

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

By email: rdtaxcredit@treasury.gov.au

26 October 2009

Dear Sir/ Madam

Submission in relation to the Treasury Consultation Paper – “The new research and development tax incentive” – September 2009

Senetas Corporation Limited (“Senetas”) welcomes the opportunity to make this submission in relation to the Consultation Paper released by Treasury on 18 September 2009.

COMPANY BACKGROUND

Senetas (ASX:SEN) is a ten year old ASX-listed Australian public company and the global leader in the research, development and commercialisation of high speed network encryption technology used to secure critical networks, including government, defence, banking and secure commercial networks in Australia and overseas.

Demand for information security is being driven across global markets by the need for organizations to secure their critical assets - information, communications channels and critical infrastructure - from both internal and external threat. This growing demand is driven by regulatory compliance, corporate governance and increasing cyber-threat.

The Senetas CypherNet Multi Protocol Encryption Security Platform is the only network encryption hardware that is dual-accredited to the highest international government security standards (FIPS140-2, Level 3 and Common Criteria EAL4 (soon to be the higher accreditation of EAL4+)). Using this best of breed 100% owned and Patented (Australian Patent # 2005213327) technology platform, the company intends on expanding its product offering aimed at new domestic and global markets.

The company currently re-invests 27% of its yearly revenue in research and development expenditure, this expenditure is essential to ensure that the company’s technology remains at the innovative forefront of the industry and ahead of our competition.

One of our primary research and development projects commenced this year is the landmark development of an indigenous High Grade (Secret) encryptor with the written sanction and co-operation of the Australian Department of Defence Signals Directorate. This will be Australia’s first development of a High Grade (Secret) encryptor and is of national importance. When complete it will be available for export to protect secret communications networks in New Zealand, Canada, United Kingdom and the United States.

MELBOURNE

✉ Level 1/11 Queens Road
Melbourne VIC 3004
Australia
☎ Phone: +61 3 9868 4555
☎ Fax: +61 3 9821 4899

SYDNEY

✉ Suite 5, Level 13
327 Pitt Street
Sydney NSW 2000
Australia
☎ Phone: +61 2 9283 2333
☎ Fax: +61 2 9283 7558

✉ corporate@senetas.com
www.senetas.com

Senetas is a current claimant of the Concession and intends to continue to claim. R&D is essential to the commercial success of the company and we encourage the Government to continue its support of the program. We will focus our response on those principles and questions that are relevant to our circumstances.

OUR SUBMISSION

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.

We agree with the proposed Principle of removing the relevance of the location of ownership of the resulting IP.

Question 1

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

We do not have comments in relation to Question 1, as our R&D is presently conducted in Australia and will continue to be.

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.

We do not have comments in relation to Principle 2, as our annual company turnover at present is less than \$20 million.

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.

We support the Government's proposal to increase the base rate of claim benefit and for increasing the threshold for current R&D tax offset claimants; however, in our opinion:

- The \$20 million threshold between the non-refundable and refundable schemes is set too low and does not act an incentive for growth. A hi-tech company on the cusp of a \$20 million turnover is at a critical stage in its lifecycle - cash flow is key and it is still likely to be in tax losses. A refundable credit would be of much greater benefit in these circumstances. We draw your attention to the \$50 million turnover threshold proposed under the National Innovation System (NIS) Review (of 29 August 2008). We submit that if a threshold is to be imposed by reference to company turnover, it be raised to the NIS Review's recommendation of \$50 million.
- The proposed base rate of 45c per dollar of R&D spend is also too low when taking into account the reduction in benefit from the repealing of the 50% Premium amount deduction provisions. We submit that the base rate be increased appropriately to compensate for the loss in incremental benefit. If the rate were higher, we would invest more in R&D.
- Issues previously encountered by setting a demarcation between schemes, i.e. the R&D tax concession and the R&D tax offset, will still exist under this proposed Principle. We submit that the imposition of a strict demarcation between the non-refundable and refundable schemes be reassessed. We submit that a soft target be introduced instead,

whereby the refundable component remains accessible to all companies up to a certain threshold, and that above that threshold, the non-refundable component starts to apply.

Question 2

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

R&D expenditure currently deductible at 100 per cent should continue to attract the credit. Smaller growing firms do make use of cashing out the benefit from claiming R&D expenditure deducted at the 100 per cent rate. The proposed scheme should continue to allow for this important cash flow incentive.

Question 3

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

We have no comments in relation to Question 3.

Principle 4

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

We support the Government in its proposal for more efficient and effective administration of the scheme. In this respect, we suggest that the Government employ more technically qualified, knowledgeable and capable assessors who seek to understand the work that we do in commercial realities, and who have an existing appreciation of industry and the technological gaps currently faced.

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.*

We support the proposed Principle on the basis that it is similar to what is supported under the current scheme.

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.*

Should the definition of eligible R&D activities be restricted from involving “either innovation or high levels of technical risk” to involving “both innovation and high levels of technical risk”, a number of issues need to be addressed.

- A solution which is clear, practical and workable must still result from a fundamental change to the definition of eligible R&D activities. Innovation must be defined clearly and in the context of the commercial reality, which is that the vast majority of technological advancements in Australia are achieved incrementally, and not through

fundamental overhauls of existing knowledge. This has arisen partly due to already insufficient Government funding and support for innovation in Australia.

