26 October 2009

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

Dear Sir/Madam,

Submission on New R&D Tax Incentive Consultation Paper

UniQuest welcomes the Government's initiative to restructure the tax incentive program relating to Australian R&D activities, and is pleased to provide the following response to the Government's Consultation Paper.

UniQuest has been involved in the commercialisation of intellectual property and research capabilities from Publicly Funded Research Agencies (PFRAs) for 25 years. It now provides commercialisation services to:

- The University of Queensland;
- The University of Wollongong;
- The University of Technology, Sydney;
- James Cook University;
- The University of Tasmania;
- The Mater Medical Research Institute;
- The Australian Research Council Centre of Excellence for Integrated Legume Research; and
- The Australian Research Council Centre of Excellence for Functional Nanomaterials.

UniQuest has assisted these research institutions in the translation of their research outcomes to commercial use, by licensing technologies to major corporations and the formation of new Australian companies (start-up companies). Intellectual Property commercialised with UniQuest's assistance now underpins the sale of products and services around the world worth US$5.2 billion per annum, generating a return to a range of Australian companies, research institutions and the economy in general.

It has long been recognised that Australia has an internationally competitive research sector but has struggled for a range of reasons to effectively commercialise the results of that research for the benefit of the economy and society as a whole. Recognising this, the Government undertook a most comprehensive review of the National Innovation System, the results of which are found in the review report "Venturous Australia" and the Government's response "Powering Ideas".

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The formation, financing and growth of start-up companies is an effective mechanism for the commercialisation of new innovations utilised throughout the world, and has been supported by the Government through a number of policy and program initiatives, including those managed by Innovation Australia.

UniQuest has assisted the formation and financing of over 60 Australian start-up companies. While not a venture capital investor itself, UniQuest is supported in this important activity by:

- Early-stage Venture Capital funds, an industry which has grown substantially over the past decade;
- Dedicated Commercialisation Funds, focused on seed financing for start-up companies emanating from PFRAs and Medical Research Institutes, such as Uniseed and the Medical Research Commercialisation Fund;
- Angel investors, which are now emerging as a significant source of finance in Australia; and
- Strategic investors from the corporate sector.

UniQuest welcomes the direction of the Government's proposed changes to the R&D Tax incentive regime, which will provide greater support for innovative SMEs, including start-up companies. However, UniQuest strongly recommends that the Government revise its approach to the limits on grouped revenue and shareholdings by tax exempt entities. As they are presently drafted, the limits will exclude many innovative start-up companies emanating from PFRAs and Medical Research Institutes, supported by the funding organisations above, from the full benefit of the R&D Tax incentive. Such companies should be equally as eligible for the full benefit of the proposed Refundable Tax Credit as other innovative Australian SMEs. To treat them differently may well generate a comparative barrier to investment in Australian public sector innovations.

UniQuest's detailed response is attached and follows the format of the Government's Consultation Paper.

We look forward to working further with the Commonwealth Government in developing the R&D Tax incentive program. Should you have any questions in relation to this submission, please contact me or Andrew Davis at UniQuest.

Yours sincerely,
UniQuest Pty Limited

David Henderson
Managing Director

The new research and development tax incentive

Consultation Paper –

Response by UniQuest Pty Limited

26 October 2009

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ACCESS TO THE NEW INCENTIVE

Principle 1

The new R&D tax incentive will be available to companies incorporated in Australia for R&D conducted in Australia. Location of ownership of the resulting IP will not be relevant.

Companies incorporated in Australia

1. Australian Incorporated Entities – UniQuest supports the incentive being available to Australian tax paying entities. As the Government intends by this principle, the critical element is that the R&D is predominantly undertaken in Australia (see paragraph 27). Hence, R&D activities will contribute to both economic activity and the enhancement of Australia R&D capacity, both of which have spill-over effects for the economy and international competitiveness.

2. IP Location – This is a useful amendment as the intent would be for core R&D activities to be undertaken within Australia, without a limitation upon ownership and hence, potentially, the economic benefit derived by requiring Australian ownership of the resulting IP. The cost of developing such IP by Australian companies should not effectively be increased by falling outside the incentive regime.

