

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

October 26, 2009

The New Research and Development Tax Incentive

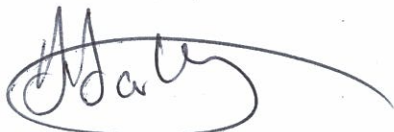
Dear Sir/Madam,

ATP Innovations is pleased to provide comment and feedback on the new research and development tax incentive program.

ATP Innovations is Australia's leading business incubator, working with entrepreneurs from the private and public sectors to commercialise technology. In 2008 our 55 client companies raised over \$33 million in capital, had revenues in excess of \$40 million, and employed more than 450 staff. The incubator is owned by four of Australia's premier universities – The Australian National University, the University of New South Wales, The University of Sydney, and the University of Technology Sydney.

ATP Innovations' response has been constructed from a series of interviews and roundtable discussions conducted with the founders and managers of early stage technology companies based in ATP Innovations' facility at the Australian Technology Park. Many aspects of the proposed program were well received by the companies; however several areas have been highlighted as of concern for early-stage R&D intensive companies. We endorse the intent to provide focus, impact and additionality for the new program, however we caution that restrictions and tightening of eligibility may impact negatively on the very stakeholders that the program is designed to assist.

Yours sincerely,



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The New Research and Development tax Incentive: Industry feedback on Consultation Paper

Summary

The ATP Innovations is the largest community of technology entrepreneurs in Australia, with close to 10 years experience working with high performing Australian technology companies to successfully build their businesses and attain leading positions in global export markets.

We welcome the Government's decision to revise the R&D Tax Incentive Scheme and believe that an effective consultation process that has been undertaken by the departments involved. This submission is in response to the Consultation Paper released in September 2009.

In general, the changes proposed will continue to support R&D activities in technology companies. Some of the proposed changes will have a direct reduction in the level of R&D claims that technology companies can claim. It is important to note, that for technology SMEs where R&D is the primary activity, if these changes are implemented without recognition of the SMEs vulnerable cash position and the importance of the R&D tax refund/credit, this will directly and significantly reduce the level of future R&D undertaken in this market segment

This response is based on an extensive feedback from our current clients and our own experience working with over 100 small to medium sized technology companies at ATP Innovations. The general profile of these companies is;

- Commercialising emerging technology
- Even spread across 3 broad sectors: IT, biotechnology/medical device and engineering
- R&D as the primary activity (>75% of all activities)
- Revenue below \$20million
- Small profit, breakeven or pre-profit/revenue
- Accessing the R&D incentive scheme between 1 – 5 years

The 2008 performance, based on consolidated figures from 55 companies at the ATP Innovations, demonstrates the value in incentivizing this sector:

- 450 Full time employees
- Employed 95 new graduates
- Attracted \$21m in private investment and \$11m in government grants
- Launched 78 new products or services
- 80% of companies had sales, generating \$40m in aggregate revenue
- Over 80% of companies have offshore activities and export opportunities

General Feedback on the current R&D Tax Incentive Scheme

Overall the scheme is very well regarded by technology SMEs for the following reasons:

- The scheme, being a non-competitive and ongoing annual program, has provided consistent and reliable government support for early-stage R&D intensive companies. The scheme plays a vital role assisting Australian companies to undertake innovative or highly risky activities by reducing their cash exposure.
- The Scheme has a material impact on the business's cash flow and consequently directly impacts the level of R&D undertaken in technology SME's.
- The refundable option for pre-profit companies is critical for supporting future R&D activities in these businesses.
- The inclusion and equal treatment of supporting activities are particularly important for technology SMEs as the cost to fund the infrastructure (i.e business overheads, pre-clinical trials, prototype production, and quality control) required for development can be inhibitory for an early-stage business and restrict the level of core R&D undertaken.
- The application process is straight forward once the systems are in place to identify and collect the information needed for the application.
- Overall the administration of the scheme is carried out well by AusIndustry.

