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Submission

Re: think Tax Discussion Paper

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Tax White Paper Task Force
The Treasury
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1. Introduction

1.1.Our Credentials

Michael Johnson Associates (MJA) welcomes the opportunity to make this submission to the “Re: think Tax Discussion Paper” (the Paper) process.

Established in 1983, MJA is a national professional services firm that specialises in assisting Australian companies in accessing Federal Government (the Government) support programs for innovation with a particular focus on the Research and Development (R&D) Tax Incentive (the Incentive). Our specialist team of engineers, scientists, miners, IT professionals, accountants, tax experts and lawyers has extensive hands-on experience in the preparation of Incentive claims Australia-wide and our team understands exactly how client technology links to the R&D tax rules.

MJA currently services over 150 organisations operating in all Australian states and territories. These organisations range in size from small start ups to ASX Top 100 listed companies. Since the R&D tax rules commenced in 1985, we have prepared claims in all sectors ranging from manufacturing, information technology, telecommunications, biotechnology, mining and fast moving consumer goods.

MJA is recognised as a thought leader in the area and we have genuine relationships with the relevant government bodies including the Department of Industry and Science, AusIndustry, the Treasury and the Australian Taxation Office (ATO). MJA was instrumental in the consultation process that set up the R&D Tax Concession (the Concession) program back in 1985 and we have continued this tradition through our participation in the 2008 *National Innovation Review* and the more recent Incentive design and delivery forums and reviews.

In 2011, MJA became a founding member of the Federal Government’s R&D Tax Incentive National Reference Group (NRG). The NRG provides key stakeholders and administrators with a forum for the identification, prioritisation and discussion of views on significant technical and administrative issues relating to the Incentive. We have also joined the recently-formed State Reference Groups (SRGs) in Brisbane, Melbourne and Sydney.

Our academic credibility is reflected by the fact that MJA is responsible for writing the CCH *Federal Tax Reporter* commentary and the *Master Tax Guide* on the Incentive.

Beyond the Incentive, MJA has consulted extensively in a range of other Federal Government innovation and venture capital programs, and has worked with a diverse range of organisations on the best ways to capitalise on the advantages offered by innovation.

1.2. The Importance of Business Innovation

MJA practices in the area of Australian innovation because of our unwavering belief in its importance. Our company vision incorporates MJA’s commitment to making a significant contribution to the Australian economy by promoting and delivering the benefits associated with innovation.

The Paper acknowledges the benefits associated with an innovation-led economy in Section 5.3: 'Entrepreneurship and innovation' and the role that the tax system can play in both encouraging and discouraging innovation. From MJA's perspective, our focus is on the impact that the tax system has on innovation in the private sector, with innovation being regarded as the commercialisation of ideas. We see companies as being interested in undertaking innovative practices as a result of two main drivers of their businesses – product/process differentiation and cost reduction.

In terms of measurement, there is a plethora of methodologies and evidence to consider. Suffice to say, it has long been the case that Australia's private sector innovation performance has been seen to lag behind our outstanding public sector achievements and this has been reflected in most benchmarking exercises.

For example, the Federal Government recently launched the Global Innovation Index 2014 (GII) (www.globalinnovationindex.org) leading into the G20 Summit. Against the 143 economies surveyed, Australia ranked 7th in tertiary education, 8th in R&D, 9th in general infrastructure yet only 17th overall (up from 19th in 2013). The lagging performance of the private sector is an undoubted contributor to the lower overall ranking than some of our 'Top 10' areas. Further, various assessments of Australian innovation invariably conclude that sustained commercialisation of our innovation outputs is an area that requires significant improvement.

The current debate regarding Australia's innovation system covers a range of issues including the following:

- The establishment and promotion of an Australian innovation culture and mindset
- The emerging link between R&D, science and technology and productivity
- The innovation opportunities in areas such as health, climate change, food security and the transition from finite resources
- The relationship between innovation inputs – institutions (human capital; research infrastructure; market sophistication; business sophistication) and outputs (knowledge; creative; technology)
- The impact of increasing globalisation – accessing the 98% of innovation that occurs offshore; the need for internationally scaleable business; retention of local talent
- The intractable issues that surround private/public sector collaboration
- The negotiation of the commercialisation "valleys of death"
- The role of start ups and venture accelerators – where will our high value advanced technology businesses come from and how are they to be fostered
- The state of Australia's nascent Venture Capital market

Against this background, this submission will focus on the emphasis that the Paper placed on the fact that one of the four ambitions of the Government's Industry Innovation and

Competitiveness Agenda is to encourage more business innovation. It will do so by directly addressing the implications of Discussion question 39:

Does the R&D tax incentive encourage companies to conduct R&D activities that would otherwise not be conducted in the absence of government support?
Would alternative approaches better achieve this objective and, if so, how?

