TR 2002/19 - Income tax: licence arrangements for intellectual property - Division 40 - tax avoidance schemes

Taxation Ruling
Income tax: licence arrangements for intellectual property – Division 40 - tax avoidance schemes

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Preamble

*The number, subject heading, **Class of person/arrangement, Date of effect** and **Ruling** parts of this document are a 'public ruling' for the purposes of Part IVAAA of the **Taxation Administration Act 1953** and are legally binding on the Commissioner. The remainder of the document is administratively binding on the Commissioner. Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a public ruling and how it is binding on the Commissioner.*

What this Ruling is about

1. This Ruling examines tax avoidance schemes connected with intellectual property. Specifically, it examines arrangements under which taxpayers, with little or no financial exposure to the success or failure of the commercialisation of the intellectual property, obtain the benefit of deductions under Division 40 of Part 2-10 of the *Income Tax Assessment Act 1997* ('ITAA 1997'). These arrangements distort the operation of Division 40 and are considered to be tax avoidance schemes.

2. This Ruling does not deal with arrangements where the real risks and benefits of ownership are acquired in respect of the intellectual property.

3. The conclusions reached in this ruling in relation to the application of Division 40 also apply to arrangements entered into:

- prior to 22 June 1998 where deductions are claimed under Division 10B of Part III of the *Income Tax Assessment Act 1936* ('ITAA 1936'); and
- prior to 30 June 2001 where deductions are claimed under Division 373 of Part 3-45 of the ITAA 1997.

Class of person/arrangement

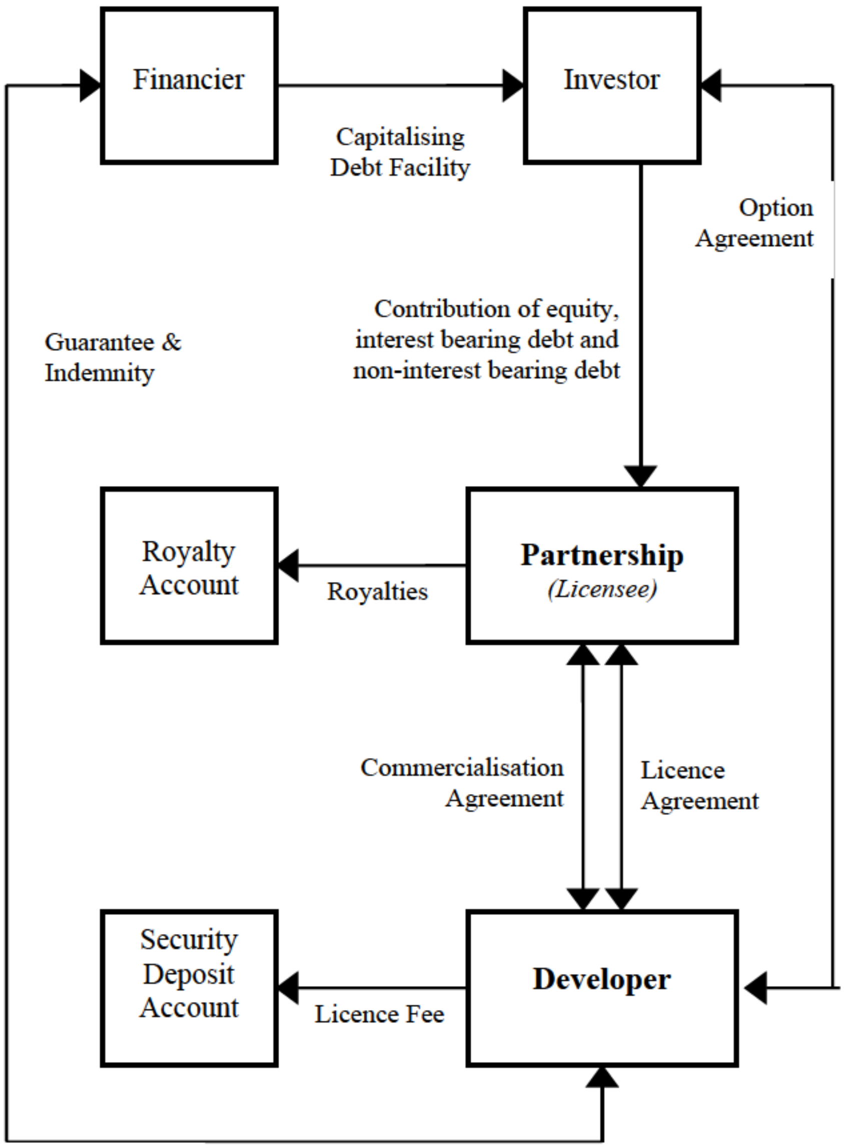
4. This Ruling applies to persons who enter into or carry out the following or a similar arrangement:

- A special purpose partnership ('the partnership') is established to acquire from a developer a licence to use and commercialise existing intellectual property;
- Each investor in the partnership borrows funds from a financier under a capitalising debt facility established for all investors;
- The funds borrowed, together with the funds provided by each investor from their own resources, are used to make a contribution to the partnership of:
  - a nominal amount of equity;
  - an interest bearing debt advance ('IBD'); and
  - a non-interest bearing debt advance ('NIBD');
- The amount of the IBD equates to the value of the funds borrowed under the capitalising debt facility;
- Interest accrues and is capitalised on the IBD on the same basis and at the same rate as interest accrues and is capitalised on the borrowed funds;
- The contributions are used by the partnership to acquire the licence and to finance the commercialisation;
- Under a licence agreement the partnership acquires from the developer an exclusive licence to use, develop, exploit and commercialise the intellectual property for an agreed period. Beyond the licence period, the partnership may benefit from the exploitation of application results through licensing or through realising the value contained in them;
- The partnership owns the application results which arise from the commercialisation of intellectual property but it is the developer who must pay to protect these results;
- The developer places the licence acquisition amount on deposit with the financier to be held as security for the funds borrowed by the investor;
- Interest which accrues on the security deposit is equal to the interest accruing under the capitalising debt facility;
- The balance of the security deposit account cannot be less than the amount outstanding under the debt facility;

