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The new Research and Development Tax Incentive

Thank you for the opportunity to make a submission regarding the new research and development tax incentive.

Starfish Ventures is an Australian-owned venture capital firm with $400 million under management. Starfish Ventures invests in innovative, globally competitive technology companies with an Australian base including information and communication technologies, life science and clean technology. We are passionate believers in innovation and its ability to create high value jobs and exports for Australia.

Early-stage technology companies are on the cutting-edge of innovation. A mix of strong technology with a skilled and visionary management team can create businesses with global impact. This has already been proven in Australia from successful venture-backed companies like ResMed, Hitwise, and Cochlear. Australian-born companies like these will continue to emerge and can flourish with a supportive R&D tax incentive.

A strong R&D tax incentive has the potential to position Australia as a global innovative leader while retaining and recruiting a high-skill work force. It is of critical importance, therefore, that the eligibility requirements of the Government's new tax incentive do not unduly limit R&D activities. **In its current proposed format, the R&D tax incentive has the potential to severely limit innovation and business creation.**

An R&D tax incentive that supports early-stage companies will prove a strong asset for Australia's global economic competitiveness. As such, this submission addresses several design questions outlined in the consultation paper while proposing that the Government extend the definition of eligible R&D activity for early stage companies supported by government-sponsored innovation programs and/or venture capital funding.

We also make an additional proposal to expand the R&D tax incentive to include Australian superannuation funds with the aim of increasing the investment in innovative, early stage companies.

PART 1 - Addressing Design Questions
Design Question 1: Should there be an exception to the general rule that eligible R&D activity must be conducted in Australia?
By limiting eligible R&D activity to Australia-only, the Government is limiting the ability to conduct critical core R&D while discouraging global collaboration. This applies to clinical trials for life science companies as well as with IT and cleantech sectors where vital testing equipment does not exist in Australia.

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Starfish Ventures backed company, Mimetica, is a case in point. Funded from the Government's Pre Seed Fund program, Mimetica is developing a topical treatment for acne that lacks the serious side effects of the current treatments on the market. Approximately 95% of Mimetica's R&D is contracted to overseas providers because there are no suitable clinical trial providers in Australia. The benefits of Mimetica's R&D accrue in Australia, yet Mimetica cannot access the R&D tax rebate which would support the company to further develop its product portfolio.

A related issue is when the technical expertise to conduct the R&D is available in Australia but its cost structure is not globally competitive. In this case Australian companies may forgo the R&D activity altogether due to the cost burden of pursuing the R&D in Australia. This is not in the best interest of Australia and we believe that a scheme that allowed access to more cost effective international research providers would lead to a more competitive local market.

Recommendation: Eligible R&D activity can include overseas R&D when it is proven that such activities cannot be easily replicated in Australia. We also recommend that a cost threshold be implemented. If the Australian-based cost of the R&D activity exceeds 60% of the overseas cost, then the overseas R&D activity should be eligible for the tax incentive.

Design Question 5: Should the current list of activities excluded from being considered core R&D be amended in any way?
A significant expense for early-stage technology companies are the commercial, legal and administrative aspects of patenting their innovative intellectual property. With an average cost of $100,000 per patent, early-stage, cash strapped companies must overcome considerable expense to protect their IP, which is their most vital asset. By extending eligibility to patent expenses and making the process less costly for emerging businesses, Australia is creating an incentive for companies to continue to pursue innovation.

Recommendation: Patent expenses, including commercial, legal and administrative aspects, are included in eligible R&D activity.

Design Question 6: How should the new R&D tax incentive treat software R&D?
Software has become a fundamental part of our economy. Australian success stories like Hitwise and Wotif.com are products of this development. Given the integral nature of software companies and software development in the global economy, software R&D eligibility should be treated similar to other R&D activity in the tax incentive scheme.

