assurance* case opined at [9] ('***emphasis added***'):

> **For it is incontestable here that the moneys are paid in order to acquire a capital asset.** The documents make it quite clear that these payments constitute the price payable on a purchase of land, and that appears to me to be the end of the matter. It does not matter how they are calculated, or how they are payable, or when they are payable, or whether they may for a period cease to be payable. If they are paid as parts of the purchase price of an asset forming part of the fixed capital of the company, they are outgoings of capital or of a capital nature. It does not indeed seem to me to be possible to say that they are incurred in the relevant sense in gaining or producing assessable income or in carrying on a business - any more than payment of a lump sum would have been so incurred if the purchase price had been a lump sum payable on transfer. **The questions which commonly arise in this type of case are (1) What is the money really paid for? - and (2) Is what it is really paid for, in truth and in substance, a capital asset?** [24]

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[22] *Sun Newspapers Ltd & Associated Newspapers Ltd v FCT* [1938] HCA 73; (1938) 61 CLR 337 per Rich J Latham C.J., Dixon and McTiernan JJ (see Austlii link - http://www.austlii.edu.au/cgi-bin/viewdoc/au/cases/cth/HCA/1938/73.html).

[23] *Colonial Mutual Life Assurance Society Ltd v Federal Commissioner of Taxation* [1953] HCA 68; (1953) 89 CLR 428 per Williams A.C.J., Webb, Fullagar, Kitto and Taylor JJ. (see Austlii link - http://www8.austlii.edu.au/cgi-bin/viewdoc/au/cases/cth/HCA/1953/68.html).

[24] Colonial Mutual Life Assurance Society Ltd v Federal Commissioner of Taxation [1953] HCA 68; (1953) 89 CLR 428 per Fullagar J. (see Austlii link - http://www8.austlii.edu.au/cgi-bin/viewdoc/au/cases/cth/HCA/1953/68.html).

Goodman Fielder Wattie case

The Federal Court decision of *Goodman Fielder Wattie case*[25] considered the question as to whether an whether expenditure of capital nature and provides a useful example of the application of the principles from *Sun Newspapers* case in an IP context at paragraph [65].

The following proposition is relevant to our study relating to the deductibility of expenditure incurred in developing, maintaining or changing a website will predominantly consist of labour. The characterisation of the labour expenses will be a question of fact and determined objective based on the circumstances of a particular case.

Hill J opined in *Goodman Fielder Wattie case*[26] at paragraph [65] ('***emphasis added***') the following:

> "The **judgment in the Sun Newspapers case makes it clear** that it is necessary to consider carefully the nature of the business which is carried on, so as to be able to distinguish between recurrent expenditure, that is to say ``expenditure which is made to meet a continuous demand'' (per Rowlatt J in Ounsworth v Vickers Ltd [1915] 3 KB 267 at 273) and that expenditure which is made once and for all. A pharmaceutical company, the business of which includes continuing research and development as part of the continuous or constant demand for expenditure in its business, does not each time that expenditure is incurred make an outlay of capital or of a capital nature. Its business, when properly analysed, includes its research and development, at least in the ordinary case. No doubt, there are matters of degree involved, and in a particular case the research and development may be concentrated on a product so far removed from the day to day products of the taxpayer, that the expenditure cannot be properly seen as part of its working expenditure."

And relevantly at paragraph [72] ('emphasis added'):

> A company engaged in an enterprise involving new technology such as the applicant, where the nature of its activity requires as part of its business ongoing research into product development incurs expenditure which is recurrent, **expenditure which is part of the regular cost of its trading operations. That expenditure is, to adopt the words of Dixon J in Sun Newspapers, part of the process by which the organisation (being an organisation where research is part of its business activity) operates to obtain regular returns by means of regular outlays**.

Hill J allowed the taxpayer's appeal in part and formed the view (cited in TR 2017/1 at [24]) in *Goodman Fielder Wattie case,*[27] that the nature or character of the advantage sought, rather than any advantage that is ultimately obtained (for example in the form of an asset or assets), is the essential matter to be determined. In this case, Hill J at [72] formed the view that the expenditure in issue in the present case, except perhaps so much of it as concerned the salary of Dr Watson, in the time he was involved in the patent dispute, was expenditure on revenue account rather than on capital account.

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[25] Re Goodman Fielder Wattie Ltd v Commissioner of Taxation [1991] FCA 206; 29 FCR 376 (22 May 1991) per Hill J (see Austlii link - http://www8.austlii.edu.au/cgi-bin/viewdoc/au/cases/cth/FCA/1991/206.html).

[26] Re Goodman Fielder Wattie Ltd v Commissioner of Taxation [1991] FCA 206; 29 FCR 376 (22 May 1991) per Hill J (see Austlii link - http://www8.austlii.edu.au/cgi-bin/viewdoc/au/cases/cth/FCA/1991/206.html).

[27] Re Goodman Fielder Wattie Ltd v Commissioner of Taxation [1991] FCA 206; 29 FCR 376 (22 May 1991) per Hill J (see Austlii link - http://www8.austlii.edu.au/cgi-bin/viewdoc/au/cases/cth/FCA/1991/206.html).

3.2.3 The key questions to characterise expenditure

It is necessary to characterise the nature of the expenses in relation to the costs incurred in creating or developing IP by answering the following four questions below:

1. x What IP rights arise as an outcome of the activities and expenditure?
2. What expectations arise for the enduring benefit to the business?
3. What purpose arise for the expenditure?
4. What are the anticipated future economic benefits to the business of the expenditure?

3.2.4 TR 2016/3

The attendees are encouraged to read the ruling of TR 2016/3 form the ATO's website (if not have done so already).

The Commissioner has finalised a public ruling (**TR 2016/3**) in respect of the deductibility of expenditure incurred in acquiring, developing, maintaining and modifying a website[28]. It contains some useful guidance on some of the principles summarised in this paper in the context of website development. There are over 26 examples to consider via illustration of the Commissioner's view on the topic. Reliance of the ruling is useful – the Commissioner must apply the law to you in way set in the ruling.

TR 2016/3 cover the following matters:

- section 8-1 of the *ITAA 1997 (Cth)*;
- Division 40 (capital allowances) of the *ITAA 1997 (Cth)*;
- Division 328 (small business entities) of the *ITAA 1997 (Cth)*;
- Parts 3.1 and 3.3 (capital gains tax) of the *ITAA 1997 (Cth)*;
- section 40-880 (black-hole expenditure) of the *ITAA 1997 (Cth)*;
- the definition of 'in-house software' in the of the *ITAA 1997 (Cth)*.

For completeness, it is noted that TR 2016/3 does not cover the following matters:

- expenditure on computer hardware.
- cross-border issues where a business is carried on outside Australia.
- when software is trading stock.
- research and development (R&D) concessions.

[28] See weblink : https://www.ato.gov.au/law/view/document?DocID=TXR/TR20163/NAT/ATO/00001&PiT=99991231235958.

3.2.5 Conclusion – Outright revenue deduction possible under section 8-1 of the ITAA 1997 (Cth)?

Yes – but it is very difficult to get an outright revenue deduction under section 8-1 of the *ITAA 1997 (Cth)* for expenditure associated with the creation of IP.

A taxpayer should therefore prudently consider the following provisions in relation to expenditure for the creation of IP expenditure:

1. **Eligible R&D Expenditure** and consider applying the R&D provisions; or
2. **Depreciable Asset Cost / Effective Life** and consider applying Division 40 *ITAA 1997 (Cth)* (depreciating assets) for relief; or
3. **Balancing Adjustments due to sale of the business**; or
4. **CGT Costs base** - having determined that the profit from the sale of IP Assets is not ordinary income, then it is necessary to consider the other basis for inclusion in assessable income as statutory income, such as CGT provisions; or
5. As a last resort, consider the project cost – **black hole deduction** under section 40-880 of the *ITAA 1997 (Cth)*.
6. ***Overlapping Provisions** in the ITAA 1997 (Cth).*

3.3 Common Tax Provisions

3.3.1 R&D Expenditure

The Research and development (R&D) tax incentive encourages companies to engage in R&D benefiting Australia, by providing a tax offset for eligible R&D activities. It has two core components:

1. a refundable tax offset for certain eligible entities whose aggregated turnover is less than $20 million
2. a non-refundable tax offset for all other eligible entities.

The object of the incentive in Division 355 of the *ITAA 1997 (Cth)* is to encourage industry to conduct research and development activities that might otherwise not be conducted because of an uncertain return from the activities, in cases where the knowledge gained is likely to benefit the wider Australian economy.

R&D Tax Offset

It is sufficient to say that a refundable tax offset, if you can get it, is more beneficial than a straight-out deduction. It provides targeted R&D tax offsets designed to encourage more companies to engage in R&D. The incentive has two core components and entities engaged in R&D may be eligible for:

1. a 43.5% refundable tax offset for eligible entities with an aggregated turnover of less than $20 million per annum, provided they are not controlled by income tax exempt entities.

2. a 38.5% non-refundable tax offset for all other eligible entities (entities may be able to carry forward unused offset amounts to future income years).

The rate of the R&D tax offset is reduced to the company tax rate for that portion of an entity's notional R&D deductions that exceed $100 million for an income year.[29] The rate of the R&D tax offset and whether it is refundable or not depends primarily on the R&D entity's aggregated turnover.

R&D Turnover

If your aggregated turnover:

1. is less than $20 million and you are not controlled by any exempt entities, then you can claim the 43.5% refundable tax offset.

2. is $20 million or more, or you are controlled by exempt entities, then you can claim the non-refundable 38.5% tax offset.

Aggregated turnover is the sum of the annual turnover for all the following:

- the R&D entity.
- any entity connected with the R&D entity.
- any entity affiliated with the R&D entity.

Any dealings between these entities are excluded.

R&D Activities

The definition of core R&D activities are noted within section 355-25 of *ITAA 1997 (Cth)*. An R&D entity can notionally deduct its expenditure on registered R&D activities for which certain conditions are met. The value of the tax offset available under the incentive is the expenditure (including the decline n the value of the R&D asset) on R&D activities (see section 355-20 of the *ITAA 1997 (Cth)*). These activities include "*core R&D activities*" and "*supporting R&D activities*".

The core activities are experimental activities[30]:

- whose outcome cannot be known or determined in advance on the basis of current knowledge but can only be determined by applying a systematic progress of work that is based on principles established science and proceeds from hypothesis to experiment, observation and evaluation, and leads to logical conclusions.

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[29] This change applies to assessments for income years starting on or after 1 July 2014 and before 1 July 2024.

