General Manager
Business Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

05 February 2010

Dear General Manager of the Business Tax Division

Submission in response to the 'exposure draft' of the Tax Laws Amendment (Research and Development) Bill 2010, released 18 December 2009

Please find following the AusBiotech submission, which encompasses feedback from consultation with AusBiotech members, coupled with technical R&D tax expertise from Australia's leading tax experts.

Background
This is AusBiotech's second submission on the subject of R&D tax credits; the first was in response to the consultation paper, in October 2009.

Innovation in biotechnology is a key driver of economic growth in Australia, providing highly skilled, highly paid jobs, as well as solutions to issues in health, food, fuel and climate change. AusBiotech represents more than 3,000 members - the majority are typically small or medium growth enterprises, which conduct comparatively high levels of R&D. AusBiotech members, are therefore, very interested in and excited about the benefits offered by the R&D tax credit announced in the 2009 Budget measures for science and innovation. The tax credit initiative was very well received by industry.

AusBiotech has publicly welcomed the 45% refundable tax credit as the most significant reform to tax-based innovation policy since the R&D tax concession was introduced in 1986 - as well welcoming the 40% non-refundable tax credit for larger companies. AusBiotech and its members support the stated intent of the policy in delivering a "more generous, more predictable, and less complex tax incentive". However, there are wide-spread concerns about the draft legislation and its ability, if passed, to deliver the intent of the policy.

Key concerns
We understand the Government's intention to tighten eligibility in order to focus incentives on worthwhile activities, which will promote innovation and benefit Australians and the Australian economy. However, unquestionably the multiple hurdles contained in the exposure draft in its current form have gone too far and will drastically reduce access to the R&D tax incentive program, leaving companies (and ultimately Australians) unable to benefit under the new program.

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Specifically, our key concerns and recommendations are summarised below:

- The number and nature of the hurdles companies need to overcome before their R&D is eligible is unreasonable. They include:
    1. The introduction of the 'and' test for the eligibility test of considerable novelty AND high levels of technical risk;
    2. 'Considerable novelty' in place of 'innovation';
    3. The 'dominant purpose' test for supporting activities;
    4. The exclusion of a large number of activities from being either core or supporting activities;
    5. The 'augmented feedstock provisions' effectively limits R&D incentives to the net expenditure on the R&D activities.

- The 'exclusions list' is open to interpretation and could be understood to exclude clinical trials. Clinical trials should be protected and included as eligible as core R&D. This is of major concern to the industry and a statement clarifying the issue would be very helpful.

- The 'augmented feedstock provisions' limits eligibility to net expenditure on the R&D activities – as well as introducing a new level of uncertainty as claims are 'clawed back'. For SMEs, the administration, management and uncertainly of potential 'claw backs' create unwanted complexity and cost.

- There is a compelling case for dealing with SMEs differently by loosening eligibility for companies with turnover under $20million, which would support innovation, especially in its infancy.

In addition to the above, AusBiotech would like to reiterate a number of points made in its first submission in October (included as an appendix), which have not been addressed in the draft legislation:

- While the tax exempt ownership interest has increased to 50%, this is still inadequate and should be increased to 75% for private companies with university equity before loss of the entitlement to the R&D tax credit. The cap should be removed for publicly funded research.

- A payment option should be available for eligible claims to be paid on a quarterly basis. A key factor to the success of R&D projects is access to adequate capital and project funding. A survey, conducted by Ausbiotech and Deloitte as part of a series of tax credit briefings in July 2009 indicated that almost every respondent entitled to the refund believed the timing of the receipt of tax credit payments (i.e. quarterly or annually) will be a critical factor in their value as an incentive for additional R&D activities. We propose that claimant companies with group turnover of less than $20m receive the R&D tax credit on a quarterly basis in the year the expense is incurred, and aligned with the Business Activity Statement.

- The wording around "additionality and spillovers" should not remain in the legislation as a rationale that underpins its intent. While we support the concept, we do not support the proposition that this principle be included in the legislation as its inclusion is open to abuse and misinterpretation.

- Core R&D should not be differentiated from supporting R&D. AusBiotech believe this runs counter to simplification of the system and in fact creates compliance burden, the cost of which is expected to discourage claimants.

