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ICT Newsletter

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ICT Industry Update

This Edition

The following update canvasses some of the tax and commercial issues which are particularly relevant for companies and businesses operating in the ICT sector and for entities considering acquisitions/due diligence in that space.

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Preface

The following ICT newsletter updates previous newsletters and reflects some recent changes to tax and accounting law; and possibly to business practices particularly in light of the economic conditions. Later it notes some aspects relevant for acquisitions/due diligence of companies/businesses in the ICT space.

Some of the key points arising from the update include:

1. The importance of the **correct structure to maximize the after-tax cash** arising from a sale. Aspects to consider are:
   - A profit on the sale of copyright, which is probably the most relevant IP for the IT industry, itself is not a capital gain for tax purposes. Therefore any profits do not get the Capital Gains Tax (CGT) "discount" and are not entitled to the so-called small business CGT concessions. In many cases the best structure to carry on an ICT product or service business is a company where the CGT and concessions can apply to the profit or the sale of shares.
   - As a general rule, it is better to have different ICT products/services "housed" in separate companies, possibly with a unit trust or a discretionary trust as the holding entity.
   - The so-called small business CGT concessions can apply to sizable businesses (even to a company worth $30m, or more)
2. Generally, the longer "bad" structures continue, the harder and more expensive they are to "fix"
3. Given the decline in values that public and private business have experienced over the last year or so it may be an opportune time to correct "bad" structures. The most "appropriate" valuations for internal restructuring purposes are generally derived from advisors that have a thorough understanding of the ICT industry and its key components and "drivers"
4. There is no time like the present to **prepare for a due diligence** - risks identified by a purchaser in almost all cases reduce the sale price. **A key due diligence item is always proof of IP**
5. The Government has announced there will be a new regime to encourage research and development (R&D) which will apply from 1 July 2010. It is suggested that it will provide greater rewards for companies that undertake R&D - as defined under the Tax Act. This is of course welcomed. However, the Government has also promised a new definition of "R&D" – to ensure only "genuine" R&D is supported, and the concessions are properly targeted. Will the greater announced "rewards" eventuate in practice? Possibly this extra support from the Government benefit, makes up for not including the acquisition of software in the investment allowance (tax break concessions) for business
6. **Employee share arrangements (particularly those offering "sweat equity") should be reconsidered**, which may give rise to higher cash salaries for a number of ICT companies.

7. **ICT businesses are currently experiencing deferrals of some orders from business. It seems that it is even more important than ever to demonstrate ROI benefits in the sales process. As an example, if the sale is to HR, the ICT salesperson must help the HR manager sell to the CFO/ CEO**
8. Even though ROI is clearly demonstrated, there is still a deferral of orders. One hopes that, like a slow-down in the acquisition of cars (in a year cars will be a year older and will need to be replaced) in due course ICT purchase orders will get back to "normal'. What's normal?

It is important for the ICT business to ensure the products offered later will be competitive and offer benefits to customers. This will require continual examination of the market and properly targeted market-focused R&D spend.

Which entity should own an ICT business?

In my experience such a business should almost always be undertaken in a corporate structure, with the best exit being the sale of the shares. Some of the reasons are discussed below.

Changes to the Uniform Capital Allowance (UCA) regime

Changes to the Uniform Capital Allowance regime (regarding depreciation and amortisation) in 2001 have meant that various items of IP (copyright, patents and designs) are now treated as "depreciable" assets. As such, any profits arising on the sale of these assets are taxed as ordinary income and may be taxed at 46.5% if sold by an individual or trust.

However if an individual, directly or through a trust, sells shares in a company which has the IP any profit will be treated as a capital gain which may be taxed at (maximum) 23.25% if the 50% CGT discount applies. This rate may be less, if the small business CGT concessions apply also (see below).

Most ICT businesses are carried on by companies but I have sometimes seen IP held and/or businesses carried on by individuals and/or discretionary trusts in the mistaken belief that the individuals or individual beneficiaries could treat the profit as a capital gain.