[30] Section 355-25 of the *ITAA 1997 (Cth)*.

- that are conducted for the purpose of generating new knowledge including new knowledge in the form of new or improved material, products, devices, processes or services. Clinical trials carried out to determine the safety and efficacy of a dry can be core R&D activities.
- that are necessary to test a technical or scientific hypothesis and are conducted as a systematic progression of work based on principles of established science to generate new knowledge on the causal relationships being variable.

Any amount that can be deducted under the R&D rules (a notional deduction) is generally excluded from the cost base of a CGT asset pursuant to section 110-45 of the ITAA 1997 (Cth) and also from the cost of depreciating assets.

Other requirements of the R&D regime that can have an important bearing on some of the structuring issues explored below is that the R&D must be conducted by a company and that the activities must be conducted in Australia.

Key Points for the R&D Regime

Without embarking on a detailed examination of the current R&D regime, some of the key points to note regarding the interaction of the R&D rules and IP are as follows:

- A tax offset is generally available for expenditure on core R&D activities or in respect of the decline in value only of tangible depreciating assets used in R&D.
- Expenditure associated with "*patenting, licensing or other activities*" is specifically excluded from the definition of core R&D activities in section 355-25(2) of the *ITAA 1997 (Cth)*.
- Section 355-25(2) of the *ITAA 1997 (Cth)* also excludes from the realm of eligible expenditure any costs associated with the development or modification of computer software for the dominant purpose of internal administration.

Disposal of R&D Results Provision

An often-overlooked provision is section 355-410 of the *ITAA 1997 (Cth)* that operates as an integrity provision to ensure statutory revenue treatment for amounts received by an R&D entity relating to the results of R&D activities. Importantly, this includes amounts received from the granting of rights to the results under a license.

ATO ID 2015/4

The issue in ATO ID 2015/4 was the following:

> Does the R&D disposal of results provision in section 355-410 of the Income Tax Assessment Act 1997 (ITAA 1997 (Cth)) contemplate apportioning an amount received by an R&D entity where the amount comprises of payment for results from research and development (R&D) and non-R&D activities?

The facts set out in ATO ID 2015/4 provide a useful example of how this provision can in practice provide what might be an unexpected outcome when a taxpayer receives a lump sum that on the face of it may seem to be capital in nature:

> The taxpayer is an R&D entity within the meaning of section 355-35 of the ITAA 1997 (Cth). The taxpayer incurs R&D expenditure on various Innovation Projects and claims the tax offset under section 355-100 of the ITAA 1997 (Cth). The taxpayer also undertakes Innovation Projects for which it is not entitled to any tax offset under section 355-100 of the ITAA 1997 (Cth). The taxpayer owns the intellectual property (IP) developed or related to all of these Innovation Projects.
>
> Company A and the taxpayer enter into a Licence Agreement in respect of the taxpayers Innovation Project IP pursuant to which Coy A makes a buy-in payment of $1 million to the taxpayer. This payment is for the grant of an exclusive, perpetual, royalty free, fully paid up licence by the taxpayer to Company A allowing Company A to access the results of the taxpayer's Innovation Project activities and use and exploit the Innovation Project IP owned by the taxpayer and identified in a schedule to the Licence Agreement.
>
> The Innovation Project IP that is the subject Licence Agreement (as identified in a schedule to the Licence Agreement) includes those that were developed from the taxpayer's R&D activities for which a tax offset was claimed under section 355-100 of the ITAA 1997 (Cth) and those developed from activities for which the taxpayer had no tax offset entitlement under that section.
>
> The Licence Agreement also attaches a specific value to each Innovation Project IP identified in the schedule to the Licence Agreement. The values disclose that $900,000 of the $1 million buy in payment related to Innovation Project IP developed as a result of R&D activities for which the taxpayer was entitled to the tax offset under section 355-100 of the ITAA 1997 (Cth). The remaining $100,000 related to Innovation Project IP developed from other activities in respect of which the taxpayer had no tax offset entitlement under section 355-100 of the ITAA 1997 (Cth).

Whether the IP in question is a depreciating asset or a CGT asset will potentially impact upon the outcome, but the provision needs to be carefully considered. Section 355-410(2) of the *ITAA 1997 (Cth)* includes as a "results amount" ('**emphasis added**'):

Disposal of R&D results Amounts

> (2) For each results amount, the following amount is included in the * R&D entity's assessable income for the results year:
>
> (a) if the **results amount** is only a results amount because of subparagraph (1)(b)(v), and the asset referred to in that subparagraph is a * depreciating asset--an amount equal to the extent (if any) that the results amount exceeds the asset's * cost just before the disposal or grant;
>
> (b) if the **results amount** is only a results amount because of subparagraph (1)(b)(v), and the asset referred to in that subparagraph is not a depreciating asset--an amount equal to the extent (if any) that the results amount exceeds the asset's * cost base just before the disposal or grant;
>
> (c) otherwise--the **results amount**.

The disposal of IP assets under an asset purchase agreement where the assets in question were not a depreciation asset under Division 40 assets will give rise to application of section 355-410(2) of the *ITAA 1997 (Cth).*

The amount assessable is generally the amount received or receivable.

Nonetheless, where the amount is from disposing of a CGT asset that is a depreciating asset, or from granting a right to occupy or use such an asset, the assessable income amount is the amount received or receivable less the cost of the asset (just before the disposal or grant).

Where the amount is from disposing of a CGT asset that is not a depreciating asset, the amount assessable is the amount received or receivable less the cost base of the asset (just before the disposal or grant).

3.3.2 Depreciable Asset

This section of the paper will delve into the taxation consequences of several key events that may happen to intellectual property over its lifetime.

Division 40 sets out entitlement to deductions for certain types of capital expenditure.

The specific provision that deals with the definition of a depreciating asset is section 40-30 of the *ITAA 1997 (Cth)* ('emphasis added'):

> (1) A **depreciating asset** is an asset that has a limited * effective life and can reasonably be expected to decline in value over the time it is used, except:
>
> ....
>
> (c) **an intangible asset, unless it is mentioned in subsection (2).**
>
> (2) These intangible assets are depreciating assets if they are not * trading stock:
>
> ....
>
> (c) items of * **intellectual property**[31].

To be entitled to a deduction for the cost of a depreciating asset during an income year section 40-25 of the *ITAA 1997 (Cth),* sets out certain requirements:

1. that any deduction must be reduced to the extent that the asset is not used for a *taxable purpose*;[32]
2. that *taxable purpose* is defined in section 40-25(7) of the *ITAA 1997 (Cth)* as the **purpose of producing assessable income;*[33] and
3. section 40-25(7) of the *ITAA 1997 (Cth)* relevantly includes a Note 2 described below:

> **Note 2**: When this Division notionally applies under section 355-310 (about depreciating assets used for R&D activities), the taxable purpose is sometimes only the purpose of conducting R&D activities.

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[31] Defined in the Dictionary – section 995-1 of the *ITAA 1997* (Cth).
[32] Section 40-25(2) of the *ITAA 1997 (Cth).*
[33] Section 40-25(7) of the *ITAA 1997 (Cth).*

Entitlement to R&D Tax Offset

Any entitlement to a deduction under Division 40 for *acquired* IP will only arise upon satisfaction of the requirements of Division 40 of the *ITAA 1997 (Cth)*. The requirements are detailed above and any entitlement to a notional deduction under the R&D regime within paragraph 355-100(1)(b) of the *ITAA 1997 (Cth),* only arises in relation to tangible depreciating assets.

3.3.3 Anti-overlap provisions – General Exemptions (or reduction) to Capital Gain

There are a number of the anti-overlap provisions that will have application in determining the quantum of the capital gain (if any) is included in a vendor of IP assets assessable income.

The relevant anti-overlapping provisions to consider are the following:

- section 118-20 of the *ITAA 1997 (Cth)*;
- section 118-24 of the *ITAA 1997 (Cth)*; and
- section 118-35 of the *ITAA 1997 (Cth)*.

Exemption - Section 118-20 ITAA 1997 (Cth)

Paragraph 118-20(1)(a) of the *ITAA 1997 (Cth)* provides:

> (1) A *capital gain you make from a *CGT event is **reduced** if, because of the event, a provision of this Act (outside of this Part) includes an amount (for any income year) in:
>
> (a) your assessable income or *exempt income; …

Section 118-20 of the *ITAA 1997* (Cth) only provides for a reduction in the capital gain that is to be included in a taxpayer's assessable income. Consequently, the Taxpayer would still be required to include a capital gain in its assessable income if no other provision of the Act (outside of Part 3) included an amount in assessable income. Additionally, the provision also leaves open the operation of the CGT provisions if that other provision does not fully include that relevant amount in the Taxpayer's assessable income (for example of IP that is also a depreciating asset is not used wholly for income producing purposes).

Exemption - Section 118-24 of the ITAA 1997 (Cth)

Paragraph 118-24(1)(a) of the ITAA 1997 (Cth) provides:

> (1) A *capital gain or *capital loss you make from a *CGT event (that is also a *balancing adjustment event) that happens to a *depreciating asset is disregarded if the asset was:
>
> (a) an asset you *held; …

This specific provision will not operate in relation to the disposal of any of the Taxpayer's IP Assets which are either acquired depreciating assets, or internally generated depreciating assets.

Exemption - Section 118-35 of the ITAA 1997 (Cth)

Section 118-35 of the *ITAA 1997 (Cth)* allows a Taxpayer to disregard a capital gain or loss where the amount included is included in assessable income under section 355-410 of the *ITAA 1997 (Cth)* .

The section provides:

> **Disregard** a *capital gain or *capital loss from a *CGT event if an amount is included in your assessable income in any income year under section 355-410 (about disposal of R&D results) because of that CGT event.

3.3.4 Balancing Adjustments -sale of depreciating IP assets

Generally, the sale of depreciating assets will constitute a balancing adjustment event.[34] Any resulting profit or loss is included as income or a deduction in the taxpayer's return.

The '*balancing adjustment*' rules[35] will apply first in relation to any 'disposal' of IP that is a depreciating asset and the CGT rules (specifically CGT event K7[36]) will only have residual application. For example, where the IP was used for used partially for non-taxable purposes.

Additionally, it should be noted that CGT event K7 takes precedence over other CGT events that also amount to a balancing adjustment event in respect of a depreciating asset.

The licence of IP will generally activate a balancing adjustment under Division 40 of the *ITAA 1997 (Cth)*[37] and CGT event K7 for due to the operation of section 40-115(3) of the *ITAA 1997 (Cth)*. The effect of a balancing adjustment is that it will include an amount in assessable income (of the grantor) to the extent that the 'termination value' (proceeds) exceeds its 'adjustable value' (which is the cost of the asset less its decline in value over time) – if a loss is made a deduction may be allowed.

