18 April 2010

General Manager
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The Treasury
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Dear Sir

SUBMISSION RE SECOND EXPOSURE DRAFT OF LEGISLATION PERTAINING TO THE NEW RESEARCH AND DEVELOPMENT TAX INCENTIVE

Executive Summary

M Squared & Associates Pty Ltd ('M Squared') welcomes the opportunity to provide further comment on the revised version of the legislation pertaining to the proposed new R & D tax incentive that is embodied in the second exposure draft and associated documentation.

It is the submission of M Squared that the second release of this incomplete draft legislation remains deeply flawed for, *inter alia*, the reasons set out in the attached document. Further, the implementation of the legislation in its current form will be detrimental to Australia's national interest though its draconian impact on Australian business. It's introduction will be completely at odds with challenges, in the form of carbon reduction schemes, novel energy generation, storage, transmission and efficiency measures and the national broadband network to name a few, currently being faced by an Australia business sector which has just commenced a re-building phase.

The position is exacerbated because there is no apparent or communicated need for the unseemly haste to adopt the incomplete draft legislation with effect from 1 July 2010, so in the event that changes to address the above concerns cannot be achieved, it is further submitted that the due date for commencement be deferred until at least 1 July 2011 to allow business and the regulators sufficient time to determine precisely how they can make the scheme work at a practical level.

M Squared has provided greater detail and set out the reasoning behind our submission, in the attached document.

If you would like to discuss this submission in more detail please do not hesitate to contact on (08) 630 7800.

Yours sincerely
M SQUARED & ASSOCIATES PTY LTD

CRAIG MILLER
Director

Enclosure: Submission Reasoning

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M SQUARED & ASSOCIATES PTY LTD SUBMISSION RE SECOND EXPOSURE DRAFT OF LEGISLATION PERTAINING TO THE NEW RESEARCH AND DEVELOPMENT TAX INCENTIVE

Submission Reasoning

M Squared wish to firstly observe that the timing of the issue of this draft legislation is most problematic, in that it coincides with the commercial and legislative imperative to lodge registration applications with AusIndustry for the research and development ('R & D') activities undertaken by taxpayers in the year ended 30 June 2009, by 30 April 2010.

This legislative deadline has meant that M Squared (and many, if not all, other specialist R & D practitioners and consultants around the country) has been unable to detail its concerns over aspects of the draft legislation as fully as it might have otherwise wished.

Indeed, this is perhaps one of the concerning aspects of the draft legislation – its unseemly haste that is not allowing the concepts, issues and consequences to be fully evaluated by all interested parties. This is exemplified by the omission from the second exposure draft of one of the key technical matters (augmented feedstock provisions) that caused sufficient significant negative reaction so as to require the withdrawal of the first exposure draft of the R & D tax incentive legislation.

In fact the undue haste in re-releasing the second attempt at the legislation is explicitly cited in 2.46 of the Explanatory Memorandum ('the EM') where it states:

> *Drafting of the feedstock adjustment provisions was not completed at the time of release of this revised exposure draft package.*

If for no other reason, M Squared believes this draft legislation cannot equitably be progressed further without the disclosure and due consideration of the feedstock provisions that form such a critical part in the quantification of any benefit arising from the conduct of eligible R & D activities.

Prior to addressing specific aspects of the draft legislation, M Squared seeks to place the draft legislation and our responses to it, within a larger context.

Australia heralds itself as a first world economy and for a number of years, governments have developed fundamental policies that are aimed at up-skilling its population and moving the country and its economy from a position of the world's 'quarry and farm', to a position where Australia can derive significant benefit from the intellectual prowess of its citizens. A slogan nominating Australia as the 'clever country' is merely one of many that symbolise the desire to develop a country and an economy that is based on the commercial exploitation of the intellectual capital developed within Australia.

Given this broad background, the announcement of the Cutler review of innovation within Australia, the generally positive nature of the report of the Review Panel entitled 'Venturous Australia' and the government's initial position as advocated in its "Powering Ideas – An Innovation Agenda for the 21st Century", the expectations of business were that the changes to be introduced would be ones that enhanced, promoted and provided greater accessibility, predictability and transparency, and reduced complexity and uncertainty within the R & D landscape.

This is not what was embodied in the first round of draft legislation and it is M Squared's position that the second tranche of draft legislation also fails to deliver and in some cases is more complex, more unpredictable, more restrictive, more draconian and more unworkable that the prior draft legislation.

M Squared is of the view that much of the damage that will result from the introduction of the new legislation stems from a misplaced desire to create 'spill-overs' and 'additionality'. These concepts, whilst overtly omitted from the second legislative release, are still clearly key concepts in the second release material.

These concepts skew the idea of government supported R & D away from a practical view of R & D, towards a more theoretical approach to R & D that relies on activities constituting formal scientific experimentation.