- Under a commercialisation agreement, the partnership grants the developer an exclusive right to use the intellectual property for the period of the licence;
- As consideration, the developer agrees to pay as royalty income the greater of an agreed minimum amount per annum and a percentage of gross marketing income from the commercialisation proceeds;
- The developer undertakes an agreed development and commercialisation program on behalf of the partnership for a fee which is paid in advance;
- As further security for the funds borrowed by the investors, the partnership is required to deposit 50% of the royalty income into a royalty deposit account, held in the name of the partnership, with the financier;
- The financier's recourse to the investors is limited to the amount of the royalty deposit account and the investors' interest in the partnership assets;
- Both the partnership and the developer provide cross guarantees and indemnities;
- The partnership, the developer and an associate of the developer enter into an option agreement, under which a put option and an exit option are granted to the investors and a call option is granted to the developer;
- Upon the exercise of the put option the developer is required to take up a 75% partnership share by paying an additional capital contribution to the partnership;
- Upon the exercise of the call option, the developer becomes a partner by paying an additional capital contribution;
- The capital contribution payable upon the exercise of the put and call option consists of a nominal amount of equity and an additional amount representing the balance of the IBD less the balance of the royalty deposit account;
- The additional contribution is funded by the amount held in the security deposit account;
- The additional capital contribution is distributed by the partnership to the investors, who apply the funds to repay moneys borrowed under the capitalising debt facility;

- After the exercise of the put or call option, the investors may exercise an exit option requiring the associate of the developer to acquire their remaining interests in the partnership;
- The associate is required to pay the greater of an agreed minimum price and 25% of the market value of the partnership assets; and
- All agreements are entered into and have effect on the same day.

5. The following diagram illustrates the key features of a typical arrangement.



6. This Ruling also applies to persons who enter into or carry out the following or a similar arrangement:

- A company, trust, partnership, joint venture of investors, or individual acquires rights as owner, licensee, or patentee of intellectual property for the purposes of Division 40;
- The rights are realised or partially realised by transfer or sublicense to, or exploitation by, the developer, or an associate of the developer. This is achieved by way of:
  - an assignment;
  - a commercialisation agreement entered into either immediately or soon after the rights are acquired; or
  - a put and/or call option (or an embedded put and/or call option) in respect of the rights that it is reasonable to assume will be exercised, granted to or by the developer, or an associate of the developer, either immediately or soon after the rights are acquired;
- The company, trust, partnership, joint venture, individual, or an associate, obtains finance either directly or indirectly from the developer or an associate of the developer, or a guarantee from the developer or an associate of the developer, and the finance represents the substantial part of the price of acquiring the rights;
- The combined effect of the loan and guarantee arrangements and the tax saving ensures there is little or no financial exposure associated with the investment.

7. Where elements of an arrangement vary from those noted in paragraphs 4 and 6, the consequences for the investor may be the same, depending on the overall interaction of the elements of the varied arrangement. Whether this is so will require consideration of the circumstances of the particular case.

8. In paragraphs 13 to 31 of this Ruling:

- a reference to an investor is a reference to an investor as in paragraph 4 and any shareholders in a company, beneficiaries of a trust, investors in a joint venture, partners in a partnership or other persons who may acquire rights as owner or licensee of intellectual property for the purposes of Division 40 as in the first dot point in paragraph 6;

- a reference to a commercialisation agreement is a reference to a commercialisation agreement as in paragraph 4 and any mechanism by which the exploitation rights in relation to an item of intellectual property are realised by the developer, or an associate of the developer, as in the second dot point in paragraph 6.

9. The Explanations are based on the arrangement identified in paragraph 4. However, the principles contained therein also apply to the arrangement identified in paragraph 6.

Background

The operation of Division 40

10. Under Division 40 a holder of a depreciating asset can deduct an amount equal to the decline in value for an income year of the depreciating asset held for any time during the year (subsection 40-25(1)). The deduction is reduced by the part of the asset's decline in value that is attributable to the use of the asset for a purpose other than a taxable purpose (subsection 40-25(2)).

11. 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 and specifically includes, as an intangible asset, items of intellectual property (subsection 40-30(1) and paragraph 40-30(2)(c)).

12. 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;

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

(c) the owner, or a licensee, of copyright;

or of equivalent rights held under a foreign law (subsection 995-1(1)).

Ruling

Holder of the item of intellectual property

13. The partnership is never the 'holder' of the item of intellectual property during the year. Therefore, Division 40 has no application.

14. The licence agreement and the commercialisation agreement simultaneously transfer the rights from the developer to the partnership and then back to the developer. There is never a measurable period of time during which the partnership holds the rights. The integrated nature of the licence and commercialisation agreements has the effect that the developer retains effective possession and control of the item of intellectual property.

Cost of the item of intellectual property

15. Alternatively, if the partnership does become the holder, the deduction under subsection 40-25(1) is based on the cost of the intellectual property at the time the partnership acquired the item. The financing arrangements, the guarantees and the put and call options strongly suggest that the relevant parties to these arrangements are not dealing at arm's length in respect of the item of intellectual property. The 'cost' is the market value of the item of intellectual property at the time the partnership started to hold the item under the arrangement as the parties are not dealing at arm's length (subsection 40-180(2) table item 8).

Disposal of all the rights

16. If the partnership becomes the holder, the partnership immediately disposes of all of its rights to use, develop, and exploit the item of intellectual property under the commercialisation agreement. The transfer of the licence back to the developer for the purpose of commercialisation constitutes a disposal of all of the rights.

17. Where there has been a disposal of the item of intellectual property, the partnership has stopped holding the asset, a balancing adjustment event occurs (section 40-295) and a balancing adjustment is required (section 40-285). The balancing adjustment is the difference between the value of the asset just before the partnership stopped holding the asset (the termination value) (section 40-300) and its cost (the adjustable value) (section 40-85(1)(a)). If the termination value is more than the adjustable value the difference is included in assessable income (subsection 40-285(1)). If the termination value is less than the adjustable value a deduction is allowed (subsection 40-285(2)).

