



Submission in Response to the Treasury Consultation Paper on the R&D Tax Incentive

Context

ABOUT THE AUTHOR

The author has 38 years experience in the finance industry, and has had substantial experience to venture and commercialisation activities over the past decade. Over the past nine years he has been engaged in advising institutional investors on portfolio investment in venture capital and related areas, including the building of Australia's largest institutional venture capital portfolio. This activity has included the research and selection of numerous venture managers, and the participation on advisory committees for 10 venture funds. Based on his advice, his clients were the leading private sector investors in the 2002-3 Pre-seed Program and have been foundation institutional investors in five major Australian venture fund managers. The author also has designed and executed four “*Commercialisation Collaborations*” between institutional investors and publicly funded research bodies, which today serve 10 universities and 26 medical research institutes. He has played and continues to play an active role in the operations of these Collaborations. He has designed two other similar Collaborations, which were implemented by colleagues. The author also serves on the Board/Advisory Committee of two university commercialisation companies.

ADAPTING INCENTIVE POLICY TO MARKET STRUCTURES

R&D tax policy and its implementation will work best if it is able to recognise that those entities involved in R&D activity are not monolithic in their character. The R&D activity undertaken by a large established firm is very likely to have a different context and character to the R&D undertaken by start up firms seeking to exploit the potential of a new technology. It appears that all of the examples given of potential misuse of the R&D tax credit relate to establish businesses and most often relate to the expansion or improvement of existing products, services or customer service itself. This is relevant because the attempt to limit or define exclusions in one context may be totally counter-productive in another. For example exclusions or limitations on product prototyping may well make sense in the context of an organisation with an existing product being sold to customers but will be adverse to the intention of the R&D incentive for the start-up company developing a totally new product.

The recommendations tabled in this paper are based on administering the rebate under different processes for Start-up companies and others. Distinguishing between these two sectors offers net benefits to the administrative and supervision processes applicable to the rebate, while the process of categorisation of the two sectors is not burdensome. The net benefits are that each sector can be supervised according to the guidelines sensible to its circumstances, relieving AusIndustry and the ATO having to adopt one set of supervision principles that will be at times inherently contradictory, as demonstrated in the Consultative paper's own examples of undesirable outcomes. To define the two sectors is a only matter

of carving out the Start-up sector – say, companies without prior revenues above \$1 million, yet to achieve profit, and commercialising an innovative technology (applying grouping principles) and placing all others in the other category.

OTHER CARVE OUTS WARRANTED TO MEET PROGRAM OBJECTIVES

The relevance of the context of the R&D activity extends beyond a simple contrasting of established and start-up firms. Some R&D activities exist as part of a systematic process of innovation. Venture capital funds, the new Commercialisation Collaborations and some angel investment syndicates are distinctive examples of this systematic process of identifying new technologies, creating new companies, and the subsequent conduct of R&D activity within these companies to transform the technology into products and services of value to users. As these systematic processes are typically capital constrained, every dollar of R&D tax credit will have demonstrated additionality not only within the start-up company undertaking the specific research and development but by enabling the venture fund or Collaboration or syndicate to fund additional new companies. In this context of a systematic process of innovation, restrictions on the dimensions of ownership and technical delineations between core versus supplemental activity are counter-productive to the encouragement of innovation, and to the objectives of the R&D incentive.

THE IMPACT OF CERTAINTY

The different sectors undertaking innovation also have different requirements for certainty. The established firm undertaking new product development may well be influenced by the incentive of the tax credit but is probably nonetheless capable of accepting a degree of uncertainty about the level of financial support. For the start-up entity with tight capital limitations, certainty of tax position is critical to avoid such risks as unintentional insolvency. For a director governing a start-up company, it is axiomatic that the degree of certainty will relate directly to the degree of additionality achieved. This axiom also applies to the next level up in the systematic sectors where the degree of certainty has a strong influence over each venture fund's or Collaboration's willingness to accept investment risk and support individual innovation developments. At this higher level, portfolio diversification does provide some mitigation to the risk of variability at the entity level, but uncertainty creates barriers to the ability to encourage new capital to invest in such systematic processes.

Specific Submission Points

GENERAL

1. As a general rule, the legislation should distinguish the rules and administration processes applicable to R&D in new start-up companies, relative to established firms. Larger established firms would have a higher obligation to demonstrate Spillover and be subject to a wider exclusion list, which would assist in addressing the excesses in undesirable claims. By separating the tests for the sectors, the administration of start up entities could be administered with greater efficiency and greater certainty to this start up sector. Perhaps the two (or even more) sectors could be administered by different panels, so that each could develop relevant expertise.

