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To the Review Team

Exposure Draft: Tax and Superannuation Laws Amendment (2016 National Innovation and Science Agenda) Bill 2016: Intangible asset depreciation (Exposure Draft)

Telstra welcomes the opportunity to comment on the Exposure Draft.

The Exposure Draft is part of the Government's package announced on 7 December 2015 "designed to incentivise and reward innovation". The 7 December announcement stated:

> "The Turnbull Government is committed to building an innovative and more agile economy through strong growth policies that will boost growth and jobs.
>
> "Innovation is critically important to every sector of the economy and the Government's tax and business incentives under the NISA will encourage smart ideas to encourage innovation, risk taking and build an entrepreneurial culture in Australia."

Summary of Telstra's comments

Telstra's vision is to be a world class technology company that empowers people to connect. Technology is taking us into a world of rapid change, constant innovation and competition. It is a time of enormous opportunity and we need relevant taxation provisions that are agile and that promote and reward innovation.

Telstra has a strong track record in innovation. We have the capabilities, insights and initiatives to be a leader in this area. We partner with customers, technology partners, suppliers, governments and community organisations on technology and innovation.

We strongly believe that the taxation treatment of capital assets, tangible and intangible, significantly influences investment decisions in Australia. In turn, investment decisions drive innovation and create a more agile, internationally-competitive economy that will boost growth and jobs.

We believe that the Exposure Draft is a very positive step towards attempting to align the Uniform Capital Allowances (UCA) provisions contained in Division 40 of the *Income Tax Assessment Act* 1997 (Tax Act) with the commercial reality in which wasting intangible assets are being developed, acquired and used. However, we do not believe that the Exposure Draft goes far enough. This is a great opportunity to remove current investment biases from the UCA provisions and to future proof the provisions. We believe that the development and use of intangible assets is key to the furthering of an innovative and entrepreneurial culture in Australia and will contribute to our international competitiveness.

We believe this Exposure Draft provides an opportunity to modernise and amend the UCA provisions to provide a generic depreciation regime for both tangible and intangible assets. Such a change would reflect (and encourage) the commercial realities of those who seek to operate innovative and internationally competitive businesses in the 21st century digital economy. Such a change would remove any investment decision bias created by the UCA provisions (i.e. between investing in tangible or intangible assets) and would also future proof the UCA provisions for unforeseen innovative intangible asset developments.

Given that software is particularly important to the innovative development of virtually all Australian businesses and given the pace of software development, we believe that expenditure on all software should be carved out of the UCA provisions and should be made specifically deductible, as incurred. This would encourage and incentivise digital innovation in Australia.

Should the argument for the outright deductibility of software be rejected we strongly recommend the removal of the limitations in the "Associate Rule" contained in subsections 40-95(4) and (5) as it applies to software. Applying such a rule serves no useful purpose and results in a tax regime that isn't competitive when compared to best practice regimes internationally and in our view results in an outcome that is anti-innovation.

Finally, investment and innovation would further be encouraged by the introduction of capital incentives, which do not discriminate between investments in tangible or intangible assets. Such investment incentives could include accelerated depreciation, immediately deductible investments (as discussed above in respect to software expenditure), investment allowances or depreciation cost base loading.

Specific comments

1. Intangible assets should be depreciable

The UCA provisions provide a depreciation regime for wasting assets. However, the UCA provisions specifically carve out intangible assets from the definition of "depreciable assets" unless such assets are specifically included/named in Division 40 (Specifically Included Intangibles) e.g. in-house software, indefeasible rights to use a telecommunications cable system (IRU), spectrum licences etc. This results in a regime that provides a generic depreciation regime for all wasting tangible assets but only a depreciation regime for specific and limited intangible assets that are Specifically Included Intangibles. To get intangible assets included as Specifically Included Intangibles involves costly and time consuming lobbying by investors in such assets. Further, even if the lobbying is successful it results in a considerable time lapse between the actual investment in the intangible asset and certainty that adequate tax relief will be available. Clearly such uncertainty creates further biases in making investment decisions.

Telstra has in the past had to make representations to get IRU, spectrum licence and telecommunication site access rights (TSARs) within the ambit of the UCA provisions. Clearly each of these assets are wasting intangible assets used to produce assessable income. They are fundamental to the operations of a telecommunication business and have flow on effects for every Australian business and Australia's international competiveness. This constant need to make representations results in the UCA provisions lagging behind a constantly developing innovative digital economy.

Further, it should also be noted that investment in spectrum licences is not only an essential and costly investment in a vital but wasting intangible asset, it is also essentially a licence fee imposed on the telecommunication industry. Adequate tax relief should be easily accessible in an agile tax system especially given there are reasonably incurred business related imposts levied in specific industries.