Adjustable value and termination value on disposal

18. Where there has been an immediate disposal, the adjustable value of the item of intellectual property is the cost (paragraph 40-85(1)(a), subsection 40-180(2) table item 8) (refer paragraph 15 above). The termination value (section 40-300) of the item of

intellectual property is worked out at the time the balancing adjustment event occurs. The termination value is the market value of the asset just before the partnership stopped holding the asset (subsection 40-300(2), table item 6). The market value cannot change between the time of acquisition and the immediate disposal of the rights. Therefore, no amount is deductible or assessable under subsections 40-285(1) and (2).

Partial disposal of the rights

19. Alternatively, there is an immediate partial disposal of the item of intellectual property by way of the grant of an exclusive licence, and the partnership has stopped holding part of the asset (subsection 40-115(3)). Just before the partnership stops holding that part, it is taken to have split the item into 2 assets (i.e., the part it stops holding becomes one asset and the other part becomes another asset) (subsection 40-115(2)). A balancing adjustment event occurs in respect of the asset that the partnership stops holding (section 40-295). The adjustable value of that asset is the cost (paragraph 40-85(1)(a), subsection 40-180(2) table item 8) (refer paragraph 15 above). The termination value (section 40-300) is worked out at the time the balancing adjustment event occurs. The termination value is the market value of the asset just before the partnership stopped holding the asset (subsection 40-300(2) table item 6). The market value cannot change between the time of acquisition and the immediate disposal and the asset retained by the partnership is of no value. Therefore, no amount is deductible or assessable under subsections 40-285(1) and (2).

Commercialisation fees, interest and other fees

20. Subject to the application of section 82KL and Part IVA, expenditure on commercialisation fees, interest on borrowings and other fees is allowable under section 8-1 of the ITAA 1997 to the extent of the income received in each year of the arrangement.

Recouped expenditure - the application of section 82KL

21. Section 82KL of the ITAA 1936 applies to the arrangement to deny any deduction for interest as the interest expenditure is ‘relevant expenditure’ incurred as part of a ‘tax avoidance agreement’ and the expenditure is effectively recouped under the arrangement.

Eligible relevant expenditure

22. The interest incurred by the investors is eligible relevant expenditure (subsection 82KH(1F) and paragraph (d) of the definition of ‘relevant expenditure’ contained in subsection 82KH(1)). The benefit in respect of which the interest was incurred is the availability to the investor of the money borrowed (paragraph 82KH(1G)(d)).

Tax avoidance agreement

23. These arrangements constitute a ‘tax avoidance agreement’ under subsection 82KH(1) for the purposes of section 82KL.

Additional benefit

24. An arrangement which involves deductible expenditure being financed wholly or partly by a loan which will be effectively repaid by another person is a ‘recoupment arrangement’. An amount recouped under a recoupment arrangement is an additional benefit (subsection 82KH(1) and paragraph 82KH(1F)(b)).

25. Under these arrangements a loan is obtained by each investor to finance the acquisition of the item of intellectual property. The loan is effectively guaranteed by the developer. The effect of the various agreements is such that it is reasonable to expect that:

- the investors will not have to repay the whole or a part of the loan prior to the put or call option being exercised;
- a put or call option will be exercised while the debt remains outstanding; and
- the security deposit will be relied upon to enable repayment of the outstanding debt.

The additional benefit is the benefit the investor receives by having their loan obligations discharged without recourse to their own funds.

Expected tax saving

26. The tax saved by the investor is an expected tax saving (subsections 82KH(1) and (1B)).

27. Under the put and call options the developer becomes a partner in the partnership. As a result of the exercise of the put or call option the developer contributes an amount to the partnership which is distributed to the partners and used to repay the borrowings.

28. Section 82KL will apply to disallow the interest deductions claimed as the partner's additional benefit plus the partner's expected tax saving equals or exceeds the amount of the partner's deductions.

General anti-avoidance provisions - the application of Part IVA

29. The arrangements have a number of features which achieve the following results:

- the lack of any financial risk to the investor;
- the obtaining of a profit by the investor regardless of the success or otherwise of the commercialisation program;
- tax savings to the investor in excess of the cost to the investor of participating in the scheme; and
- the provision of funds from sources other than the investors to enable repayment of the loans without those amounts being income of the investors.

30. Having regard to the eight factors in paragraph 177D(b) a reasonable person would conclude that the sole or dominant purpose of a person or persons entering into or carrying out the scheme is to enable the investors to obtain a tax benefit.

31. Therefore, Part IVA will apply to deny the deductions claimed.

Date of effect

32. This Ruling applies to years of income commencing both before and after its date of issue.

33. This Ruling does not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Explanations

The operation of Division 40

34. Division 40 of the ITAA 1997 provides a set of general rules (in Subdivision 40-B) to calculate the deduction available to taxpayers for the notional decline in value of most depreciating assets they hold. A depreciating asset is broadly defined in section 40-30 as being an asset that has a limited effective life and can reasonably be expected to

decline in value over the time it is used. Some types of intangible assets are depreciating assets to the extent that they are not trading stock. Items of intellectual property are one such intangible asset that is specifically included in the definition of depreciating asset.

35. Under subsection 40-25(1) an entity can deduct an amount equal to the decline in value for an income year of a depreciating asset that it held during the year. Usually, the owner of a depreciating asset holds the asset and can claim deductions for its decline in value.

36. Property which has become ‘partnership property’ or a ‘partnership asset’ at general law is beneficially owned by all of the partners, even if only one partner is the legal owner. Thus, the partnership, and not any individual partner, is regarded as holding the asset (section 40-40, table item 7).

37. Subdivision 40-C defines the cost of a depreciating asset on which the deductions under Subdivision 40-B are based. Where a taxpayer becomes the holder of a depreciating asset under an arrangement in which the taxpayer did not deal at arm’s length with one or more of the other parties to that arrangement, and paid (or is taken to have paid) more than the market value of the asset, the cost is the market value of the asset when the taxpayer started to hold it (subsection 40-180(2), table item 8).