3. Grouping Provisions and Tax Exempt Entities – UniQuest welcomes the proposal to increase the limit on ownership by tax exempt entities in relation to the Refundable R&D Tax Credit from the present level under the R&D Tax Offset. However, we believe that the proposed grouping provisions and 50% limit on tax exempt ownership will result in a significant number of small Australian companies, focused on the development of innovative products and services, being excluded from the benefit of 45% Tax Credit. These are companies founded on public sector research outcomes.

4. We believe that this would be inconsistent with the objectives of the National Innovation System review and the resultant report "Venturous Australia", as well as some of the initiatives since announced by the Government, such as the formation of the Commonwealth Commercialisation Institute.

5. Public sector research organisations, such as universities, have founded a significant number of Australian start-up companies, which have been supported with financial and management resources by the early stage venture capital community, angel investors and strategic corporate investors. UniQuest alone has formed over 60 start-up companies, founded on intellectual property developed at the University of Queensland and other Australian research institutions. Two of these have gone on to list on the Australian stock exchange, some have been acquired by larger corporates and many are still operating as stand-alone companies. The start-up company pathway is a proven mechanism for the translation of public sector innovation to industry application.

6. There is no corporate sector for which the efficient management of capital is more critical than start-up companies and SMEs. We believe that companies operating in this sector would clearly be the target of initiatives such as the new R&D Tax Credit program, but a number will be excluded if a number of the provisions outlined in the Consultation Paper (and described below) are implemented.

7. Many of the venture capital (VC) investors in this sector are structured as unit trusts, and as such are not permitted to take a controlling interest in start-up companies. Hence, unless there is more than one VC investor in companies founded by a public sector research organisation, then the start-up company will fail both the grouped turnover test (<$20 million) and the tax exempt shareholding test (<50%) that would permit the start-up entity to claim the 45% Refundable R&D Tax Credit, at the period of the company's life where it would most benefit from it.

8. In circumstances where investors were able to take a majority interest, the availability of the Tax Credit should not become a driver to the structure of an investment in a start-up company. The equity positions of the founding public research organisations and the incoming investors should be representative of the relative value of the underlying intellectual property assets of the company and the cash to be invested. By prescribing a limit of <50% ownership by a tax exempt, or even a higher figure, the result is that the higher the value of the Australian intellectual property, the less likely it is that the start-up company founded on that IP will be able to benefit from the higher rate and refundable Tax Credit. Putting this another way, the lower the perceived value of the IP, the greater chance it has of obtaining the benefit of the Tax Incentive.

9. Further, such a structure may lead to investments being made at values substantially less than might be obtained in other capital markets, which provides little incentive for Australia's researchers to develop and commercialise their intellectual property in Australia.

10. On the grouped turnover limitation, we assume that the Government is seeking to exclude large corporations from the refundable credit regime, as they are seen to be of a size and having the capital resources to finance their R&D activities without such a benefit. This is not the case with start-ups in which universities hold a substantial interest.

11. While many Australian universities are actively supportive of the commercialisation of their R&D outputs, they see this activity as best being driven by the external commercial world and the financing of start-up companies falls largely outside the universities' core mission of teaching and research. Some universities have taken the step of providing capital to early stage venture funds (see paragraph 17), but have done so in such a way that these funds are managed at arms length to the university by professional venture fund managers.

12. Further, the typical investment structure for many start-up companies sees the investors obtain preference shares with the founding university holding ordinary shares. The rights attaching to the preference shares typically provide that major decisions relating to the business or application of capital for the investee company require the consent of the investors or their representatives on the Board of the company. Hence, the tax exempt entity is typically not in a position to exercise absolute control over critical business matters, despite being seen to be the majority shareholder by virtue of its Ordinary Shareholding.

