2016 National Innovation and Science Agenda

of the

Commonwealth of Australia, Treasury Department

Intangible Asset Depreciation – Exposure Draft

Submission Paper by

The Franksons Group

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NATIONAL INNOVATION & SCIENCE AGENDA: INTANGIBLE ASSET DEPRECIATION – EXPOSURE DRAFT

We thank the Commonwealth Treasury for providing the opportunity to comment on the *Intangible Asset Depreciation – Exposure Draft,* released as part of the Australian Government's National Innovation and Science Agenda.

We expect to see more developments in this area and hope that more investment in Australia's great potential will be forthcoming in the future – from all levels of government and from the broader business community.

It is paramount that Australia continue to diversify its economy and develop new technology across industries, from new processes, efficiencies and capabilities in traditional industries such as mining and agriculture, to entirely new technological arenas such as virtual and augmented reality, artificial intelligence, nanotechnology, to name a few.

About Franksons

The Franksons Group is a strategic consulting firm, specializing primarily in new and emerging technology businesses across South-East Asia, Europe and North America. Franksons also invests in new technology and resource projects around the world.

Therefore, much of Franksons work is affected both directly in our projects that we own and indirectly through our clients. Franksons also provides legal and visa services to international businesses, including tax advice, structuring and litigation.

With staff in our team who have previous experience at companies such as Deloitte, EY, Commonwealth Bank, and McKinseys, and in countries ranging from USA, UK, Asia and Australia, our team has experience and expertise in Finance, Law & Policy, and Technology consulting.

We would like to thank our team who assisted with research and preparation of this submission: Sal Rahmaty, Kimberley Grellinger, Raihan Hossain, Cecilia Tran and Sahar Radfar. We would also like to thank our affiliates Ali Yaseen and Ala Al-Assadi for their contributions as well.

For more about the Franksons Group, please visit www.franksons.com.

Main Contributors

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Francois Brun is head of the Franksons Group, a strategic consulting and venture capital firm since 2009. His expertise is in technology, mining and property industries. He previously worked in corporate auditing and advisory since 2004 for firms such as Deloitte and Ernst & Young, in Australia, the USA and the UK. He has advised government on various policy areas relating to international business, taxation and economic development. He has also previously lectured in taxation and commercial law. He has bachelor degrees in Accounting and Law, and a Masters in Law. For more information, see Francois' LinkedIn Profile.

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Mr Rahmaty has over 15 years experience in management consulting in USA and Canada, specialising in business start-ups and business expansions. Sal heads Franksons operations in North America. He has assisted numerous companies as director, operational manager, strategic consultant and venture capitalist. Sal has numerous degrees in business and information technology, and has taught in business schools across Canada. For more information, see Sal's LinkedIn Profile.

Franksons' Submissions

Introduction

Franksons would like to thank Treasury for the invitation to make submissions in relation to the Exposure Draft. We note our submissions point to various elements of the Explanatory Memorandum as well as the proposed amendments, in addition to our own suggestions for legislative changes.

Background

The Australian Federal Government has outlined its plans for intangible asset depreciation by businesses as a means to encouraging innovation, as noted on the National Innovation and Science Agenda[1] website:

> *"Generally, acquired intangible assets, for example goodwill, do not have taxable effective lives and cannot be depreciated. However, specific intangible assets are accorded a statutory effective life so that they can be brought into the depreciation regime and their cost to businesses depreciated.*
>
> *The statutory effective lives of these assets however, can be longer than the actual life of the asset and, unlike for most tangible assets, these intangible assets with a statutory effective life cannot be self-assessed to bring the tax life in line with the economic life of the asset."*

Franksons recognises that depreciation of intangible assets affords a much more difficult balance to be struck between the varying expectations of Government and the business community. The context of amendments are also noted in Appendix E.

Nonetheless, the issue remains whether a change in the system will have a meaningful impact for business, and whether that impact will not be adverse to the interests of innovation in the future.

[1] NISA website http://www.treasury.gov.au/Policy-Topics/Taxation/NISA/Intangible-asset-depreciation, viewed 17 April 2016.

