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To Whom It May Concern

On behalf of **Australian Interactive Media Industry Association (AIMIA) -** Innovation Research & Development Committee, I welcome this opportunity to provide feedback on the exposure draft of the Tax Laws Amendment (Research and Development) Bill 2010 released 18 December 2009 ("the exposure draft").

AIMIA is an industry body that represents 600+ companies in the ICT industry. A significant proportion of our members are in the business of developing innovative software for the global market. I myself am an entrepreneur with a number of successful companies and 7 years of experience in R&D. I also hold numerous positions with industry bodies and am an advocate of companies exporting their technology to Asia from an Australian base.

AIMIA commends the Government's stated intent in delivering a "more generous, more predictable, and less complex tax incentive", however we do not believe the legislation achieves this intent in its present form.

We believe a significant proportion of businesses undertaking R&D will be affected with the resulting effect likely to be:

1. wind up operations before the new legislation comes into effect;

2. offshore R&D into countries with more clearly defined and rewarding taxation structures such as Singapore;

3. plan commercialisation strategies in favourable regional hubs like Bangkok and Singapore with Australia as a last market approach; and

4. not begin innovative businesses in Australia as the start-up costs will be too high without R&D incentives.

The proposed legislation in its current form will:

1. unfairly restrict Research and Development in emerging markets like digital media and mobile telecommunications applications where innovation is occurring in software systems that are novel online services with core R&D innovation and patentable IP. The proposed legislation would appear to deny R&D benefits to these parts of the ICT industry on the basis that they are services rather than product developers. This area requires nurturing not a broad brush stroke that potentially wipes out any R&D claims: and

2. over burden SME's who may not have the funds or knowledge to seek advice.

This is a double whammy for businesses who already find it difficult attracting equity investment from overseas venture capital funds which are wary of the possible taxation impact of equity investment in Australian companies. The proposed “augmented feedstock” legislation may severely impact a start-up company at a critical point in its lifecycle in those circumstances where such a company commercialises its R&D effort. The success of the company may trigger the feedstock rules, creating the need for the company to repay the government the R&D benefits the company enjoyed during the development of the new service offering. Why would someone invest in an Australian company with an un-quantifiable financial position due to legislation that is not clearly defined?

So what are our members saying about the changes? Well, one of the more vocal comments was "The death of Innovation in Australia". Is this the death of innovation in Australia? It looks like it from an industry perspective, even if it is not at the least it will trigger a significant collapse of Australian R&D investment with resultant job losses in the local economy.

At a time when Australia is being recognised as a solid financial performer, government should be providing clarity not changes that create ambiguity and multiple hits to companies providing innovation.

Another choice comment from an ex investment banker now involved in commercialisation was "why would I invest in Australian R&D when there is less chance of securing capital investment and even if I can achieve that investment and we make a profit it will be clawed back?".

Whilst we understand the Government’s intention to tighten eligibility in order to focus incentives on worthy activities which will provide spillover benefits to the broader Australian economy, we believe the combination of *the high number* of tightening measures contained in the exposure draft serves to drastically reduce the generosity, accessibility and attractiveness of the R&D Tax Incentive program.

Is the government’s goal of fostering Australian innovation and industry growth being achieved by the introduction of the new legislation? We think not. We believe the new legislation will foster companies to windup prior to profitability or sell valuable IP assets to offshore countries that favour continued R&D. What it will do is decrease Australian ICT investment, create job losses and begin the migration of Australian professionals to smarter countries.

We have included specific examples related to our major concerns below.

Major concerns

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 generous, more complex and less predictable* to Australian businesses.

1. The requirement for ‘considerable novelty’ in place of ‘innovation’ – this both 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 shift in term seems to favour the “blue sky” R&D common in academic settings over business innovation – the incremental improvements which are vital to business competitiveness;
2. The introduction of the “and” test for the eligibility test of considerable novelty <u>and</u> 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 will not be fulfilled.

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 only 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 severe evidentiary burden on claimants of the new R&D tax credit. 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. Please 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). We believe that this change, while having obvious negative consequences for the computer science and information technology industries in Australia, also has (possibly unintended) consequences, including that:

    a. s355-35(2)(p,q and r) reads "

       (p) integrating off-the-shelf commercial computer software;

       (q) integrating off-the-shelf open source computer software;

       (r) computer software services not otherwise covered by this subsection".

       Such a series of tests will result in the exclusion of the majority of IT related R&D from obtaining support under the program.

Lets look at an example for Australia's most successful internet start-up where I myself was the Development Manager. This internet start-up called www.seek.com.au had a product as an online service, core systems were designed and built using some very innovative concepts and software but also included some third party software, under proposed legislation it could potentially be excluded on the basis of:

i. computer software services (not otherwise covered); and

ii. integrating off the shelf commercial computer software.