13. We would argue that start-up companies which are members of groups based on public sector research organisations, such as universities, should be treated quite separately to those companies which are part of a large corporate tax payer. On both the grouped turnover and tax exempt shareholding provisions, it is important that the focus is on the substance rather than the form of the arrangements. It is difficult to see how an early stage company, developing ground-breaking Australian intellectual

property from the public research sector should be given less incentive from a R&D focussed tax policy than a company that the investment community has deemed to be of lesser value and potential. This would appear to be inconsistent with the Government's policy objectives for the Australian innovation system.

14. **Recommendation: The grouped turnover limit of $20 million should not apply to companies which are part of a public sector research organisation's group of companies.**

15. In recommending this, we recognise that the Government may be concerned about this providing a mechanism for funding structures for University research through wholly-owned subsidiaries. Hence, we make the following recommendation in relation to the ownership interests of tax exempts.

16. **Recommendation: Rather than the proposed limit on tax exempt ownership of 50%, the qualification test should be that there has been an arms-length and substantive investment in the applicant start-up company.**

As an alternative, the test may be that the tax exempt shareholder does not have the ability (in its own right) to exercise Board or member control over critical business matters (to be defined) such as the application of the company's capital.

17. As previously mentioned, a number of public sector research organisations have contributed capital to pre-seed venture capital funds or "commercialisation funds" as they are known in the industry. These funds are established to bridge the funding gap between universities and traditional venture capital. Uniseed (http://www.uniseed.com) is an example of one of these, with its partners being the Universities of Queensland, Melbourne and New South Wales, and Westscheme. These commercialisation funds have become an important part of the funding continuum for public sector founded start-up ventures. While universities are amongst the founding investors and are therefore beneficiaries of these commercialisation funds, typically as unit holders in a trust, they have been established separate to the universities and have experienced investment managers running their operations.

18. Under the structure of the existing R&D Tax Offset, the tax exempt ownership or beneficial interest test meant the interest of universities in these funds was taken into account in the tax exempt test. Where universities and other public sector research institutions wish to support the commercialisation of their intellectual property through investment in a commercialisation fund, the R&D tax incentive regime should apply equally to those funds for their having contributed as it would if a private sector entity had contributed.

19. **Recommendation: The interests held by public sector research organisations in early stage venture funds (Commercialisation Funds) should not be taken into account in any tax exempt tests applied for the R&D Tax Credit.**

20. We note that paragraph 22 of the Consultation Paper states that the "new Refundable R&D Tax Credit will be open to companies with up to 50 per cent ownership by exempt entities (such as universities). This is double the 25 per cent cap that exists under the current R&D Tax Offset." However, unlike paragraph 16 of the Consultation Paper (which makes it plain that firms that don't qualify for the 45% Refundable R&D

Tax Credit under the proposed grouping provisions would be eligible to access the 40% Standard R&D Tax Credit), paragraph 22 is silent as to the eligibility of companies with more than 50% ownership by a tax exempt for the R&D Tax Credit at any level. We assume that under the proposed terms it is not intended that such firms be excluded from the incentive program, as this would again be inconsistent with the Government's policy objectives for the promotion of innovation and commercialisation, but would be eligible for the Standard R&D Tax Credit.

21. **However, if this is the intent then UniQuest would argue strongly that companies with more than 50% ownership by a tax exempt for the R&D Tax Credit should be eligible to claim the R&D Tax Credit**. Under the present R&D Tax Concession arrangements, such companies, while not able to obtain the Tax Offset, are able to claim a deduction at the concessional rate. As mentioned, there a number of professional investment organisations, such as venture capital and commercialisation funds, which finance university-founded start-up companies, and these companies may still be majority-owned by the founding institution post-investment, particularly in their early life. To exclude such companies from the R&D Tax Credit program would make investment in this sector far less attractive to such investors, and greatly impede the start-up pathway as a valid and proven route for commercialising intellectual property in this sector.

R&D to be conducted in Australia

Question 1

Should there be any exceptions to the general rule that eligible R&D activity must be conducted in Australia?

22. Australian Universities by their very nature nurture and encourage innovation in Australia.

23. While UniQuest supports the principle that the R&D Tax incentive should support the conduct of R&D within Australia, it should be recognised that some components of an R&D program may not be undertaken in Australia due to lack of local expertise or it is inefficient to do so.

