26 October 2009

PROFESSOR LES FIELD

DEPUTY VICE-CHANCELLOR
(RESEARCH)

General Manager
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The Treasury
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Dear General Manager,

UNSW RESPONSE TO *"THE NEW RESEARCH AND DEVELOPMENT TAX INCENTIVE: CONSULTATION PAPER"*

The University of New South Wales welcomes the opportunity to provide this submission to the Treasury's *"New Research and Development Tax Incentive: Consultation Paper"*.

This submission confirms that the recommendations set out in the Consultation Paper are for the most part a positive response to the Cutler Review of the National Innovation System regarding Tax support for research and development, however there are a number of issues which still need to be considered further.

UNSW is pleased to see that investment in research and innovation has been acknowledged for its economic benefits in this way. ***There is no question that a strong research and development base underpins the national economy and drives innovation.***

1. INTRODUCTION

This submission is being made on behalf of The University of New South Wales (UNSW) following discussions with key staff of the University and UNSW's commercialisation company, ***NewSouth Innovations Pty Ltd***[1].

UNSW is a member of the ***Group of Eight***[2] research intensive Universities, and a member of ***Universitas21***[3], an international network of research intensive Universities.

NewSouth Innovations (NSi) and its forerunner, Unisearch, have sponsored the incorporation of many new start-up businesses during their combined 45 year history. University spin-off companies are established to facilitate the commercialisation of technologies that can stand alone with a business offering or be used as a vehicle for capital raising. Many of NSi's spin-off companies[4] have ongoing operations, with some now seeking further investment including ***Dosimetry & Imaging Pty*** Limited (monitors exposure to radiation in real time), ***Cystemix Pty Limited*** (anti-cancer drugs), ***V-Fuel Pty Ltd*** (advanced vanadium redox battery systems) and ***BT Imaging*** Pty Ltd (luminescence imaging systems for solar cells).

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[1] See http://www.nsinnovations.com.au/
[2] See http://www.go8.edu.au/
[3] See http://www.universitas21.com/
[4] See http://www.nsinnovations.com.au/aboutnsi/spinoffs.html

2. EXECUTIVE SUMMARY

- There is no question that a strong research and development base underpins the national economy and drives innovation.

- The proposed changes may mean (the Guidelines are ambiguous on this matter) that only those that have a greater than 50% shareholding held by Universities will now qualify for the proposed R&D Tax Credits.

- The apparent attempt to increase the number of companies that would qualify for the new scheme by raising the threshold on shares held by Universities from 25% to 50% should be commended.

- Thus we have a situation where a company may have successfully raised significant capital and has committed a majority of that capital to R&D and yet does not qualify for the new Refundable R&D Tax Credits. This does not appear to encourage investment in innovation or be consistent with "the Case for Reform".

- There is a strong case that there should be no threshold but that eligibility should be based on a company having successfully secured an external investment and having committed much of that investment to R&D.

- UNSW strongly supports the recommendation that the new R&D tax incentive will not consider whether IP from an eligible R&D activity is owned in Australia or overseas.

- There should be no restriction on where our spin off companies are located and incorporated in Australia and where they carry out qualifying R&D.

- A simpler alternative to that proposed5 would be to allow all R&D expenditure to be deductible, subject to it comprising less than 10-20% of not "at-risk" expenditure (interest, allowable core-technology).

- A requirement should be that the permitted R&D expenditure is paid in cash. This will be simpler and will ensure that the Refundable Tax Credit, in particular, is not open to abuse.

- UNSW believes that it is important to have an appropriate level of administrative support built into the legislation for the new R&D tax incentive.

- The R&D tax incentive will only apply to that R&D that occurs in addition to other R&D activities that would otherwise have occurred. This creates a significant problem for early stage spin off companies, depending on how this rule applies, particularly in the absence of the current 125% R&D tax concession.

- It is almost impossible to determine what R&D would have happened anyway and what is a result of the incentive program.

