



Submission in Response to the R&D Tax Exposure Draft Legislation

Scope of Submission

This submission covers three topics:

1. The intention of the tax policy is to incentivise and support early stage innovation through the provision of the 45% refundable tax credit. The current drafting blocks this incentive from being available to a key innovation sector namely the commercialisation of new technologies emanating from the Publicly Funded Research Agencies, specifically universities and medical research institutes.
2. The drafting of some of the Exclusions may create unintended blockages to, or at the least uncertainties about, the application of the Act to some activities clearly intended as eligible R&D. More generally some interpretations could have unintended consequences on a wide scale.
3. The timing of the refundable credit.

The PFRA Spin Out Dilemma

The Tax proposals have acknowledged the role that the commercialisation of new technologies emanating from the research outputs of Australia's Publicly Funded Research Agencies (PFRA) to the country's innovation output. This acknowledgement is evidenced in the lift of the tax exempt ownership threshold to 50% and the availability of the 40% tax offset to all R&D Entities, including those more than 50% owned by tax exempt entities. However, the refundable tax credit remains inaccessible to the spin-out companies undertaking the commercialisation of these new innovations where it is clear the policy intent is to support such commercialisation activity.

The example below illustrates the practical nature of the problem.

The PFRA conducts research leading to a discovery determined to be appropriate for commercialisation. The PFRA creates a spin out company that is 100% owned, and licences the technology into this company.

The PFRA then seeks funding to progress the commercialisation of the technology. Typically seed funding of \$500,000 is raised for the company from taxpaying investors for an agreed 45% interest in the company. However, this funding is also typically provided in two or more tranches (say two tranches of \$250,000 for this example) which may be spread over more than one year.

By a shareholder agreement, the PBRA yields absolute control of the company by agreeing that critical decisions will require agreement of both shareholders.

While the company's R&D activity is being funded by capital from the taxpaying entity, its immediate interest in the start-up company is only 22.5% with the PBFA still owning 77.5%,

far from the 50% proposed to provide incentive for such start-ups. Even when the whole of the seed capital is invested, the PFRA still owns more than 50%.

However, assuming the investment milestones have been met, then a further round of funding is undertaken, again generally sourced from taxpaying investors, which when invested, will cause the PBRA interest to fall below 50%. In fact by the point at which the commercialisation process are concluded, the PFRA will have been diluted in percentage ownership terms to a very small interest (although ideally still one of value).

As it is beyond any debate that the policy intention of the legislation is to support the development of innovative new technologies, and the public budget invests heavily in research whose objectives include the creation of new technology, the legislation needs to provide for eligibility for such entities.

Our earlier submission in response to the Consultative Paper suggested some means to address this. We now offer another solution. All are set out below.

Solution #1 – Retrospective Eligibility

Majority tax exempt companies which have undertaken R&D and which become majority tax payer owned within three years of the expenditure, should be permitted to lodge an amended tax return and be able to claim retrospectively the 45% refundable tax offset on the basis that for the purposes of the Act they are deemed to have been eligible for the rebate from the time of the expenditure. This will incentivise the private sector taxpaying investors to support the commercial development of these new innovations.

Solutions #2 – A Higher Threshold

As an alternative, the ownership threshold limit could be raised to 60% or at the very least 51%, however, noting in many instances, this is a marginal benefit (but note in the example above, this is not a fully effective solution due to the tranching of the seed investment capital).

Solution #3 – Legislative Carve Out

A legislative carve out could be introduced to make the spin-outs commercialising discoveries and licensed from the from the PFRA eligible for the refundable credit simply on the basis that the organisation is not wholly owned by the PFRA and demonstrates to AusIndustry that it is pursuing a commercially based R&D program.

We comment further on this carve out approach later in this submission.

Exclusions

The draft language of the exclusions presents some risk to the operation of the Act as intended by its policy setting. In each case the intention of the provision appears obvious but the interpretation of the drafting could be problematic. We pose the following questions to illustrate the uncertainties.

1. Could the phrase “activities associated with complying with statutory requirements or standards” be interpreted to include any activity any activity associated with Occupational Health and Safety Standards? Virtually all lab based if not all technical development is “associated with” OH&S standards. Similarly all clinical R&D is “associated with” TGA or other regulatory standards.
2. Given that (i) all activities occurring prior to commercial production are by definition “pre-production” and (ii) in the commercialisation process virtually all R&D is incurred to move the discovery or invention towards commercial viability, will the

phrase “pre-production activities including demonstrating commercial viability” have an unintended broad impact on eligibility.

The software provisions are problematic at several levels.