The so-called "small business" CGT concessions.

These relatively new concessions can be very beneficial - it is surprising how many vendors and their advisors are not aware of the possibilities, and don't structure the business entity and/or sales of a business entity to maximise the benefits.

It should be appreciated that these concessions may be available even if the value of the company being sold is considerable – for example, $30m or more. These concessions may be particularly relevant for ICT and other technology companies where the revenue may be small but the value is high.

If these concessions are available to an individual vendor (or an individual beneficiary of a trust) on the top marginal rate, the CGT rate on any profit would be 11.63% rather than a 23.25% which may apply if the "small business" CGT concessions are not available. This would be an even lower rate if other small business CGT concessions apply. The concession rate (11.63% in the example) is only available to sales of capital gains assets such as goodwill, or shares.

The reduced CGT that may be available if the concessions are available, can of course be significant.

Where the owners of the company may qualify for the so-called small business CGT concessions, considerable care is required with the ownership structure, as the concessions can be easily lost.

The rules are complex but require serious consideration in structuring investments in, and sales of, ICT or any businesses.

Tax consolidation, and the value of software

Following the introduction of the tax consolidation regime, corporate groups acquiring a company may now be able to obtain a deduction for the amortization/ "depreciation" of the value of copyright, patents and designs acquired, even though the IP is owned by the company acquired and has low book value for the IP.

Before these changes there was possibly an incentive for a company or corporate group to acquire the IP (copyright) directly, rather than the company which owned the IP. The issues should be kept in mind to ensure that the assets (IP, goodwill etc) are correctly characterised and valued when a business or company is acquired.

Legal practicalities and due diligence

There are other reasons which encourage the sale of shares rather than the sale of an ICT business including:

- Potential stamp duty savings
- The sale of a business will require the transfer of licence and maintenance agreements (as well as the transfer of employees etc) which can add complexity to the contract – sometimes resulting in a "lawyers' picnic".

Of course, in order to sell a company it is important the company is clean and will satisfy due diligence.

Experience shows that this aspect should be kept in mind during the life of the company, not just at sale time. It is important to ensure there is appropriate and sufficient ongoing documentation to reduce the likelihood of due diligence issues arising. There is no time like the present to start to get documentation in order. Generally the longer it is left, the harder and more expensive it is to fix matters.

In my experience, it is generally a good investment for the owners of a business/company to have a trial due diligence completed well ahead of any contemplation of a sale.

Generally, risk areas arising to a purchaser (eg. not being able to prove ownership of IP) will reduce the sale price.

Although warranties may be able to cover some due diligence issues, or other possible liabilities in private sales, often contingent liabilities can become real liabilities in IPO's.

What if there are a number of products and/or services in the same ICT business or ICT company?

Often ICT businesses develop different products, and/or sell products and/or services and/or consulting. Sometimes products are developed from a consulting business. Generally in my experience, in these circumstances it is desirable for the group to have discrete products/services in different companies to enable the shares in those companies to be sold separately, and also possibly for liability reasons.

However, a corporate group structure (ie. holding company and subsidiaries) prima facie may make it difficult for the shareholders of the holding company to obtain the discount CGT rate (maximum 23.25%, or less if the CGT concessions would otherwise be available) when a subsidiary is sold.

In these circumstances the tax "demerger" rules may have been thought to be useful in enabling the holding company (and the subsidiaries) to separate such that each are owned by the shareholders of the holding company. However those rules and related issues such as section 45B need to be carefully considered. Amongst other things it seems the Commissioner intends to take a tough line in these situations at least for smaller and medium sized business groups. The Commissioner's view, to my mind, is not the policy of parliament in enacting the demerger rules, nor should it have been. Nevertheless it is the reality.

Use of trusts

In a situation where a purchaser may want to acquire some but not all of the businesses ("subsidiaries") and/or the IP, it may be attractive to have a unit trust as the holding entity owning various "subsidiaries", which each carry on different businesses and/or own different IP,

This structure may be attractive as this may enable the 23.25% concession CGT tax rate to apply to the sale of shares owned by that trust.