- The principal of spillover benefits being part of the definition of eligible R&D may be at odds with the commercial principal that spin off companies invest in R&D to gain a competitive advantage in the market place and to develop monopoly rights over IP developed through the patenting process.

- It must be recognised that support for successful innovation and R&D that is commercialised from Australian Universities may assist the development of an industrial

[5] Paragraphs 37 and 38, Page 6, The New R&D Tax Incentive

base in the major overseas markets through which Universities and their spin off companies will benefit from licensing arrangements.

- UNSW believes that supporting activities should be capped as a proportion of expenditure on core R&D.
- A reduced value should be applied to industries for which supporting activities play a less important role in the pursuit of core R&D.
- UNSW supports the adoption of a compromise such as is suggested in the consultation document with the permitted activities being "predominantly for the support of core R&D activity". Supporting activities shoud exclude production activities or dual role activities. Only supporting activities should be eligible on a net expenditure basis. Core R&D activities that are profitable through the sale of outputs should not be supported by this scheme. Supporting activities should attract a lower rate of assistance than core R&D.
- The current list of activities excluded from being considered core R&D is reasonable in terms of activities being excluded from the core R&D definition.
- Certain activities excluded from consideration as core R&D should remain permitted supporting activities.

3. UNSW SPECIFIC COMMENTS

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

- This new scheme replaces the existing R&D tax concessions and is stated as being more generous than the current 125% R&D tax concessions.[6] UNSW is aware that all spin off companies, irrespective of their shareholding currently qualify for the 125% tax concessions. It is only the tax rebate scheme that is currently restricted to companies that have a 25% or less shareholding owned by tax exempt institutions. ***The proposed changes may mean (the Guidelines are ambiguous on this matter) that only those that have a greater than 50% shareholding held by Universities will now qualify for the proposed R&D Tax Credits.*** This could mean that many of those companies that at least would have got the 125% R&D Tax Concessions would now get nothing. UNSW believes, that if this is the case, then this does not assist innovation and the commercialisation process in those cases.
- ***The apparent attempt to increase the number of companies that would qualify for the new scheme by raising the threshold on shares held by Universities from 25% to 50% should be commended***. Unfortunately, there will be many deserving companies that will still not qualify for the refundable element of the tax credits for quite some time. UNSW accepts the argument that companies wholly owned by Universities would not qualify,[7] but we do not necessarily believe that the 50% shareholding threshold is the correct one to foster investment in innovation. .
- In the typical life cycle of a spin off company, it is very often the case that, despite a serious injection of capital by an investor, depending on the share price set for that investment, the University's equity position in that company may not fall below 50%. This is particularly the case where the injection of capital is tranched (*i.e.* progressive payments are made over time). It may even take 12-18 months for the tranched funding to be completed and for the University's equity position to get down to the threshold or

[6] Paragraph 11, Page 2, The New R&D Tax Incentive
[7] Paragraph 22, Page 3, The New R&D Tax Incentive

below, if at all. In many cases it will take at least a second round of external investment before the threshold is achieved. ***Thus we have a situation where a company may have successfully raised significant capital and has committed a majority of that capital to R&D and yet does not qualify for the new Refundable R&D Tax Credits. This does not appear to encourage investment in innovation or be consistent with "the Case for Reform".***[8]