38. Effective life varies for different types of intellectual property. It is generally linked to the period for which the intellectual property rights subsist under the relevant Commonwealth law. The effective life of an item of intellectual property acquired under a licence is the term of the licence (subsection 40-95(7) table item 6).

39. Sections 40-70 and 40-75 contain the general rules for working out the decline in value of depreciating assets. Under the prime cost method (the method which must be used for items of intellectual property) (subsection 40-70(2)), for any year after the first (in which the prime cost formula ensures that no more than cost can be claimed) the decline is limited to the opening adjustable value (the cost remaining after the previous year’s decline) (subsections 40-70(3) and 40-75(7)).

40. Balancing adjustments (section 40-285) must be made when a balancing adjustment event occurs. A balancing adjustment event occurs when:

- a taxpayer stops holding a depreciating asset or part of a depreciating asset;
- a taxpayer stops using a depreciating asset for any purpose and expects never to use it again;
- a taxpayer has not used a depreciating asset and decides never to use it; or

- there is a change in the holding of, or in the interest of entities in the asset, and one of the entities that have an interest after the change, held the asset before the change.

41. In these cases, the adjustable value (section 40-85) of the asset is compared with its termination value (section 40-300). If the termination value is higher than the adjustable value (which reflects past decline and original cost) just before the event occurred, the difference is included in assessable income (subsection 40-285(1)). If the termination value is lower than the adjustable value the difference is a deduction (subsection 40-285(2)).

Holder of the item of intellectual property

42. An entity that acquires rights as licensee is the holder of an item of intellectual property. An entity that has used an item of intellectual property for the purpose of producing assessable income can deduct an amount for a year of income (subsection 40-25(1) and paragraph 40-30(2)(c)). However, an entity cannot deduct an amount if they have not held the depreciating asset for any time during the year. In our view, the various agreements outlined at paragraph 4 have the effect of ensuring that the partnership is never the holder of an item of intellectual property and Division 40 does not apply.

43. Under the arrangements, the developer retains its proprietary rights in the intellectual property and grants an exclusive licence to the partnership to use, exploit and commercialise the intellectual property. The partnership, being the licensee, then contracts with the developer to commercialise the intellectual property and sub-licenses the intellectual property back to the developer.

44. Under the terms of the licence agreement the legal title remains with the developer. The effect of the agreements is that the developer does not surrender effective possession or control of the rights in respect of the item of intellectual property. As the developer maintains effective possession and control of the item of intellectual property, the partnership is never the holder of a depreciating asset and Division 40 has no application.

Alternative view

45. Submissions have been received which argue that the term ‘never the holder’ is too absolute. It is argued that based on the documents, the partnership does not dispose of the intellectual property and therefore at general law retains some rights over the property and thus ownership.

46. We reject this view. We believe that such submissions do not directly address the point that the partnership is never the holder for the purposes of Division 40. The integrated nature and terms of the licence agreement and the commercialisation agreement have the effect that there is never any acquisition by the partnership. In particular, if any rights accrue to the partnership they are of no value when compared to the totality of rights which ordinarily accrue to the owner of a item of intellectual property.

Cost of the item of intellectual property

47. Alternatively, if the partnership did become the holder of an item of intellectual property, the deduction under subsection 40-25(1) is based on the cost of the intellectual property at the time the partnership started to hold the item. The 'cost' is the market value of the item of intellectual property at the time the partnership started to hold the item under the licence agreement as the parties are not dealing at arm's length (subsection 40-180(2) table item 8).

48. The integrated nature and terms of the various agreements entered into strongly suggest that the parties to the arrangements are not dealing at arm's length in relation to the acquisition, use and exploitation of the item of intellectual property.

49. In these arrangements the parties are not dealing with each other at arm's length (notwithstanding that they are otherwise unconnected parties) for the following reasons:

- the terms of the contractual and financing arrangements effectively eliminate any adverse commercial consequences;
- the debt borrowed from the financier to fund the intellectual property licence is never at risk because of the various put and call options which pay out the borrowings plus interest;
- funds are borrowed by the investors from the financier under a facility which was set up on their behalf;
- the security deposit plus the accrued interest on the security deposit and the amount in the royalty account equate to the amount required to pay out the debt facility;
- the licence fee is paid into the security deposit account by the licensee at the direction of the developer;
- the provision of the guarantee and indemnity by the developer to the financier secures the capitalising debt facility of the investors;

- the developer takes responsibility for any costs or losses incurred by the financier under the facility agreement;
- although the partnership owns the application results which arise from the commercialisation of intellectual property, it is the developer who must pay to protect these results;
- the partnership is indemnified under the licence agreement against any loss arising from the use of the intellectual property; and
- the option agreements guarantee that investors' funds are not at risk.

Whilst particular terms of the facility agreement, the licence agreement, the commercialisation agreement and the option agreement, may be commercial when read on their own, the integrated nature of the agreements strongly suggests that the parties are not dealing at arm's length in relation to the transaction.

Alternative view

50. Submissions have been received, supported by reference to the case of *Granby Pty Ltd v. FC of T* 95 ATC 4240; (1995) 30 ATR 400, that the partnership and the developer are dealing at arm's length because they are unrelated and have used their independent minds in the bargaining process.

51. We reject this view. In *Granby*, the parties were dealing at arm's length over the acquisition of an asset although the price paid was less than the market value of the asset. But, as Lee J said (at 95 ATC 4244; 30 ATR 404):

> 'That is not to say, however, that parties at arm's length will be dealing with each other at arm's length in a transaction in which they collude to achieve a particular result, or in which one of the parties submits the exercise of its will to the dictation of the other…'

52. In these arrangements, despite the fact that the parties are unrelated, the integrated nature and terms of the various agreements do not support a conclusion that the parties acted at arm's length in relation to the transaction. For the reasons outlined at paragraph 49 we believe that the principles which underpin the decision in *Granby* clearly support our conclusion that the relevant parties in these arrangements cannot be said to be dealing at arm's length.