The 'termination value' to be ascribed to the IP will reflect the amount being paid for the grant of the licence (where applicable). The amount paid in respect of the grant of the license should be distinguished from any ongoing licence fee.

It is important to note the following three points:

- the Division 40 of the *ITAA 1997 (Cth)* market value substitution rule in item 6 of the table in section 40-300(2) of the *ITAA 1997 (Cth)* may apply. This issue may arise where there is at least one other party to the arrangement with whom the grantor did not deal at arm's length.
- Where the parties to the license are related there may be a danger that, in the absence of arm's length terms, the parties could be viewed as not dealing with each other at arm's length

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[34] Section 40-285 in the *ITAA 1997 (Cth).*
[35] Section 40-285 in the *ITAA 1997 (Cth).*
[36] Section 104-235 in the *ITAA 1997 (Cth).*
[37] Section 40-285 in the *ITAA 1997 (Cth).*

and a market value may be substituted for the termination value. In such conditions, a valuation would be required to determine the question of the value of the granting of the licences.

- Any potential 'non-cash benefit' that may arise under item 4 in the table in s 40-305(1)(b) of the ITAA 1997 (Cth). Potentially for the right to receive the licence fee payments, should be nil because it should be correctly viewed as ordinary income and not as amounts received under item 4 in respect of the grant of the licences.

The above views are supported by the Commissioner's position in ATO ID 2006/168.[38] The facts for the Commissioner in ATO ID 2006/168 were the following:

- Company A (non-resident of Australia for taxation purposes) enters into a licence agreement with company B (resident for taxation purposes) for the exploitation by company A of company B's patented invention. Company B retains all propriety rights to the patent while company A is granted exclusive rights to exploit the invention protected by the patent in a foreign jurisdiction for a fixed period of time.

- The rights company A has been granted in respect of the licence agreement under foreign law are similar to the rights that would have been granted for such an agreement in Australia under Australian law.

The issue for the Commissioner in ATO ID 2006/168 was the following:

> Does a balancing adjustment event occur for a depreciating asset under section 40-295 of the Income Tax Assessment Act 1997 (ITAA 1997) when an entity is granted a licence to exploit another entity's patent?

The decision for ATO ID 2006/168 was - Yes. A balancing adjustment event occurs for a depreciating asset under section 40-295 of the *ITAA 1997* because company B is taken to have stopped holding part of a depreciating asset. In ATO ID *2006/168*, the Commissioner relevantly decided:

> A balancing adjustment is required if a balancing adjustment event occurs for a depreciating asset whose decline is worked out under Subdivision 40-B of the ITAA 1997 (section 40-285 of the *ITAA 1997*)
>
> Paragraph 40-295(1)(a) of the *ITAA 1997* provides that a balancing adjustment event occurs when an asset stops being held by an entity. For depreciating assets satisfying the definition of the term 'intellectual property' in subsection 995-1(1) of the *ITAA 1997*, the granting or assigning of an interest in the asset is treated as if the asset is split into two assets with the holder ceasing to hold the part of the original asset that represents the interest granted or assigned to the other entity (subsection 40-115(3) of the *ITAA 1997*).

3.3.5 Statutory Income - CGT – Sale of CGT assets

CGT is always included as statutory income. The main method under which an amount of statutory income received by a taxpayer will be included in their assessable income is the CGT regime set out in Chapter 3 of the *ITAA 1997 (Cth)*.

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[38] ATO Interpretative Decision.

The starting point in analysing the CGT provisions is the identification of the CGT asset pursuant to section 108-5(1) of the *ITAA 1997 (Cth)*. A CGT asset is very broadly defined within the legislation as any kind of property; or sub-section (b) a legal or equitable right that is not property.

There must be a CGT event for the CGT provisions to apply. Subsection 100-20(1) of the *ITAA 1997 (Cth)* specifies that you only make a capital gain or loss if a CGT event happens.

CGT event A1

The most obvious starting point is CGT event A1. The disposal of IP Assets by a seller[39] will most likely trigger CGT event A1. This is a plausible conclusion as there will be a change in the legal and beneficial ownership of the IP Assets. The timing of the CGT Event will be the time when the contract to dispose of those assets is entered into.

Subsection 102-5(1) of the *ITAA 1997 (Cth)* provides that your assessable income includes any net capital gain for the income year. Consequently, in the absence of any exception or exemption, the vendor of an IP asset will need to include the net capital gain from the disposal of its IP Assets.

The capital gain will be calculated by reference to the capital proceeds received in respect of the sale and the market value substitution rules[40] may apply in a variety of circumstances, including where the sale of the IP is for consideration less than the market value and the parties are not acting at arm's length.

3.3.6 Black hole Deduction

Attendees should also read the following Taxation Ruling in addition to this paper – **TR 2011/6** - *Income tax: business related capital expenditure - section 40-880 of the Income Tax Assessment Act 1997 core issues (Published on 13 July 2016).* In the ruling there are 41 useful factual scenarios to consider.

There is potentially some possibility for application of section 40-880 of the *ITAA 1997 (Cth)* to apply to expenditure connected with IP assets that are perhaps are neither a Division 40 *ITAA 1997* (Cth) depreciating asset nor a CGT asset.

For example, it is generally accepted that information itself is not property and therefore not an asset.[41] It would seem that caution must be exercised when potentially using section 40-880 of the *ITAA 1997 (Cth)* as a "provision of last resort" in the context of IP.

One real life example dealing with Blackhole deduction and IP assets is outlined as Annexure in Part 4 of the paper as a case study:

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[39] Outside of a tax consolidated group.
[40] Section 112-20 in the *ITAA 1997 (Cth).*
[41] Refer to ATO ID 2009/3.

- **See Case Study 3** that deals with the Business capital expenditure - section 40-880 of the Income Tax Assessment Act 1997.[42]

3.4 Goodwill

The below provides critical insight into a seminal High Court of Australia authority.

3.4.1 High Court of Australia authority - *Placer's case*

The seminal goodwill case is the Commissioner of *State Revenue v Placer Dome Inc* [2018] HCA 59 ("***Placer's case***").[43] *Placer's case* considered the nature of legal form goodwill, and whether certain valuation methodologies are appropriate in ascertaining the value of "land".

The statutory context was critical to the dispute, and broadly required the parties to determine whether the value of all 'land' to which Placer was entitled was 60 per cent or more of the value of all property to which it was entitled. Any value ascribed to goodwill was pivotal in determining whether this ratio was breached.

This decision will now be the leading judicial precedent on the legal nature of goodwill - expanding upon and clarifying *Murry's case*[44] which was the previous leading authority.

The structure of the *Placer's case* judgment is helpful in clearly setting out:

- the nature of goodwill and the HCA's view that the attraction of custom is central to goodwill as a concept;[45]
- to be property (important for this statutory context) goodwill must be comprised of those rights or privileges that preserve the custom attracted to that business;[46]
- the sources of goodwill must have a unified purpose and generate or add value or earnings to the business by attracting custom;[47]
- the value of goodwill can be determined by reference to 'the difference between the present value of the predicted earnings of the business and the fair value of its identifiable net assets"

[42] Source – ATO Website: Authorisation Number: 1051437161631 - Date of advice: 15 October 2018.
[43] *Commissioner of State Revenue v Placer Dome Inc [2018] HCA 59* (5 December 2018) - http://www.austlii.edu.au/cgi-bin/sinodisp/au/cases/cth/HCA/2018/59.html.
[44] *Commissioner of Taxation (Cth) v Murry* [1998] HCA 42.
[45] *Commissioner of State Revenue v Placer Dome Inc [2018] HCA 59* (5 December 2018) - http://www.austlii.edu.au/cgi-bin/sinodisp/au/cases/cth/HCA/2018/59.html at [12]-[22].
[46] *Commissioner of State Revenue v Placer Dome Inc [2018] HCA 59* (5 December 2018) - http://www.austlii.edu.au/cgi-bin/sinodisp/au/cases/cth/HCA/2018/59.html at [19], [23].
[47] *Commissioner of State Revenue v Placer Dome Inc [2018] HCA 59* (5 December 2018) - http://www.austlii.edu.au/cgi-bin/sinodisp/au/cases/cth/HCA/2018/59.html at [24]-[47].

but **cannot** be the “fair value of Placer’s identifiable net assets [compared] to the purchase price of the business”;[48] and

- the High Court of Australia did not accept the broader “*added value*” approach to determining goodwill in reinforcing the primacy of the “added custom” approach.

The takeaway points of *Placer’s case* are:

1. Separate sources of goodwill will need to be identified by taxpayers separate to the portfolio of land assets. [49]

2. The HCA cautioned against “attributing a value to goodwill which actually inhered in an asset which was a source of goodwill”. [50]

3. The High Court of Australia held that in the circumstances it could not be demonstrated that the various sources existed or that the sources could generate earnings by attracting custom. This reinforces the importance of appropriately instructed expert valuers. [51]

4. The value of goodwill must be determined by reference to the nature of goodwill as being the attractive force which brings in custom. The HCA rejected the concepts of "*added value*" goodwill or "*going concern*" goodwill, as “goodwill at law does not extend to include every fact or matter that adds value to a business”. [52]

3.4.2 Public Ruling – Goodwill – the Cost base of goodwill – TR 1999/16

The Commissioner has expressed a view in relation to the cost base of goodwill in TR 1999/16 at paragraphs [53] to [58] the following:

> 53. The cost base of goodwill purchased in an arm's length transaction includes money paid or required to be paid in respect of acquiring the goodwill and the market value of any other property given or required to be given in respect of its acquisition.
>
> 54. The cost base of internally generated goodwill does not include any expenditure incurred in the course of carrying on a business which has the essential character of a working expense of the business or a cost of the trading operations of the business. In any event, expenditure that you have deducted or can deduct might not form part of the cost base of your goodwill or your interest in goodwill.

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[48] *Commissioner of State Revenue v Placer Dome Inc [2018] HCA 59* (5 December 2018) - http://www.austlii.edu.au/cgi-bin/sinodisp/au/cases/cth/HCA/2018/59.html at [78].
[49] *Commissioner of State Revenue v Placer Dome Inc [2018] HCA 59* (5 December 2018) - http://www.austlii.edu.au/cgi-bin/sinodisp/au/cases/cth/HCA/2018/59.html at [209].
[50] *Commissioner of State Revenue v Placer Dome Inc [2018] HCA 59* (5 December 2018) - http://www.austlii.edu.au/cgi-bin/sinodisp/au/cases/cth/HCA/2018/59.html at [83].
[51] *Commissioner of State Revenue v Placer Dome Inc [2018] HCA 59* (5 December 2018) - http://www.austlii.edu.au/cgi-bin/sinodisp/au/cases/cth/HCA/2018/59.html at [72].
[52] *Commissioner of State Revenue v Placer Dome Inc [2018] HCA 59* (5 December 2018) - http://www.austlii.edu.au/cgi-bin/sinodisp/au/cases/cth/HCA/2018/59.html at [114].