For example, the concept of spill-over is predicated on a belief that knowledge produced by a firm should have benefits for other firms or the economy as a whole. This may be true for theoretical or pure R & D, undertaken for the sake of knowledge or greater understanding of fundamental principles by academia, however it does not recognise the potential commercial value to Australia associated with a firm undertaking 'applied' R & D and, with considerable financial risk, converting some aspect of pure R & D into a working, income and employment generating technology that the firm will seek to protect.

Similarly, the concept of additionality seeks to ensure that future eligible R & D is restricted to activities that are additional to those an Australian firm would have done without the tax incentive. However, this concept does not recognise the base level of R & D currently being undertaken within Australia that would not be undertaken now, were it not for the existing R & D tax incentive scheme.

Increasingly, Australian business is required to compete on a global stage, from an economy that now has relatively low tariffs, and in order to do this successfully, many businesses have relied on a variety of government assistance measures, one of which is the current R & D Tax Concession and Tax Offset.

The removal of the current measures and their replacement with something comparable or better, will satisfy an additionality criterion, if the status quo is compared with the position where no assistance measure existed, however, the repeal of the existing legislation and its replacement with the draft legislation as contained in the second release, will, in the mind of M Squared, result in the decimation of R & D undertaken by current business, because there is no recognition of existing R & D activity.

Turning to specific issues within the legislation and associated documentation, one of the greatest legislative uncertainties lies in the registration requirement proposed in the first draft legislation and exacerbated in the second release, being the requirement that claimants will need to distinguish between their 'core' and their 'supporting' R & D activities in registering and ultimately working out their claim.

Under the proposed second release, it is further complicated via the need to determine if the supporting activity was undertaken for 'the dominant purpose' of supporting a core R & D activity (as required within a production environment) or was undertaken for a merely 'directly related purpose' (as required in non-production environments).

M Squared is of the opinion that this measure will result in most if not all current claimants failing to satisfy the legislative registration requirements needed to access the proposed R & D tax incentive scheme for the following reasons.

At its most basic, M Squared is not aware of any commonly used business system (let alone one that could be deployed en masse across Australia in time for a start date of 1 July 2010) that would enable claimants to contemporaneously:

1 distinguish between a core activity and a supporting activity; and
2 determine if the supporting activity requires the application of a 'dominant purpose' test or a 'directly related' test; and
3 be able to overtly identify the core activity that the supporting activity supports

so as to be in a position that the claimant can complete the proposed registration form and determine their entitlement to any R & D tax incentive benefit in accordance with the proposed law.

Given that claimants under the existing and proposed incentive schemes must be companies; this places an unfair, unjust and unwelcome burden on company directors who must sign off on the claims made. This is especially true, given the increased scrutiny of company directors by corporate regulators like ASIC and the ASX, as well as explicit warnings to company boards by the Commissioner of Taxation to verify and ensure their company's compliance with the law.

Another one of the major changes identified by business in the first release of the draft legislation as causing a restriction on R & D was the proposed requirement that activities be both innovative AND technically risky, instead of the current requirement to satisfy one OR the other.

This matter was the subject of considerable debate in the Senate Estimates Hearing in February 2010, where it was conceded by Senator Carr that this particular change was restrictive in nature and because the relevant department (AusIndustry) had not kept any statistics as to whether any current claimant could satisfy both criteria (as opposed to current practice of allowing a claimant through once they had satisfied one) it was impossible to quantify or estimate the impact of this change on current claimant numbers.

Per paragraphs 10 and 11 of the Consultation Guide that accompanies the second release, this perceived restriction was a misunderstanding that resulted in confusion caused by the use of ambiguous concepts and has been addressed by the use of clear language.

M Squared is of the opinion that the requirement to satisfy both innovation AND technical risk is still present in the second release, via the embodiment of these concepts in the new definitions used.

Paragraphs 2.11 to 2.21 of the EM discuss the meaning of 'core R & D activities'. Reference to the EM in conjunction with the draft legislation is essential as these are explicitly stated to embody new concepts.

Paragraph 2.18 states:

> *The need to employ the scientific method will reflect a threshold degree of novelty in the new ideas being tested.*

Given the requirement to always have a core R & D activity, clearly there is, under the proposed legislation a need for a degree of novelty which is recognised as a clear indicator of innovation.

Paragraph 2.13 states:

> *The requirement for the scientific method establishes a threshold for the knowledge gap and degree of uncertainty that an eligible experiment will be seeking to address. That is, the knowledge of whether something is scientifically or technologically possible, or how to achieve it in practice, will not be deducible by a competent professional in the field on the basis of current knowledge, information or experience.*

Paragraph 2.14 continues:

> *Further, there will be a significant risk that the outcome of eligible experiments will not be the desired one.*

The import of the above two paragraphs is clear – in order to be a core R & D activity the activity must contain sufficient risk that a competent professional will not, on the basis current knowledge, information or experience be able to deduce the outcome. This is a clear definition of 'technical risk'.