Submissions

1. Franksons submits that, in principle, the notion of providing a choice to tax-payers is an overall positive move. In reference to paragraph 1.13 of the Explanatory Memorandum, the following criteria are considered:

> 1.13 In self-assessing the effective life of the asset, the taxpayer must work out the effective life in accordance with section 40-105, which includes taking into account:
>
> - how they expect to use the asset;
> - the estimated period of time that the asset can be used by any entity to derive income at its start time (for taxable purpose, for producing exempt income and non-assessable non-exempt income or for the purpose of conducting research and development activities);
> - the rate of wear and tear reasonably expected from the intended use assuming the asset will be maintained in reasonably good order and condition;
> - the likelihood of the asset becoming obsolete; and
> - the estimated time when the asset is scrapped or abandoned.

Source: Explanatory Memorandum, Intangible Asset Depreciation Bill 2016, p 2.

2. However, Franksons also submits that it is questionable whether giving the taxpayer a choice of depreciation methods for intangible assets will in fact provide the desired outcome. For example, a 15-year patent, as described in Example 1.1 (See Appendix A) of the Explanatory Memorandum was acquired for $150,000. Under the new laws a choice between the statutory method of 15 years or the effective life which would by 12 years in the example provided allows for the depreciation of the asset over what is only a slightly shorter period.

3. Franksons submits that the benefit is not substantial to the taxpayer and in fact leaves open a small risk of liability where that method is not deemed to be correct against the criteria, and once the issue is identified 2 or 3 years later a sizeable tax liability will

have accrued, resulting in back-dated interest and penalties. The cost-benefit of taking the more favourable methodology is negligible.

4. Specifically, the issue is that a self-assessment method that allows for taxpayers to choose may also result in unintentional errors and tax controversy in the future which may see some taxpayers have to deal with issues in prior years, in some cases have to pay back amounts where the tax depreciation method was incorrect and/or too aggressive.

5. Further to the above, the same can also be seen in the recalculation of effective life provisions in the new law, arguably opening taxpayers to more scrutiny and re-assessment in the future (See Appendix D).

6. Furthermore, the list of intangible assets to which the choices are available is not extensive, nor is it without restrictions. See extract of the Explanatory Memorandum at Paragraph 1.7 below:

depreciating assets in the table in subsection 40-95(7). The intangible assets to which this choice applies are:

- a standard patent;
- an innovation patent;
- a petty patent;
- a registered design;
- a copyright (except copyright in film);
- a licence (except one relating to a copyright or in-house software);
- a licence relating to a copyright (except copyright in a film);
- an in-house software;
- a spectrum licence;
- a datacasting transmitter licence; and
- a telecommunications site access right.

Source: Explanatory Memorandum, Intangible Asset Depreciation Bill 2016, p 2.

7. Franksons submits that the depreciation by way of a straight line method or any choice in the use of that method does not go far enough to encourage innovation. For more start-ups, innovation-based, small-cap businesses, once they start generating positive cash flows and net profit in their early years of operation, they need to have a larger benefit from depreciation.

8. By way of its own experience with start-ups, both on a consultancy basis and in its own experience, Franksons has noticed that a "front-loading" of expenses would benefit start-ups much more. Similar to the Agricultural concessions provided for fencing where expenditure is immediately able to be written off.

9. Additionally, Franksons submits that greater depreciation concessions be provided to truly encourage business to increase their expenditure. The current proposed amendments only add to the complexity of the existing system by providing choice.

10. Franksons would also submit that the Treasury look to why other jurisdictions either have no intangible asset depreciation, such as Hong Kong and Singapore, yet Taiwan allows for Goodwill to be amortised (See Appendix B). Notwithstanding Australia's IFRS and GAAP rules, a concession on other Intangibles would arguably have a positive on investment in innovation. A possible explanation for Hong Kong and Singapore not having an intangible depreciation allowance is that those countries tax rates are lower, but they would attract more investment and therefore tax revenue as a result.

11. Without setting criteria on innovation, an intangible asset system could in corporate a cap or limitation by way of quantum, possible $100,000 to $200,000, preventing abuse of the system.

12. Franksons submits that Australia look to overseas jurisdictions by way of reference, and look to lead the region in reforming tax such that it is simplified. Singapore, allows for certain items to be instantly written off, and Malaysia interestingly

provides special tax and depreciation concessions for agriculture and forestry (See Appendix C).

13. Franksons submits that more simplified provisions be put in place, with limitations on the amounts that can be depreciated, but allowing for accelerated depreciation for new entities engaged in innovation. This does not of itself require a definition of innovation, although a simplified definition would assist to allow for the NISA policy to be properly rolled out.