24. Under the current R&D tax concession, a limitation of 10% of the Research Budget for overseas eligible expenditure may be claimed where those activities cannot be conducted in Australia. UniQuest believes that some provision for overseas conducted activities be retained with the incentive, but that the scheme provide for the inclusion of overseas activities based on substance over form and impose a requirement for non-Australian R&D expenditure to be able to validate that.

25. For example, in the life sciences, in order to achieve international product registration and produce valuable export income for products such as the Gardasil cervical cancer vaccine, the technologies require extensive clinical trials to obtain regulatory approval of bodies such the US FDA. These trials, which by their nature would meet the R&D eligibility tests, often require multi-centre international studies. The cost of these clinical trials will most likely exceed the current 10% eligibility limit.

26. At the same time, UniQuest recognises that the Government wishes to avoid setting up a program which sees foreign-owned and conducted R&D being subsidised by Australian tax-payers without significant economic benefits to Australia.

27. **Recommendation:** **The general principle that the majority of R&D activities should be undertaken in Australia should be maintained.. HOWEVER, provision should also be made for overseas expenditure to be eligible where such activities, defined in the Research Plan (see paragraph 31), are approved by Innovation Australia in advance of such expenditure. Innovation Australia would take account of the eligibility of the expenditure, the nature of the activities that require them to be undertaken overseas and the national benefits derived for the Australian economy.**

THE NEW R&D TAX CREDITS

Standard R&D Tax Credit

Principle 2

The Standard R&D Tax Credit will be available at a rate of 40 per cent for eligible R&D expenditure and can be carried forward where a company's income tax liability is zero.

28. All incentives through the Income Taxation system are welcomed.

Refundable R&D Tax Credit

Principle 3

The Refundable R&D Tax Credit will be available to companies with a turnover of less than $20 million at a rate of 45 per cent for eligible R&D expenditure.

29. Timing of the R&D Tax Credit – Venture backed start-up companies and other SMEs are an important part of Australia's innovation system. Such companies are investing the majority of their capital in R&D and business development, and are typically loss-making. The efficient use of this capital is critical to the company's survival and development. The Consultation Paper proposes that companies can access refunds after their tax assessment is completed. Whilst it is recognised that the Tax Credit should not be considered as a source of start-up funding, the benefit provided to early stage companies from the Tax Credit will be increasingly diminished as the timing from expenditure to receipt increases, decreasing innovation momentum.

30. **Recommendation:** **Companies eligible for the Refundable R&D Tax Credit should be able to claim their cash refund on a more frequent basis than annually. This could be achieved, with minimal additional administration, by incorporating the claim within the Business Activity Statement process. Companies wishing to make such claims would be required to pre-register their Research Plan (see paragraph 31) and would self-assess eligible expenditure consistent with this.**

31. Research Plan – Some may consider it to be an administrative burden to require the preparation and registration of a Research Plan. This has been a part of the R&D tax incentive regime in the past. We consider the Plan as a necessary step. All quality and commercially focused research ought to be supported by a well structured Plan to consider the inherent research risks, market opportunities, IP implications etc before embarking on a lengthy and expensive research program. This would assist in the simpler administration and assessment of eligible activities and expenditure.

Non-enhanced deductions

Question 2

How should the new R&D tax incentive treat R&D expenditure that is currently deductible at 100 per cent?

32. The deductibility of R&D expenditure is welcomed both at 100% and increased levels. The current non-enhanced deductions for core technology and, to a lesser extent, interest are of some value to innovative start-up companies and SMEs, although the benefit in commercialising IP is deferred until the company generates taxable profits.

33. It is understood that the Government has the objective of revenue neutrality with the changes to the R&D tax incentive. The proposed tightening of the definition of eligible R&D activities will likely preclude large industrial development projects from the program that were previously able to claim the accelerated R&D deduction resulting in a large reduction in costs to the tax system. We believe that these savings would be well applied to permitting companies eligible for the refundable Tax Credit to cash out non-enhanced deductions at the company tax rate further enhancing the attractiveness of investment in the Australian innovation system.