2. MJA's Summary Position and Recommendations

MJA believes that the Incentive is the fundamental mechanism by which the Government is able to increase the amount of R&D conducted by the private sector. As will be discussed, we do not believe that alternative approaches are available to better achieve this objective. However, we submit that the program is being severely compromised in its ability to deliver its innovation dividend due to the constant alterations being made to the Incentive as the result of a never-ending political review of the provisions. We submit that the Paper process offers the chance to draw a line in the sand by instituting a holistic and bipartisan examination of the Incentive as an immediate priority. The legislated program that results should then be given a five year time horizon to prove its worth.

MJA understands that a promised specific review of the Incentive leading into the Paper process has been taken off the table. Later in this submission, we will refer to the "review fatigue" associated with the constant scrutiny that the program has been under since 2008, potentially the reason why the proposed review was shelved.

Yet it is for this reason that MJA submits that a comprehensive review of the Incentive be commissioned as a priority for the Government. We will argue in this submission that the constant scrutiny and alterations have bent the Incentive out of shape and it is now operating in a sub-optimal manner with no stability or certainty around the provisions. Holistic program reform with bipartisan support is urgently required to restore the program to rude health. The constant tinkering needs to be stopped immediately.

We would like to make one comment by way of introduction. Inevitably, any government review of the Incentive such as we are recommending now begins with a statement that R&D is not "business as usual" activity. This always sets the debate off on the wrong foot. All the evidence suggests that the types of R&D activities defined in the Incentive need to be part of the everyday operations of a successful and sustainable business. MJA has devoted 30 years to communicating the benefits of innovation to the Australian business community and our submission is predicated on our continuing belief that the Incentive must support the breadth of innovation activities necessary to help Australia's future economic prosperity.

MJA remains firmly of the belief that the Incentive remains the best method of encouraging Australian private sector innovation available to the Government. The Paper itself highlights the widespread availability of R&D tax incentives globally, including most OECD countries, on page 101, which speaks to the widespread acceptance of the approach. The Government has reported that participation rates in the Incentive have risen sharply in recent times with around 12,000 organisations now claiming the program.

This acceptance reflects the clear advantages of a tax mechanism. It provides the best coverage through the general self-assessment foundation of company tax. No direct grant or subsidy can achieve the same level of awareness and availability. The significantly lower costs of administration also play in favour of the tax incentive approach.

The Paper points out the numerous versions of R&D tax incentives globally and this underlines the fact that the perfect system is not settled, but the volume-based approach of the Australian version, which has been available since 1985, has an enviable record of success which we highlight later in this submission.

In examining the Incentive in particular, MJA believes that the constant scrutiny that the program has been subjected to since 2011, both in its design and in its delivery, has weakened the contribution the program has been able to make to the encouragement of business innovation. The taxpayers with whom MJA interact tell us that this been due to the great uncertainty about the ongoing availability and operation of the program.

Allied to this is the fact that a number of changes to the Incentive that have been mooted and/or enacted – rate cuts; expenditure caps; unlimited cash refunds; unworkable legislative features – have contributed to the program becoming severely bent out of shape, with a stark contrast emerging between categories of taxpayers in terms of the levels of available benefits and real behaviour incentives.

The Paper asserts on page 101 that the Incentive is “simpler and more generous” than the Concession it replaced. MJA submits that the Incentive is more generous for some taxpayers, but not all. We also submit that the program is not simpler. In fact we believe that greater program complexity is the real issue that is plaguing the Incentive, not whether it needs to be replaced with a better alternative as posited in Discussion question 39.

At the heart of our concerns are the combined effects of the recently introduced $100 million expenditure cap and the introduction of a second Bill seeking a reduction of both R&D Tax Offset rates by 1.5% with both these measures taking retrospective effect from 1July 2014. No detailed modelling of the impacts of these changes has been provided by the Government, but it is apparent that the amount of the reduction in overall R&D support is at least a third. This represents the single largest cut to Australian innovation support since the 1996 changes to the Concession (when the rate of deduction was halved to 125% along with the introduction of the feedstock offsets) which saw Australian BERD drop for five years consecutively after two previous decades of growth. The combined impact of the announced cuts means that Australian BERD faces the same threat today.