- It should be noted that eligibility for the Refundable R&D Tax Credits in particular could be used as a powerful tool to attract investors ***in the first instance*** as it offers a more cost effective way of utilising invested capital. With a refundable tax credit on offer, the company's cash position is also improved and this delays the need for additional capital raising and prevents excessive and early dilution of the University's equity interests in a spin off company. However, if the first round of external investment in a company (which could typically be say between $250k and $750k) does not attract any benefit under the scheme then the company may not get past first base.
- ***There is a strong case that there should be no threshold but that eligibility should be based on a company having successfully secured an external investment and having committed much of that investment to R&D.*** For this case to be accepted there would be an acknowledged need to review the proposed criteria related to Group turnover as any spin off company that remains a controlled entity of a University would under the proposed rules be disqualified from being eligible for the Refundable R&D Tax Credit.
- Uniseed[9] and similar venture capital funds sponsored by Universities pose a special and more complex case. The shares held in combination between the University and Uniseed, if it invests, will all be counted together to assess the threshold for eligibility despite the fact that Uniseed money will mostly be used for R&D purposes. Thus Uniseed's involvement represents poorer value than securing an investment from other external sources.
- ***UNSW strongly supports the recommendation that the new R&D tax incentive will not consider whether IP from an eligible R&D activity is owned in Australia or overseas.***[10] The "Effective ownership" of IP developed as a consequence of an R&D project should be qualified to ensure that this counts IP that would be legally owned by a company (by assignment from the University if necessary) AND IP that the company has control over as consequence of it being granted the right to exploit that IP through a licence agreement as necessary. This takes into consideration the fact that in typical business models used by Universities, IP is most commonly licensed to the spin off company rather than simply being assigned at the outset.
- ***There should be no restriction on where our spin off companies are located and incorporated in Australia and where they carry out qualifying R&D.***[11] UNSW believes that it is likely that some R&D will need to be carried out overseas for a variety of reasons. The current maximum threshold of 10% provides a simple mechanism that enables some flexibility in the performance of R&D while at the same providing Australian tax payers an increased return on investment by maximizing R&D spend in Australia. Having the entire allowable R&D spend able to attract favourable tax concessions is vital in order that Australian-based companies be globally competitive by being able to access cutting edge technologies even when they are only available overseas (subject to the 10% threshold). Foreign-owned companies should be treated in the same way, subject to the threshold of 10% and the need to demonstrate that this R&D could not be conducted in Australia. Alternatively, the government could permit the 10% threshold only to Australian-owned companies, but this would appear unnecessarily restrictive and could act as a disincentive to foreign investment into Australia.

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[8] Page 2, The New R&D Tax Incentive
[9] See http://www.uniseed.com/
[10] Paragraph 28, Page 4, The New R&D Tax Incentive
[11] Paragraphs 28-30, Pages 4 and 5, The New R&D Tax Incentive

PRINCIPLE 2 - THE STANDARD R&D TAX CREDIT WILL BE AVAILABLE AT A RATE OF 40 PERCENT FOR ELIGIBLE R&D EXPENDITURE AND CAN BE CARRIED FORWARD WHERE A COMPANY'S INCOME TAX LIABILITY IS ZERO.

- UNSW supports the principle that the standard R&D tax credit will be available at a rate of 40 percent for eligible R&D expenditure and can be carried forward where a company's income tax liability is zero.[12]

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.

- ***A simpler alternative to that proposed[13] would be to allow all R&D expenditure to be deductible, subject to it comprising less than 10-20% of not "at-risk" expenditure (interest, allowable core-technology)***. This would simplify administration of the scheme and give greatest flexibility and tax-concession value to those companies engaging in genuine R&D.
- ***A requirement should be that the permitted R&D expenditure is paid in cash.[14] This will be simpler and will ensure that the Refundable Tax Credit, in particular, is not open to abuse*** by R&D cost shifting between associated entities. Alternatively, the scheme could simply have the Refundable Tax Credit option open to those companies that have incurred R&D expenditure which has been paid in cash. This would avoid the risk to Australian tax payers that cash refund payments to companies are generated on the basis of non-cash transactions between associated entities.

PRINCIPLE 4 – LEGISLATION FOR THE NEW R&D TAX INCENTIVE WILL PROVIDE SUPPORT FOR THE SCHEME'S EFFICIENT AND EFFECTIVE ADMINSTRATION.

- UNSW believes that ***it is important to have an appropriate level of administrative support built into the legislation for the new R&D tax incentive.[15]*** In this way the program can be accountable and properly resourced.

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..