PRINCIPLE 1

2. The 50% limit on exempt ownership traps early stage investment in new Publically Funded Research Agencies (PFRAs) technologies by venture funds and the Collaborations between this exclusion and the tax rules applicable to unit trusts (> 50% ownership by a trust in a company causes trust to be taxed as company). It is

also noted that these companies are already penalised by loss of access to other programs such as ARC or NHMRC. As PFRA's generate a significant proportion of Australia's new technology innovations, it seems counterproductive to then place barriers in the path of the commercialisation of these new technologies. It is also noted that in most instances the R&D activity is being wholly funded by non-exempt investors who are earning their way into the PFRA spin out entity.

Solution:

Preferably there would be a means of providing exemption to the exempt ownership test where the R&D activity is being done in start up entities where it is expected as the company develops that the exempt ownership test is likely to be met. As an alternative, the limit should be raised to 60% or at the very least 51%, however, noting in many instances, this is a marginal benefit (see transaction description at end of submission as illustration of challenge).

3. The Grouping Rules also have the same impact on new PFRA's spin out companies, although here the solution may be different. As noted above, new PFRA spin out companies are typically still >50% owned by the PFRA, causing them to be part of the PFRA group under the rules, and thereby being ineligible for the credit. In practice, the new investors and the PFRA have a shareholders agreement that removes the PFRA's absolute control over the entity and again in practice the PFRA intend the spin out to be an independent entity. While the same solution of providing exemption to the Grouping Rules to start up entities from the PFRA sector would be the simplest solution, the other path is to ensure the grouping rules are based on control tests rather than simple ownership percentages.

PRINCIPLE 3

4. The timing of refunds should be accelerated for companies obviously without any chance of near term tax liability. It is obvious the incentive is intended to assist those start-up companies developing new technologies. Ideally such companies would be able to submit their project intentions and corporate tax profile to AusIndustry to be classified as a "Start-up" entity which would then allow the company to submit claims for the rebate say, quarterly with claims paid within 30 days.

PRINCIPLES 4, 5 & 6

5. In this Start-up sector, core R&D should be assessed on a whole of project basis, and a liberal view taken to the definition of core innovation. At the least, AusIndustry should provide early guidance about the principles of what will constitute core R&D whether this is a reaffirmation of current principles or new ones.

There is great risk and administrative cost to a path that involves over-deconstruction of the R&D activity. The test of core should relate to the integral nature of the activity to the whole of the project. The purchase of the petrie dish is neither risky nor innovative but essential to the in-vitro research trial. This may be obvious but other examples may be less obvious. The R&D done to characterise IP in order to support a patent application might be viewed as neither innovative or risky but such research is nonetheless essential to the whole of the project, the project itself being both clearly innovative and risky.

6. To the extent R&D activity in the Start-up company exists, it would be best simply to treat it as core and not have any differentiation between core and supplemental

activity. If this start-up sector cannot be segregated in the administration of the rebate, then it would be most efficient to maintain the current definitions of core and supplemental and apply a standard difference in rebate level to the supplemental - expenditure.

7. For start-up entities, there should be no statutory excluded activities; if exclusions become necessary, then AusIndustry should be enabled to develop a codified list of such activities.

Addendum – Typical PRFA Seed Transaction (Simplified)

The PFRA conducts research leading to a discovery determined to be appropriate for commercialisation. The PFRA creates a spin out company that is 100% owned, and licences the technology into this company.

The PFRA then seeks funding to progress the commercialisation of the technology. Seed funding of \$500,000 is raised for the company from a non exempt entity for an agreed 45% interest in the company. However, this funding is provided in two tranches of \$250,000 of which only the first tranche happens to be invested in the first tax year.

By a shareholder agreement, the PBRA yields absolute control of the company by agreeing that critical decisions will require agreement of both shareholders.

While the company's R&D activity is being funded by capital from the non exempt entity, its immediate interest in the start-up company is only 22.5% with the PBFA still owning 77.5%, far from the 50% proposed to provide incentive for such start-ups. In practice the first tranche can easily be less than this \$250,000.

Usually it is at the Series A round when other investors participate that the PBRA interest will fall below 50%.