However, this structure may give rise to difficulties if there are losses in different companies and/or there are to be transfers of assets between those companies. Such a unit trust owned group would not obtain the advantages of tax consolidation. There may be other disadvantages. Nevertheless, a unit trust structure may be appropriate in the right circumstances.

Current action may be appropriate

Given the current economic conditions, including the reduced amount of funds available for debt and equity investments, and the perceived increase in risk for the economy generally (and by investors specifically) deals are being done at lower valuations and multiples than in previous times. Some established software houses have been sold at 2x EBIT (or less)!!!; compared to say 4x (or more) 24 months ago.

However, we are seeing a pick-up in valuations recently.

It may be an opportune time to correct" bad" structures, in that it may be possible to adopt lower valuations which may reduce or eliminate CGT or other costs of restructuring.

Also, the most appropriate valuations for internal restructuring purposes are derived from the advisors who have a thorough understanding of the ICT industry - its key components and drivers. Experience shows that on examination things are not always what they seem. For example, the value of many companies (or businesses) may be derived from the employment of the leaders of the business. Hence, the existence of employment contracts with these business leaders may affect the value of the business.

Financing

Sometimes technology companies raise funds by a combination of debt and equity – convertible notes and the like. Although generally not a problem, care needs to be taken with the debt/equity rules and the small business CGT concessions. It should be appreciated the CGT discount (23.25%) does not apply to the convertible note itself as it is a "traditional security", but only after conversion into shares.

Another issue to note is that certain securities that are not normally considered equity may be treated as such under the debt/equity rules. This may cause shareholdings in a company to be diluted and the concessions may not be able to be utilised by individuals that would otherwise be treated as CGT concession stakeholders.

The Commercial Ready regime

Even though it has now gone, the way it went requires some comments.

The original START and later Commercial Ready grants had been useful for the ICT sector however, these (and other concessions) were withdrawn from 2008 Budget night, (12 May 2008).

Those who have been involved with these grants know there was a lot of effort, and generally money spent, in completing an application that has a chance of success. For the Government to announce on Budget night that the grants would not be available from that night was, in my view, unfair to many businesses that had applications lodged or in progress. In my opinion to be "fair" (to use the Government's words throughout their Budgets), the grants should have been available for applications lodged within (say) a month of the Budget or other transition measures.

The Government has announced a complete review of grants and other policies that are designed to encourage innovation, hopefully they are user-friendly.

One hopes the Government demonstrates more understanding of how business operates in the future than it demonstrated in terminating the Commercial Ready scheme the way it did.

Employee shares

The 2009 Budget announced changes to the tax treatment of employee share arrangements.

All arrangements will require a rethink.

These types of arrangements are sometimes used in technology companies where companies are trying to preserve cash and offer "sweat equity".

The general affect of the proposed changes will be to tax all gains as ordinary income at the time of grant. The Government announced it was

going to offer some concessions but the concessions are limited.

Companies may need to pay more cash salary or undertake one of the alternative arrangements which are possible, although possibly more cumbersome. As salary paid in cash is tax deductible to the company, whereas issuing shares generally does not give rise to a tax deduction, one would have thought as a "recession" budget measure the Government would want to encourage the issue of shares by companies to employees.

It may be possible to still structure employee share to achieve a reasonable tax effect.

The company and employee/director will generally want to avoid a situation where the employee has to sell shares in the company in order to pay any tax on the issue of the shares/options. The problem is that the tax liability arises before there is cash realized from the transaction.

Apart from the employee/director's position, a sale of shares is generally not in the company's interest.

Further, directors cannot just sell at any time on the open market.

An appropriate strategy may be to grant options of little or no value. This can be done by issuing options at a strike price equal to market value plus a small amount representative of time value. This ought to ensure the employees can share in the upside without having to pay a significant up-front tax liability.