Disposal of all the rights

53. If the licence agreement does constitute an acquisition of an item of intellectual property so that the partnership becomes the holder of a depreciating asset, the sub-licensing under the commercialisation agreement amounts to a disposal of all of these rights. The developer is the grantor of the licence under the licence agreement and the recipient of a virtually identical set of rights under the commercialisation agreement.

54. Where there has been a disposal of the item of intellectual property, the partnership has stopped holding the asset, a balancing adjustment event occurs (section 40-295) and a balancing adjustment is required (section 40-285). The balancing adjustment is the difference between the value of the asset just before the partnership stopped holding the asset (termination value) and the cost (adjustable value). If the termination value is more than the adjustable value, the difference is included in assessable income (subsection 40-285(1)). If the termination value is less than the adjustable value, a deduction is allowed (subsection 40-285(2)).

Alternative view

55. Submissions have been received which argue that the sub-licensing of the intellectual property back to the developer under the commercialisation agreement does not constitute a disposal. The view is put that a disposal will only occur if the rights are assigned under the agreement.

56. We reject this view. No case law has been cited to directly support these submissions. In the absence of any compelling authority to the contrary, we believe that the sub-licensing under the commercialisation agreement is in substance a disposal of the asset such that, for the purposes of Division 40, the partnership cannot be regarded as the holder. If contrary to that view there has been a disposal in part, the asset retained by the partnership is of no value (as explained in paragraphs 59 and 60 below).

Adjustable value and termination value on disposal

57. Where there has been an immediate disposal, the adjustable value of the item of intellectual property is the cost (paragraph 40-85(1)(a), subsection 40-180(2) table item 8) (refer paragraph 15 above). Based on the matters referred to in paragraph 49 above, the parties are not dealing at arm’s length in relation to the disposal of the rights under the commercialisation agreement. As the partnership grants the licence to the developer under the commercialisation agreement, the termination value will be the market value of the item

of intellectual property just before the partnership stops holding the asset. As the value of the partnership's rights in relation to the licence does not change between the time of its acquisition under the licence agreement and its immediate disposal under the commercialisation agreement, the termination value will equal the adjustable value.

Partial disposal of the rights

58. Alternatively, if it is found that there has not been a disposal in whole, the sub-licensing under the commercialisation agreement will constitute a disposal in part.

59. As there is a disposal in part of the partnership's rights in relation to the intellectual property, the partnership has stopped holding part of the asset (subsections 40-115(2) and (3)). Just before the partnership stops holding that part, it is taken to have split the item of intellectual property into two assets, the asset they retain and the asset disposed of to the developer. In such a case a balancing adjustment event occurs in respect of the asset disposed of (section 40-295), and a balancing adjustment is required (section 40-285). The balancing adjustment is the difference between the market value of the asset when the partnership started to hold part of the asset (adjustable value) and the market value just before the partnership stopped holding the asset (termination value). If the termination value is more than the adjustable value, the difference is included in assessable income (subsection 40-285(1)). If the termination value is less than the adjustable value, a deduction is allowed (subsection 40-285(2)).

60. Under the terms of the commercialisation agreement the asset retained by the partnership is of no value as all of the value is represented in the asset disposed of to the developer.

Commercialisation fees, interest and other fees

61. Under the terms of the arrangement the partnership incurs expenditure for commercialisation fees, interest on borrowings and other fees.

62. The partnership sub-licenses the intellectual property in exchange for the royalties and pays the developer commercialisation fees to maximise the potential income (royalty) stream.

63. For the deductions to be allowable under section 8-1 of the ITAA 1997 there must be a reasonable expectation of income and not a mere theoretical possibility. In the arrangement described at paragraph 4 the partnership derives the guaranteed minimum royalty in each year. The arrangement will only be profitable if the commercialisation program exceeds business plan projections. In our

view, there is only ever a mere theoretical possibility, rather than a reasonable expectation, of additional royalty income.

64. The decision in *Fletcher & Ors v. FC of T* (1991-1992) 173 CLR 1; 91 ATC 4950; (1991) 22 ATR 613 makes clear that, in a case where there is an apparent disproportion between the detriment of the outgoing and the benefit of the income, the problem of characterisation of the outgoing needs to be resolved by a weighing of the various aspects of the whole set of circumstances, including direct and indirect objects and advantages which a taxpayer seeks to achieve in making the outgoing. It is a commonsense or practical weighing of all factors which will provide the ultimate answer. At CLR 18; ATC 4958, ATR 623 their Honours noted that:

> '…if, however, that consideration reveals that the disproportion between outgoing and relevant assessable income is essentially to be explained by reference to the independent pursuit of some other objective and that part only of the outgoing can be characterised by reference to the actual or expected production of assessable income, apportionment of the outgoing between the pursuit of assessable income and the pursuit of that other objective will be necessary.'

65. In *Fletcher* the deduction was limited in each year to the amount of income derived in that year because the disproportion in that year was not explainable by reference to surplus assessable income which was expected to be derived in subsequent years. In the arrangement described at paragraph 4 a minimum royalty will be derived in each year. However, in our view there is only a remote possibility of any additional income being derived.

66. The common sense weighing of the circumstances would mean that deductions claimed under section 8-1 of ITAA 1997 for commercialisation fees, associated interest outgoings and other fees be limited to the extent of the income returned.

Recouped expenditure – the application of section 82KL

67. Section 82KL of the ITAA 1936 is a specific anti-avoidance provision that operates to deny an otherwise allowable deduction for certain expenditure incurred by the taxpayer, but effectively recouped. Under subsection 82KL(1), a deduction for 'eligible relevant expenditure' is disallowed where the sum of the 'additional benefit' plus the 'expected tax saving' in relation to that expenditure equals or exceeds the 'eligible relevant expenditure'.