34. Further, enhanced deductions for core technology should provide an incentive for the private sector to in-license technology developed by Australian public sector research agencies and their related companies.

35. To apply differing levels of deductions to Core R&D and, for example, core technology, as well as make some deductions refundable and others not, will add significant complexity to compliance, administration and, hence, the cost of the program.

36. **Recommendation: The enhanced rate of deduction for Core R&D should apply to other related expenditure presently deductible at 100%, such as core technology expenditure. If this is not achievable within the Government's policy objectives, then the current non-enhanced (100%) deductions should be maintained for such expenditure.**

37. **Recommendation: Companies eligible for the Refundable Tax Credit should be able to cash out these deductions at the applicable rate of deduction.**

Payments to associates

Question 3

Should expenditure incurred to associate entities only be eligible for the new R&D tax incentive where paid in cash?

38. For public sector research commercialisation, a start-up companies is typically an associate of the institution (eg university) where the original IP was developed, through a shares held by the institution. In the early stages of that company's development, further R&D is often carried out at the founding institution.

39. UniQuest believes that the cost of activities undertaken by associate entities should be eligible on an accrual basis consistent with other such expenditure, so that there is no additional administrative burden of complex reconciliations of accrual based R&D expenditure with cash based R&D expenditure. The income for services would be taxable in the accounts of the associate on an accruals basis.

40. The Act provides a number of mechanisms for dealing with transactions between associates, including anti-avoidance provisions, and these should be adequate to deal with uncommercial transactions.

41. **Recommendation: Expenditure incurred to associate entities should be eligible for the new R&D tax incentive on an accrual basis.**

ADMINISTRATION

Principle 4

Legislation for the new R&D tax incentive will provide support for the scheme's efficient and effective administration.

42. The desire to create an efficient system is endorsed.

43. We note that, given the substantial changes that the Government has flagged within the Consultation Paper, there is a real risk that this objective will not be met if all changes are implemented. There is a need to define clear program criteria and administrative procedures that do not result in a greater level of uncertainty, greater compliance requirements and the greater use of external professional advisors. To do otherwise would be to the disadvantage of small technology companies, which operate under tight budgets.

ELIGIBLE R&D ACTIVITY

Principle 5

The new R&D tax incentive should target R&D that:

(a) is in addition to what otherwise would have occurred; and

(b) provides spillovers — benefits that are shared by other firms and the community — that are large relative to the associated subsidy.

44. Universities foster creative thinkers and innovative ideas. Such innovation will flow on to ensuring that Australia remains a productive country.

45. To transition such innovation into a commercial outcome requires research and validation of a hypothesis. University funding does not extend to advancing these early stage concepts into robust datasets worthy of a commercial product.

46. Early stage projects would not progress without investment and certainly would not be considered activities that would otherwise have been incurred.

47. Hence, UniQuest supports the intent of Principle 5.

What is R&D?

Core R&D

Principle 6

Eligible R&D activity will be defined as systematic, investigative and experimental activity that:

(a) involves both innovation and high levels of technical risk; and

(b) is for the purpose of producing new knowledge or improvements.

48. UniQuest agrees with that the definition of R&D should be consistent with international standards.

49. UniQuest strongly endorses the refined definition of eligible R&D proposed in the Consultation Paper.

50. It is important, however, to ensure that the elements of a R&D program necessary to achieve a technical and innovative outcome are included within the scope of eligible Core R&D. A research program may typically be broken into sub-units of work, and while not all of those sub-units might of themselves pass the eligibility test, they are necessary in achieving the overall objectives.

51. **Recommendation: The scope of Core R&D should be defined by the overall program objectives, which of themselves are seen to be**

innovative, and the research methodology, which will involve technical risk.

52. This recommendation is seen to be consistent with the objective of the R&D Tax Credit program to be administratively efficient.

Supporting R&D

Principle 7

Supporting R&D will continue to be recognised under the new R&D tax incentive but claims will be subject to new limitations.

Question 4

Should supporting activities:

(a) be capped as a proportion of expenditure on core R&D?

