AUSTRALIAN INNOVATION ASSOCIATION

Submission to the Joint Standing Committee
on Public Accounts and Audit
Inquiry reviewing a range of taxation issues within Australia.

The Australian Innovation Association welcomes the Committee's invitation to make a submission to its inquiry into certain aspects of the administration of taxation matters by the Australian Taxation Office. Our submission covers two items in PART A of the inquiry, namely,

- the impact of the interaction between self-assessment and complex legislation and rulings
- the level and application of penalties, and the application and rate of the General Interest Charge and Shortfall Interest Charge.

EXECUTIVE SUMMARY

In 1986 the then government introduced legislation to encourage private sector investment in research and development. This led first, in about 1988, to the formation of the first R&D Syndicates. Under syndicated arrangements, groups of financial investors formed syndicates to support particular R&D projects. This development was viewed favourably by Government at the time as a means of broadening the investor base in R&D and boosting Australia's internationally low levels of R&D Spending. To qualify for the tax concessions provided in the legislation each syndicate required the formal consent of the Industry Research and Development Board (IRDB) and vetting by the Australian Taxation Office (ATO). The projects were required to be either innovative or involve technical risk. Accordingly there was likely to be a high failure rate, but the tax concession was not contingent on the commercial success of the project.

Over 240 syndicates over the 8 year period 1988 - 1996 were successful in meeting the IRDB and ATO requirements, resulting in a significant boost to private R&D expenditure. The investors, in responding to a government sponsored scheme, and having met the stringent requirements of the vetting process, believed that they had made a secure investment.

In 1992 the government, in responding to some perceived flaws in the scheme, amended the legislation to tighten the eligibility criteria. However, the Government of the day clearly continued to view syndication as a critical policy initiative, and this was confirmed by studies commissioned by the Government at the time.

In 1996 the incoming Government ended the scheme. In introducing the measures the Treasurer cited four examples of abuse of the scheme, although none of these four projects had achieved registration. From this moment on, R&D Syndicate investors have had the impression that the ATO has regarded them as potentially in the same category. From 1998 onwards the Government exerted pressure on investors to wind up those syndicates not in a position to repay the original investment plus a dividend.

Since 1999 the ATO has retrospectively challenged the value of core technologies licensed by researchers to investors, at least six years and up to twelve years after the license was entered into. As far as is known to the AIA, the vast majority of such revaluations have resulted in core technologies being assessed at nil or negative value. These include cases where the project concerned has had substantial commercial success or sold later at a substantial value. Following these revaluations the ATO has issued position papers and amended assessments denying tax concessions, sometimes adding fifty percent penalties and interest charges to the primary tax demanded.

In July 2002 the AIA gained the agreement of the Tax Commissioner to a process of mediation designed to produce a generic framework for the resolution of disputed assessments. The objective was to avoid the substantial costs of litigation. However, it was not until September 2004 that this process resulted in the issue of guidelines against which syndicates would be judged as complying with legislation. It was significant that the judgement as to compliance remained with the ATO. In the meantime the ATO had

unsuccessfully challenged an R&D syndicate in the Administrative Appeals Tribunal and the Federal Court (the "Zoffanies" case).

Despite protestations to the contrary by top management of the ATO, AIA members have continued to encounter aggressive attempts by ATO front line officers to induce taxpayers to settle with the ATO to their financial disadvantage. They regard the ATO's actions so long after the event (up to 13 years) as the equivalent of retrospective legislation and as unconscionable in light of the fact that the arrangements were fully disclosed to, and ruled upon by the ATO, and as syndicates were simply a reflection of formal Government policy at the time. They have drawn the issue to the attention of the Inspector-General of Taxation, who is conducting an inquiry into the ATO's handling of the matter.

It is a matter of continuing concern that no time limits are placed on the ATO in relation to R&D Syndicates and R&D investment generally. Taxpayers incur substantial legal and administrative costs in responding to ATO demands, made significantly higher because of the almost (in a commercial context) archaeological nature of the search for documents. The experience of significant investors with this scheme, entered into at the express invitation and encouragement of the Australian Government, has cast a shadow over their approach to R&D investment generally.

