

REVIEW OF ASPECTS OF INCOME TAX SELF ASSESSMENT

Submission by the Australian Innovation Association

21 May 2004

The Australian Innovation Association (AIA) welcomes the opportunity to address issues raised in the Review's Discussion Paper of March 2004, specifically as they affect the rights of AIA members who participated in the Government's R&D syndication scheme of the late 19880s, and who continue to suffer from the actions of the Australian Taxation's Office (ATO) in issuing amended assessments a decade or more after the event.

The Australian Innovation Association

The AIA was formed by a group of investors and researchers actively involved in the commercialisation of Australian scientific and technological inventions. The objectives of the AIA are to advance Australia's capacity for innovation and to promote a consistent and certain environment for R&D, thereby enhancing the country's international competitiveness in the years ahead. A description of the AIA, including the composition of its Committee of Management, is attached.

In view of the long lead times and high risk of failure inherent in R&D programs, it is important that government policy, and the administration of the policy which regulates investment in R&D activities, is stable and administered consistently throughout the life of the concession. This requirement is an underlying theme of a broad ranging AIA submission on innovation policy made last year to the Federal Government in connection with its review of the 'Backing Australia's Ability' program.

In this submission we concentrate attention on the administrative actions of the ATO in relation to the taxation of R&D Syndicates, in which many of our members participated at the express invitation and with the encouragement of the Federal Government.

These members, who comprise R&D companies, non profit research institutes and investors have a substantial grievance both in the application of the law and in the administrative actions of the ATO. The law currently allows the Commissioner to amend R&D assessment at any time under subsection 170(10A), ITAA. The AIA is concerned with this open ended statutory power as it creates significant uncertainty for taxpayers and provides no incentive for the Commissioner to resolve R&D syndicate matters on a timely basis. With the passage of time the taxpayer may be unable to demonstrate that the parties dealt at arm's length, as documents may not be able to be located, the parties to the dealing may have difficulty recalling the specifics of the matter, or they may have left the company, retired or died. The lack of a sunset date on the issue of amended assessments in the current legislation is acting as a significant deterrent to R&D investment. Before outlining the history of R&D Syndication and its sorry aftermath, we summarise our recommendations to the Review in response to certain questions raised in the Discussion Paper.

Recommendations for Legislative and/or Administrative Changes

The changes sought by the AIA to apply to concessions introduced to encourage particular forms of economic activity are:

1. The Commissioner should be precluded from issuing an assessment or an amended assessment in relation to the operation of the concession two years after the end of the income year in which the concession is claimed. (Reference Question 3G)
2. Where the Commissioner has issued a private binding ruling or an advance opinion prior to July 1992 on a particular issue, he should be precluded from issuing an assessment or an amended assessment in relation to the ruling applicant, (or a group company to which the benefit of the concession has been transferred under the group loss transfer provisions) in relation to issues which are the subject of the ruling. This limitation would not apply where the Commissioner can demonstrate that the ruling was obtained through the making of a material misstatement by the applicant. (Reference Question 3H)
3. Where specific anti-avoidance provisions are designed to apply to legislated tax concessions the Commissioner should be precluded from cancelling a tax benefit under Part IVA where the specific anti-avoidance provisions do not have the effect of cancelling the tax deductions in dispute. (Reference Question 3H)
4. Taxpayers should be protected from administrative inefficiencies. Where the Commissioner has not raised any issues regarding a specific tax concession one year from the date that the relevant tax deductions were claimed, the Commissioner should be precluded from applying GIC if these arrangements are subsequently the subject of an amended assessment. (Reference Question 3H)

Given the serious negative impact of the current action by the Commissioner of Taxation on investment in innovation, and the reliance placed in good faith on the administrative process introduced to facilitate the earlier concession, we propose that these changes have retrospective effect to the date the syndicated R&D concession was first made available i.e. September 1989.

R&D Syndication

R&D syndication was a government sanctioned investment program to promote private sector investment in large R&D projects. As part of the introduction of the 150% R&D tax concession in the late 1980s, the Federal Government legislated for the financing of R&D programs by investors independent of the company running the R&D program. A substantial number of companies participated in over 240 R&D syndicates on the express encouragement and formal consent from the Industry Research and Development Board (IRDB) and the Australian Taxation Office. Many (if not all) of the syndicated arrangements took advantage of section 73CA permitting a guaranteed return, thereby accepting a lower level of deduction (being 100% not 150%).

The syndicated R&D projects were required by the Income Tax Assessment Act (ITAA) and the Industry Research & Development Act to be either innovative or involve technical risk. Accordingly there was likely to be a high failure rate due to the early stage nature of the

technology. The tax concession was not contingent on the commercial success of the project. The syndicate participants provided copious information to the IRDB and the ATO in order to gain the required registration approvals, including full disclosure of the R&D program, the R&D spend, the core technology licence, the transaction legal documents, the independent valuation of the core technology and the specifics of the finance scheme.

The ATO initially provided written advance opinions and then private binding rulings for individual syndicate investors and researchers. These were intended to provide comfort that the anti-avoidance provision of the ITAA, Part IVA, would not apply on the mutual understanding that the primary purpose of the syndicates was not for tax benefits. Given the detailed examination of each project by the IRDB and the ATO, and the formal registration of each project, it was assumed by investors and researchers that the process provided sufficient assurance to genuine investors and researchers to enable them to commit themselves to participation. Inevitably there may have been at the fringe some who took advantage of the initial guidelines to design schemes whose primary purpose was to secure tax benefits, but the vast majority of participants were in accord with the intentions of the government's policy initiative. The program was continually modified from its inception to improve its effectiveness, eg the exclusion of public and later private tax exempts from involvement in syndication, a reduction in the rates of deduction for core technology and R & D expenditure and the eligibility requirements for the proposed core technology and finance scheme.