Eligible relevant expenditure

68. To the extent that interest is deductible under section 8-1 it is 'relevant expenditure' and is 'eligible relevant expenditure'. 'Eligible relevant expenditure' (subsection 82KH(1F)) is 'relevant expenditure' incurred under a tax avoidance agreement where, under the tax avoidance agreement, the taxpayer (or an associate) obtains an 'additional benefit'. Where a taxpayer incurs relevant expenditure in respect of interest, the benefit in respect of which the relevant expenditure was incurred is the availability to the taxpayer of the money borrowed (paragraph 82KH(1G)(d)).

Tax avoidance agreement

69. A 'tax avoidance agreement' for the purposes of section 82KL means 'an agreement that was entered into or carried out for the purpose, or for purposes that included the purpose, of securing that a person … would not be liable to pay income tax … or would be liable to pay less income tax …' (subsection 82KH(1)).

70. An 'agreement' for the purposes of section 82KL means 'any agreement, arrangement, understanding or scheme …'. The arrangement described in paragraph 4 constitutes an agreement.

71. A tax avoidance purpose will be present where features of the kind outlined in paragraph 29 above are found.

Additional benefit

72. An additional benefit' (see the definition of 'additional benefit' at subsection 82KH(1) and paragraph 82KH(1F)(b)) is a benefit received which is additional to the benefit in respect of which the relevant expenditure is incurred.

73. In these arrangements the investors will not have to repay the whole or a part of the loan prior to the put or call option being exercised. The option agreements enable the investors' loan obligations to be discharged without recourse to the investors' own funds. This is an additional benefit.

74. For the purposes of the expression 'the amount or value of the additional benefit' in section 82KL, 'amount' refers to the face value of an additional benefit expressed in monetary terms, and value refers to the monetary value of property not expressed in monetary terms. The additional benefit referred to in paragraph 73 above is expressed in monetary terms. Accordingly, it is the face value that is the relevant amount of the additional benefit, not the market value or net present value.

Expected tax saving

75. The 'expected tax saving' (see the definition of 'expected tax saving' at subsections 82KH(1) and 82KH(1B)) is essentially the tax saving obtained by the taxpayer or another person if a deduction is allowed for the eligible relevant expenditure. The expected tax saving of an investor in the partnership is:

(a) the amount of tax the investor would pay if the interest deductions were not allowable; less

(b) the amount of tax the investor would be liable to pay if the deductions were allowable.

76. Section 82KL will apply to disallow the interest deductions claimed where the amount payable by the developer (the amount of the unpaid loan at the time when the option is exercised) plus the expected tax saving equals or exceeds the amount of the deductions.

77. Subsection 82KL(1) applies where the relevant events have occurred. However, subsection 82KL(2) allows the Commissioner to apply section 82KL to disallow a deduction where the relevant events may not have occurred but the Commissioner is satisfied that section 82KL might reasonably be expected to operate at a later time. It is reasonable to expect that the partnership will rely on the option agreement to repay the loan obligations and therefore the additional benefit will be obtained.

78. Where the Commissioner has applied subsection 82KL(2), but later is satisfied that the particular circumstance relied upon to disallow the relevant deduction will not eventuate, the Commissioner will amend the assessment to allow a deduction for the expenditure (subsection 82KL(3)).

79. Subsection 170(10) enables the Commissioner to give effect to section 82KL by amending assessments of taxpayers at any time.

General anti-avoidance provisions – the application of Part IVA

80. For the general anti-avoidance provisions of Part IVA of the ITAA 1936 to apply, there must be a 'scheme' (section 177A) and a 'tax benefit' (section 177C), and it must be concluded that the scheme was entered into or carried out by a person or persons for the sole or dominant purpose of enabling the relevant taxpayer to obtain the tax benefit (section 177D). See generally, *FC of T v. Peabody* (1994) 181 CLR 359; 94 ATC 4663; (1994) 28 ATR 344, and *FC of T v. Spotless Services Ltd & Anor* (1996) 186 CLR 404; 96 ATC 5201; (1996) 34 ATR 183.

Scheme

81. The arrangement described at paragraph 4 constitutes a 'scheme' for the purposes of Part IVA.

82. The 'scheme' includes:

- the formation of the special purpose partnership;
- the agreements, undertakings, and courses of action and conduct through which the special purpose partnership acquires the licence from the developer and enters into the commercialisation agreement with the developer; and
- the funding for and payment of the licence fee, the facilitation and servicing of the debt, the payment of the minimum income, the put and call option mechanism, and the mechanism whereby the developer or an associate of the developer effectively repays the investors' loans.

83. The parties to the scheme include the investors in the special purpose partnership, the developer, an associate of the developer, the promoter, the financier, and any guarantor.

Tax benefit

84. A 'tax benefit' is obtained by the investor from the scheme. The 'tax benefit' to the investors will be the share of the loss in the partnership. The losses are generated in the partnership solely by its participation in the arrangement. It could reasonably be expected that the arrangements would not have been entered into but for the benefits available under the scheme. But for the scheme, it may reasonably be expected that the deductions would not be available to the partnership and the investors would not have a share in a partnership loss.

85. The interest deductions under the financing arrangements also provide a tax benefit to each investor.

Purpose

86. Part IVA applies where the investor, or another person or persons, entered into or carried out the scheme, or a part of the scheme, for the sole or dominant purpose of enabling the investor to obtain a tax benefit. This is to be determined having regard to the eight factors referred to in paragraph 177D(b) of the ITAA 1936.

87. A scheme 'may be … both "tax driven" and bear the character of a rational commercial decision. The presence of the latter characteristic does not determine the answer to the question of

whether, within the meaning of Part IVA, a person entered into or carried out a "scheme" for the "dominant purpose" of enabling a taxpayer to obtain a "tax benefit"' (refer *Spotless* 186 CLR 404 at 415; 96 ATC 5201 at 5206; 34 ATR 183 at 188). A taxpayer's tax saving exceeding their real economic outlay may indicate a sole or dominant purpose of obtaining a tax benefit, notwithstanding that the investment may bear the character of a rational commercial decision.

88. The promotion of the scheme by others or the existence of a commercial purpose does not preclude the application of Part IVA. Part IVA will apply when the sole or dominant purpose under section 177D is to enable the investors in the partnership to obtain a tax benefit in connection with the scheme.