AUSTRALIAN INNOVATION ASSOCIATION

The Australian Innovation Association (AIA) is a group of investors and researchers set up in July 2002 to represent the interests of R&D participants in Australia. The objectives of the AIA are to advance Australia's capacity for innovation and to promote a consistent and certain environment for R&D, thereby enhancing the country's international competitiveness in the years ahead. A description of the Association, outlining the rationale for its establishment, its objectives and the composition of its Committee of Management is attached.

Early in its life the Association identified the treatment by the ATO of participants in R&D Syndicates as a serious obstacle to attracting investment in commercially viable R&D activity in Australia.

Members of the AIA who had participated in the Federal Government's R&D syndication program in good faith and had followed the elaborate accreditation process involving the IRDB and the ATO expressed their concerns on the actions of the ATO in issuing position papers and amended assessments some years after the initial investment. Particular concerns included the retrospective nature of the actions, the excessive delays in audits, the departure from private rulings, arbitrary revaluations and the inappropriate application of Part IVA.

BACKGROUND

R&D syndication was a government sanctioned investment program to promote private sector investment in large R&D projects. As part of the introduction of the 150% R&D tax concession in the late 1980s, the Federal Government legislated for the financing of R&D programs by investors independent of the company running the R&D program. A substantial number of companies participated in over 240 R&D syndicates on the express encouragement and formal consent from the IRDB and the ATO. Many (if not all) of the syndicated arrangements took advantage of section 73CA permitting a guaranteed return, thereby accepting a lower level of deduction (being 100% not 150%).

The syndicated R&D projects were required by the *Income Tax Assessment Act* (ITAA) and the *Industry Research & Development Act* to be either innovative or involve technical risk. Accordingly there was likely to be a high failure rate due to the early stage nature of the technology. The tax concession was not contingent on the commercial success of the project. The syndicate participants provided copious information to the IRDB and the ATO in order to gain the required registration approvals, including full disclosure of the R&D program, the R&D spend, the core technology licence, the transaction legal

documents, the independent valuation of the core technology and, where applicable, the specifics of the finance scheme.

The ATO initially provided written advance opinions and then private binding rulings for individual syndicate investors and researchers. These were intended to provide comfort that the R&D deductions would be available and that the anti-avoidance provision of the ITAA, Part IVA, would not apply on the understanding that the primary purpose of the syndicates was not for tax benefits. Given the detailed examination of each project by the IRDB and the ATO, and the formal registration of each project and ATO rulings on each project,, it was universally assumed by investors and researchers that the process provided sufficient assurance to genuine investors and researchers to enable them to commit themselves to participation.

Inevitably there may have been at the fringe some who took advantage of the initial guidelines to design schemes whose primary purpose was to secure tax benefits, but most such abusive syndicates were rejected by either the IRDB or ATO. The vast majority of participants were therefore in accord with the intentions of the government's policy initiative and received IRDB and ATO sign off. The program was continually modified from its inception to improve its effectiveness, eg the exclusion of public and later private tax exempts from involvement in syndication, a reduction in the rates of deduction for core technology and R&D expenditure and the eligibility requirements for the proposed core technology and finance scheme.

The main features of a typical R&D syndicate were summarised in para 4 of the ATO's ruling IT 2635 dated 9 May 1991 and the attachment to that ruling. The preamble to the ruling specifies that the purpose of the R&D concession is to increase the level of industrial R&D in Australia and that the tax concession was introduced to compensate for the higher commercial risks which R&D entails. The ruling required the payment for the core technology to be at an arms length market value price.

R&D syndication resulted in a significant increase in business expenditure in bona fide R&D and funded a significant amount of R&D for early stage researchers, involving many of Australia's leading innovative, export oriented R&D companies and non profit research institutes. It is clear that many of Australia’s leading researchers would not be successful today if not for the R&D syndication program.