General Feedback on the Consultation paper

The points below represent a consensus reached amongst the technology companies at ATP Innovations and how the proposed changes in the paper will impact on the level of R&D undertaken by these businesses.

Positive impact on SMEs that will directly increase the level R&D activity undertaken

- Principle 1 – Location of ownership of IP removes a barrier for foreign companies to undertake contract R&D or collaborations in Australia.
- Principle 3 – Refundable Tax credit for companies with turnover less \$20m at a rate of 45% has a direct financial benefit to the business
- Principle 4 - Improve efficient and effective administration of the Scheme will have a direct cost saving to SME's who as a whole do not rely on consultants

Negative impact on SMEs that will directly reduce the R&D activity undertaken:

- Principle 7 - Narrowing the activities that can be claimed and benefits attributed back through the program will materially reduce the financial benefit flowing back to the technology SMEs where the primary focus is on R&D. Limiting the supporting activities via any one of the options proposed will materially reduce the financial benefit flowing back to the technology SMEs through the scheme. Separating core and supporting activities will create a greater administrative burden and cost on technology SMEs. Consequently the changes proposed in Principle 7 will have a significantly reduce the level of future R&D undertaken by technology SMEs where R&D is the primary activity.

Specific Feedback by Principle and Question on the Consultation Paper

Principle 1.

The proposal to make the R&D incentive available to companies incorporated in Australia and the location of ownership of resulting IP irrelevant will most likely have a positive impact on technology SMEs. The proposed changes could remove hurdles and incentivize companies offshore to collaborate with Australian technology companies to do R&D locally. The impact of this may be stronger global networks for Australian companies leading to an increase in successful commercialisation of products, export sales and acquisition activity. Another outcome of these changes could be greater skills and infrastructure for late stage development work such as facilities and resources that are GLP, GMP compliant or FDA compliant. This would be a significant positive outcome, as currently Australia is heavily criticized for lacking these development skills and resources.

The proposal that the R&D tax credit should be open to companies with up to 50% ownership by exempt entities is positive. However many early stage, high tech, R&D based start-ups may still not be eligible for the R&D tax credit in their formative pre-seed and seed stages even though the ownership threshold for exempt entities has been increased to 50%. In most medical research institute, or university, spin-outs / start-ups the exempt entity (institute or university) often owns greater than 50% of the equity after the first (seed) round of investment – particularly when the tranching of investment payments is taken in to consideration. Furthermore, these start ups are not eligible for “public support” through other programs (e.g. from the ARC, NHMRC). We believe that there is a case for removing this ownership threshold R&D start-ups spun out of Australian Medical Research Institutes and other Publicly Funded Research Agencies. This exemption could be conditional on their turnover being less than \$1 million to make sure it was targeted at very early stage R&D start-ups.

A second point for consideration is that most of the early stage venture funds that are currently supporting the Commercialisation of Australian Intellectual Property by investing in new start-up companies (e.g. MRCF, Trans Tasman Commercialisation Fund, Stone Ridge Ventures and Uniseed) are structured as unit trusts. This means that these funds never wish to own controlling (i.e. greater than 49%) equity stakes in any of their start-up investees (as a >50% ownership by a trust in a company causes the trust to be taxed). Given these funds are often the first investors in new R&D based start-ups an increase in the ownership by tax exempt entities to over 50% would help ensure these start-ups are eligible for the R&D tax credit.

***Recommendations:** That the ownership threshold for exempt entities is either abolished (or raised to say 80%) for R&D start-ups with a turnover of less than \$1 million spun out of Australian Medical Research Institutes and other Publicly Funded Research Agencies.*

Alternatively, this threshold is raised from 50% to 51% to facilitate investments made by early stage commercialisation/venture funds structured as unit trusts.

Question 1.

