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Submission on new R&D Tax Incentive

Please find the attached submission from Uniseed with our feedback to the new research and development tax incentive consultation paper.

Yours sincerely,

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Uniseed Submission on R&D Tax Incentive Scheme

Introduction

Uniseed welcomes this policy initiative as an essential stimulus to technology innovation in Australia. However we would like to stress that the majority of tomorrow's technology leaders will emanate from publicly funded research organisations (PFRO) and that under the proposed structure these companies may be left without support due to the 50% exempt entity ownership limit and the group turnover test.

The innovation system in Australia is fortunate to be supported by a number of early stage Commercialisation Funds (such as Uniseed), that invest directly in companies based on early stage technical promise. These funds bear the brunt of the early developmental risk. Under the proposed scheme, this high risk R&D investment will not be eligible for the R&D Tax Credit which will disproportionately disadvantage these companies. Furthermore, other investors (angel investors or venture capital firms) will be discouraged from making riskier early stage investments, as their effective cost of capital would be increased relative to later stage deals.

It is important to note that relaxation of the 50% limit on ownership and group turnover rules will only have small impact on the Government's taxation revenue, yet a major impact on the competitiveness of R&D intensive start-ups, as the typical investment at this stage is less than $500,000. When these early stage companies achieve milestones and successfully raise follow-on capital, exempt entity ownership limits would fall below 50% through the follow-on investment by other investors (e.g. venture capital funds). Consequently, it is during the first (seed) rounds of investment that the company is unable to draw on the R&D Tax Credit, which is arguably the time that the company needs this most.

Consultation Paper Point 22: Tax Exempt Entities

The proposal that the new R&D tax credit will be open to companies with up to 50% ownership by tax exempt entities (such as universities) creates the potential to significantly stifle the innovation process as most university based start-ups will be ineligible. It is strongly suggested that this threshold be raised considerably (to 90%), or that an exemption to this rule is made whereby university start-ups funded by commercialisation funds or other legitimate investors are eligible.

The reasons for the suggested change are:

1. In the majority of university start-ups the university still owns >50% of equity after the first (seed) round of investment.
2. Furthermore, some commercialisation funds, a major source of financing of university start ups, have university shareholders, further increasing the university's equity.
3. These start ups are not eligible for traditional university support through public programs such as the ARC or NHMRC.
4. The proposed 50% rule will exclude most of these start-ups from making a claim.
5. This will effectively stifle the innovation process (these start ups are first link in process) and will disadvantage commercialisation of publically funded research (which contradicts the Government's stated intention for the R&D tax changes being considered)
6. It is noteworthy that previously the limit was lower (25%) but this was only for the R&D Tax Rebate. That is, previously these start-ups were all able to claim the 125% R&D Tax Concession - but now they won't be able to claim anything!

A detailed explanation of this issue is provided as an Appendix to this paper.

Recommendations

Uniseed recommends removal of the 50% limit altogether and inclusion of a condition that university or similar start-ups need to be funded by external (arms length) investment from commercialisation funds or some other legitimate investor. Commercialisation funds/investors may need to be pre-qualified (a once off approval process) which may include criteria such as the fund having multiple shareholders or a superannuation fund as limited partner or that the tax exempt shareholder does not have the sole power to exercise control over critical business matters. This qualification process could be carried out by Innovation Australia or alternatively AusIndustry or the Commonwealth Commercialisation Institute. An alternative is to raise the 50% limit to at least 90%.

In either scenario above, non-PRFO (external) funding will still be necessary to trigger eligibility. Universities will not be able to start up companies alone and receive the benefit of the tax credit. That is, this still provides protection against the R&D Tax Credit being used to fund non-business R&D that could receive public support through other programs or is indeed not truly commercial in nature. It is noteworthy that university start-ups cannot access public funding such as ARC Linkage.

In addition, interests held by publicly funded research organisations in early stage commercialisation funds should not be taken into account in any tax exempt tests applied.

Consultation Paper Points 16 & 37: Group Turnover

Further to the description above, we are concerned that university start-ups will also be ineligible based on the group turnover test, as universities who are shareholders in start-up companies have a turnover of >$20 million.

Recommendation: Specifically exclude publicly funded research organisations, or more generally, exclude the turnover of tax exempt entities from the group turnover test.