A change in government resulted in the cessation of new syndicate registrations in July 1996. In introducing the measures, the Treasurer cited four examples in which the intentions of the scheme had been perverted by investors whose main purpose was not the pursuit of sound industrial research and development. These examples had been rejected for registration by the IRDB and accordingly did not proceed. Subsequently mainstream investors and researchers pursuing legitimate objectives have had the impression that the ATO has treated them as being potentially in the same category.

From 1998 onwards, the Government, AusIndustry and the IRDB have put increasing pressure on investors and promoters to wind up existing syndicates where the syndicates will not be in a position to repay the original investment plus a dividend. Senator Minchin, the then Minister for Industry, Science and Resources publicly endorsed action taken in good faith by syndicate investors to wind up substantial numbers of R&D syndicates with a resulting saving to the Australian taxpayer.

ATO ACTION

Despite this cooperation on the part of syndicate participants, the ATO has, over the last seven years, conducted a program of retrospectively revaluing core technologies licensed by researchers to investors. These revaluations have been based on ATO valuations obtained from the Australian Valuation Office and selected external valuers, some at least 6 and up to 12 years after the licence was entered into. As far as is known, the ATO commissioned valuers and informal valuations undertaken by ATO staff have, in most cases, determined that the value of core technology is either nil or a negative value. (Of course, the concept of negative value is an absurdity - unless there is a liability attached, which is not the case here, an asset can never have a negative value). This is despite the syndicates in question employing vastly different technologies and having different but appropriately qualified independent valuers who valued the technology

based on the best available principles and methodology at the time. These valuations were always disclosed to the ATO at the time and ordinarily formed part of the ruling request. The regulatory rulings implicitly recognised the validity of this approach and the arms length nature of it.

The ATO valuation process, conducted many years after the original investor and researcher commitment in good faith to the program is seen as tendentious. It is an attempt to argue that the arrangements were not conducted at arms length, and that therefore the anti-avoidance provisions of Section 73B should apply. As a result, the ATO has issued position papers and amended assessments denying tax deductions for core technology and the related interest. Penalties (sometimes at 50%) and interest have been added to the primary tax.

The ATO has also attempted to use Part IVA to strike down legislated concessions. An example was the Transgenic R&D Syndicate which licensed core technology from the University of Adelaide in 1992. The ATO commenced an audit of the syndicate in 1994 which concluded in 2000 with the issue of amended assessments. The matter ("Zoffanies") was litigated in the AAT in 2002, where the AAT found that

- the parties dealt at arm's length;
- the price paid for the core technology licence of approximately $15 million was appropriate;
- the valuation obtained by the syndicate in 1992 was the appropriate valuation;
- the expert valuation evidence presented by the ATO in court was flawed: and
- Part IVA did not apply i.e. the dominant purpose was investment in R&D, not to obtain tax benefits.

The ATO appealed all of the above findings to the Federal Court but dropped the objections against arm's length dealing and valuation findings in the week prior to the hearing in July 2003. It argued in the Federal Court that there was an error of law in the decision of the AAT on the findings on Part IVA.

The Federal Court upheld the Commissioner's appeal in connection with certain elements of Part IVA and the matter was partially remitted back to the AAT on 24 October 2003 on Part IVA. However the Commissioner abandoned the matter in mid-April 2004 and the AAT handed down orders in favour of the taxpayer on 5 May 2004.

MEDIATION AND GUIDELINES

An important element in the ATO's handling of the R&D Syndicates issue has been the mediation process involving examination of a specific syndicate conducted by Sir Anthony Mason. This process was seen by the AIA as a potentially effective way of resolving outstanding issues speedily and fairly, thus avoiding expensive litigation. In practice the outcome has been disappointing, and has failed to achieve the objectives set at the outset of the process. It is worth recounting the history of mediation, and the resulting "guidelines".

In a meeting with the Chairperson of the AIA in March 2002 Commissioner Carmody offered to engage in what might be called a 'generic' mediation process with taxpayers nominated by the AIA, with the objective of producing a set of guidelines which could be used to apply to all outstanding syndicates - in effect a set of rules agreed by parties to the mediation as being fair and reasonable in assessing liability for tax. The main area of disagreement raised at the meeting was that of core technology valuations.