89. The relevant person who for the purposes of Part IVA may be judged objectively as having the dominant purpose of enabling the investors in the partnership to obtain a tax benefit may not be the investors or the developer. It may be the person who designed the scheme or some other person who participated in carrying out the scheme or a part of the scheme.

90. Alternatively, the purpose or purposes of the investor's professional advisers in recommending the scheme may be attributed to the investor entering into and carrying out the scheme on the basis of their advice (refer *FC of T v. Consolidated Press Holdings Limited (No. 1)* 99 ATC 4945 at 4973; (1999) 42 ATR 575 at 603 per French, Sackville and Sundberg JJ). On appeal this was confirmed by the High Court, particularly where the transactions in question are complex (refer *FC of T v. Consolidated Press Holdings Limited & Anor* 2001 ATC 4343 at 4360; (2001) 47 ATR 229 at 247 per Gleeson CJ, Gaudron, Gummow, Hayne and Callinan JJ). The investor may be judged objectively as having the dominant purpose of obtaining a tax benefit, albeit by reference to the purpose of the investor's professional adviser. Refer also *Vincent v. FCT* [2002] FCA 656 where French J held that the purpose of a scheme's promoter was relevant to the application of Part IVA to a scheme.

91. In our view the only party with a relevant commercial purpose under these arrangements is the developer. The investor's only real economic benefit arises through the income tax deductions.

92. The arrangement in paragraph 4 has certain features which identifies it as an arrangement where a reasonable person would conclude that the sole or dominant purpose is to obtain a tax benefit. Whilst there may be commercial elements in the arrangement, a reasonable person, having regard to all of the features, would draw the conclusion that the sole or dominant purpose was to obtain a tax benefit.

93. The factors discussed in the following paragraphs support the conclusion that the sole or dominant purpose of an investor participating in these arrangements would be to obtain a tax benefit.

The contrived creation of a tax benefit

94. The primary result under these arrangements is the creation of a Division 40 deduction to the partnership which is distributed to the investors as their share of the partnership loss. This is achieved by the transfer of the intellectual property from the developer to the partnership under the licensing agreements.

95. The form of the arrangement is such that ownership is purportedly held by the partnership which does not bear the normal risks and benefits of ownership. The substance of the arrangement is that the partnership is never the holder of the item of intellectual property.

The immediate disposal of all effective rights, on non-arm's length terms, following its acquisition

96. The integrated nature of the agreements is such that what the developer transfers is immediately transferred back. As indicated at paragraph 49, we do not accept that the partnership is dealing at arm's length with the developer and the associate of the developer in relation to these agreements.

The lack of any financial risk to an investor, and the manner in which the risk is removed

97. In these arrangements the investor is not subject to any financial risk when the tax saving and the put and call options are taken into account. The investors are not subject to any risk because of the mechanisms to fund the loan repayment.

98. The investors partly finance the deductible expenditure through borrowings. The put and call options guarantee that the balance of the security deposit account is available to fund the loan repayment if there are insufficient profits.

The provision of guarantees to the investors in the partnership

99. Payment of the minimum income amounts and repayment of the loan principal are guaranteed by security provided by the developer. The value of the 'security' is sufficient to cover the loan obligations under the facility agreement.

The use of the licence fee payment to effectively underpin the various guarantees

100. Where the licence fee payment is used to underpin the various guarantees, there is a round robin arrangement within the definition in Taxation Ruling TR 2000/8. Paragraph 27 of TR 2000/8 defines a round robin arrangement to include any mechanism employed to effect discharge of liabilities but which does not, in reality, result in an equal enrichment of the creditor either by cash accretion or the gaining of valuable realisable assets.

101. In these type of arrangements, a round robin exists where:

- the investors borrow an amount from the financier;
- the amount borrowed is then used, together with the funds the investors have contributed from their own resources, to pay the developer for the licence;
- the developer places the licence acquisition amount on deposit with the financier to secure the repayment of the borrowing; and
- the security deposit, the accrued interest on the deposit and the royalty account are used to extinguish the borrowing under the capitalised debt facility.

A round robin is not determinative of tax avoidance in itself (refer *Howland-Rose v. FCT* [2002] FCA 246). However, when coupled with the other factors it suggests a sole or dominant purpose of enabling the investors to obtain a tax benefit.

The matching of guarantees with the liabilities of the investors

102. The minimum income guarantee and the security deposit are designed to cover the loan obligations. The security deposit and the accrued interest on the deposit and the royalty account will satisfy the investors' loan repayment obligations.

The effective presence of non-recourse loans

103. The loan to the investors in the partnership is a non-recourse loan within the definition at paragraphs 20 - 22 of Taxation Ruling TR 2000/8.

104. These arrangements are non-recourse because the lender has no recourse beyond the partnership assets.

The realisation of a commercial return by means of a tax concession

105. The attraction of the scheme to a potential investor is deductions by way of the partnership loss.

106. The arrangement will only be profitable if the commercialisation program exceeds business plan projections. Viewed objectively, there is only a mere theoretical possibility, rather than a reasonable expectation, of additional royalty income.

107. Under the scheme, the tax saving from the partnership loss exceeds the investor's cash outlay and the investor profits regardless of how successful the commercialisation program is.

108. In these circumstances, it would be appropriate to apply in principle the 'no sense' test in *Spotless* (*Hart v. FCT* 2001 ATC 4708; (2001) 48 ATR 317; and *Howland-Rose*). Without the tax saving, the arrangement makes no commercial sense.

The presence of dealings, which are not at arm's length, between the parties

109. The integrated nature of the agreements means that the parties to the scheme are not dealing at arm's length in relation to the agreements and the transactions.

110. The features of this arrangement which do not appear to involve arm's length dealings include the features identified in paragraph 49.

The commercialisation agreement

111. The effect of the commercialisation agreement is that the intellectual property is returned to the control of the developer.