Key concerns - detail

Within the exposure draft, there are now five key ways in which eligibility has been significantly tightened and claims will be curtailed, making the system less accessible, more complicated and less clear to Australian businesses.

1. The introduction of the 'and' test for the eligibility test of considerable novelty AND high levels of technical risk. We believe that this change to the definition will lead to the exclusion of many genuine R&D activities that should be supported and are currently eligible for support under the existing R&D tax concession. As a stand alone measure, this change may be acceptable, but in combination with the other new eligibility restrictions, it will exclude too many meritorious R&D endeavours and overall support for innovation will be considerably reduced. If this change is to be adopted, then other proposed restrictions should not be introduced otherwise the aim of the new tax credit to provide a more generous concession may not be fulfilled.
2. The requirement for 'considerable novelty' in place of 'innovation' raises the bar for eligibility of potential claimants, while increasing uncertainty by replacing a well understood and defined term. Innovation is a well understood term, and the relationship between innovation, productivity and growth is similarly well understood, across OECD countries and in a local context. The change of terminology seems to discourage incremental improvements that are vital to both research and business competitiveness;
3. The introduction of the 'dominant purpose' test for supporting activities. This represents a significant tightening over the existing test in the current program, which requires that a support activity be carried out for 'a' purpose directly related to the core R&D activities.

   This new test will greatly reduce the amount of eligible support activities that may be claimed, and will also impose a serious evidentiary burden on claimants. Many support activities will have a commercial purpose as well as an R&D purpose and providing evidence that one purpose is clearly dominant over the other will be almost impossible in many cases. This introduces considerable uncertainty over the eligibility of claimed supporting activities and is highly undesirable as a consequence. We note, this uncertainty is acknowledged in the discussion of the new test in the Explanatory Memorandum.

4. The apparently arbitrary exclusion of a large number of activities from being either core or supporting activities, via the repurposing of the former s73B(2C) of the Income Tax Assessment Act 1936 (ITAA 1936) is concerning. We believe that this change will have the negative consequences (possibly unintended), including it the legislation:

   a. s355-35 (2)(l) may render clinical trials ineligible as they are performed for (amongst other purposes) the preparation of a regulatory requirement of the Therapeutic Goods Administration;

b. may drastically reduced the eligible manufacturing processes, including clinical trials, with the expansive drafting of s355-35(2)(h);

c. s355-35(2)(i) may be difficult to apply as it is broadly drafted and lacks clarity;

5. The 'augmented feedstock provisions' effectively limit eligibility to the net expenditure on R&D activities. This obviously decreases the incentive, and has other major consequences:

    a. it makes the incentive less predictable, as the value of the output may be clawed back at a future date, making budgeting projects and accounting for incentives difficult (i.e. how would one carry the potential liability?);

    b. it favours failure over success. We believe that having taken on the technical and financial risk of an R&D activity, a claimant should not be negatively treated at a indeterminate point in the future due to the disposal of the outputs of R&D;

    c. the scope of what is included in the 'output's cost' should not include labour and plant depreciation. A company takes on a real *opportunity cost* by diverting staff and assets from normal duties to an R&D activity – this cost is in fact never fully recovered, even if the outputs of R&D are sold. The current feedstock provisions of the R&D Tax Concession, which deal only with material inputs and energy, amply claw back incentives on profitable trial activities.

There is a case for dealing with SMEs differently by loosening eligibility for companies with turnover under $20million, which would support innovation, especially in its infancy, and protect from large claims. For innovation to benefit Australia - its people and it economy, research needs to progress from an experiment to commercialisation, where it can reach those who can benefit from it. Research is not an end itself, but an evolutionary process.

In the biotechnology sector, it is common for companies to be born from a research project and 'spin out'. Their transition from the laboratory to becoming self sustaining contributors to the economy is known as the valley of death, which implies a liability of newness.

Cognisant of the unique business model required by biotechnology, where significant funds are required up front before any return can be realised, sympathetic public policy, including tax incentives, are vital if innovations and the biotechnology industry are to thrive in Australia.

It is therefore reasonable, if not sensible, to be more lenient on start up companies. The $20million segregation line would be a fitting demarcation.

