
Secretary and Registrar's Office

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**TAX RULINGS THREATEN THE COMMERCIALISATION ACTIVITIES OF
WHOLLY-OWNED UNIVERSITY COMPANIES**

Policy Context

It is Commonwealth Government policy to encourage innovation and enterprise throughout Australia. The importance of universities to the success of this policy has been emphasised in many of the programmes underpinning and supporting Backing Australia's Ability. The Government's 2005-06 Innovation Report comments:

Australian universities play a vital role in the national research and innovation system. They are major contributors to the generation and transmission of knowledge in Australia. Many of Australia's leading researchers are internationally recognised for their high levels of skill and expertise in their respective fields of research. This exemplary standard enhances Australia's reputation to effectively contribute to the global development of knowledge. (p.30)

Research Commercialisation at the University of Queensland

The University of Queensland is one of Australia's strongest performers in the exploitation and commercialisation of intellectual property generated by its staff. For many years, the University has managed risk and limited its liability in commercial ventures through a company structure regulated by the Corporations Act. A holding company, UQ Holdings Pty Ltd (UQH), has oversight of three wholly owned subsidiaries – UniQuest Pty Ltd, IMBcom Pty Ltd and JKTech Pty Ltd. These three companies provide patent management services, develop IP through contract research and consultancy services, pursue commercialisation through licensing and create spin-off companies, many of which receive investment from third parties. The University further exploits its IP through Uniseed, a joint venture commercialisation entity established in partnership with the University of Melbourne, the University of New South Wales and Westscheme, a large industry superannuation fund based in Perth, WA.

In the past five years UniQuest has generated \$40.5 million in research contracts, \$24.2 million from consultancies and \$23.1 million in licence and royalty payments. It has equity interests in 45 start-up companies with an estimated portfolio value of \$38.4 million and which have raised \$115 million in external funding. Backing Australia's Ability and Commonwealth Government support for innovation and enterprise has contributed significantly to these achievements.

However, it now appears that future successes are being placed in potential jeopardy through Government action to regulate the tax status of university wholly-owned commercialisation companies such as UniQuest.

Recent Tax Rulings threaten research commercialisation

Universities are tax exempt entities through their status as charitable organisations. From their inception UQ Holdings and its major subsidiaries were endorsed by the Australian Taxation Office as having a similar status. Their purposes are to undertake activities on behalf of UQ and to generate funds for the benefit of the University. On closure, all of their assets must revert to the University.

The ATO has now taken the view that the tax status of entities wholly-owned by charities should be changed. Despite a detailed appeal, UQH's endorsement as a tax exempt entity was withdrawn from July 2006. The operating subsidiaries have now had to inform the ATO that their tax endorsement should be revoked as a result of the impact of Tax Rulings 2005/21 (*Income tax and fringe benefits tax: charities*) and 2005/22 (*Income tax: companies controlled by exempt entities*), both issued in December 2005 to take effect on 1 July 2006. While these Tax Rulings are not aimed specifically at universities, they are caught up in them through their status as charitable institutions.

It is generally recognised that most universities will not generate significant profits from the activities of their commercialisation companies. In many cases they are established to manage risk and provide a measure of protection for public assets. Universities receive the benefits of their operations indirectly through research contracts, consultancies, licensing and royalties. Occasionally a university will have a significant commercial success such as Melbourne IT or Gardasil but these are exceptional. The ATO appears to have accepted that making such companies liable to tax will not generate significant revenues for the Government and has readily agreed to 1 January 2007 as the effective date from which UQ companies will be tax liable.

Implications

The revocation of their endorsement as tax exempt entities has the potential to seriously impact on the ability of UQ's wholly-owned subsidiaries to pursue their objectives.

The ATO argues that the net effect on the University group will be minimal. University companies may distribute their profits in the form of a fully franked dividend and the University may then apply for reimbursement of the franking credit. This argument, however, ignores issues such as the need for the companies to retain profits for working capital and cash flow purposes. There may also be cases where there are taxable profits but no accounting profits, thus making the payment of a dividend impossible. Moreover, there are numerous situations where a controlled entity, when licensing technology to a start-up company in exchange for shares in the start-up, will find itself with paper profits but no cash with which to pay the resulting tax. Finally, it does not take into account the high compliance costs associated with preparing tax returns and separating tax assessable and tax deductible income and expenses from financial reports. There are, of course, actions which can be taken to minimise tax in these circumstances, but they require the use of fixed trusts, create a significant increase in administrative complexity and have adverse impacts on balance sheets. This in turn could inhibit a controlled entity's ability to attract external investment. Further, it could make it impossible for a controlled entity to undertake some deals such as syndicated R&D. Deals involving structured finance, which in the past have been very productive, could also be at risk. The transfer of assets, businesses and thousands of executed agreements and patents from existing commercialisation companies into fixed trusts will not be able to be achieved without significant cost. Every deal or company action will now need to be considered for its tax implications with a significant increase in the cost of compliance.

The ATO's actions could seriously jeopardise the ability of all universities to continue to contribute to the successful achievement of the Government's policy objectives in *Backing Australia's Ability*.

Proposed Policy Solution

In 2005, the UK Government was faced with an analogous situation when a change in the Tax Act inadvertently resulted in the value of shares to university staff in start-up companies being subject to income tax. In most cases this was deemed income and there was no cash distribution from which tax could be paid. This impacted adversely on the willingness of staff to support start-ups. The UK Government changed its position and moved quickly to amend the relevant legislation to ensure that the income tax system did not present any unfair barriers to the formation of spinout companies from universities and publicly funded research establishments by virtue of their intellectual property sharing policies.

It is argued that similar barriers to the exploitation and commercialisation of intellectual property by public universities in Australia should also be removed. This could be achieved reasonably easily by

adding those publicly funded universities which are designated as Higher Education Providers under Table A of the Commonwealth Higher Education Support Act to the list of government entities in Division 1AB of the Income Tax Assessment Act 1936 (ss24AK- 24AV). This provision exempts from income tax government entities and entities wholly owned or controlled by government entities (State and Territory Bodies (STBs)). A company limited by shares, where all of the shares are owned by a government entity or another STB, is itself an STB, and therefore exempt from tax under these provisions. Certain STBs are excluded from the definition - public hospitals, public educational institutions, and municipal corporations (Excluded STBs). This is because they were already exempt from tax under the specific charity type provisions. Without this exclusion UQH and all of its wholly owned subsidiaries would be STBs and exempt from tax.

A precedent occurred in 2001 when the provisions were amended to make entities wholly owned by municipal corporations STBs (although the municipal corporations themselves remain excluded). This was done by including municipal corporations in the definition of government entity but keeping the municipal corporations themselves as Excluded STBs.

The STB provisions were introduced pursuant to an agreement between the Commonwealth and the states and territories reached at the March 1994 Premiers' Conference, where the state and territory governments committed to introducing tax equivalent regimes for their trading enterprises for the purposes of promoting competitive neutrality between GOCs and the private sector. The inclusion of university commercialisation entities within this provision is an easy method of removing them from the Federal Income Tax Regime, but any flow on consequences at a state level needs to be further investigated.

Recommendation

It is recommended that serious and urgent consideration be given to these issues and the proposed policy solution.

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