

Tax Aspects of Creating or Acquiring Intellectual Property

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

What is Intellectual Property?

The term "intellectual property" is defined in section 995-1 as follows:

"an item of intellectual property consists of the rights (including equitable rights) that an entity holds under a Commonwealth law as:

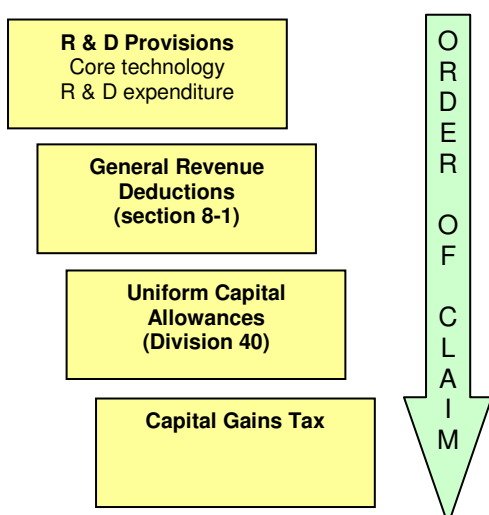
- (a) *the patentee, or a licensee, of a patent; or*
- (b) *the owner, or a licensee, of a registered design; or*
- (c) *the owner, or a licensee, of copyright; or of equivalent rights under a foreign law".*

This tax law definition is significantly narrower than the legal concept of IP, which includes additional classes of intangible assets such as trademarks and confidential information. The restricted tax definition of IP becomes particularly relevant in relation to depreciation, which we will cover later in this article.

Claiming a tax deduction for creating or acquiring IP

Of prime interest to most entities which create or acquire IP assets is the ability to claim a tax deduction for their costs. These costs might include patent or trademark registration fees, royalties, legal costs and salaries and equipment costs for R&D activities.

As there are a number of general and specific tax provisions relevant to this issue, we will consider these provisions in the order of most-favourable to least-favourable tax treatment.



1. R & D provisions

Whilst a detailed discussion of the R&D tax concessions is outside the scope of this article, the following points should be noted:

- a. The R&D regime allows a deduction for 100% of expenditure incurred in the acquisition of "core technology", subject to an annual limit of 1/3rd of the R&D expenditure on activities related to the core expenditure;
- b. Qualifying R&D expenditure connected with development of IP may give rise to concessional deductions at either 125% or 175% of eligible expenditure;
- c. Small companies and particularly tax loss companies may be eligible for the R&D Tax Offset, which gives rise to a tax rebate.

TIP: Due to the strict eligibility requirements, it is vital that entities seeking access to these concessional deductions take action to ensure eligibility before commencement of R&D activities.

2. Revenue deductions

If the general deduction section 8-1 is satisfied, expenditure incurred in the development of IP will be deductible in full in the year in which it is incurred.

Assuming that the expenditure has the necessary connection with the derivation of income, the key issue under section 8-1 is whether the expenditure is of a revenue nature (deductible) or of a capital nature (not deductible under this section).

A number of cases have been fought on this revenue/capital question and much will depend upon the particular facts of the case. Some general principles, however, can be drawn from the case material:

- a. IP acquisition costs - likely to be of a capital nature;
- b. IP creation costs – costs may be deductible where activities giving rise to the IP are of an ongoing and recurrent nature. This could include salary or wage payments of employees engaged wholly or partly in the development of IP;
- c. A distinction must be drawn between the costs of creating or acquiring IP and the cost of maintaining or defending it;
- d. The treatment of the cost of acquiring a license over IP will depend upon the term of the license. Short term licenses are more likely to be revenue in nature.

Prior to 1 July 2001 the Tax Act also provided an outright deduction for expenditure in obtaining the

grant of a patent or the registration of a design or copyright. This was repealed with the introduction of Division 40 (see below).

TIP: Care should be taken to thoroughly analyse expenditure capitalised for accounting purposes, as it is easy to overlook possible deductions.

3. Capital Allowances

If you are ineligible for the R&D concessions and unable to claim an outright deduction for IP related expenditure under section 8-1, the next alternative is to obtain an annual depreciation deduction for expenditure on IP capital assets.

Division 40 provides for deductions for the decline in value of “depreciable assets” that you hold. It is important to note that “depreciable assets” are specifically defined to exclude intangible assets except to the extent that they are:

- a. items of “intellectual property” as defined in section 995-1 (ie. only patents, registered designs and copyright);
- b. in-house software;
- c. certain other mining-related or telecommunication-related rights (outside the scope of this article).

Generally, deductions are available under Division 40 for the decline in value of IP assets you own, calculated using the prime cost method of depreciation. The Act sets out prescribed effective lives for various classes of IP assets, with a deduction available from the time when the IP asset is ready to operate, commercialise or use.

The Act also contains specific rules in relation to in-house software and website development costs.

Key issues in relation to application of Division 40 to IP are:

- a. Does Division 40 apply to the IP asset in question? It is important to consider the nature of the IP and the form the end product will take.
- b. Who has the ownership rights in the IP and is therefore entitled to depreciate it?
- c. Does the IP asset have a value that can reasonably be expected to decline over its life?
- d. What capital outlays should be included in establishing the depreciable cost?
- e. Has the IP been used or held ready for use for a taxable purpose?

4. Capital gains tax

Unlike the restricted definition of IP applied in the depreciable assets definition in Division 40, any form of IP may be a CGT asset. Section 108-5(1) defines a CGT asset as any kind of property, or a legal or equitable right that is not property.

Where IP is a CGT asset, costs incurred in developing or acquiring the IP may form part of the cost base of the IP asset. In saying this, it is important to note:

- a. The sale or disposal of IP assets which fall under the scope of the depreciable asset rules of Division 40 will be subject to the disposal rules in Division 40. The CGT provisions will not apply to the disposal of such items of IP.
- b. The CGT provisions contain various rules concerning the calculation of the cost base. It is important to understand the various elements of the cost base and ensure that only allowable items are included.
- c. The cost base of IP assets can be created or reset in certain circumstances, including on transition into a tax consolidation group.

Conclusion

IP assets represent an increasing proportion of the value of modern businesses. In order to maximise the tax benefits in relation to expenditure on IP assets, it is essential to have a clear understanding of the nature of your IP assets, the method by which you intend to commercialise those assets and the concessions available. Significant tax and cash flow benefits are available with careful forward planning.

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