> 55. The cost base of goodwill is separate and distinct from, and does not include, the cost base of other assets of a business - even business assets which are sources of goodwill.
>
> 56. If a taxpayer commences a business, or internally generates goodwill in an existing business, the cost base of the goodwill does not include any figure for the taxpayer's (that is, sole trader's or partner's) own effort in building up the goodwill. The value of services performed by an individual taxpayer personally are not included in the cost base of an asset.
>
> 57. The cost base of goodwill includes capital expenditure to the extent it is incurred to increase the value of the goodwill and is reflected in the state or nature of the goodwill when a CGT event happens (subsection 110-25(5)). It also includes capital expenditure to the extent it is incurred to establish, preserve or defend the taxpayer's title to, or right over, the goodwill (subsection 110-25(6)).
>
> 58. Costs incurred in acquiring knowledge or information - e.g., know-how, mining, quarrying or prospecting information, trade secrets and secret formulae - do not form part of the cost base of goodwill. Similarly, costs incurred in establishing and maintaining the get-up of a business and in developing work in progress do not form part of the cost base of goodwill.

One real life example dealing with Goodwill and IP assets is outlined as Annexure in Part 4 of the paper as a case study:

- **See Case Study 4** that deals with Goodwill. [53]

3.5 GST

This paper does not propose a detailed analysis of the GST rules as they relate to dealings in intellectual property in this part of the paper. The below is an overview of the topic.

GST is payable on a taxable supply, which is defined as a "*supply*" made for "*consideration*" in the course of further of an enterprise that is connected with the "*indirect tax zone*" (Australia). [54]

Supplies that are "GST-free" or "input taxed" are excluded from being taxable supplies. A GST liability will only arise for suppliers that are "registered" or "required to be registered for GST purposes".

This condition effectively allows enterprises with a turnover of less than $75,000 to remain outside the GST system[55].

The concept of a supply is important – all practitioners should read GSTR 2006/9. This Ruling examines the meaning of 'supply' in the A New Tax System (*Goods and Services Tax) Act* 1999 (GST Act). A "supply" for GST purposes is "*any form of supply whatsoever"* and includes, amongst other things, "*a creation, grant, transfer, assignment or surrender of any right".* [56]

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[53] Source – ATO Website: Authorisation Number: 1051226759903 - Date of advice: 19 May 2017.

[54] Section 9-5 of the *A New Tax System (Goods and Services Tax) Act* 1999 (**GST Act**).

[55] Regulations 23-15.01 of the *A New Tax System (Goods and Services Tax) Act* 2019 (**GST Regulations**).

[56] Section 9-10 of the *GST Act*.

The definition of a supply is very broad. Two real life and specific GST issues are dealt with in the Annexure as Part 4 of the paper as case studies:

- GST Case Study 1 that deals with the GST on Assignment of Intellectual Property; and
- GST Case Study 2 that deals with GST and supply of software development consulting work for a non-resident company (NR).

The very broad definition of supply means that almost any transaction involving IP that are entered into in the course of an enterprise, where there is consideration, will be subject to GST. Thus, the outright sales, licencing of IP rights may be taxable supply.

In conclusion, attendees are encouraged to consider the following questions:

1. Has appropriate documentation been prepared and exchanged?[57]
2. What is the timing of the GST liabilities and input tax credits – the attribution rules? [58]
3. Is the supply connected with the Indirect Tax Zone? [59]
4. Is any part of the supply "input taxed", such as where IP is exchanged for shares or an interest in a trust or partnership?
5. If there is a sale, does the sale of the going concern rules apply such that the supply will be GST-free?[60]
6. Can one of the "exported services and cross border supplies" apply to make the supply GST-free?[61]
7. Can one of the reverse charging provisions apply? You are responsible for making a reverse charge GST payment if an offshore purchase falls under the reverse charge rules. [62] There are some circumstances where GST is paid by the purchaser. This is called a 'reverse charge'.

3.6 ESIC – Early stage innovation company[63]

In general, a grant or subsidy[64] received in the ordinary course of business will be treated as ordinary taxable income.[65] There is a need to understand the interaction of business planning with structure of

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[57] Subdivision 29-C of the *GST Act.*
[58] Division 29-C of the *GST Act.*
[59] Section 9-25 of the *GST Act*.
[60] Section 38-325 of the *GST Act*.
[61] Section 38-190(1) of the *GST Act*.
[62] Section 84-10 of the *GST Act*.
[63] Source: https://www.ato.gov.au/business/tax-incentives-for-innovation/in-detail/tax-incentives-for-early-stage-investors/
[64] *Early Stage Innovation Companies* – Division 360 of the ITAA 1997 (Cth).
[65] The issue has also been recognised by the Commissioner of Taxation – see the website: https://www.ato.gov.au/Business/Tax-incentives-for-innovation/In-detail/Tax-incentives-for-early-stage-investors/

various grants and incentive schemes available. The below considers the early stage investors tax incentives that are available in 2020.

From 1 July 2016, if you invest in a qualifying early stage innovation company (ESIC), you may be eligible for tax incentives. The tax incentives for early stage investors (sometimes referred to as 'angel investors') are contained in Division 360 of the *ITAA 1997 (Cth)*. The ESIC tax incentives provide eligible investors who purchase new shares in an ESIC with a:

- **non-refundable carry forward tax offset** equal to 20% of the amount paid for their qualifying investments. This is capped at a maximum tax offset amount of $200,000 for the investor and their affiliates combined in each income year; and
- **modified capital gains tax (CGT) treatment**, under which capital gains on qualifying shares that are continuously held for at least 12 months and less than ten years may be disregarded. Capital losses on shares held less than ten years must be disregarded.

From a tax policy perspective, the early stage investor tax incentives are available to both Australian resident and non-resident investors. Other consideration includes the following:

- If the investor is a trust or partnership, special taxation rules apply so that the entitlement to the tax offset flows through to the member of the trust or partnership (or the ultimate member if there is a chain of trusts or partnerships).
- The maximum tax offset cap of $200,000 doesn't limit the shares that qualify for the modified CGT treatment. Investors that don't meet the *'sophisticated investor'*[66] test under the *Corporations Act* 2001 (Cth) won't be eligible for any tax incentives if their total investment in qualifying ESICs in an income year is more than $50,000.

A general caution - any such manipulation of the tests needs to be carefully considered in light of the potential application of the general anti-avoidance rules in Pt IVA of the *1936 Act*[67].

3.7 CRC-P - Co-operative research centre project grants

There is a need to understand the interaction of business planning with structure of various grants and incentive schemes available. One of the best examples of the complexities and competing drivers that can exist in a structuring of a business is the CRC-P grant program.

The program is administered by Federal Government – the Department of Innovation and Science Australia . This program is designed to support industry-led collaborations between industry, researchers and the community. It aims to connect researchers (predominantly universities) with industry to focus on research and development towards use and commercialisation.

The CRC-P program aims to:

[66] Section 708 of the *Corporations Act* 2001 (Cth)
[67] *Income Tax Assessment Act* 1936 (Cth)

- improve the competitiveness, productivity and sustainability of Australian industries, especially where Australia has a competitive strength and in line with government priorities
- foster high quality research to solve industry-identified problems through industry-led and outcome-focused collaborative research partnerships between industry entities and research organisations; and
- encourage and facilitate small and medium enterprise (SME) participation in collaborative research.

The overarching CRC-P grants offers support to industry, research and the community through the following grant:

- *Cooperative Research Centres Projects* ***(CRC-P) grants*** – to support short term, industry-led collaborative research, up to 3 years.[68]

This grant supports short-term (up to 3 years), industry-led collaborations. The relevant projects must:

- develop a product, service or process that will solve problems for industry and deliver real outcomes.
- benefit small to medium enterprises (SMEs);
- include education and training activities.

You can use the funding to cover costs directly related to your project including:

- new research
- proof of concept activities
- pre-commercialisation of research outcomes
- industry-focused education and training activities
- conferences, workshops, symposia related to the joint research
- information sharing and communications related to the research

This is not a complete list and other costs may also be eligible.

One of the key requirements is for the lead participant under a CRC-P project to receive the project contributions requires early identification of the correct entity as the applicant. The "project" has to be run by the applicant which can create issues with control and managing the other parties.

Managing the ownership and use of IP rights belonging to other parties in the venture/partnership can be difficult. The ownership rights to any IP developed under the project needs to be carefully considered along with which of the parties has the commercialisation rights.

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[68] Source: https://www.business.gov.au/Grants-and-Programs/Cooperative-Research-Centres-Projects-CRCP-Grants

A number of legal agreements will be required, for example:

- *A Funding Agreement* – this will include standard terms and conditions and schedules which address specific activities and funding.
- *A Participant Agreement* - all Participants in a CRC must contribute resources to the CRC. The total of these resources including cash and in-kind, tied and untied, must at least match the amount of funding sought from the Program over the funding period
- *A Licensing Agreement* – this will govern the use of any pre-existing IP that is “contributed” by any of the parties and will set out the relevant terms and conditions.

4 ANNEXURE: Edited Private advice (ATO) – Recent IP Examples – 2017 to 2019 – ATO Legal Database

4.1 GST - Case Study 1

Subject: GST on Assignment of Intellectual Property[69]

Question

Are you, X Pty Ltd, liable for GST payable on the sale of assets previously used in your business pursuant to section 9-40 of the *A New Tax System (Goods and Services Tax) Act 1999* (GST Act)?

Answer

Yes

4.1.1 Relevant facts and circumstances

- You, X Pty Ltd, registered for GST on a date. At that time you were trying to sell your intellectual property from a business in which you had ceased trading. You were previously registered for GST but cancelled on a date. You then decided to re-register for GST because you were advised to register for GST before you sold your intellectual property. You were registered for GST at the time of the sale of the assets.

- You entered into a Deed of Assignment ("the Deed"), on X to assign your various assets to another company for the sum of $X. The Deed provides that the assets include Trademarks, Trade Mark Registrations, the Domain Name, the Website content and the Customer contact List ("**the IP Assets**").