Final Remarks

Whilst Franksons supports the intention that the Treasury and Government are making to provide reforms to the tax system, we raise concerns as to whether some of the new laws serve only to complicate and already complicated system.

We would like to thank the Treasury for the opportunity to comment on the Exposure Draft and we welcome an opportunity to discuss our comments further.

Yours sincerely,

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Appendix A

Example 1.1

Amy acquired a standard patent on 1 July 2017 for $150,000. She self-assesses the effective life of the standard patent to be 15 years and works out the decline in value to be $10,000 per annum.

Amy deducts the decline in value of the standard patent for the 2017-18, 2018-19 and 2019-20 income years.

On 1 July 2020, Amy sells the standard patent for $130,000 to an associate, Michael.

Michael is not able to choose to self-assess the effective life or use the statutory effective life for the standard patent, because the associate rule in subsection 40-95(4) would apply to him. He must use the effective life Amy has been using that is yet to elapse at the time he started to hold the standard patent.

On 1 July 2020, there were 12 years yet to elapse on the effective life that Amy has been using, so Michael must use an effective life of 12 years for the standard patent in working out his decline in value.

Source: Explanatory Memorandum, Intangible Asset Depreciation Bill 2016, p 5.

Appendix B

Table 12.10: Summary of annual depreciation rates (selected assets) — Hong Kong, Malaysia, Singapore and Taiwan

	Equipment (approximately 8 year life)	Buildings	Computers	Intangibles
Hong Kong	Initial allowance of 60 per cent for non-manufacturing plant and machinery and office equipment when purchased. Annual allowance of 10 per cent, 20 per cent or 30 per cent is allowable under declining balance method. 100 per cent of manufacturing plant and machinery can be written off when expended.	Industrial buildings — initial allowance of 20 per cent granted on new industrial buildings in year expenditure incurred. Annual allowance of 4 per cent when building first used. No initial allowance for existing buildings. Commercial buildings — annual 4 per cent allowance.	100 per cent can be written off immediately the expense is incurred.	Not allowable.
Malaysia	20 per cent prime cost initial allowance, then 8 per cent to 40 per cent afterwards. Average 10 per cent to 20 per cent.	10 per cent initial allowance, then 3 per cent only for industrial buildings.	Some immediate otherwise 20 per cent initial allowance; then an annual allowance of 40 per cent.	Non-deductible.
Singapore	Straight line allowance: 20 per cent initial allowance, balance over useful life. Equipment depending on the type may have a specified working life of 5 to 16 years. Accelerated allowance: generally three years (although if automated equipment or computers — can be claimed over one year).	25 per cent initial allowance, 3 per cent for subsequent years based on costs for qualifying areas.	Accelerated allowance of one year.	No tax depreciation available nor is goodwill tax deductible.
Taiwan	11.11 per cent (based on useful life plus one year). The useful life of equipment is ranging from 3 to 20 years depending on the type of such equipment.	1.96 per cent = 1/(50+1) 6.25 per cent = 1/(15+1) based on purchase price. Rates based on expected life plus one year.	25 per cent (based on useful life plus one year).	Goodwill cannot be amortised longer than 20 years.

Source: Australian Treasury Website[2]

[2] Australian Treasury website, http://comparativetaxation.treasury.gov.au/content/report/html/14_Chapter_12-05.asp, viewed 19 April 2016.