  (i) If so, what would be the appropriate proportion (for example, 1:1)?

(b) only be eligible where they are for the sole purpose of supporting core R&D activity?

(c) exclude production activities or dual role activities?

(d) only be eligible on a net expenditure basis?

(e) attract a lower rate of assistance than core R&D?

  (i) If so, what would be the appropriate rate be?

53. UniQuest is supportive of the sole purpose test.

54. As mentioned previously, it is important that all elements of a R&D program necessary to achieve a technical and innovative outcome are included within the scope of eligible Core R&D.

Excluded activities

Question 5

Should the current list of activities excluded from being considered core R&D be:

(a) amended in any way?

(b) extended to exclude certain activities from being considered supporting activities?

55. UniQuest believes that a number of the activities previously excluded from Core R&D should now be included.

56. Research in social sciences, arts or humanities can lead to the development of new products, processes and services that benefit the economy. The following is an example from the University of Queensland

57. Leximancer is a tool for extracting thematic meaning from large amounts of text, unstructured or structured, in any language. The key researcher examined the way in which humans used cognition and memory to extract key themes from large amounts of information, and then applied a range of mathematical tools to describe this. The results were then reduced to software, tested and refined. The resultant software tool is now licensed to users around the world, from researchers to large corporate clients. Leximancer is being commercialised by Leximancer Pty Ltd, an Australian start-up company, which has secured venture finance and continues to support new applications R&D. UniQuest believes that the fundamental social science research behind this product and the new products in development, would meet the novelty and technical risk tests proposed for the R&D Tax Credit. It is this test that should define eligibility, not the field in which the research is undertaken.

58. **Recommendation: Research in social sciences, arts or humanities should not be automatically excluded from eligible Core R&D activities. The narrower definition of eligibility, that is, that the activities involve both innovation and high technical risk, should be the only determinant, rather than the discipline of the sciences or the arts to which the research relates.**

59. Pre-production, demonstrations, tooling and trial runs often form an essential element of an R&D program. Until a product has passed a rigorous testing regime technical risk remains. Often there is a large technical risk in scaling up from a prototype through trialling before reaching a commercial product. Clinical trials are an example of such activities. As per paragraph 50, if these activities form an essential component of meeting the novel objectives for a program and removing technical risk, then they should fall within the scope of the Core R&D program.

Software

Question 6

How should the new R&D tax incentive treat software R&D?

60. Again, the narrower test for eligible R&D activities should apply as the determinant for their accessing the R&D Tax Credit, not which particular field of development that the activity belongs to.

61. **Recommendation: Software R&D should be eligible for the R&D Tax Credit where it satisfies narrower definition of eligibility, that is, the activities involve both innovation and high technical risk.**

SUMMARY

62. The Government's initiative to support innovative R&D through the tax system is to be applauded. UniQuest strongly recommends that, in order that the proposed changes provide the greatest leverage for Australian innovations, they:

- apply equally to companies founded on intellectual property generated from public sector research institutions, regardless of the level of shareholding of those institutions (tax exempt or otherwise), from the earliest stages of their life post initial investment;

- apply to all types of company R&D activities, including social sciences and software, so long as those activities pass the tighter eligibility test of being innovative and having technical risk; and

- take account of the tight and short-term nature of cashflow issues for early stage ventures by providing for companies that qualify for the 45% Refundable Tax Credit to obtain the cash rebate on a more regular basis than with their annual tax return, for example, through the Business Activity Statement process.

63. Through the tightening of the definition of eligible R&D activities, the cost to the R&D Tax incentive program associated with, for example, large industrial projects is likely to be significantly reduced. While a significant focus for, and proportion of, expenditure for early stage venture companies, the total cost of R&D activities in this industry sector is significantly less. Hence, expanding the R&D incentives for this sector, including public sector research founded companies, should be manageable within the Government's objective for revenue neutrality with the changes to the R&D Tax provisions.

64. Companies operating in this sector by their nature face high technical and commercial risk, and have the potential to offer significant returns to investors, the National Innovation System and the economy.