Accordingly, M Squared believes that for an activity to be considered as a core R & D activity it must be both technically risk and innovative - that is, there has been no change from the position adopted in the first release of the draft legislation.

However, M Squared is also of the opinion that the new release is even more restrictive that the first release thus.

Paragraph 2.13 (above) sets a threshold test and uses the skills of a 'competent professional' to determine if the knowledge gap and degree of uncertainty is sufficiently large to warrant the activity being classed as 'core R & D'.

This is a very high standard that needs to be met and is akin to the requirement to obtain a patent where the test applied is that of a 'person skilled in the art'. This can be contrasted with the current position where the legislation and the courts have applied a concessional or expansive view to the threshold gap sought to be bridged by the R & D activity.

Given the ability of the regulatory authorities to review decisions made by claimants, with the benefit of hindsight, it will prove increasingly difficult for claimants to demonstrate the knowledge gap underpinning their R & D activities, where the threshold being applied uses that of a competent professional who presumably has access to knowledge, information and experience on a global basis. It is also noteworthy that the EM states in paragraph 2.16:

> *This purpose test will not be satisfied by experimental activities that merely confirm what is already known – even though that knowhow might not exist within the firm conducting the activities.*

Similarly, paragraph 2.18 also states:

> *The knowledge that is being sought will go beyond validating a simple progression from what is already known and beyond merely implementing existing knowledge in a different context or location.*

Both of the above excepts indicate that to be a core R & D activity, the activity must seek to progress beyond what is "known" (as defined by reference to the knowledge, information and experience of a competent professional, rather than by reference to the knowledge within the claimant entity) and to do so in a way that goes beyond taking the next logical step (even if this is into completely new territory) or beyond seeking to apply something that is known in one area, but the claimant believes it has novel application in another context or location (i.e. a completely new application of technology, etc).

M Squared is of the opinion that the operation of this measure has the potential to severely restrict current R & D activities undertaken in Australia, where significant intellectual capital and commercial value arises out of redefining the uses of existing technology and applying existing knowledge in novel ways and in situations that were not contemplated by original inventors.

M Squared thinks it noteworthy that even the identification of a core R & D activity is problematic under the proposed legislation.

For example, paragraphs 2.22 and 2.23 of the EM state:

> *Core R & D activities will be part of the eligible experiment, rather than merely related to it. ... This scope may be narrower than what the firm might view as its R & D project. An activity will not fall within the scope of the experiment merely because the experiment cannot take place without it.*

Other aspects of the second release legislation that M Squared believe are drafted in a manner that will harm and restrict Australian R & D, rather than promote and provide incentive to undertake it, include the introduction of a charge to the company's franking account.

Currently, a claimant under the R & D Tax Concession and Tax Offset is able to obtain a cash injection worth 37.5% of the company's spend on eligible activities. This cash injection is akin to an individual's tax refund cheque – it is not assessable income for tax purposes and carries no further tax consequences – in accounting parlance it creates a permanent difference.

Under the first and second releases, the receipt of a refundable R & D tax credit will result in a debit to the company's franking account. What this means is that the company's franking account will be decreased, and in most instances move into the negative. The consequence of having a negative balance in the franking account is that prior to the company being able to pay a franked dividend to its shareholders; it must pay sufficient company tax to put the franking account back into positive territory. Put simply, if it receives a refundable tax credit of $10, it may pay $10 in company tax, before it can pay franked dividends to its shareholders. In accounting terms, the refundable R & D tax credit will become a timing difference, in that the cash received from the ATO via the credit, must ultimately be repaid in full to the ATO.

M Squared believes this measure will act as a disincentive to domestic venture capitalists and domestic investors in R & D companies, because any start-up entity that has received a refundable R & D tax credit will carry an obligation to repay the value of the credit to the government, prior to being able to pay dividends to its shareholders.

That is, why invest in a risky venture (start –up R & D company) in the full knowledge that prior to getting any return on the investment; the venture must make potentially substantial repayments to the government by way of company tax.

As a measure, it may result in a greater attraction for foreign investors to acquire equity interests in high tech Australian firms because they are happy to receive unfranked dividends, however such an outcome runs contrary to the government's stated intention of the R & D incentive scheme to boost Australian intellectual capital.

Whilst there are other aspects of the second release that M Squared believe require further examination and contemplation, time does not permit M Squared to continue to elaborate its concerns via this submission.

M Squared contends that the above concerns necessitate the deferment of any legislative release of the draft legislation till 1 July 2011 at a minimum, and constitute such a significant threat to Australian business and the national interest they warrant a complete review and re-write as part of an extensive dialogue with industry and practitioners who have commercial experience in the field.