- The Deed provided that the sale price of $X was inclusive of GST. The Deed contained no written indication that the parties intended the transfer to be a GST-free sale of a going concern.

[69] Source – ATO Website: Authorisation Number: 1051330851221 - Date of advice: 13 February 2018.

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- The payments were in two instalments – one of $X on a date and the balance of $X on a date.

- At the time of transfer of the IP you were not using it in carrying on your online trading enterprise.

- You supplied a copy of a letter showing you had requested the Registrar of Trademarks to transfer your Trademark Registration to the transferee.

- You did not issue a tax invoice to the transferee nor did they request one.

- You have contended that your supply is GST free pursuant to section 38-325 of the GST Act.

4.1.2 Relevant legislative provisions

- *A New Tax System (Goods and Services Tax) Act 1999* section 9-5

- *A New Tax System (Goods and Services Tax) Act 1999* section 9-40.

- *A New Tax System (Goods and Services Tax) Act 1999* section 38-325.

4.1.3 Answer

In this reasoning, unless otherwise stated,

- all legislative references are to the *A New Tax System (Goods and Services Tax) Act 1999* (GST Act)

- all legislative terms of the GST Act marked with an asterisk are defined in section 195-1 of the GST Act

Under section 9-40, you must pay GST on any taxable supply you make.

Section 9-5 of the lists the elements necessary for there to be a taxable supply:

> **9-5 Taxable supplies**
>
> You make a taxable supply if:

(a) you make the supply for *consideration; and

(b) the supply is made in the course or furtherance of an *enterprise that you *carry on; and

(c) the supply is *connected with the indirect tax zone; and

(d) you are *registered, or *required to be registered.

However, the supply is not a *taxable supply to the extent that it is *GST-free or *input taxed.

Applying the above to your situation:

(a) you transferred the IP Assets for consideration of $X;

(b) you transferred the IP Assets in the course or furtherance of an online sales enterprise you carried on;

(c) the supply was connected with the indirect tax zone;

(d) you were registered for GST at the time of supply.

As your supply was not input taxed, it would have been a taxable supply unless it was GST free.

You contend that your supply is GST free pursuant to section 38-325 as a GST free supply of a going concern.

Section 38-325 states:

38-325 Supply of a going concern

(1) The *supply of a going concern is *GST-free* if:

(a) The supply is for *consideration; and

(b) the *recipient is *registered or *required to be registered; and

(c) the supplier and the recipient have agreed in writing that the supply is of a going concern.

(2) A supply of a going concern is a supply under an arrangement under which:

> (e) the supplier supplies to the *recipient all of the things that are necessary for the continued operation of an *enterprise; and
>
> (f) the supplier carries on, or will carry on, the enterprise until the day of the supply (whether or not as part of a larger enterprise carried on by the supplier).

Goods and Services Tax Ruling GSTR 2002/5 *Goods and services tax: when is a 'supply of a going concern' GST-free?* sets out the Commissioner's view on what elements are necessary for there to be a GST free supply of a going concern. In particular, paragraphs 17 and 18 respectively state:

> 17. An arrangement satisfies paragraph 38-325(2)(a) where each of the following elements is present:
>
> - the supplier supplies to the recipient;
> - all of the things that are necessary for the continued operation;
> - of an enterprise.
>
> 18. Paragraph 38-325(2)(b) of the definition also requires two additional elements to be present:
>
> - the supplier carries on, or will carry on, the enterprise (whether or not as part of a larger enterprise);
> - until the day of the supply.

As there:

- was no agreement in writing that the supply would be a GST-free supply of a going concern, and
- you did not operate the enterprise up until the day of the supply,
- your supply of the IP Assets do not meet the requirements of section 38-325
- your supply of the IP Assets does not meet the requirements of section 38-325

However, as you meet the requirements of section 9-5, and the supply is not GST free nor input taxed, you are liable for GST on the supply of the IP Assets pursuant to section 9-40 of the GST Act.

4.2 GST - Case Study 2

Subject: GST and supply of software development consulting work for a non-resident company (NR)[70]

Question

Are you making a GST-free supply of software development services under the agreement with NR?

Answer

Yes, your supply of software development services to NR is a GST-free supply under item 2 in the table in subsection 38-190(1) (Item 2) of the *A New Tax System (Goods and Services Tax) Act 1999* (GST Act)

4.2.1 Relevant facts and circumstances

- You are registered for GST.

Background:

- NR develops software and sells software licences to Oz Co.
- Oz Co is a completely separate company from NR.
- Oz Co acts like a dealership. The personnel of Oz Co go to business owners in Australia and find out the requirements for computer application software (software) and sign contracts with them to supply the software, install the hardware, support services, configuration, etc.
- Oz Co contracts NZ to buy software licences.
- NR contracts you and others to develop software (which is different from a license to use the software). The software you develop is “general purpose” for an industry, and the local dealers buy the licence to configure the software for the specific businesses that the software is being installed at.

[70] Source – ATO Website: Authorisation Number: 1051247901009 - Date of advice: 24 July 2017.

- Your role is a developer helping to build software. You are not involved with the actual licensing– who should be sold what license and at what cost.

Consultancy Agreement (Agreement) between you and NR

- According to the Agreement, you supply software development services to NR. You are not an employee, worker, agent or partner of NR. You are paid a fee per hour.

You state that you are a software developer/computer programmer by trade. You design, develop, test and implement software according to the functional specifications and related information provided to you by NR. You conduct your supply of software development services as follows:

- You receive a requirement for development by from NR ;

- You use electronic means to conduct regular planning meetings with NR. You discuss the exact extent of the work, how it should be done and the timelines for completing the work;

- You then download the relevant customer code (you have access to a server controlled by NR, and located overseas), do your development work on a computer (supplied by NR and located on a workstation at the premises of Oz Co.) and upload the updated code back to NR’s server.

Oz Co does not attend these planning meetings, nor do they have the ability to dictate to NR what software to develop.

You agree to travel overseas at the request of NR, with associated expenses paid by NR.

All the software /intellectual property which you create will be solely owned by NR who sell licenses to use the software to Oz Co, but NR retains all Intellectual Property rights/ownership of the software.

You give NR written or oral advice or information in relation to your software development services. You also give advice on what functionality will improve and what functionality will hinder the software owned by NR.

You report to XY of NR, who is based overseas.

You submit your invoices to NR, and XY of NR chooses whether to pay you and whether to continue offering you more work.

Your understanding is that NR is a foreign resident entity that is not required to register for GST in Australia.

Oz Co is not owned/related to NR through subsidiary or otherwise. If Oz Co ever wanted to use your services, they would have to contract with you directly and you would invoice Oz Co separately.

You work at Oz Co’s workstation (using their facilities) on a full time basis on Oz Co’s premises. NR supplies you with the computer and tools used to develop NR's software.

4.2.2 Relevant legislative provisions

A New Tax System (Goods and Services Tax) Act 1999, Section 9-5

A New Tax System (Goods and Services Tax) Act 1999, Section 38-190

A New Tax System (Goods and Services Tax) Act 1999, Section 195-1

4.2.3 Answer

GST is payable on a taxable supply under section 9-5 of the GST Act, which states:

> You make a *taxable supply* if:
>
> a) you make the supply for *consideration
>
> b) the supply is made in the course or furtherance of an *enterprise that you *carry on
>
> c) the supply is *connected with the indirect tax zone, and
>
> d) you are *registered, or *required to be registered, for GST.
>
> However, the supply is not a *taxable supply to the extent that it is *GST-free or *input taxed.

(* denotes a defined term in section 195-1 of the GST Act)

The supply of software development services by you to NR satisfies the requirements under paragraphs 9-5(a), 9-5(b), 9-5(c) and 9-5(d) because:

- the supply is made for consideration;

- the supply is made in the course or furtherance of your business which you carry on;
- the supply is connected with the indirect tax zone because it is made through an enterprise (business) that you carry on in the indirect tax zone; and
- you are registered for GST.

However, the supply is not a taxable supply to the extent that it is GST-free or input taxed.

From the facts provided, your supply of software development services is not input taxed. We need to determine whether the supply satisfies the GST-free provisions.

GST-free supply

Section 38-190 specifies the circumstances where the supply of things other than goods or real property for consumption outside Australia is GST-free. Of relevance to the facts provided is item 2 in the table in subsection 38-190(1) (Item 2).

Goods and Services Tax Ruling GSTR 2000/31, Goods and Services Tax Ruling GSTR 2003/7, Goods and Services Tax Ruling GSTR 2004/7, and Goods and Services Tax Ruling GSTR 2005/6 address the operation of Section 38-190.

Item 2 provides that a supply of a thing (other than goods or real property) made to a non-resident is GST-free if it is a supply that is made to a non-resident that is not in Australia when the thing supplied is done, and:

> a) the supply is neither a supply of work physically performed on goods situated in Australia when the work is done, nor a supply directly connected with real property situated in Australia; or
>
> b) the non-resident acquires the thing in carrying on the non-resident's enterprise, but is not registered or required to be registered for GST.

Goods and Services Tax Ruling GSTR 2004/7 (available on the legal database of www.ato.gov.au) provides guidance on Item 2.

> 241. We consider, therefore, that a non-resident company is in Australia for the purposes of item 2 and paragraph (b) of item 4 if that company carries on business

> (or in the case of a company that does not carry on business, carries on its activities) in Australia:
>
> > (a) at or through a fixed and definite place of its own for a sufficiently substantial period of time; or
> >
> > **(**b) through an agent at a fixed and definite place for a sufficiently substantial period of time.
>
> 242. In addition to producing an outcome that is more aligned with the policy intent to tax supplies consumed only in Australia, this approach also means that guidance on the application of these criteria for presence in Australia of a non-resident company can be found in the jurisdictional case law.
>
> 243. This approach is also supported by the broader framework of section 38-190. If a supply is made to a non-resident company that is not in Australia (because it does not have a presence in Australia as determined under the test in paragraph 241) but the supply is provided to a representative in Australia such as an employee, the presence of that employee in Australia is addressed by means of subsection 38-190(3). That subsection negates the GST-free status that would otherwise apply to an item 2 supply, if that supply is provided to another entity in Australia, such as an employee. Thus, although presence of the non-resident company in Australia is determined by whether the company is carrying on business in Australia, another provision takes into account the presence of representatives in Australia if the non-resident company does not carry on business in Australia

Following the above, we do not consider that NR carries on business/activities in Australia. Nor do we consider that Oz Co is a representative/agent of NR in Australia. NR supplies software licences, while Oz Co installs, configures and gives support services to business owners to enable the use of the licence.