The consultation paper outlines the UK standards as a potential way to define eligibility for software R&D. This list is so restrictive in its nature that most software companies would not be eligible for the tax concession. If the Government was to adopt a similar definition, two outcomes could occur:

1) A decrease in software company start-ups in Australia, as the costs of innovation outweigh the benefits of pursuing a business venture;
2) Software R&D will go off-shore where there are more economical options for companies, taking valuable jobs away from Australians. Currently, South-East Asian countries like India are very attractive places to conduct software R&D activities because of its lower relative R&D costs.

Of particular note are internet-based software applications. The proposed guidelines exclude the expenditure of R&D for internet-based companies, limiting Australia's opportunities to build the next Hitwise or Ebay. The Government has already substantiated the need for the next generation of internet-based innovation with the implementation of the National Broadband Network. Additionally, as a sign of the value of internet-based businesses, venture capital firms globally are increasingly focusing funding on software companies which are solely or predominatly internet based.

Internet based software has become a critical factor in developing IT companies and R&D activities centered on the creation of websites or web-based software should be eligible for the tax concession. This is such an important element in today's internet-based world that we recommend the definition for eligibility for these activities be extended so that it is eligible if the activity is innovative ***or*** technically risky.

<u>Recommendation</u>: Internet-based software and internet related R&D that prove to undertake innovative ***or*** technically risky activities are eligible for the R&D tax incentive.

PART 2 – PROPOSALS

In addition to the recommendations posed above, we also believe it is important that the Government provides greater incentives for early stage innovative Australian companies to pursue R&D activities.

<u>Proposal 1 - Incentives to boost investment in early-stage innovation by the superannuation industry</u>

The current R&D tax review provides a valuable opportunity for the Government to further boost investment and support for early stage, innovative Australian companies to pursue R&D activities. The Government has already acknowledged this lack of funding and market failure through the creation of the well received Commercialisation Australia institute.

Now there is an opportunity to create a compelling incentive for the superannuation fund industry to invest in innovation and commercialization to help address the funding need.

We propose that superannuation funds which invest in eligible companies (as defined below) be themselves eligible to participate in the R&D tax incentive. Specifically this means a superannuation fund is entitled to a proportional interest of the R&D tax incentive received by the eligible company. The proportion would be based on the superannuation fund's relative ownership of the eligible company. For example, if a superfund invests $1,000,000 in an eligible company for a 10% equity stake and the company spends $1,000,000 in eligible R&D activity, 10% of the rebate is paid to the superfund, with the company receiving the remaining 9%. This benefit to superfunds would be limited to the investment amount made into the eligible company.

<u>Proposal 2 – Expanded definition of Eligible R&D</u>
We propose that the definition of Eligible R&D be expanded to activity that is innovative ***'or'*** technically risky for companies that meet the following criteria:

- Less than $20 million in revenue
- Have received support from government-sponsored innovation programs or venture capital funding.

We make this distinction because the test of securing government-sponsored innovation support or venture capital funding ensures the R&D activity addresses Principles 5 and 6 as outlined in the Consultation Paper.

Innovation programs recipients for this extended definition include both federal and state-based programs such as: COMET, Pre Seed Fund, Commercialisation Fund, VCLP, IIF, and IIFF, among others.

Additional guidelines for eligibility for the R&D tax incentive

- Eligible R&D activity can include overseas R&D when it is proven that such activities cannot be easily replicated in Australia. We also recommend that a cost threshold be implemented. If the Australian-based cost of the R&D activity exceeds 60% of the overseas cost, then the R&D activity should be eligible for the tax incentive.
- 100% of patent expenses, including commercial, legal and administrative aspects, are included in eligible R&D activity.
- Web-based software and web-based hosting R&D that prove to undertake innovative ***or*** technically risky activities are eligible for the R&D tax incentive.

By implementing such a proposal, the Australian government can continue to foster innovation, new business development and create more high value jobs in Australia.

We welcome the opportunity to discuss these matters with you further.

Respectfully,

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