Consultation Paper Point 26: R&D Conducted in Australia

Question 1: Exceptions to the general rule that eligible R&D must be conducted in Australia

In the biotechnology industry, for example, there are often situations whereby a specialised component of the R&D has to be conducted outside Australia. This is especially true of human clinical trials that may be required to be done in multiple countries prior to registration of the new product. Alternatively, facilities for specific preclinical development may not be available (e.g. use of specific animal species) or there are occasions where some activities are better conducted overseas as an overseas provider may provide a superior service to a local one or may be able to conduct the activity faster and to a better quality standard. This is certainly the case with outsourcing preclinical research studies in biotechnology. For example, companies may choose to conduct an animal study in a U.S. university because the investigator is considered a key opinion leader, and this will add more weight in commercial discussions and will improve the chance of success of licensing the product to a pharmaceutical company.

Recommendation: If no suitable alternative exists in Australia, activities conducted overseas should be exempt from the 10% cap on overseas expenditure. If there is an alternative in Australia, overseas R&D needs to be justified in terms of what value it offers the overall development program (e.g. time, cost, quality), rather than just availability.

Consultation Paper Point 38: Access to Funds

The Paper proposes that start-ups can only access refunds after their tax assessment is completed. This presents start-up companies with a cash flow challenge. Indeed they may not have the cash to be able to continue as viable entities long enough to claim their refund. If credits / payment could be preapproved in a quarterly online registration of claims system small start-ups would be able to manage cash flow and investment with a significantly more confident manner. These could be in line with BAS returns.

Recommendation: We recommend that small start-ups be able to claim their R&D tax refunds on a quarterly basis, possibly at the same time as their BAS statement.

Principles 6 & 7: Definitions of Eligible & Supporting R&D

It is proposed that eligible R&D involves innovation AND high levels of technical risk. It is possible that some parts of the R&D process use standard research methodology and are therefore not necessarily innovative but are essential to the R&D program and still considered to have high technically risk.

Recommendations: Innovation should be assessed using the overall project objectives, while methodology should be used to assess technical risk. Furthermore, software R&D, and research in social sciences, arts and humanities should be eligible if this research meets the above criteria.

Appendix:

Detailed Explanation Regarding Point 22: Tax Exempt Entities

University Intellectual Property (IP) Policy

Most universities in Australia operate under a 'splits' agreement whereby the commercialisation/technology transfer office/holding entity of the university (e.g. UniQuest) holds equity in a start-up company on behalf of the university and the researcher/inventor employed by the university. A typical arrangement is that any commercial returns to the university are 'split' with the investors, who usually receive 30-40% after the university commercialisation office's costs are deducted.

Company Incorporation

Investments in university start-ups are typically made into an incorporated company limited by shares. It is noteworthy that these companies are not eligible for public support through programs such as the ARC and NH&MRC, though they can receive government funding through COMET, Climate Ready and some other programs.

License to the Initial Intellectual Property

The typical university spin-out investment is based on intellectual property (IP) owned by university. Most commonly this IP relates to one or more patent applications which are the result of the inventive work of the university's researchers.

These patents are made available to the company through the establishment of a license between the spin-out company and the University, or to be precise, the holding entity of the University.

The license would normally be world-wide and exclusive and hence provide sole access to the company to commercialise the IP. The University would also usually be granted back a sub-licence giving it the right to continue research in the field unimpeded. The start-up company would usually bear the costs of prosecuting the patents whilst the license is in force.

Due to the amount of research funding required to develop IP to a stage where investment is justified, university technologies are typically valued above $500,000 at the time a company is incorporated or an investment is secured.

The University (or its holding entity) receive a payment of the IP value (>$500,000) for licensing the IP to the start-up company. In return, the university (or its holding entity) apply for equity in the company – usually to the value of the IP license. The university typically receives Ordinary shares in the start-up company.