The fact that you use a workstation and relevant facilities from Oz Co does not mean that NR carries on business in Australia 'at or through a fixed and definite place of its own for a sufficiently substantial period of time.'

On the basis of the facts provided, the supply of software development services by you to NR will satisfy the precondition and paragraph (a) of Item 2 because:

- you supply of software development services to NR, who is a non-resident entity that is not in Australia (and has no representative in Australia) in relation to your services; and

- the supply of software development services is neither a supply of work physically performed on goods situated in Australia, nor a supply directly connected with real property situated in Australia.

We note that since you state that NR acquires your software development services in carrying on its enterprise of supplying software licences, and is neither registered nor required to be registered for GST in Australia, hence the requirements of paragraph (b) of Item 2 would also be satisfied.

Having met the requirements of either paragraph (a) or (b) of Item 2, the supply of software development services made by you to NR is GST-free under item 2 to the extent that the supply is not negated by subsections 38-190(2), 38-190(2A) and 38-190(3) of the GST Act.

From the information received, subsections 38-190(2) and 38-190(2A) of the GST Act are not applicable to your supply of software development services because:

- your supply is not a supply of a right or option to acquire something the supply of which would be connected with Australia and would not be GST-free under subsection 38-190(2) of the GST Act;

- the acquisition of your supply does not relate (whether directly or indirectly or wholly or partly) to the making a supply of real property that would be wholly or partly input taxed under subsection 38-190(2A) of the GST Act.

The next step is to consider whether subsection 38-190(3) of the GST Act will apply to your supply of software development services to NR.

Subsection 38-190(3) of the GST Act

The issue is: According to your arrangements with NR, are you required to provide your software development services to another entity in Australia?

Subsection 38-190(3) of the GST Act has been amended with the addition of paragraph (c). The application date of the amendment is 1 October 2016. Subsection 38-190(3) of the GST Act provides that without limiting subsection 38-190(2) or (2A), a supply covered by item 2 in that table is not GST-free if:

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a) it is a supply under an agreement entered into, whether directly or indirectly, with a non-resident; and

b) the supply is provided or the agreement requires it to be provided to another entity in Australia; and

c) for a supply other than an input taxed supply – none of the following applies:

i. the other entity would be an Australian-based business recipient of the supply, if the supply had been made to it;

ii. the other entity is an individual who is provided with the supply as an employee or officer of an entity that would be an Australian-based business recipient of the supply, if the supply had been made to it; or

iii. the other entity is an individual who is provided with the supply as an employee or officer of the recipient, and the recipient's acquisition of the thing is solely for a creditable purpose and is not a non-deductible expense

From the information received, your supply will satisfy paragraph (a) of subsection 38-190(3) as your supply is under an agreement with a non-resident.

In respect of paragraph (b) of subsection 38-190(3), paragraphs 277 and 285 of GSTR 2005/6 state:

> 277. A clear understanding of the exact nature of the supply is essential to determining whether that supply is provided to another entity. By determining what is in substance and reality being supplied, it is possible to identify to which entity the supply is provided.
>
> 285. In situations where the contractual flow of the supply is to an entity (other than an individual), and it is necessary to determine whether the actual flow of the supply is to another entity (other than an individual), we consider that a strong indicator that the supply is provided to another entity is that the contracting entity has no further interaction with, or participation in, the provision of the supply beyond contracting and paying for the supply…

From the fact provided, NR decides which software to develop and what features the software will have, gives you functional specifications and related information to enable you to design the software.

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NR has planning meetings with you, decides the exact extent of the work, how it should be done and the timelines for completing the work; and pays you directly.

Therefore, following the above view, you supply to NR. We do not consider that your supply is provided to another entity in Australia. Nor does the agreement with NR require your supply to be provided to another entity in Australia.

Since paragraph (b) of subsection 38-190(3) of the GST Act is not satisfied, there is no need to discuss paragraph (c) of subsection 38-190(3) of the GST Act.

Hence subsection 38-190(3) of the GST Act will not negate the GST-free status of your supply under Item 2.

Accordingly, your supply of software development services to NR will be GST-free under paragraph (a) or (b) of Item 2.

For more information on subsection 38-190(3) of the GST Act please refer to Goods and Services Tax Ruling GSTR 2005/6.

4.3 Blackhole Expenditure - Case Study 3

Subject: Business capital expenditure - section 40-880 of the Income Tax Assessment Act 1997[71]

Question

Is the expenditure which ABC incurred deductible under section 40-880 of the *Income Tax Assessment Act 1997* (ITAA 1997 (Cth))?

Answer

Yes, to the extent the expenditure is not on in-house software, nor expenditure that forms part of a cost base of a CGT asset.

Question 2

---

[71] Source – ATO Website: Authorisation Number: 1051437161631 - Date of advice: 15 October 2018.

Is the expenditure which ABC incurred for certain legal expenses deductible under section 40-880 of the ITAA 1997 (Cth)?

Answer

Yes, to the extent the expenditure does not form part of a cost base for a CGT asset.

4.3.1 Relevant facts and circumstances

The Entities

CBC

- CBC is a company originally founded in a foreign country and is listed on a foreign stock exchange.
- CBC operates in the financial services arena in various countries.
- CBC disclosed total income in a recent Annual Report which exceeds A$25 million.

ABC Pty Ltd

- ABC Pty Ltd ('ABC') was established a couple of years ago as a tax resident of Australia and is a wholly-owned subsidiary of ICI. ICI is incorporated in a foreign jurisdiction, and is in turn a wholly-owned subsidiary of CBC.
- ABC was established and funded by ICI as a holding structure to partner with an unrelated Australian entity, AustCo, to start up a new financial services business in Australia.
- AAA Pty Ltd ('AAA') and DBC Pty Ltd ('DBC') were also established as part of this process. ABC holds over 40% of each of AAA and DBC.
- ABC will derive assessable income from its investment in DBC through the receipt of dividends from AAA.

AAA Pty Ltd (AAA)

- AAA is a tax resident of Australia which was established for the purpose of investing in DBC.

DBC Pty Ltd (DBC)

- DBC is a tax resident of Australia.
- DBC was established to run a financial services business in Australia.
- DBC will derive assessable income from these activities.

At the time the expenditure was incurred by ABC, DBC was not established or had not yet commenced its business. DBC could not be established until certain 'conditions precedent' were met.

The Transactions

1) Costs incurred to establish DBC

ABC incurred several costs to establish the DBC's business. This included expenditure for the shareholders agreements.

All of the costs were initially invoiced by the third-party service providers to AustCo. Some of the costs were incurred on the development of DBC's commercial website.

In accordance with the relevant shareholders agreement, AustCo then invoiced ABC for ABC's share of the third-party fees.

Apart from a statutory licence, none of this expenditure related to other licences.

DBC was subsequently granted a licence to operate a financial services business.

Staff from both AustCo and FinServ worked on the project on a full time basis. Each party was to fund the costs' in accordance with its respective share. FinServ and various other providers invoiced AustCo, and then AustCo in turn invoiced ABC for its share.

Each party to the shareholder agreements carried its own costs for drafting the agreements.

AAA's share of the costs were initially invoiced to AustCo which on-charged a portion of the costs to ABC.

2) Costs incurred to draft various agreements

ABC incurred legal costs to draft the various agreements. The legal services were provided by a law firm.

The legal costs were invoiced to ICI which in turn raised an invoice to ABC for the costs.

Other Matters

Licences and Intellectual Property

There are no licences of intellectual property ('IP'), however the agreements allow for a grant of non-exclusive licenses to use certain IP in carrying on the business.

There is no income generated from the non-exclusive licence.

4.3.2 Relevant legislative provisions

- *Income Tax Assessment Act 1997* subsection 40-25(7)
- *Income Tax Assessment Act 1997* subsection 40-880(1)
- *Income Tax Assessment Act 1997* subsection 40-880(2)
- *Income Tax Assessment Act 1997* paragraph 40-880(2)(c)
- *Income Tax Assessment Act 1997* subsection 40-880(2A)
- *Income Tax Assessment Act 1997* subsection 40-880(4)
- *Income Tax Assessment Act 1997* paragraph 40-880(4)(a)
- *Income Tax Assessment Act 1997* subsection 40-880(5)
- *Income Tax Assessment Act 1997* paragraph 40-880(5)(a)
- *Income Tax Assessment Act 1997* paragraph 40-880(5)(b)
- *Income Tax Assessment Act 1997* paragraph 40-880(5)(c)
- *Income Tax Assessment Act 1997* paragraph 40-880(5)(d)

- *Income Tax Assessment Act 1997* paragraph 40-880(5)(e)
- *Income Tax Assessment Act 1997* paragraph 40-880(5)(f)
- *Income Tax Assessment Act 1997* paragraph 40-880(5)(g)
- *Income Tax Assessment Act 1997* paragraph 40-880(5)(h)
- *Income Tax Assessment Act 1997* paragraph 40-880(5)(i)
- *Income Tax Assessment Act 1997* paragraph 40-880(5)(j)
- *Income Tax Assessment Act 1997* subsection 40-880(6)
- *Income Tax Assessment Act 1997* subsection 40-880(7)
- *Income Tax Assessment Act 1997* subsection 40-880(8)
- *Income Tax Assessment Act 1997* subsection 40-880(9)
- *Tax Laws Amendment (2006 Measures No.1) Act 2006* section 3 and Schedule 2 item 51(1)

4.3.3 Answer

All legislative references are to the *Income Tax Assessment Act 1997* (ITAA1997) unless otherwise specified.

Question 1

Summary

To the extent the expenditure is not on in-house software or expenditure that forms part of a cost base for a CGT asset, ABC is entitled to deductions under section 40-880 for business capital expenditure. The requirements in subsections 40-880(2) and (4) were satisfied, and the requirements of subsections 40-880(5) to 40-880(9) do not apply.

The expenditure is deductible under section 40-880 in equal proportions over a period of five (5) income years starting in the year of income in which ABC incurred the expenditure.

4.3.4 Detailed reasoning

Subsection 40-880(2)

Subsection 40-880(2) states that you:

> … can deduct, in equal proportions over a period of 5 income years starting in the year in which you incur it, capital expenditure you incur:

…

> **(c)** in relation to a business proposed to be carried on; or

…

In ABC's circumstances, paragraph 40-880(2)(c) is relevant, as the expenditure ABC incurred was in relation to the financial services business which at the time was proposed to be carried on by DBC.