The main features of a typical R&D syndicate were summarised in para 4 of the ATO's ruling IT 2635 dated 9 May 1991 and the attachment to that ruling. The preamble to the ruling specifies that the purpose of the R&D concession is to increase the level of industrial R&D in Australia and that the tax concession was introduced to compensate for the higher commercial risks which R&D entails. The ruling required the payment for the core technology to be at an arms length market value price.

R&D syndication resulted in a significant increase in business expenditure in bona fide R&D and funded a significant amount of R&D for early stage researchers, involving many of Australia's leading innovative, export oriented R&D companies. It is clear that many of Australia's leading researchers would not be successful today if not for the R&D syndication program.

A change in government resulted in the cessation of new syndicate registrations in July 1996. In introducing the measures, the Treasurer cited four examples in which the intentions of the scheme had been perverted by investors whose main purpose was not the pursuit of sound industrial research and development. We understand that these arrangements were not registered with the IRDB. Subsequently mainstream investors and researchers pursuing legitimate objectives have had the impression that the ATO has treated them as being potentially in the same category.

From 1998 onwards, the Government, AusIndustry and the IRDB have put increasing pressure on investors and promoters to wind up existing syndicates where the syndicates will not be in a position to repay the original investment plus a dividend. Senator Minchin, the then Minister for Industry, Science and Resources publicly endorsed action taken in good faith by syndicate investors to wind up substantial numbers of R&D syndicates with a resulting saving to the Australian taxpayer.

ATO Action

Despite this cooperation on the part of syndicate participants the ATO has, over the last four years, conducted a program of retrospectively revaluing core technologies licensed by researchers to investors. These revaluations have been based on ATO valuations obtained from the Australian Valuation Office and selected external valuers, some at least 6 and up to 10 years after the licence was entered into. As far as is known, the ATO valuers have, in every case, determined that the value of core technology is either nil or a negative value. This is despite the syndicates in question licensing vastly different technologies and having different but appropriately qualified independent valuers who valued the technology based on the best available principles and methodology at the time. These valuations were always disclosed to the ATO at the time and ordinarily formed part of the ruling request. The regulatory rulings implicitly recognised the validity of this approach and the arms length nature of it. The ATO valuation process, conducted many years after the original investor and researcher commitment in good faith to the program is seen as tendentious. It is an attempt to argue that the arrangements were not conducted at arms length, and that therefore the anti-avoidance provisions of Section 73B should apply. As a result, the ATO is issuing position papers and amended assessments denying tax deductions for core technology and the related interest. Penalties (at 50%) and interest have been added to the primary tax.

The ATO has also attempted to use Part IVA to strike down legislated concessions. An example was the Transgenic R&D Syndicate (invested in by Macquarie Bank Limited and BresaGen Limited) which licensed core technology from the University of Adelaide in 1992. The ATO commenced an audit of the syndicate in 1994 which concluded in 2000 with the issue of amended assessments. The matter ("Zoffanies") was litigated in the AAT in 2002, where the AAT found that

- the parties dealt at arm's length;
- the price paid for the core technology licence of approximately \$15 million was appropriate;
- the valuation obtained by the syndicate in 1992 was the appropriate valuation; and
- Part IVA did not apply i.e. the dominant purpose was investment in R&D, not to obtain tax benefits.

The ATO appealed all of the above findings to the Federal Court but dropped the objections against arm's length dealing and valuation findings in the week prior to the hearing in July 2003. It argued in the Federal Court that there was an error of law in the decision of the AAT on the findings on Part IVA.

The Federal Court upheld the Commissioner's appeal in connection with certain elements of Part IVA and the matter was partially remitted back to the AAT on 24 October 2003 on Part IVA. However the Commissioner conceded the matter in mid-April 2004 and the AAT handed down orders in favour of the taxpayer on 5 May 2004.

Effect on Investors and R & D Enterprises

Participants in genuine R & D syndicates did so in good faith at the invitation of the government of the day. Whilst they fully recognised the right of an incoming government to change policy, they were nonetheless dismayed that they were being characterised as tax avoiders. The subsequent actions of the ATO have reinforced this impression, leading to a strong sense of resentment at having been persuaded to participate in what was initially regarded by the government of the day as being in the national interest, only to be characterised retrospectively as behaving improperly.

Given the elaborate screening procedures initially carried out both by the IRDB and the ATO, syndicate participants were entitled to believe that their investments were soundly based. They therefore regard the administrative actions of the ATO as equivalent in effect to retrospective legislation, and therefore a direct attack on private property rights.

It is not surprising therefore that investors have decided that they have no alternative but to resort to litigation to protect their rights and property. As is well known this results in a prodigious expenditure of time and money, most of it long before the ATO is obliged to make a similar investment. This is time and money that ought to be spent on productive activities to enhance the nation's wealth.

For some enterprises which have provided indemnities to investors there is also the threat of bankruptcy. In addition many publicly funded research institutions which have been the beneficiaries of syndicate investment have been caught up in responding to ATO audits, soaking up time and resources which they are singularly ill placed to afford.

Overall the ATO's actions have led to a serious loss of faith in the fairness and consistency of government policy, and have had an adverse impact on the willingness of investors to support R & D based companies and institutions.

It needs also to be observed that the AIA includes taxpayers who are significant claimants of the general R&D tax concession. These taxpayers, in line with Syndicate investors, are also subject to the prejudicial impact of no time limits on the issue of amended assessments. This means that their R&D tax affairs are never closed. This cannot but have a depressing effect on R&D investment generally.

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