- ***The R&D tax incentive will only apply to that R&D that occurs in addition to other R&D activities that would otherwise have occurred.16 This creates a significant problem for early stage spin off companies, depending on how this rule applies, particularly in the absence of the current 125% R&D tax concession.*** Most capital raised by a company will be used for R&D purposes by the very nature of venture capital. ***It is almost impossible to determine what R&D would have happened anyway and what is a result of the incentive program.*** By default, only a proportion of the R&D would qualify when all of the R&D being undertaken is an investment in innovation. ***The operation of this principal may not encourage investment via early stage spin off companies***.
- ***The principal of spillover benefits being part of the definition of eligible R&D may be at odds with the commercial principal that spin off companies invest in R&D to gain a competitive advantage in the market place and to develop monopoly rights over IP developed through the patenting process***. Innovative R&D programmes that

[12] Paragraphs 35-36, Pages 5 and 6, The New R&D Tax Incentive
[13] Paragraphs 37 and 38, Page 6, The New R&D Tax Incentive
[14] Paragraph 42, Page 7, The New R&D Tax Incentive
[15] Paragraphs 44 to 47, Pages 7 and 8, The New R&D Tax Incentive
[16] Paragraphs 48-49, Page 8, The New R&D Tax Incentive

achieve these commercial objectives should not be excluded from the incentive program on the basis that other (competitive) industry players may not initially have access to the benefits. However, significant benefits will be generated through the advancement and uptake of new technologies which will assist with the overall competiveness of Australian industry and through the establishment of new industries. ***It must be recognised that support for successful innovation and R&D that is commercialised from Australian Universities may assist the development of an industrial base in the major overseas markets through which Universities and their spin off companies will benefit from licensing arrangements.***

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.

- This Principal is consistent with UNSW's interests with the above comments in mind.

PRINCIPLE 7 – SUPPORTING R&D WILL CONTINUE TO BE RECOGNISED UNDER THE NEW R&D TAX INCENTIVE BUT CLAIMS WILL BE SUBJECT THE NEW LIMITATIONS.

- ***UNSW believes that supporting activities should be capped as a proportion of expenditure on core R&D***. This is a sensible approach although the supporting activities will probably vary from industry to industry and the proportion may need to be categorized on that basis. The running and maintenance of animal houses (including breeding of animals), bioreactors, tissue-culture laboratories and analytical facilities, where they are used to support core R&D, are examples of onerous supporting activities that would justify a 1:1 proportion being applied in the biotechnology and pharmaceutical industries. Some other industries on the other hand are likely to be able to support core R&D using facilities that are extensively used in production and quality-control. ***A reduced value should be applied to industries for which supporting activities play a less important role in the pursuit of core R&D.***
- Some activities that are carried for the support of core R&D may, for efficiency reasons, occasionally be carried out in the support of production and non-core R&D. In that case, however, only the activity that is required and actively performed in the support of core R&D should be claimable. UNSW accepts, in the spirit of the scheme, that activities that are predominantly carried out for core R&D should be the target of the R&D Tax Scheme. Therefore, ***UNSW supports the adoption of a compromise such as is suggested in the consultation document with the permitted activities being "predominantly for the support of core R&D activity". Supporting activities shoud exclude production activities or dual role activities. Only supporting activities should be eligible on a net expenditure basis. Core R&D activities that are profitable through the sale of outputs should not be supported by this scheme. Supporting activities should attract a lower rate of assistance than core R&D.***
- ***The current list of activities excluded from being considered core R&D is reasonable in terms of activities being excluded from the core R&D definition***. The list of activities should not be extended to exclude certain activities from being considered supporting activities. ***Certain activities excluded from consideration as core R&D should remain permitted supporting activities***. For example, a consequence of genuine core R&D should be the filing and maintenance of IP instruments such as patents. These activities should remain eligible supporting activities subject to the demonstration that they relate to the core R&D activities of the company.

4. SUMMARY

In summary, UNSW believes that the proposed new R&D tax incentive goes a long way to providing a more effective and predictable system in Australia for companies conducting

R&D. While there are a number of very positive incentives recommended in the consultation paper, there does however remain a few key issues which need addressing/clarifying.

The University of New South Wales would welcome the opportunity to contribute further to the consultations on the new R&D Tax Incentives.

Yours Sincerely,

Professor Les Field
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