To exclude all offshore R&D expense from being eligible would have a negative impact on many technology SMEs. In the overwhelming majority of the cases, offshore R&D is undertaken by these companies because there is NO alternative available anywhere in Australia. Travel, additional time required for project management, time and language differences make offshore R&D riskier and more expensive for small companies. Excluding the offshore R&D will not increase the R&D activity in Australia but reduce the technology SME's claim and therefore reduce the level of total future R&D undertaken.

Recommendation: For SME's with a turnover of less than \$20m, there should be no general rule that eligible R&D activity must be conducted in Australia provided it can be clearly demonstrated that the skill or resource is currently not available locally. The current cap of 10% should be removed or lifted to 50% on this condition of unavailable local capability.

Principle 2

The standard R&D tax Credit will be available at a rate of 40% for eligible R&D expenditure and can be carried forward as well received. The change in most cases would have a positive impact on technology SMEs.

Principle 3.

The Refundable R&D Tax Credit available to companies with a turnover of less than \$20m was well received and will have a positive impact for these businesses. An increase in the benefit flowing back to technology SMEs for R&D activity will improve their cash position and directly increase the level of future R&D undertaken.

In regards to point 38 where companies can only access refunds after their tax assessment is completed, this currently presents potentially long lead times between when the costs were incurred and when the refund flows back to the company. This lead time is challenging for small companies managing their cash flows particularly in the early stages when these entities have limited cash reserves.

Recommendation. SMEs with a turnover of less than \$20m could submit quarterly or six monthly claims and have these approved as part of BAS reporting thus allowing access to refunds during the financial year.

Question 2.

Any added level of complexity to SMEs application process will increase the cost and/or time spent for SMEs and potential errors and additional cost and/or time spent by the administering departments AusIndustry and the ATO.

Recommendation: For SMEs with a turnover of less than \$20m maintain the current rules to ensure the process does not get more complex.

Question 3.

No comments.

Principle 4.

Streamlining to improve efficiency and effectiveness of the process is welcomed by technology SMEs as this would have a direct cost saving to SME's who have limited staff capacity to undertake the application process and are less likely to engage consultants.

Recommendations: The following points would improve the process i) Appropriate level of guidance and ii) one helpline rather than split between AusIndustry and ATO. For SMEs with a turnover of less than \$20m, the current position that companies do not have to identify core and supporting costs should be maintained. What is core and what is supporting activities can be very subjective and would add a significant level of complexity and time for SMEs and the Government administrators.

Principle 6.

Changing the definition of eligible R&D activity to "innovative and technically risky", in principle would not have a material impact on technology SMEs. Following consultation sessions and other presentations by the Government, the sector understands that the definition has been changed to cull projects that are not true R&D i.e air strips at mine sites. If the changes to the program are administered with this intent then technology SMEs with a primary focus on R&D should not be disadvantaged.

However, the Program should be aware that good R&D by its nature is incremental to minimise technical risk in a highly innovative environment. Thus costs for R&D programs in the majority of cases will reflect incremental change, improvement or optimisation in order to minimise the risk of technical failure. With the new definition, the Government and its administrators should make a conscious decision not to limit claims on increment R&D as it would consequently discourage companies undertaking industry best practice in R&D. .

Recommendations: All claimants continue to demonstrate the innovation and technical risk in their R&D projects but should additional requirements be added to demonstrate the validity of the R&D project then SME's with a primary focus on R&D should be exempt as this brings additional complexity to the process and increases the costs to SMEs to access the program.

Principle 7.

Limiting claims for supporting R&D will have a significant impact on SMEs with a turnover of less than \$20m and was not welcomed by the industry. For SMEs with a primary focus on R&D such as those companies developing emerging technology, 75% or more of their costs are research related. R&D activity is always a priority and other costs are incurred only if absolutely required for that business to function and to maintain the R&D. The cash positions of growing businesses are fragile and a direct reduction in their R&D claim would reduce their capacity to undertake future R&D.