Subsection 40-880(2A)

Deduction

Subsection 40-880(2A) provides that you can deduct the entire amount of the capital expenditure in the income year in which you incur it if:

> **(a)** the expenditure is incurred in relation to a business that is proposed to be carried on; and
>
> **(b)** the expenditure is incurred:
>
> > **(i)** in obtaining advice or services relating to the proposed structure, or proposed operation of the business; or
> >
> > **(ii)** in payment to an *Australian government agency of fees, taxes or charges relating to establishing the business or its operating structure; and
>
> **(c)** you are a *small business entity for the income year, or both of the following apply:

(i) you are not carrying on a *business in the income year;

(ii) you are not *connected with, or an *affiliate of, another entity that carries on a business in the income year and that is not a small business entity for the income year.

ABC incurred the expenditure in relation to the financial services business that was proposed to be carried on by DBC. The expenditure was incurred for a business that was proposed to be carried on and included obtaining legal advice and other services relating to the proposed structure and the proposed operation of the business. Therefore the requirements of paragraph 40-880(2A)(a) and subparagraph 40-880(2A)(b)(i) are satisfied.

Meaning of small business entity

Turning to paragraph 40-880(2A)(c), subsection 995-1(1) states that the term ‘small business entity’ has the meaning given by section 328-110. Subsection 328-110(1) states you are a small business entity for an income year (the current year) if:

You are a *small business entity* for an income year (the *current year*) if:

(a) you carry on a *business in the current year; and

(b) one or both of the following applies:

(i) you carried on a business in the income year (the *previous year*) before the current year and your *aggregated turnover for the previous year was less than $10 million;

(ii) your aggregated turnover for the current year is likely to be less than $10 million.

Meaning of aggregated turnover

Subsection 328-115(1) provides that your aggregated turnover for an income year is the sum of the relevant annual turnovers (as set out in subsection 328-115 (2)) excluding any amounts covered by subsection 328-115 (3).

Subsection 328-115(2) provides that the:

… *relevant annual turnovers* are:

(a) your *annual turnover for the income year; and

(b) the annual turnover for the income year of any entity (a *relevant entity*) that

is *connected with you at any time during the income year; and

(c) the annual turnover for the income year of any entity (a *relevant entity*) that

is an *affiliate of yours at any time during the income year.

Meaning of connected with an entity

Subsection 328-125(1) states that an entity is connected with another entity if:

(a) either entity controls the other entity in a way described in this section; or

(b) both entities are controlled in a way described in this section by the same

third entity.

'Control' is defined in subsection 328-125(2) and includes:

- owning interests in another entity which carry a right to receive at least 40% of dividend or capital distributions, or

- owning equity interests in a company that carry a right to exercise at least 40% of the voting power in the company.

ABC is controlled by CBC as CBC wholly-owns ABC. Therefore, paragraph 328-125(1)(a) operates such that the annual turnover of CBC is taken into account in the calculation of CBC's relevant annual turnover; paragraph 328-115(2)(b). As the annual turnover of CBC exceeds $25 million, neither subparagraph 328-110(1)(b)(i) nor and subparagraph 328-110(1)(b)(ii) are satisfied, and accordingly ABC is not a small business entity under subsection 328-110(1).

As ABC is not a small business entity under subsection 328-110(1), the requirements of paragraph 40-880(2A)(c) are not satisfied, and ABC is ineligible to deduct the capital expenditure *entirely* in the income year in which ABC incurred the expenditure.

Subsection 40-880(3) - taxable purpose requirement

Subsection 40-880(3) states that:

> You can only deduct the expenditure, for a *business that you carry on, used to carry on or propose to carry on, to the extent that the business is carried on, was carried on or is proposed to be carried on for a *taxable purpose.

The relevant business is or was proposed to be carried on by DBC.

Therefore, subsection 40-880(3) is not relevant in the circumstances of ABC's expenditure in this matter.

Subsection 40-880(4)

Subsection 40-880(4) states that:

> You can only deduct the expenditure, for a *business that another entity used to carry on or proposes to carry on, to the extent that:
>
> **(a)** the business was carried on or is proposed to be carried on for a *taxable purpose; and
>
> **(b)** the expenditure is in connection with:
>
> **(i)** your deriving assessable income from the business; and
>
> **(ii)** the business that was carried on or is proposed to be carried on.

Subsection 995-1(1) states that 'taxable purpose' has the meaning given by section 40-25.

Section 40-25

Taxable purpose - meaning.

Relevantly, paragraph 40-25(7)(a) provides that a 'taxable purpose' is:

> **(a)** the *purpose of producing assessable income; or …

ABC will derive assessable income from its investment in DBC through the receipt of dividends from AAA on equity interests owned in DBC which will in turn fund dividends to its shareholders including ABC. Therefore, the requirement of paragraph 40-25(7)(a) is satisfied.

In ABC's circumstances, as the business of DBC was proposed to be carried for a taxable purpose, the paragraph 40-880(4)(a) requirement is satisfied. Further, the expenditure is in connection with ABC deriving assessable income by way of dividends which will flow indirectly from DBC's proposed business. Therefore, the paragraph 40-880(4)(b) requirement is satisfied.

Accordingly, ABC satisfies the requirements of subsection 40-880(4).

Subsection 40-880(5)

Subsection 40-880(5) provides that:

> You cannot deduct anything under this section for an amount of expenditure you incur to the extent that:
>
> **(a)** it forms part of the *cost of a *depreciating asset that you *hold, used to hold or will hold; or
>
> **(b)** you can deduct an amount for it under a provision of this Act other than this section; or
>
> **(c)** it forms part of the cost of land; or
>
> **(d)** it is in relation to a lease or other legal or equitable right; or
>
> **(e)** it would, apart from this section, be taken into account in working out:
>
> **(i)** a profit that is included in your assessable income (for example, under section 6-5 or 15-15); or
>
> **(ii)** a loss that you can deduct (for example, under section 8-1 or 25-40); or
>
> **(f)** it could, apart from this section, be taken into account in working out the amount of a *capital gain or *capital loss from a *CGT event; or

(g) a provision of this Act other than this section would expressly make the expenditure non-deductible if it were not of a capital nature; or

(h) a provision of this Act other than this section expressly prevents the expenditure being taken into account as described in paragraphs (a) to (f) for a reason other than the expenditure being of a capital nature; or

(i) it is expenditure of a private or domestic nature; or

(j) it is incurred in relation to gaining or producing *exempt income or *non-assessable non-exempt income.

The expenditure is not on 'one item', but rather is the total of various expenditures for various items. For subsection 40-880(5), it is important to consider the expenditure for each item.

Subsection 40-880(5) ensures that section 40-880 operates as a provision of last resort. Where expenditure on an item is deductible under another provision of Australian Income Tax legislation, forms part of the cost of a depreciating asset, forms part of the cost base of a CGT asset, and so on, the expenditure on that item will not be deductible under section 40-880 in accordance with subsection 40-880(5).

As DBC had not commenced business when ABC incurred the items of expenditure, the items of expenditure were incurred 'at a point too soon' to enable ABC a general deduction for the items of expenditure under section 8-1.

The items of expenditure are also not deductible under another specific deduction provision (other than section 40-880), and do not obtain tax recognition elsewhere in Australian income tax legislation, with exceptions for the extent that the items are for the commercial website (discussed below).

In ABC's circumstances, some of the costs incurred to establish DBC were incurred on the development of DBC's commercial website. Paragraph 52 of Taxation Ruling *TR 2016/3 Income tax: deductibility of expenditure on a commercial website* ('TR 2016/3') sets out the Commissioner's view that section 40-880 will generally not apply to allow deductions for capital expenditure on commercial websites as it is usually 'in-house software' and, if not, is likely to be part of the cost base of a CGT asset.

Accordingly, to the extent that part of the costs incurred to establish DBC is expenditure on 'in-house software' or is included in the cost base of a CGT asset, the subsection 40-880(5) requirement applies to deny the deduction under section 40-880 for that item.

This does not operate to limit or deny ABC's entitlement to a deduction for the remaining part of the expenditure incurred to establish DBC under section 40-880.

Subsections 40-880(6), 40-880(8) and 40-880(9) are not relevant to ABC's circumstances.

Subsection 40-880(7)

Subsection 40-880(7) states that you cannot deduct an amount under paragraph 40-880(2)(c):

> … in relation to a *business proposed to be carried on unless, having regard to any relevant circumstances, it is reasonable to conclude that the business is proposed to be carried on within a reasonable time.

In ABC's circumstances, the Commissioner accepts that the business which DBC proposed to carry on commenced within a reasonable time. Accordingly, ABC satisfies the requirements of subsection 40-880(7).

Question 2

Summary

To the extent the expenditure does not form part of a cost base of a CGT asset, ABC is entitled to deductions for the legal expenses under section 40-880 as business capital expenditure. The requirements in subsections 40-880(2) and (4) were satisfied, and the requirements of subsections 40-880(5) to 40-880(9) do not apply.

The expenditure is deductible under section 40-880 in equal proportions over a period of five (5) income years starting in the year of income ABC incurred the expenditure.

Detailed reasoning

Subsection 40-880(2)

Subsection 40-880(2) states that you:

> … can deduct, in equal proportions over a period of 5 income years starting in the year in which you incur it, capital expenditure you incur:

…

(c) in relation to a business proposed to be carried on; or

…

In ABC’s circumstances, paragraph 40-880(2)(c) is relevant, as the expenditure ABC incurred was in relation to the financial services business which at the time was proposed to be carried on by DBC.

Subsection 40-880(2A)

For the same reasons as set out in the *Detailed reasoning* for subsection 40-880(2A) in *Question 1* above, ABC is ineligible to deduct the capital expenditure *entirely* in the income year in which ABC incurred it.

Subsection 40-880(3) - taxable purpose requirement

For the same reasons as set out in the *Detailed reasoning* for subsection 40-880(3) in *Question 1* above, subsection 40-880(3) is not relevant in the circumstances of ABC’s expenditure in this matter.

Subsection 40-880(4)

For the same reasons as set out in the *Detailed reasoning* for subsection 40-880(4) in *Question 1* above, ABC satisfies the requirements of this subsection.

Subsection 40-880(5)

Subsection 40-880(5) is quoted in full in the *Detailed reasoning* for this subsection in *Question 1* above. Most of the analysis in the *Detailed reasoning* for this subsection in *Question 1* above is relevant for the various items of expenditure making up the legal expenses (with the exception of the discussion on items of expenditure on the commercial website).

To the extent that an item of the legal costs is expenditure that is included in, or forms part of, the cost base of a CGT asset, the subsection 40-880(5) requirement applies to deny the deduction under section 40-880 for that item. In particular, to the extent the item of expenditure is for drafting clauses in the shareholder agreements and / or for granting the non-exclusive licence, that extent forms part of the cost base of a CGT asset (being the non-exclusive licence),

This does not operate to limit or deny ABC’s entitlement to a deduction for the remaining part of the expenditure under section 40-880.