- In assessing what is sufficient for innovation, we draw reference to the patent legislation and the concept of “a person skilled in the art” and whether it would be obvious to combine knowledge from different sources of known technology. The greater the number of different sources of known technology to be combined, the more likely it is that the concept is inventive. New Zealand, in developing its definition, made reference to the concept of “a competent professional”. We submit that it would be impractical and commercially unrealistic that the test for R&D activity be more rigorous and restrictive than that for the granting of a patent.
- Clarification is required in relation to the restriction in purpose requirement from “creating new or improved materials, products, devices, processes, or services” to “producing new knowledge or improvements”. It should not be forgotten that the original intent of support for R&D is to provide an incentive for greater levels of R&D in Australia across a range of industries. We highlight that this proposed change is already more restrictive than that required for patents. Commercial reality should never be removed from the framework of the proposed Principles.

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.

We submit that the split between core and support R&D is a tax fiction not reflected in commercial R&D developments. High tech development companies like ours do not manage their projects according to core and supporting activities, so asking us to do so is a significant and unnecessary administrative burden that diverts effort away from, and reduces the benefit of, the R&D being carried out.

Projects are managed at Senetas according to objectives, tasks and milestones – objectives set the framework of the project, tasks are the effort required to achieve on objectives, and milestones are the deliverables. All tasks within the R&D phase of a project are necessary to bring that project to completion.

We submit the following:

- the fiction created by the classification of supporting and core R&D be reassessed
- the new R&D incentive uses the opportunity to update the assessment such that it is based on the commercial realities of how a project is conducted
- new limitations do not unnecessarily restrict technological developments occurring through legitimate R&D projects and activities for the sake of reducing a small proportion of companies making ‘whole of mine’ claims. We draw attention to the NIS Review articulating the need to address such claims in its own right, and not by default through a general tax concession
- all five forms of limitation proposed for supporting activities, as provided by Question 4, create inequality and are likely to result in skewed claims without the purpose of reflecting the true involvement of R&D in the project

Question 4

Should supporting activities:

- (a) *be capped as 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?*

Should limitations be imposed on all supporting activities, we submit that proposal (b) be adopted due to a compromise between the relative ease of administration of this option and the benefit likely to be gained from the scheme for our cross-section of R&D 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?*

We submit the following:

- the current list of activities excluded from being considered core R&D be retained and unmodified from its current form
- the list should not be extended to exclude certain activities from being considered supporting activities.

Further, in the context of the type of R&D we carry out (refer to details provided in response to question 6), we note that it is necessary to test our presumptions and hypotheses through pre-production activities such as the construction of a prototype(s).

We therefore specifically submit that activity (h) from the current list (pre-production activities) not be excluded from being considered supporting activities.

Question 6

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

We submit the following:

- A separate definition should not be created to assess eligible software R&D, the reason being that an inequality would arise between developments in different industries if a distinction is introduced. We also make reference to the fact that the lower level software development considered by the consultation paper to be ineligible will already be made ineligible through the proposed changes to the definition of core R&D, thus making a separate definition to restrict software R&D an unnecessary further addition and complexity.
- The requirements for “innovation” should be carefully considered and clarified in the context of commercial reality for software development under the proposed definition for eligible R&D activity stipulating “both innovation and high levels of technical risk”. We draw attention to the NIS Review’s reference to software R&D and note that eligible software R&D was referred to in the context of technical risk only, and not in the context of innovation, recognising that software R&D is predominantly considered eligible on the limb of technical risk, and not under the limb of innovation. In spite of this, the NIS Review notes the importance of software development as eligible research and development and its potential for substantial spillovers for the rest of the community.
- A greater quantity of relevant and commercially realistic guidance material is required in relation to what the Government considers to be eligible software R&D. We find that the guidance materials and examples of what is viewed by the authorities to be likely eligible and ineligible R&D (as outlined at clauses 76 and 77 of the Consultation Paper) to be vague, ambiguous and lacking in an understanding of what is true leading edge R&D in the area (of particular note is the example “*the creation of...software using tools designed for that purpose*” will be ineligible). For your reference, we provide you here with a description of Senetas’ R&D including the elements of software R&D, some of which are

no doubt developed by use of other software tools because that is how software is developed.

LEADING EDGE DEVELOPMENT AT SENETAS

Senetas Security designs and manufactures hardware based encryption platforms for sale both domestically and internationally to over 30 countries. All design work is performed in house, with activities ranging from the design of mechanical enclosures, electrical hardware engineering and software engineering.

Software R&D activities carried out are for the direct use in the CypherNet / CypherStream product range, resulting in firmware/FPGA binary images loaded into the production units, or Management Software (CypherManager) used for client configuration and management of the encryptor products.

Software activities can be broken into three distinct areas for the purposes of providing an overview of software disciplines utilised. These are firmware (FPGA), embedded software, and application management software. All of these areas form part of the final hardware encryption product range.

Software development occurs across a range of niche, market leading developments relating to OSI layer 2 encryption, key management algorithms and protocols, and high speed interface development. This work involves the development of new key exchange protocols, encryption implementations and supporting infrastructure such as SNMP management support.

Also, due to the markets in which our encryption products are sold, our products typically demand one or both EAL4+ Common Criteria and FIPS140-2 Level 3 security accreditations. With this in mind, additional development and process overhead is incurred. Designing under these constraints introduces high technical risk in both design acceptability and project schedules. Typically, the acceptability review is executed after all Engineering works are complete, and expenses are incurred.

Conclusion

In summary, we wish to highlight the need to consider the commercial realities of the research and development effort in industry in Australia in developing the Principles and specifics of the new R&D tax incentive. We would be happy to discuss any of our comments further. Please do not hesitate to contact me on 03 9868 4555 to discuss.

Yours sincerely



Andrew Wilson
Chief Financial Officer
Senetas Corporation Limited