The legislation should be drafted to clarify the specific instances e.g. no more than 20% of the software effort can be integration work. It is important to understand that software development of innovative products is often based on integration of pre existing software. No software developer in their right mind would rebuild software that already exists and works well. Consider Seek.com, we used third party mail software that was created solely for the purpose of mass mailing for us to build that technology from scratch would have cost as much as the entire project. But the final nail in the project would be computer software services, that's exactly what the seek website is and what comprises ALL mobile phone applications! No we do not mean SMS ringtones and such applications we are talking about commercial grade products like staff management, flight booking systems, tracking systems, information management systems etc. The sort of technology that is in growth phase and set to overtake internet usage.

Section s355-35(2)(p,q and r) alone will destroy R&D in the mobile industry and digital media.

Here is another related example from a company that wishes to remain nameless:

Company B had 3 years of R&D support for a core software system that had 80% of its innovative efforts in its own patentable software development and 20% in integrating other commercial products into this core system. This software was for a mobile phone based flight booking system which is now in more than 7 APAC countries. Under proposed legislation it could potentially be excluded on the basis of:

i. computer software services (not otherwise covered); and

ii. integrating off the shelf commercial computer software.

The success of this company was only due to the R&D investment and when asked if they would undertake R&D again the resounding answer was "It was hard enough going through the previous government R&D process, with the proposed changes we would have no idea where we stand and cannot be certain about the fiscal benefits. It actually looks like we would not qualify."

5. The "augmented feedstock provisions", effectively limit R&D Incentives to the net expenditure on the R&D activities. This obviously decreases the generosity of the incentive, however it 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.

Here's a related example from an equity investor position:

Company C has a revolutionary process for a software product that will manage carbon credits:

- 2010/11 - owner funded $2 million in eligible R&D activities for the development of computer software, resulting in a $900,000 R&D Tax Offset under the new legislation.

- begin to commercialise the product in 2012, small profit of $5,000
- capital investment is sought from a foreign investment company in 2013 for $1 million to continue commercialisation for Asian markets as the Australian market is too small.

An Information Memorandum and due diligence documents are prepared for the company showing excellent success in R&D with a small profit in 2012 and a potential for a $1 million profit in 2013.

However, the investors' advisors complete their due diligence and discover that there is a potential $900,000 tax liability for R&D tax offsets to be clawed back under the new augmented feedstock rules. If the deal proceeds and the R&D tax offset is clawed back everyone loses as the product only has one more year to get a solid footing in the market which won't be achieved. The claw back of the R&D tax offset would potentially kill the next years cash flow and ability for the company to remain solvent.

So what options are available to Company C:

1. lose an investor and wind the company up as it's unlikely any investor would risk a claw back; or
2. sell the IP to the foreign investment company for a market rate of $100K based on previous sales, shareholders take options on a future equity position in the foreign investment company and offer to assist setting up development operations overseas, then shut down the Australian company as a non profitable venture (thus avoiding the feedstock provisions as they are currently drafted).

So what's the impact on Australia here?

In option 1 everyone loses including employees, business owners, shareholders, investors and customers. Further, Australia also no longer have the planned investment in new jobs and the local economy consequently suffers.

In option 2 the shareholders benefit, primarily the foreign investment company and the overseas economy. Unfortunately we have job losses and another failed Australian company that could have grown to profitability here in Australia and benefited the local economy.

What does the company do? Well it has no choice as Corporations law says it must do what is in the interests of shareholders so it's option 2.

Submission Request

There is, presently, a unique 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 <u>clarify</u> those activities which are intended to be excluded;**
3. **Remove the specific exclusions on computer software to ensure that genuine R&D undertaken that is information technology related is supported by the R&D tax credit program going forward; and**

4. **Revert to the existing feedstock provisions of s73B of the ITAA 1936 which, we believe, effectively limit incentives to net cost of trials or alternatively quarantine some specific activities from being treated as input costs in the augmented feedstock provisions. We request that two categories of costs be quarantined (and not included in the feedstock calculation) being labour and plant depreciation.**

If the above 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 targets additionality and spillovers whilst maintaining revenue neutrality.

However, if the Exposure Draft is implemented in its current form, the direct outcome would be a significant lowering of the support for innovation in Australian businesses. As a result,, the Government risks losing scientific, information and engineering and other technical industries (and jobs) offshore, as well as reducing the development of products, technologies and processes which will boost productivity – the very lever which the Government has stated will support an aging population. Reduced effectiveness and uptake of the R&D Tax Incentive will also negatively affect Australia's Business Expenditure on R&D ("BERD").

If you would like to discuss this submission, please feel free to contact me on **0412 602 231**.

Yours sincerely

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