



Chartered Accountants
& Business Advisers

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Private & Confidential

Mr Stephen Hargreaves
CEO
Select Design Technologies Ltd
Level 25 Chifley Tower
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Dear Stephen

Select Design Technologies Ltd – licensing of intellectual property

We refer to our recent discussions in relation to a private ruling (**the private ruling**), Authorisation Number of 63585, issued to International Innovations Limited (**IIL**), a company associated with Select Design Technologies Limited (**SDT**). The subject of the private ruling is the application of the *Income Tax Assessment Act 1997 (1997 Act)* at the time a licence is granted to a company resident in a foreign country which will allow the foreign resident company to exploit the intellectual property covered by certain patents owned by IIL.

We understand that SDT also owns a number of patents and is also considering opportunities to licence the intellectual property represented by those patents to foreign companies. You have requested our advice in relation to the application of the private ruling issued to IIL to the licensing arrangements that SDT is now considering. That is, can SDT rely on the private ruling issued to IIL?

We have been advised by the directors of IIL that we can refer to the private ruling issued to IIL in this letter of advice to SDT and that the contents of the private ruling are to be made available to or for the benefit of SDT.

Proposed licensing arrangements

It is our understanding that SDT wishes to grant a licence to one or more foreign companies (**Foreign Co**) in relation to certain patents owned by SDT on similar terms and conditions to the licences that IIL has granted or intends to grant to foreign companies. It is also our understanding that the terms of the licensing agreement are or will be as follows:

- at the time a licence is granted, Foreign Co will not pay or provide any monetary consideration or provide any property or other benefit or thing of value in consideration for obtaining the licence
- Foreign Co will pay a percentage of the revenues it earns from exploitation of the intellectual property to SDT in the form of royalties

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- the royalties payable to SDT will be paid monthly in arrears
- the term of the licence will be for an agreed and finite period of time
- the terms and conditions of the licensing agreement will be negotiated on an arm's length basis and any amounts payable under the licence agreement will be fully negotiated and reflect arm's length pricing principles
- Foreign Co will be able to sublicense authority to other parties to exploit the patent
- SDT may terminate the agreement upon certain acts or omissions by Foreign Co, including a failure to pay the required royalties
- SDT will retain all proprietary rights to the patents and the intellectual property, and
- the rights granted to Foreign Co under the licence are the same as or similar to the rights that would have been granted for such an agreement in Australia under Australian law.

The Commissioner of Taxation (**the Commissioner**) confirmed in the private ruling that:

- CGT event D1 happens when a company creates a contractual right in another entity by granting the other entity a licence to exploit intellectual property covered by patents owned by the company. A capital gain will arise if the capital proceeds are more than the incidental costs relating to the grant of the licence.

In the situation considered in the private ruling issued to IIL, the Commissioner confirmed that whilst IIL's right to receive royalties in the future is property for the purposes of the CGT provisions, and whilst the definition of capital proceeds includes property, in IIL's case the right to receive royalties in the future related to the use of the licence by the licensee rather than to the grant of the licence by IIL. Accordingly, the right to the future royalties was not 'property' received in respect of a CGT event happening, and therefore not capital proceeds.

- a balancing adjustment event will occur at the time IIL grants a licence to another party to exploit the intellectual property covered by the patents. Section 40-115(3) operates to split the patent into two assets, being the original patent and the licence, and the granting of the licence is considered to amount to a disposal of the licence. At that time, section 40-295(1) can operate to give rise to a taxable balancing adjustment if the licence's 'termination value' is greater than its tax written down value. The termination value can include any non-cash benefits received by the licensor.

The private ruling issued to IIL addresses the meaning of the term 'non-cash benefit' at Item 4 of the table in section 40-305 of the 1997 Act. The Commissioner confirms that whilst a right to receive royalties may be a 'non-cash benefit' for the purposes Item 4 of the table in section 40-305, it is not a non-cash benefit that IIL is taken to have received under section 40-305 of the 1997 Act for the licence. Accordingly, in the absence of any monetary or other consideration, the balancing adjustment resulting from the granting of the licence to another entity is nil.

- royalties received as a consequence of granting a licence will be assessable income at the time the royalties are derived.

Application of private rulings to other taxpayers

A private ruling is binding on the person/s applying for the ruling and the Commissioner in accordance with *Division 359 Schedule 1 Tax Administration Act 1953*. A private ruling is not binding on any other party. Accordingly, SDT cannot rely on the ruling to bind the Commissioner to the position taken in the ruling in the same way that IIL can rely on the ruling.

However, the private ruling does provide a clear indication of the Commissioner's views of the correct interpretation and application of the tax law in the circumstances covered by the private ruling.

Australian Taxation Office Interpretive Decisions

Subsequent to issuing the private ruling to IIL in relation to this issue, the Australian Taxation Office (ATO) published three (3) Australian Taxation Office Interpretive Decisions (ATOID); namely ATOID 2006/167, ATOID 2006/168 and ATOID 2006/169 which address the taxation issues which can arise at the time a licence is granted in relation to intellectual property. While ATOID's are based on actual rather than hypothetical circumstances, they do not identify the taxpayers involved. Nevertheless, it is our understanding that the circumstances described in the ATOID's are taken directly from the application made by IIL for the private ruling.

While all three ATOID's are relevant, ATO ID 2006/169 in particular confirms the ATO's position where a licence is granted on terms that involve the payment of royalties arising from income generated from the exploitation of the licence but with no payment made to the licensor at the time the licence is granted. The Commissioner confirmed in ATOID 2006/169 that notwithstanding a right to earn future royalty payments had some value, the right to future royalties will not of itself give rise to an assessable balancing adjustment under Subdivision 40-D of the *Income Tax Assessment Act 1997*.

Reliance on ATOID's

The ATO publishes Interpretive Decisions to indicate the Commissioner's view on the application of the tax law in the circumstances described in the Interpretive Decision. However, ATOID's are **not** legally nor administratively binding on the Commissioner.

Notwithstanding that, a taxpayer with a **substantially similar** situation to that outlined in an ATOID can rely on the ATOID to avoid penalties for late payment of tax if the ATO subsequently changes its views about how the tax law should be interpreted and withdraws the ATOID. The taxpayer would still be liable to pay any unpaid tax and for the general interest charge.

Reliance by SDT

The ATOID's mentioned above and the private ruling issued to IIL provide a clear indication of the Commissioner's views about the tax consequences arising under the ITAA 1997 at the time a licence to exploit intellectual property is granted to another entity.

It is reasonable for SDT to conclude that the positions taken by the ATO in the ATOID's are correct and that they reflect the correct interpretation of the relevant tax laws applying at the time that a licence in relation to intellectual property is granted. It is also reasonable for SDT to rely on the ATOID's as a clear indication of the way that the ATO would interpret and apply the tax law to a licensing arrangement undertaken by SDT on similar terms and conditions and in the circumstances outlined in the ATOID's.

If SDT wishes to further limit its exposure in these circumstances, a private ruling would be required. However, given the clear indication of the way the ATO would apply the relevant tax laws in the circumstances outlined in the ATOID's, it is our view that obtaining a private binding ruling is not necessary.

If you have any queries or wish to discuss any of the above matters raised please do not hesitate to contact myself on (03) 9603 1719.

Yours sincerely

A handwritten signature in black ink that reads "John Kelly". The signature is written in a cursive style with a long, sweeping underline that extends to the left.

John Kelly
Partner

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