The AIA having agreed to a mediation process, a meeting was held between Mr. Carmody and senior officers of the ATO and representatives of the AIA on 23 July 2002, at which the outline of the mediation process was agreed. A preliminary conference was held on 23 August 2002 with Sir Anthony Mason presiding, at which certain AIA members were present. (The AIA itself was not a party to the mediation.) There were hopes that the process would be swift, with a conclusion expected by mid 2003. In fact the process was protracted and difficult, with agreement on guidelines reached only after two years of negotiations, during which the ATO officers involved exhibited little of the goodwill promised by their superiors. On 6 September 2004 the ATO published the agreed guidelines, and in late September and early October circulated a draft settlement offer which purported to take into account, *inter alia*, the number of taxpayers involved in syndicated R&D arrangements, the amount of deductions claimed by those taxpayers,

the fact that the syndicates were entered into a number of years ago, the decision in the *Zoffanies* case and consequent litigation risks and the resources, time and expense for all parties in contesting the deductions claimed.

Given these assurances one might expect that the approach of ATO officers in subsequent dealings would be far more reasonable than hitherto. However since AIA members were sceptical, the AIA wrote to Mr. Carmody on 27 October 2004 expressing, *inter alia*, the following concerns:

- Under Option 2 (i.e. rejecting a 50% offer and claiming to satisfy the guidelines) the ATO sought to abrogate its statutory obligation to form a view on valuations, effectively reversing the normal onus of proof, in that the taxpayer had to prove the validity of the core technology valuation, with all the difficulty and expense involved, particularly after the passage of so many years.
- Under Option 2, the ATO's judgement would be final, subject only to potential litigation.
- Members were sceptical, given past attitudes and approaches, of the objectivity of ATO officers conducting the examination.

On 30 November 2004, Second Commissioner Mr. Michael D'Ascenzo wrote on behalf of the Commissioner seeking to reassure the AIA of the ATO's reasonableness in conducting the process, saying *inter alia*:

"It is certainly our intent to adequately resource the process associated with the guidelines. The cases will be reviewed by senior ATO officers to ensure that both a consistent and also timely approach is taken to the application of the guidelines to the particular facts".....

"We are of the view that in relation to this matter of administration the arrangements outlined above will ensure a consistent and objective application of the guidelines".

The AIA Chairperson followed this up with a meeting on 4 February 2005 with Mr. D'Ascenzo and Mr. Kevin Fitzpatrick, First Assistant Commissioner, further expressing the scepticism of members, and received further assurances as to the genuine wish of the ATO to resolve outstanding cases in a fair and reasonable manner. Unfortunately this was not to be, and after the matter was reviewed at the AIA Annual General Meeting in November 2005 the AIA wrote on 15 December 2005 to Mr. D'Ascenzo, by now Acting Commissioner. The following extract from that letter summarises the current situation:

"Many months have passed since (the 4 February 2005) meeting, and at its Annual General Meeting in late November, the AIA conducted an assessment of the current situation. I have to say, on the reports of members, that the ATO is not meeting its commitment. There have, of course, been exclusions under the guidelines, which have been welcomed by members with smaller syndicates, and no doubt some taxpayers above the exclusion limits have, in their commercial interests, accepted the ATO offer as the least unacceptable option. But for those investors who believe they have acted properly in accordance with the former Government's intentions and rules there is a belief that the ATO officers handling the case are intent on forcing acceptance of the ATO offer."

On 22 December 2005 the AIA made a submission to the Inspector-General of Taxation, who is conducting "Reviews into the Tax Office's Ability to Identify and Deal with Major, Complex Issues within Reasonable Time Frames". The submission contains the same information as we now present to the Committee, but with additional confidential information relating to particular cases.

Mr. D'Ascenzo replied to the AIA letter of 15 December 2005 in his new role as Commissioner on 16 January 2006. Whilst admitting that the matter had gone on for too long, the Commissioner nonetheless gave no indication that there would be an early resolution, and indeed stated that some cases might result in litigation. A copy of the Commissioner's letter has been forwarded to the Inspector-General expressing AIA's continuing dissatisfaction with the process.