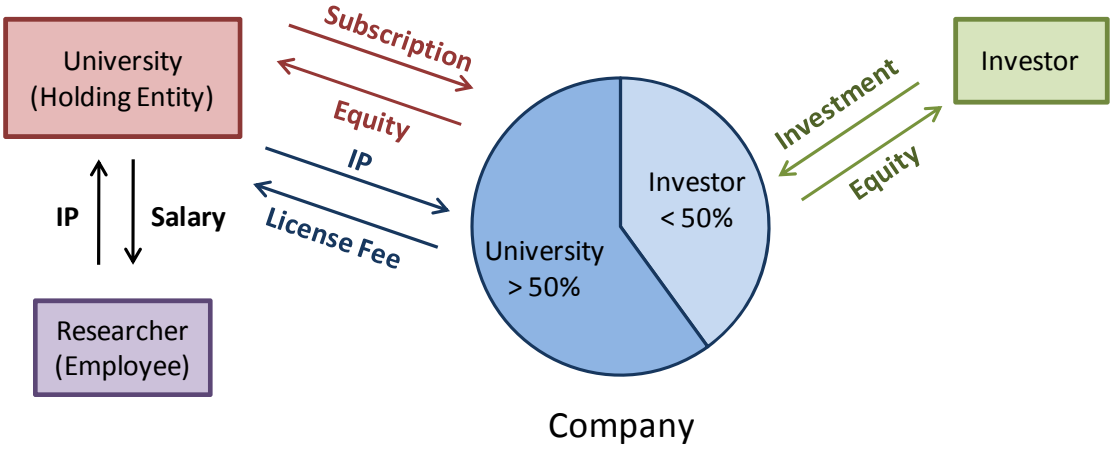
Seed Investment

Due to the early stage of investment, the investor (often a commercialisation fund) is usually the only investor in the start-up, with the investment made for Preferred equity in the company. Typically, a commercialisation fund such as Uniseed would invest less than $500,000 in milestone based tranches.

In addition, commercialisation funds typically invest through a unit trust structure. It is noteworthy that these trusts cannot hold >50% of the equity in the start-up as trading trust provisions would be triggered, and the trusts would lose their flow-through tax status.

Consequently, after investment, the shareholders in the company are the commercialisation fund (<50% equity) and the University holding entity (>50% equity).

The diagram below illustrates a typical university start-up:



Intellectual Property – Assignment

The IP license includes a provision for assignment of the intellectual property at a later stage, usually on the basis of certain milestone(s) being achieved. These milestones may be an event such as demonstration of a pivotal research result, listing on an exchange or reaching a threshold of total capital raised ($1m being a typical amount so as to trigger assignment at the next round of investment).

New Intellectual Property

Any new IP developed through the seed investment is owned by the company. Thus over time it is common that the company's intangible assets would include a mix of the initial patents and those developed within the company itself.

Commercialisation Funds and Public Research Organisations

Commercialisation funds, as distinct from traditional venture capital funds, play a crucial role in seeding investments from public research organisations in Australia and bridging the gap between academic research and the traditional investment markets. That is, these funds invest at the earliest and most risky stage – the investment leading to start-up formation. Consequently, the activity of these funds contributes directly in regard to the case for R&D tax reform – that an effective R&D tax incentive needs to result in firms conducting R&D that they would otherwise not perform because they cannot capture sufficient benefits from the activity to justify an investment (Consultation Paper point 12).

These funds are characterised by an investment partnership between Australian superannuation funds and public research organisations. The funds operate as a stand-alone entity, with investment decisions made independently of the university partners.

Today, all major Australian (Go8) universities and major research organisations are associated with a fund of some sort, examples being Uniseed (Universities of Queensland, Melbourne and New South Wales), the Trans-Tasman Fund (Auckland, Adelaide and Monash Universities) and the Medical Research Commercialisation Fund (MRCF) (over 25 medical research institutions in Victoria, NSW, Queensland and Western Australia). Effectively, these funds now play the role that the Federal Government's Pre-Seed Fund (PSF) was designed to deliver.

Commercialisation Fund Example: Uniseed

Uniseed, established in 2000, was the first fund of this type in Australia. Uniseed is a $61 million commercialisation fund operating at the Universities of Queensland, New South Wales and Melbourne. Since it was established, Uniseed has evaluation over 200 potential investment opportunities and made 35 investments across a range of technology sectors including biotechnology, cleantech, materials science and IT, with three investments exited through trade sale or IPO. Uniseed has committed over $27 million to these start-ups, and this commitment has generated over $186 million of investment from venture capital firms and other investors.

Unit holders in the Uniseed trusts are Westscheme (Western Australia's largest non-government superannuation fund) and the three universities in which Uniseed invests. These four unit holders each contribute 25% of the total investment made. Uniseed is a stand-alone entity and makes investment decisions independently of its university shareholders. Consequently, a further risk of the 50% limit rule is that equity held by commercialisation funds on behalf of its university shareholders is also included in the calculation of the 50% limit.