The Government is yet to clarify its view on appropriate valuation methods. However, it seems that "market value" is acceptable, at least at this stage.

A point of note, it appears the "grant date" is the date relevant in applying these rules (i.e. after shareholder approval has been received). The "notice date" is at least 6 weeks before the grant date, so possibly some care is required.

Some sale of business issues (tax and commercial)

1. Assets

On the sale of an ICT business, the following items would generally be transferred, whether or not they are referred to in the sale documentation.

If there is a sale/purchase of shares, as would be the case in most instances, there will not be a legal transfer of the items themselves and therefore the tax treatment regarding individual items may not be relevant.

The tax consequences for the vendor and purchaser of shares may vary depending on the value, real and documented, of some assets and liabilities. For example, as noted above, if shares in an ICT company are purchased by a consolidated tax group, the value of some of the various components may be able to be written-off for tax purposes and therefore valuation of these components is important.

Clearly the commercial consequences and the value of the company will vary depending on the existence and value of various assets and liabilities of the business-some of which are discussed below.

Goodwill

The Australian Accounting Standards require the break up the purchase consideration into of what ordinary people would consider is goodwill, into various components. It seems to me this can give rise to some bizarre accounting and financial reporting outcomes.

From a taxation point of view, if a business is sold as opposed to the shares, and goodwill is transferred there are some unclear aspects in relation to the valuation of goodwill for tax purposes or, at least, some not well understood consequences in that regard. Reference is made for example to TR 2005/17.

Information

It may well be that the sale of an ICT business may require the transfer of information. Depending on what the information is and how it is conveyed it may be the amount received for that information is not taxable. Further, the amount paid for the information that is acquired may be able to be written-off for tax purposes over 5 years.

IP / copyright

It cannot be stressed too much how important it is that business owners must do everything they can to ensure they own, and can prove they have protected, the IP that is crucial for the business. It is one of the first things reviewed in due diligence, and if not satisfactory, the possible sale price is usually adjusted downwards.

Preparing to satisfy due diligence enquiries in relation to the ownership of IP should not start when a possible sale is contemplated, but as soon as possible (ie. when the IP is created or the business activities commence). For companies in existence now, DD preparation starts now!

As noted above, any amount received for the transfer of copyright is taxed as ordinary income and not taxed under the CGT rules, where there may be concessions available.

The transfer of trademarks is not subject to the Uniform Capital Allowance (UCA) rules. The consequence is that the sale of a trademark is subject to CGT, and is not ordinary income. Amounts spent to purchase a trademark cannot be written-off over time, although they do represent cost base for CGT purposes.

From a commercial rather than tax perspective, in my experience often trade names and trademarks are developed over time and are not registered. In order to have a successful ICT business one generally has to operate on the world market. Therefore it is important that an ICT company makes an effort to have the best protection available in the jurisdictions in which it does or may operate.

Patents and designs generally can be very valuable, but require registration. Of particular relevance for ICT companies, business methods can be patented in some circumstances when software embodies those methods. As such, a new code using the concepts and techniques embodied in a company's software, is now able to be protected. However, I understand the use and protection is the subject of some controversy and litigation.

As noted above, patents are now subject to the UCA rules and, as such, any amount received for the transfer of patents is on "revenue" account.

Domain names can be a valuable asset. The transfer of, and due diligence in relation to, domain names requires careful legal attention.

Maintenance and other service agreements

Whether a vendor of an ICT business will transfer prepaid licence and maintenance agreements it has with its customers to a purchaser, or where the shares in an ICT company are sold, in many instances this will result in compensation by the vendor to the purchaser for the purchaser to continue to provide help desk and other maintenance services. This may be a simple fee calculated over the time to run on the maintenance contracts, or a more complicated adjustment to the purchase price which in many cases may be more appropriate.

Many ICT contracts have "change of control" clauses which provide for a customer/supplier to terminate the agreements if there is a change of control of the software company. Significant contracts should be reviewed for this clause including any significant contracts (eg. suppliers of hosting services or IT systems).