Appendix C

	Prime cost (straight line) or declining balance method	Determination of rate	Switching	Loadings	Balancing charge offset	Industry specific arrangements
Hong Kong	Generally can choose either prime cost or declining balance method.	Rate to be chosen that most closely reflects the use and consumption of the asset over its useful life.	Yes	Initial loadings allowed for industrial buildings, plant and machinery and motor vehicles.	Recapture rules and specific rules for asset pools but no offset rules.	Prescribed plant and equipment can be immediately 100 per cent written off.
Malaysia	Prime cost only.	Taxpayers cannot select their own rates or lives. The revenue authority publishes standard rates and the taxpayers must adopt these rates.	No	Once-off initial allowance of 20 per cent for plant and 10 per cent for industrial buildings in the first year, in addition to the standard rate.	Recapture of depreciation on disposal proceeds exceed depreciated value. Additional allowance if proceeds are less than depreciated value.	Specific regimes for agriculture and forestry.
Singapore	Generally can choose either prime cost or declining balance method. Taxpayer can elect for either method on an asset by asset basis at beginning of claim.	1. Accelerated: three years (one year for certain assets) on a straight-line basis. 2. Straight-line allowance Initial allowance of 20 per cent of the asset's cost followed by a straight-line annual allowance write off of the balance of the qualifying expenditure over the number of years of working life. There are standard depreciation rates laid down in the tax legislation. It is compulsory for the taxpayer to use the rates specified in the tax legislation, as applied to the specific asset.	No switching between methods is allowed. Deferment of depreciation claim is possible. 1. Straight-line allowance Annual straight-line allowances is given on a 'due claim' basis. However the 20 per cent initial allowance must be claimed in first year of claim; after the first year, the entire 100 per cent cost will be written off on a straight-line basis over the remaining number of years of working life. Deferment of annual allowance on a year to year basis is possible. 2. Accelerated depreciation Commencement of claim for accelerated depreciation can be deferred. However once claim starts, it cannot be deferred again.	Yes, accelerated depreciation and investment allowances in the straight-line basis in the year of acquisition. There is an incentive which grants investment allowances. Investment allowances are given in addition to capital allowances and may allow for additional deduction of usually 30 per cent to 50 per cent of the cost of acquisition of the asset.	Recapture of allowances (Balancing Charge) if proceeds exceed the declining balance method and additional allowances (Balancing Allowances) if proceeds are less than tax declining balance method. There are provisions in the tax legislation for deferment of tax impact of a balancing charge where: 1. there is replacement of the specific equipment disposed; or 2. the disposal is made to a related party and the transaction satisfies certain conditions.	No industry specific arrangements. However a special concession is available for assets with value less than S$1,000. To reduce compliance costs, the concession provides for assets costing less than S$1,000 (regardless of the nature of the assets) to be written off over one year. This is provided that the aggregate claim for the one year write off of all such assets is capped at no more than S$30,000 per tax year. For certain industries, as an incentive and to encourage capital expenditure, investment allowances may be given in addition to capital allowances (see earlier reference to investment allowances).

Source: Australian Treasury Website[3]

[3] Australian Treasury website, http://comparativetaxation.treasury.gov.au/content/report/html/14_Chapter_12-05.asp, viewed 19 April 2016.

Appendix D

New law	***Current law***
To calculate the decline in value of certain intangible depreciating assets, a holder of the asset has the choice to either self-assess the effective life or use the statutory effective life.	To calculate the decline in value of certain intangible depreciating assets, a holder of the asset must use the statutory effective life.
Unless the asset is copyright, licence relating to copyright or in-house software, a subsequent holder of certain intangible depreciating assets must use the remaining statutory effective life, if the holder chooses to use the statutory effective life.	Unless the asset is copyright, licence relating to copyright or in-house software, a subsequent holder of certain intangible depreciating assets must use the number of years remaining in the effective life of the former holders.
If a subsequent holder of certain intangible depreciating assets self-assesses the effective life of the asset, the holder is not able to adjust the prime cost method formula.	No equivalent.
If in a later income year, the effective life used for certain intangible depreciating assets is no longer accurate due to a change in circumstances relating to the nature of the use of the asset, a holder of the asset is able to recalculate the effective life.	A holder of the asset is not able to recalculate the effective life.
If the cost of the intangible depreciating asset increases by at least 10 per cent in a later income year, a holder of the asset must recalculate the effective life.	A holder of the asset is not able to recalculate the effective life.

Source: Explanatory Memorandum, Intangible Asset Depreciation Bill 2016, p 6.

Appendix E

Context of amendments

1.3 The current law mandates the effective life to be used for certain intangible depreciating assets in calculating their decline in value, which may not necessarily reflect the period of time that the assets provide economic benefits to the taxpayer.

1.4 On 7 December 2015, the Government announced a package of measures designed to incentivise and reward innovation as part of its National Innovation and Science Agenda. One of those measures is to allow taxpayers to self-assess the effective life of certain intangible depreciating assets.

1.5 This measure will better align the taxation treatment of those assets with the actual period of time that the assets provide economic benefits. It also aligns the treatment of intangible depreciating assets with that of tangible assets.

1.6 These amendments implement the measure to allow self-assessment of the effective life of certain intangible depreciating assets.

Source: Explanatory Memorandum, Intangible Asset Depreciation Bill 2016, p 1.