Subsections 40-880(6), 40-880(8) and 40-880(9) are not relevant to ABC's circumstances.

Subsection 40-880(7)

For the same reasons as set out in the *Detailed reasoning* for subsection 40-880(7) in *Question 1* above, ABC satisfies the requirements of this subsection.

4.4 Goodwill of the business - Whether pre-CGT asset - Case Study 4

Subject: Goodwill of the business - whether pre-CGT asset [72]

Subject:

Question 1

Is the goodwill of X Pty Ltd an asset that was acquired before 20 September 1985 for the purposes of Part 3-1 of the *Income Tax Assessment Act 1997* (ITAA 1997 (Cth))?

Answer

Yes.

This ruling applies for the following periods:

1 July 20xx to 30 June 20xx

The scheme commences on:

1 July 20xx

[72] Source – ATO Website: Authorisation Number: 1051226759903 - Date of advice: 19 May 2017.

4.4.1 Relevant facts and circumstances:

Person A and Person B designed a system for a particular industrial application (system) in the late 19XX's and started their business in the mid-19XX's when they first secured their on-going contract. The business was incorporated as X Pty Ltd around the same time.

With continuous research and innovation, X Pty Ltd.'s products expanded in various fields and the customer base also expanded from the local to international market. Irrespective of such growth and expansion, X Pty Ltd only manufactured its system and related products for a particular industry. It has its own extensive manufacturing facilities. It owns its own research facilities and directly owns all its intellectual properties.

There has not been any significant acquisition or discontinuance of the business during the life of the business. Its sale figures have steadily grown from mid-19XX's. There has not been any sudden shift or major overhaul of suppliers at any point.

While the growth of the business demanded appointment of new staff, the main control and management of the business continued to be held by Person A and Person B as well as the key personnel who were involved from the beginning. The business product is also known by its brand name and the control and management of the business remained mainly in its head office where it first started its business. International customers are serviced by wholly owned subsidiaries in various parts of the world.

X Pty Ltd have organised exhibition of its products in various international forums from mid-19XX's and have received awards for that particular industry on a regular basis from the very beginning.

Person A and Person B have always been the provider of majority funding for the operation of X Pty Ltd's business. They have also held majority shares in X Pty Ltd from its incorporation in mid-19XX's until present.

4.4.2 Relevant legislative provisions

Income Tax Assessment Act 1997 section 180-5

Income Tax Assessment Act 1997 section 149-10

Income Tax Assessment Act 1997 section 149-15

Income Tax (Transitional Provisions) Act 1997 section 130-20

4.4.3 Answer

All legislative references are to the ITAA 1997 (Cth) unless otherwise stated.

Establishment of goodwill

Goodwill according to Taxation Ruling TR 1999/16 *Income tax: capital gains: goodwill of a business* (TR 1999/16) has the legal definition which was established by the High court in *FC of T v. Murry* 98 ATC 4585*;* (1998) 39 ATR 129. Paragraph 12 of TR 1999/16 states that:

> … goodwill is the product of combining and using the tangible, intangible and human assets of a business for such purposes and in such ways that custom is drawn to it. The attraction of custom is central to the legal concept of goodwill. Goodwill is a quality or attribute that derives among other things from using or applying other assets of a business. It may be site, personality, service, price or habit that obtains custom. It is more accurate to refer to goodwill as having sources than it is to refer to it as being composed of elements. Goodwill is a composite thing. It is one whole. It is an indivisible item of property that is legally distinct from the sources from which it emanates. It is something that attaches to a business and is inseparable from the conduct of a business. It cannot be dealt with separately from the business with which it is associated.

Paragraph 52 of TR 1999/16 states that:

> If a taxpayer commences business and starts to create goodwill, the goodwill of the business is acquired when the taxpayer starts work that results in the creation of the goodwill (subsection 109-10, item 1). When a taxpayer starts the work resulting in the creation of goodwill of a business is a question of fact dependent on the circumstances of each particular case.

X Pty Ltd's expansion in product range, customer base, market and recognition through various awards exhibits that X Pty Ltd has created a substantive goodwill for its business. Since the work for the business started in the mid 1970's, the goodwill was acquired at the same time as per the above paragraph.

Goodwill as a CGT asset

A CGT asset is defined under subsection 108-5(1) as:

> (a) any kind of property; or
>
> (b) a legal or equitable right that is not property.

The above is further elaborated under subsection 108-5(2) as:

> (a) part of, or an interest in, an asset referred to in subsection (1);
>
> (b) goodwill or an interest in it;
>
> (c) an interest in an asset of a partnership;
>
> (d) an interest in a partnership that is not covered by paragraph (c).

X Pty Ltd's goodwill thus constitutes a CGT asset according to paragraph 108-5(2)(b).

Goodwill, as a whole, is either a pre-CGT asset or a post-CGT asset

According to TR 1999/16, goodwill is established as a whole either as a pre-CGT asset or a post-CGT asset. Paragraph 25 states:

> The goodwill of a particular business cannot be characterised as partly pre-CGT goodwill and partly post-CGT goodwill. Goodwill is a composite asset.

Therefore, X Pty Ltd's goodwill will be either pre-CGT or post-CGT asset. It cannot be partly pre-CGT and partly post-CGT.

Goodwill remains a single CGT asset if the same business continues

Paragraph 17 of TR 1999/16 states that:

> The whole of the goodwill of a business that commenced before 20 September 1985 remains the same single pre-CGT asset (subject to Division 149 - about when an asset stops being a pre-CGT asset …) provided the same business continues to be carried on. This is so even though:
>
> (a) the sources of the goodwill of a business may vary during the life of the business; or
>
> (b) there are fluctuations in goodwill during the life of the business.

Therefore, to determine whether X Pty Ltd's pre-CGT goodwill will remain pre-CGT, the same business needs to continue post-CGT. Moreover X Pty Ltd needs to satisfy Division 149. The following discusses these two aspects.

Division 149 - majority underlying interest in a CGT asset

Section 149-10 states in part as follows:

> A CGT asset that an entity owns is a pre-CGT asset if, and only if:
>
> (a) the entity last acquired the asset before 20 September 1985; and
>
> (b) …

Subsection 149-10(b) has been repealed by *Tax Laws Amendment (Repeal of Inoperative Provisions) Act 2006* which now is dealt with by sections 149-30 and 149-35. According to section 149-30, the asset stops being a pre-CGT asset at the earliest time when the majority underlying interest is no longer held by the ultimate owners who held such interest in the asset immediately before 20 September 1985.

Section 149-15 provides what constitutes a majority underlying interest in a CGT asset. It states as follows:

149-15(1) Majority underlying interests in a CGT asset consist of:

> (a) more than 50% of the beneficial interests that ultimate owners have (whether directly or indirectly) in the asset; and

(b) more than 50% of the beneficial interests that ultimate owners have (whether directly or indirectly) in any ordinary income that may be derived from the asset.

149- 15(2) An underlying interest in a CGT asset is a beneficial interest that an ultimate owner has (whether directly or indirectly) in the asset or in any ordinary income that may be derived from the asset.

> 149-15(3) An ultimate owner is:

> (a) an individual; or
>
> (b) a company whose constitution prevents it from making any distribution, whether in money, property or otherwise, to its members; or
>
> (c) the Commonwealth, a State or a Territory; or
>
> (d) a municipal corporation; or
>
> (e) a local governing body; or
>
> (f) the government of a foreign country, or of part of a foreign country.

More than 50% of beneficial interests in X Pty Ltd remain in the hands of Person A and Person B from mid-19XX's until present. Although the number of shares was increased, the same proportion of shareholding is maintained.

Same business

A business may change to such an extent that it is no longer the same business which would mean the goodwill of the old business would cease when goodwill of new business is established. Paragraph 21 of TR 1999/16 states that:

> The business does not need to be identical from its acquisition to its disposal. If the essential nature or character of the business is not changed, the business remains the same business for the CGT goodwill provisions. A business owner may expand or contract activities, or change the way in which a business is carried on, without ceasing to carry on the same business provided the business retains its essential nature or character. Organic growth, expansion or diversification of a business by, for example:
>
> (a) adopting new compatible operations;
>
> (b) servicing different clients; or
>
> (c) offering improved products or services
>
> does not of itself cause it to be a new business provided the business retains its essential nature or character.

Discussing when for example the essential nature or character of the business would remain the same, paragraph 22 of TR 1999/16 states that it would remain the same:

> … if all that happens is that portions of the operations of a business are discarded in an ordinary commercial way but the business retains its essential nature or character.

A business will also not essentially change its nature or character according to paragraph 23 of TR 1999/16, which states:

> If the types of customers a business attracts change as the business evolves over the years, this does not necessarily mean the business is no longer the same business as was originally carried on.

When deciding whether a business has the same essential nature or character, a similar kind of business being carried on would be insufficient. The same business would not be carried on according to TR 1999/16 paragraph 24 if:

> (a) through a planned or systematic process of change within a reasonable period of time, a business changes its essential nature or character; or
>
> (b) there is a sudden and dramatic change in the business brought about by either the acquisition or the shedding of activities on a considerable scale.

Paragraph 91 of TR 1999/16 also provides important factors to consider when establishing the essential nature or character of the business. It states that consideration should be given, among others, to the following:

- nature or character of the business
- its location and size
- the extent of changes in the assets and resources of the business
- the activities of the business - whether the activities constitute, or are treated by the business owner as constituting separate or distinct activities, enterprises, divisions or undertakings
- the way in which a business is structured, carried on, managed and controlled.

In the present case, the essential nature and character of X Pty Ltd's product continues to be the same from its formative period until present despite its development and expansion in market and customer base. The same system that Person A and Person B invented continues to be at the core of all its products. The brand-name by which X Pty Ltd's customers associate its products, continue to do so at present. There has not been any major overhaul of its suppliers as well as any major acquisition or discontinuance of its business. All its research, innovation, manufacturing and servicing works have always been done from X Pty Ltd's head office with wholly owned subsidiaries to service the international customers. All decision making of management functions have also always remained with Person A and Person B. While they have always been the majority shareholder, they have also always provided majority funding for the business.

Therefore, since the same business continues for X Pty Ltd from pre-CGT and since there has not been any changes in its shareholding from pre-CGT, the goodwill that X Pty Ltd acquired for its business pre-CGT continues its pre-CGT status for the purposes of Part 3-1.