Recommendations: For SMEs with a turnover of less than \$20m, the current position should remain that supporting costs are treated the same as core costs. For SMEs with R&D as their primary focus, the supporting activities are critical to the core R&D and in general are small in proportion to the core R&D costs. Exempting SMEs (<\$20m) from changes limiting supporting costs would be unlikely to have a material financial impact on the Scheme and would continue to make a significant contribution to the level of R&D undertaken by this business segment.

Question 4.

All five options have potential to reduce the claims for SMEs with a primary focus on R&D. Thus adopting any of the options (a – e) would directly reduce the level of R&D undertaken by SMEs which is not the intention of the changes. SMEs with a turnover of less than \$20m should be exempt from Principle 7.

Recommendations: For SMEs with a turnover of less than \$20m, the current position should remain that supporting costs are treated the same as core costs. For SMEs the supporting activities are critical to core R&D and in general are small in proportion to the core R&D costs. Exempting SMEs (<\$20m) from any of the five options listed in Question 4 would make a significant contribution to the level of R&D undertaken by this business segment.

Question 5.

If SMEs with a turnover of less than \$20m are exempt from Principle 7 then the list is irrelevant for this group of applicants. However should that not be the case, then this list should not contain activities that are critical to the development of new technology. We strongly disagree with the statement in the Consultation paper that “developing markets, pre-production planning or get production or control systems working” does not add as much benefit to society as core R&D. Australia is recognised as being very good at developing IP but strongly criticized for lacking the resources and skills to develop IP. The activities outlined here greatly benefit Australia by building capability to bring smart technology to market. By excluding activities which support product development the R&D Scheme could incentivize research at the expense of development.

Recommendations: For SMEs with a turnover of less than \$20m, the current position should remain that supporting costs are treated the same as core costs. Excluding some activities (market research, quality control, pre-production and patent filing) essential to good R&D from core will reduce the value of the claim and consequently reduce the ability of a SME to do future R&D.

However if this is not considered and the core activities that SMEs can claim is narrowed and the treatment of supporting costs results in a lower benefit back to applicants then the following activities should be removed from the exclusion list:

- a) Marketing research, market testing and market development*
- b) Quality control*
- h) Pre-production activities*
- k) Commercial, legal and administrative aspects of patenting*

Software: Question 6.

The consultation Paper raises valid issues around how software R&D is treated by the current R&D Tax Incentive Scheme. We agree with the fact that the Multiple Sales Rest is only applicable to a segment of IT development and restricts a broader group from accessing the program.

Recommendations. Any proposed changes should ensure that, like other industries, IT development to be eligible needs to fit the definition of R&D - being innovative and technically risky. It should be noted that IT development in SMEs (<\$20m), in general, will have lower R&D costs than other industries and so broadening the definition for IT SMEs may not have a material impact on the Scheme and will have a direct impact on the ability of technology to undertake a higher level of future R&D activity.

This group had no comments on the UK system proposed and looks forward to reviewing more specific proposed changes.

Appendix

Methodology

The comments and feedback for this paper were gathered by ATP Innovations from the technology companies that are based at the National Innovation Centre at the Australian Technology Park, Eveleigh Sydney. A general consultation process was undertaken within the ATP Innovations group of companies. The R&D Tax Incentive Consultation paper was circulated to all fifty-five companies with invitations to send comments or feedbacks to the directors.

In addition, individual companies were interviewed to capture the general experiences and impressions of the current R&D Tax Concession and more specifically on the Consultation Paper. Ten companies were used in face to face interviews to gather more in depth information of their experiences and views on the Consultation paper.

About ATP Innovations

Based in Sydney, ATP Innovations is Australia's leading business incubator, working with entrepreneurs from the private and public sectors to commercialise technology. We offer entrepreneurs and investors access to extensive business expertise, experienced technology and business community and world class offices and laboratory facilities. ATP Innovations is the largest community of technology entrepreneurs. A strong track record of building high-growth companies and the dynamic mix of technologies and industries, combine to help entrepreneurs build better businesses faster.