Staff

In a number of cases the transfer of development staff may have significant value. The value would be in the ability of the staff to "man" (person?) the help desk, the ability to fix bugs and the ability to further develop the software.

Further, there may be value in the transfer of other staff, such as those in sales, who have client contact.

If there is a lack of "documentation" of the software regarding processes and procedures, the staff transferred are even more valuable and possibly the business is less valuable. In my opinion, businesses should develop appropriate documentation as an ongoing task.

2. Liabilities

In conducting the due diligence, there are number of potential liabilities which are commonly found in ICT companies, many of which may not have been correctly recorded. These include:

Unearned income

It is usual for a software house to obtain payments for services in advance particularly for software licences and maintenance, and consulting services and in SaaS/hosting arrangements. As noted above, there are important commercial issues and the tax treatment of prepayments/unearned income to consider.

When acquiring or selling a software business, it is important to fully understand the value that should be attributed to unearned income and to negotiate accordingly.

Liabilities associated with previous and current projects

ICT companies often enter into consulting or development arrangements on a fixed price basis. All such contracts should be reviewed to ensure that the project is on track and that there are not significant cost over-runs. It should be noted that the size (dollar value) of a fixed price project is not necessarily any indication of the potential exposure that there may be to provide future services.

Contingent liabilities and contract commitments

All contracts/licence agreements should be reviewed to identify:

- The period the ICT company has committed to provide maintenance and consideration should be given to how that support commitment is to be met.
- Whether new versions of the software have been agreed within current pricing arrangements.

In my experience, it is beneficial for ICT companies to keep a legal register for ongoing management, separate from potential sales.

Sales commissions can be particularly large in the ICT industry and all obligations to pay sales commissions should be carefully assessed.

3. Deferred sales and earn-outs

As with all sales of businesses/companies, deferred sales can give rise to difficulties because it is sometimes not appreciated that for CGT purposes a sale occurs when the agreement is reached, regardless of when the cash is received. A careful cash-flow analysis is warranted by vendors.

Earn-outs, although central to many ICT sales/acquisitions, can give rise to tax difficulties through the possible unavailability of CGT concessions on the earn-out component. In addition, the value of the earn-out can be taxed before the cash is received. Earn-outs have attracted additional Tax Office attention with the release of draft tax ruling TR 2007/D10.

Under the draft ruling, the buyer is treated as giving "property" to the seller (being the earn-out right). Hence, any money paid under the earn-out is not paid to acquire the asset (ie. not included in the cost base of the asset) but rather to discharge the buyer's obligation under the earn-out. In my mind, the draft ruling is flawed in concept as it states that "the reality of the matter" is that the parties have entered into a financial arrangement that is independent of the sale transaction. Those that actually deal in these transactions know that the real "reality of the matter" is, in most circumstances, that the earn-out is a proper attempt to pay an amount that truly reflects the value of the business.

The new TOFA rules may well have applications to many earn-outs and deferred settlements arrangements in the larger end of town, and many medium-sized businesses.

The issues that result from the draft ruling and TOFA may possibly be prevented by a staggered sell-down. However, a staggered sale may create other issues relating to synergies and the ability of businesses to integrate and meet the set performance targets.

Whether a sale is made under an earn-out agreement or a staggered sell-down, it is crucial that the parties define "profits" for the purposes of determining the earn-out in the sale agreement.

4. Scrip for scrip

Where scrip is provided as consideration for the sale of shares in a company, eligibility for scrip-for-scrip rollover should be considered. One of the issues is to ensure the securities being received are the same as the securities being transferred.

It is probably fair to say the legal, tax and, possibly, accounting rules that relate to computer code, and the ICT industry generally, are not adequate and are out-of-date; technology has passed them by. From time to time, this creates uncertainty, unexpected problems and opportunities.

If there is a lesson from the comments above it is that the ICT industries have their own peculiarities and it is prudent to have advisors who know the space.

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