SPECIFIC CONCERNS OVER ATO APPROACH

In brief, the specific concerns AIA has with the actions of the ATO may be summarised as follows:

- They amount to a complete negation by administrative action of the previous government's policy intentions, enshrined in legislation and backed up by elaborate regulatory machinery. They also involve a departure from Private Binding Rulings and Opinions and the terms of IRDB approvals.
- There has been excessive delay in initiating reviews and issuing amended assessments. In some cases some 13 years have elapsed since the original investment.
- There are no statutory time limits on the Commissioner in the application of the specific anti-avoidance provisions of section 73B. Accordingly, the Commissioner may seek to amend an assessment to increase a taxpayer's liability at any time under section 170(10A) in relation to the operation of section 73 R&D provisions. The absence of any time limitation exposes taxpayers to further disadvantage. We believe that time limits should be introduced in the practical administration of R&D syndicate audits, otherwise we will have a situation where the ATO could continue to review and audit specific R&D syndicates forever.
- The general interest charge has a punitive, compounding effect. Also, as the burden of proof rests with the taxpayer, the effluxion of time makes it increasingly difficult to marshal facts and engage witnesses.
- The ATO relies on retrospective desktop valuations prepared many years after the event, which have come up with different results, predominantly by using hindsight to focus on any potential weaknesses in the assumptions in the original valuation. This approach does not give due consideration to market reality and the rapidly changing nature of technology based industries and the related valuations. Consider for example the movement in internet related technology valuations from 1998 to 2001.
- The anti-avoidance provisions in section 73B(31) require the Commissioner to be satisfied that the parties were not dealing at arm's length. In exercising this discretion, the ATO has not considered the dealing between the parties in any detail, instead relying on a retrospective valuation. This is a misapplication of the Commissioner's discretion under the section.
- A significant number of government-funded technologies were licensed to R&D syndicates. These technologies were derived from projects undertaken by government research bodies and major universities. The ATO's view is that these technologies have no value, surely a strange conclusion.
- The ATO attempted to use Part IVA to strike down legislated concessions. This action was quite contrary to the intention of Part IVA in legislation and in its normal application.

EFFECT ON INVESTORS AND R&D ENTERPRISES

Participants in genuine R&D syndicates did so in good faith at the invitation of the government of the day. Whilst they fully recognised the right of an incoming government to change policy, they were nonetheless dismayed that they were being characterised as tax avoiders. The subsequent actions of the ATO have reinforced this impression, leading to a strong sense of resentment at having been persuaded to participate in what was initially regarded by the government of the day as being in the national interest, only to be characterised retrospectively as behaving improperly.

Given the elaborate screening procedures initially carried out both by the IRDB and the ATO, syndicate participants were entitled to believe that their investments were soundly based. They therefore regard the administrative actions of the ATO as equivalent in effect to retrospective legislation, and therefore a direct attack on private property rights.

It is not surprising therefore that some investors decided that they had no alternative but to resort to litigation to protect their rights and property. As is well known this results in a prodigious expenditure of time and money, most of it long before the ATO is obliged to make a similar investment. This is time and money that ought to be spent on productive activities to enhance the nation's wealth.

For some enterprises which have provided indemnities to investors there is also the threat of bankruptcy. In addition many publicly funded research institutions which have been the beneficiaries of syndicate investment have been caught up in responding to ATO audits, soaking up time and resources which they are singularly ill placed to afford.

Overall the ATO's actions have led to a serious loss of faith in the fairness and consistency of government policy, and have had an adverse impact on the willingness of investors to support R&D based companies and institutions.

It needs also to be observed that the AIA includes taxpayers who are significant claimants of the general R&D tax concession. These taxpayers, in line with Syndicate investors, are also subject to the prejudicial impact of the absence of time limits on the issue of amended assessments. This means that the R&D tax affairs are never closed. This cannot but have a depressing effect on R&D investment generally.

Australian Innovation Association
173 Nicholson Street,
Carlton VIC 3053

Tel: 03 9349 3471
Fax: 03 9349 1969
Mobile:0418 558 939
Email: carlton.jim@bigpond.com

March 28, 2006