Factors in paragraph 177D(b)

(i) The manner in which the scheme was entered into or carried out

112. The features outlined in paragraph 4 above are relevant to the manner in which a scheme was entered into or carried out and indicate a lack of commerciality. Investors were advised that a positive after tax cash return resulted from the scheme. It is reasonable to conclude that the scheme was structured to deliver the tax benefit. This points to Part IVA applying.

(ii) The form and substance of the scheme

113. The scheme involves a number of integrated agreements which include the licence agreement between the developer and the partnership and the commercialisation agreement between the partnership and the developer. The licence agreement and the commercialisation agreement are for the same period. The licence agreement grants an exclusive licence to the partnership.

114. In substance the effect of the agreements is that the developer retains effective possession of the item of intellectual property at all times. Whilst the various agreements create a Division 40 deduction for the amount of the licence fee, the only real transfer is the payment of the commercialisation fee. Again this points to Part IVA applying.

(iii) The time at which the scheme was entered into and the length of the period during which the scheme was carried out

115. The scheme is entered into after the intellectual property has been created. The scheme is carried out over the term of the licence agreement. This feature on its own is neutral as to the application of Part IVA.

(iv) The result in relation to the operation of the ITAA 1936 or the ITAA 1997 that, but for Part IVA, would be achieved by the scheme

116. Deductions would be available to the investors and the partnership for the amortisation of the licence fee, the interest on the borrowings and the commercialisation fees. The scheme results in deductions but the integrated nature of the agreements ensures that, whilst the partnership becomes the holder of the item of intellectual property on payment of the licence fee amount, the developer does not obtain the use of the funds. This points to Part IVA applying.

(v) Any change in the financial position of the relevant taxpayer that has resulted, or will result, or may reasonably be expected to result, from the scheme

117. The investor takes on a liability for the loan and the interest payments and contributes funds by way of the commercialisation fee. However, under the terms of the financing and option agreements, the loan obligation is secured by the deposit and this ensures that the deposit is available to repay the loan. The investors' tax savings as a result of the scheme exceed their outlay and their financial position improves irrespective of the success of the commercialisation program. This points to Part IVA applying.

(vi) Any change in the financial position of any person who has, or has had any connection with the relevant taxpayer, being a change that has resulted, or will result, or may reasonably be expected to result, from the scheme

118. The developer receives funds from the investors by way of the licence fee and the commercialisation fees. However, under the terms of the agreements the licence fee is held as security for the loan to the investors. Upon the exercise of the put or call option the amount is used to pay the contribution to the partnership. This reinforces the conclusion that the arrangement is structured to create the Division 40 deduction and points to Part IVA applying.

(vii) Any other consequence for the relevant taxpayer, or for any person referred to in (vi), of the scheme being entered into or carried out

119. The investors have little or no upside exposure or downside risk but obtain a significant tax benefit which exceeds the commercial costs. This points to Part IVA applying.

(viii) The nature of any connection between the relevant taxpayer and any person referred to in (vi)

120. N/A

Detailed contents list

121. Below is a detailed contents list for this Ruling:

Commissioner of Taxation
24 July 2002

Previous draft:
Previously released as TR 2001/D15

Related Rulings:

TR 92/1; TR 92/20; TR 97/16; TR 2000/8

Subject references:

- schemes
- intellectual property rights
- partnerships
- investor
- developer
- intellectual property
- tax avoidance
- disposal of rights
- anti-avoidance

Legislative references:

- TAA 1953 Pt IVAAA
- ITAA 1997 8-1
- ITAA 1997 Div 40 of Pt 2-10
- ITAA 1997 Subdiv 40-B
- ITAA 1997 Subdiv 40-C
- ITAA 1997 40-25(1)
- ITAA 1997 40-25(2)
- ITAA 1997 40-30
- ITAA 1997 40-30(1)
- ITAA 1997 40-30(2)(c)
- ITAA 1997 40-40
- ITAA 1997 40-70
- ITAA 1997 40-70(2)
- ITAA 1997 40-70(3)
- ITAA 1997 40-75
- ITAA 1997 40-75(7)
- ITAA 1997 40-85
- ITAA 1997 40-85(1)(a)
- ITAA 1997 40-95(7)
- ITAA 1997 40-115(2)
- ITAA 1997 40-115(3)
- ITAA 1997 40-180(2)
- ITAA 1997 40-285
- ITAA 1997 40-285(1)
- ITAA 1997 40-285(2)
- ITAA 1997 40-295
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- ITAA 1997 40-300(2)
- ITAA 1997 995-1(1)
- ITAA 1997 Div 373 of Pt 3-45
- ITAA 1936 Div 10B of Pt III
- ITAA 1936 82KH(1)
- ITAA 1936 82KH(1)(d)
- ITAA 1936 82KH(1B)
- ITAA 1936 82KH(1F)
- ITAA 1936 82KH(1F)(b)
- ITAA 1936 82KH(1G)(d)
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- ITAA 1936 82KL(1)
- ITAA 1936 82KL(2)
- ITAA 1936 82KL(3)
- ITAA 1936 170(10)
- ITAA 1936 Part IVA
- ITAA 1936 177A
- ITAA 1936 177C
- ITAA 1936 177D
- ITAA 1936 177D(b)

Case references:

- FC of T v. Peabody (1994) 181 CLR 359; 94 ATC 4663; (1994) 28 ATR 344
- FC of T v. Spotless Services Ltd & Anor (1996) 186 CLR 404; 96 ATC 5201; (1996) 34 ATR 183
- FC of T v. Consolidated Press Holdings Limited (No. 1) 99 ATC 4945; (1999) 42 ATR 575; ATC 4343 (Federal Court)
- FCT v. Consolidated Press Holdings Limited & Anor 2001 ATC 4343; (2001) 47 ATR 229 (High Court)
- Fletcher & Ors v FC of T (1991-1992) 173 CLR 1; 91 ATC 4950; (1991) 22 ATR 613
- Granby Pty Ltd v. FC of T 95 ATC 4240; (1995) 30 ATR 400
- Howland Rose v FC of T [2002] FCA 246
- Hart v FC of T 2001 ATC 4708; (2001) 48 ATR 317
- Vincent v FCT [2002] FCA 656

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