Case studies

To understand how the draft legislation might impact R&D conducted by biotechnology companies, following is results from a survey of eight AusBiotech member case studies, including:

- **Bionomics**, SA (therapeutics and drug discovery and development in cancer, disorders of the central nervous system (CNS) and multiple sclerosis),
- **Proteomics International**; WA (Drug discovery (peptide therapeutics), biomarker discovery (proteins)),
- **Sienna**, VIC (developing highly sensitive and novel tests for the early diagnosis and monitoring of various cancers using telomerase biosensing technology,

- **Xenome** Limited, QLD (development of peptide drugs, primarily in the fields of pain and inflammation),
- **Biovite** Australia Pty Ltd, QLD (discovery, research and development, proof of concept, and commercialisation of bio-actives and products for use in human health, animal health and agriculture),
- **ResMed Ltd**, NSW (developer and manufacture of products for sleep disordered breathing and other respiratory disorders.)
- **Neural Diagnostics Pty Ltd**, VIC, (commercialising disruptive CNS diagnostic technology developed at Monash University),
- **Vaxine Pty Ltd**, SA (human vaccine R&D),

Seven of these companies have turnover under $20m, making them potentially eligible for the 45% refundable tax credit and one has turnover over $20m, and is potentially eligible for the 40% non-refundable tax credit. On average the companies have turnover of $4.1m, although two companies will have no income for up to three years.

Together they estimate their total expenditure on R&D between 1 Jul 2009 – 30 Jun 2010 to be $79.1m. If excluding the company with turnover over $20m, an average of $2.73m each in a range between $300k and $7m.

These companies are involved in research and development of importance to the health and well being of the Australian community, and well as economic development. Research ranges from the first clinically-proven swine flu vaccine in the world to be safe for use by the many people with egg allergy through to the identification of novel biomarkers for diabetes caused by obesity, to the development of a cancer diagnostic test based on the biotechnology for which Dr Elizabeth Blackburn recently won a Nobel Prize.

Without even considering all the hurdles to accessing the R&D tax credit present in the draft legislation, the projections of how the exclusions list and the augmented feedstock rules will affect industry are wildly divergent and uncertain. This reflects differing circumstances of companies, but more importantly it reflects the uncertain interpretation of how the legislation might apply.

Company estimates on how the exclusions list will affect their potential claims ranges from two companies that believe there will be no impact on them, to six who thought it would reduce their claim by between 12% and 100%, with an average of 52% reduction in claims.

The augmented feedstock rules were thought to reduce six companies' claims by between 20% and 100%, and have no impact on two companies, with the overall average of a 42% reduction.

Recommendations

There is, presently, an opportunity to draft the legislation precisely and specifically to meet the policy intent – this opportunity should not be missed. Given the above issues and complexities in the current exposure draft, we submit that the Government should:

1. Leave in place the well understood term 'innovation' in the definition and remove the term 'considerable novelty';

2. Delete the exclusions list and thereby not use it as a means to limit supporting activities, or, if absolutely necessary to achieve policy objectives, redraft s355-35(2) to clarify those activities that are intended to be excluded. (It is vital that it is clear that clinical trials are not to be excluded);

3. Remove the 'augmented feedstock provisions' from the draft legislation.

4. Make provisions to be more lenient on eligibility for companies with turnover under $20million.

5. While the tax exempt ownership interest has increased to 50%, this is still inadequate and should be increased to 75% for private companies with university equity before loss of the entitlement to the R&D tax credit. The cap should be removed for publicly funded research.

6. A payment option should be available for eligible claims to be paid on a quarterly basis.

7. The wording around "additionality and spillovers" should not remain in the legislation as a rationale that underpins its intent.

8. Core R&D should not be differentiated from supporting R&D. AusBiotech believe this runs counter to simplification of the system and in fact creates compliance burden, the cost of which is expected to discourage claimants.

Summary
If the above recommended changes are made to the exposure draft, the Government will be able to achieve its objectives for the new tax credit – that is, implement a more generous, more predictable and less complex incentive that maintains revenue neutrality.

To assist with clarity, certainty and simplicity, it would be of great benefit to claimants and improve the administration of the concession if industry-specific guidelines and examples were released and updated on a regular basis.

AusBiotech is available and committed to working with the Government to achieve the intended result of the tax credit. If you would like to discuss this submission, please feel free to contact me on alavelle@ausbiotech.org or on 03 9828 1404.

Yours sincerely

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