3. Some innovations rest on non-software IP but make the IP available through software based product. Take the start-up Global Kinetic Corporation Ltd. Its IP is a set of data built up over many years about the characteristics of the shaking which occurs in Parkinson’s disease. Effective measurement of this shaking allows for improved prescription of medication. Today patients are only seen by their clinicians once every several months. By capturing the data through a wristwatch device powered by software (including the software that drives the accelerometer devices), transmitting this data through the use of software to a central processor, and translating the data IP through the use of software to deliver an hourly history of the data gathered with precision instead of gathered quarterly by personal observation to the clinician, patient outcomes will be improved and health costs reduced (and Australia’s export income should also benefit). It is clear the whole of this development is novel, certainly risky, etc but it is effected through software. The challenge in the drafting is that software is a universal enabler of virtually all other IP.
4. The breakout of software costs in a project is not only costly but likely problematic in undertaking this analysis. Consider the implication of the drafting to the R&D carried out for the R&D Entity by a PFRA. The PFRA will include in its costs of research an overhead charge, typically set at universal rate (or by category) across the institution. Embedded in that overhead cost is presumably an allowance for the costs of standard Office word processing, spreadsheet and other such software. Is this to be broken out and excluded? At an even more extreme, software now powers many building systems. Do we break out the overhead cost of taking the lift to the lab? While there might be consensus that such an extreme interpretation is beyond the ridiculous, nominally subsection (r) does require us to break all these costs out. The question posed by the drafting is where the line will be drawn, given the absolute language used in the drafting.

Timing

The timing of refunds should be accelerated for companies obviously without any chance of near term tax liability. It is obvious the incentive is intended to assist those start-up companies developing new technologies. Ideally such companies would be able to submit their project intentions and corporate tax profile to AusIndustry to be classified as a “Start-up” entity which would then allow the company to submit claims for the rebate say, quarterly with claims paid within 30 days.

Other Carve Outs Warranted to meet Program Objectives

R&D tax policy and its implementation will work best if it is able to recognise that those entities involved in R&D activity are not monolithic in their character. The R&D activity undertaken by a large established firm is very likely to have a different context and character to the R&D undertaken by start up firms seeking to exploit the potential of a new technology. It appears that all of the examples given of potential misuse of the R&D tax credit relate to establish businesses and most often relate to the expansion or improvement of existing products, services or customer service itself. This is relevant because the attempt to limit or define exclusions in one context may be totally counter-productive in another. For example exclusions or limitations on product prototyping may well make sense in the

context of an organisation with an existing product being sold to customers but will be adverse to the intention of the R&D incentive for the start-up company developing a totally new product.

Distinguishing between these two sectors offers net benefits to the administrative and supervision processes applicable to the rebate, while the process of categorisation of the two sectors is not burdensome. The net benefits are that each sector can be supervised according to the guidelines sensible to its circumstances, relieving AusIndustry and the ATO having to adopt one set of supervision principles that will be at times inherently contradictory, as demonstrated in the Consultative paper's own examples of undesirable outcomes. To define the two sectors is only a matter of carving out the Start-up sector – say, companies without prior revenues above \$1 million, yet to achieve profit, and commercialising an innovative technology (applying grouping principles) and placing all others in the other category.

The relevance of the context of the R&D activity extends beyond a simple contrasting of established and start-up firms. Some R&D activities exist as part of a systematic process of innovation. Venture capital funds, the new Commercialisation Collaborations and some angel investment syndicates are distinctive examples of this systematic process of identifying new technologies, creating new companies, and the subsequent conduct of R&D activity within these companies to transform the technology into products and services of value to users. As these systematic processes are typically capital constrained, every dollar of R&D tax credit will have demonstrated additionality not only within the start-up company undertaking the specific research and development but by enabling the venture fund or Collaboration or syndicate to fund additional new companies. In this context of a systematic process of innovation, restrictions on the dimensions of ownership and technical delineations between core versus supplemental activity are counter-productive to the encouragement of innovation, and to the objectives of the R&D incentive.

While such a carve out would incur upfront time and cost in the restructure of the drafting, it would produce substantial long term benefits in the form of the ability to better control the level of the tax concession expenditure, of greater flexibility of adjustment, and a lower implementation cost to all taxpayers covered by the legislation.

Context

ABOUT THE AUTHOR

The author has 38 years experience in the finance industry, and has had substantial experience to venture and commercialisation activities over the past decade. Over the past nine years he has been engaged in advising institutional investors on portfolio investment in venture capital and related areas, including the building of Australia's largest institutional venture capital portfolio. This activity has included the research and selection of numerous venture managers, and the participation on advisory committees for 10 venture funds. Based on his advice, his clients were the leading private sector investors in the 2002-3 Pre-seed Program and have been foundation institutional investors in five major Australian venture fund managers. The author also has designed and executed four “*Commercialisation Collaborations*” between institutional investors and publicly funded research bodies, which today serve 10 universities and 26 medical research institutes. He has played and continues to play an active role in the operations of these Collaborations. He has designed two other similar Collaborations, which were implemented by colleagues. The author also serves on the Board/Advisory Committee of two university commercialisation companies.

5 February 2010