Having UCA provisions that provide a generic write-off regime for tangible assets but only allow a similar write-off regime for very limited intangible assets obviously skews investment towards tangible assets rather than intangible assets. If the asset does not fall within the UCA provisions, the only tax relief for the investor is by way of a capital loss under the Capital Gains Tax provisions in the Tax Act. Such tax relief, if any, only crystallises at the end of the relevant intangible asset effective life and only to the extent that the investor has capital gains to offset the capital loss. Clearly this is counter intuitive in a rapidly changing and developing digital economy where new forms of intangible assets are constantly being developed and such assets are key to Australia's innovation, development, job growth and our international competitiveness.

We believe the Government's commitment to reform in this area provides a great opportunity to modernise the UCA provisions by amending them to provide a generic and non-discriminatory depreciation regime for both tangible and intangible assets. Such an amendment would involve the removal of the "intangible asset" carve out in the definition of "depreciable assets". Such a change would reflect (and encourage) the commercial realities of operating an innovative and internationally competitive business in the 21st century digital economy. It would also future proof the UCA provisions for unforeseen innovative wasting intangible asset developments and would eliminate the costly and time consuming need of having to make representations to have the UCA provisions updated every time new wasting intangible assets are developed and adopted as part of an innovative business structure. This will also remove the current bias towards investment in tangible assets.

Such a proposed treatment would align the tax and accounting treatment of wasting assets. That is, pursuant to accounting standards and principles any asset used in business with a limited useful life, whether tangible or intangible (except for goodwill), is depreciable or amortisable over its useful life.

2. All software expenditure should be deductible

Software development and use is central to virtually every function of a business today, from back-of-house administration to marketing to sales processing, and is key to all current and future business innovation in the digital economy.

The current taxation laws on the deductibility of software expenditure is misaligned to the commercial reality in the way software has evolved over the last 10-20 years. The relevant UCA provisions discriminate between in-house software and non-in-house software, an issue which we believe is not clearly addressed in the Exposure Draft. Under the current law, non-in-house software is not recognised as a depreciating intangible asset, and, therefore, would be treated as copyright (depreciable over 25 years) or an intangible CGT asset. Further, it is particularly unclear (more so than with tangible assets) where the line is between expenditure on functional software improvements (capital expenditure) and non-functional software updates (revenue expenditure).

In a developing and innovative digital economy heavily reliant on software, and where software is constantly being updated for the latest innovations, we believe that all software expenditure should be made specifically deductible when incurred. This is a tangible way of encouraging and rewarding digital innovation in Australia.

3. Limitations on Associate Rule (Application to Software) should be removed

We strongly oppose the limitations contained in the "Associate Rule" in Subsections 40-95(4) and (5) of the Tax Act, especially in relation to their application to software. The Associate Rule obliges the taxpayer to adopt an effective life equal to the effective life of the former holder where that effective life is yet to lapse. The limitations apply where:

- The depreciating asset is acquired from an associate, who has claimed depreciation or could have claimed depreciation;
- continues to be used by the same user; or
- has a new user who is an associate of the former user.

We see no justification whatsoever for this. Many firms develop software which has not been eligible for the research and development tax concession and which is licensed to end-users and does not qualify as in-house software. Under current law, as interpreted by the Australian Taxation Office, the taxpayer is required to depreciate the software over 25 years. The relevant software has a very short economic life due to competition and the rate of technological change, yet the proposed limitation will ensure that the taxpayer must depreciate the software over 25 years. The same result applies where the software is acquired from an associate or where there is a new user who is an associate of the former user. Such an outcome does not assist innovation.

This also means that expenditure on upgrades and modifications to the software will be characterised as capital outgoings which will also be subject to the existing 25 years tax depreciation regime.

These limitations should be removed. Otherwise we are left with a result we believe to be contrary to the intent of Government support for innovation and not competitive internationally.

4. Accelerated Depreciation encourages investment

Telstra believes that tax incentives such as accelerated depreciation would contribute to increased investment levels in innovation. The after tax cost of an investment is a major factor for businesses in deciding whether to invest in risky capital investments.

Accelerated depreciation, in respect of both tangible and intangible assets, provides greater tax depreciation deductions enabling the recovery of the investment during the early years of an asset's life, but does not increase the nominal entitlement to taxation depreciation over the life of the asset. Consequently, accelerated depreciation provides a significant tax timing and cash flow benefit resulting in a reduced cost of holding an asset in net present value (NPV) terms. It is this reduced NPV cost of holding the asset which influences businesses investment decisions.

In addition, investment allowances or depreciating cost base loading would be effective tax incentives (and provide tax certainty) to encourage investment in innovative and risky projects as these two incentives provide businesses with a permanent rather than a timing and cash flow benefit. Consequently, such tax incentives would provide a significant reduction in the NPV cost of holding the asset.

Telstra is a strong supporter of the Government's Innovation Agenda. We would welcome the opportunity to discuss our comments on the Exposure Draft by telephone or in person. If you would like to do so, please contact Rod Marshall on (03) 8649 5917.

Yours sincerely

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