It is in this context that we offer some straightforward changes that could see the program move ahead far more effectively whilst acknowledging the current climate of fiscal restraint. We submit that the fundamental lever to achieve this is the setting of offset rates that are affordable, yet sufficiently high to provide an incentive to all Australian companies.

In summary, MJA recommends the following courses of action to the Government in the context of Discussion question 39:

- Conduct the previously-promised review of the Incentive as an immediate priority. It needs to be holistic, consultative and evidence-based.
- Determine the affordable level of support under the Incentive and then set the R&D Tax

Offset rates from 1 July 2015 accordingly.

- Abolish the $100 million R&D expenditure cap retrospectively from 1 July 2014.
- Determine and introduce a maximum amount payable as cash under the Refundable Offset from 1 July 2015 onwards.
- Institute a review of Incentive advisory and administrative practices, headed up by the R&D Tax Incentive National Reference Group (NRG) members.

We also ask that the program that emerges from this process be the result of politically bipartisan design with an agreement that it will not be changed for a five year period to provide the medium-term certainty that taxpayers crave and deserve.

3. The Challenge for Government

The Cutler Review of the Australian Innovation System was the last comprehensive review of innovation policy undertaken and it formed the basis of the then Federal Government's innovation policy announcements of May 2009.

Cutler clearly identified and articulated the need to encourage more businesses to do more R&D and thereby help create a better future for Australia as a vital plank of the Government's policy on innovation, science, research and technology. A key notion was that a systemic approach was needed embracing all Australian company groups and MJA believes in that the idea that governments should approach innovation with a 'whole of economy' mindset in designing its R&D support policies.

Recent policy announcements such as the introduction of the $100 million R&D expenditure cap in February 2015 has reflected an emerging government attitude that innovation is the province of small to medium enterprises (SMEs), yet this flies in the face of the fact that most of Australia's innovation spend comes, inevitably, from its largest organisations. These large companies interact with SMEs and the rest of the innovation community including the academic and research sectors.

The Government needs to define a role in innovation where it sees itself not as the catalyst but as a facilitator. It can be a source of advice, skills and venture capital (including grants and tax relief) but it cannot be the *raison d'etre* of innovative behaviour within companies. It should not make it a requirement of its programs that it can be proven to be so. The emphasis in the Paper's Discussion question 39 on "…R&D activities that would otherwise not be conducted in the absence of government support?" again opens up the additionality debate regarding the merits of the Incentive that is often argued in embarrassingly simplistic terms.

We believe that the Government needs to recognise that cultural signals are important. The constant changing of the flagship innovation program, the Incentive, and the recent closure of a number of discretionary support programs in the 2014 Budget has undermined the confidence of innovative companies who cannot safely factor government support into their innovation plans with any degree of certainty.

Program design and operation needs to be considered with a view to ensuring longer-term stability of the offerings. The possibility of achieving greater bipartisan agreement on the details must become a priority. Matters such as the importance of the origin and domicile of innovative activities, the funding levels available and the appropriate measurement of outcomes need to be considered through a prism that looks at innovation policies as investments not simply Budget cost items.

Importantly, the nature and results of government consultation with the innovation community must change. MJA has participated in a number of Federal Government consultative processes in the past five years and they are characterised by short response timeframes with much of the content presented as a *fait accompli* causing participants to see these initiatives as “box ticking” rather than true consultation.

There is a real risk that the current consultation reflected in the Paper ends up being similarly characterised. We are keen to roll up our sleeves and assist the Government to ensure that this does not become the case.

4. Does The Incentive Work?

The Incentive is Australia's major program for innovation support and continues to be an internationally competitive aspect of our policy mix.

MJA has been involved in the tax and innovation space since its inception in 1985 and remains committed to the values and impacts associated with the program.

The need for the Incentive is shown in the history of its predecessor, the Concession. Prior to the introduction of the Concession in 1985, Australian Business Expenditure on R&D (BERD) was only 0.39% of GDP. The success of the program in encouraging BERD that might not otherwise have occurred is shown in the growth of BERD to 1.35% of GDP by 2008. Further proof that businesses need encouragement to invest enough in R&D was shown in 1996 when the rate of encouragement was halved and eligibility tightened. BERD fell significantly and did not fully recover until corrective action was taken in 2001. A number of studies were undertaken by AusIndustry and the Productivity Commission up to 2007. All these studies identified that the Concession helped contribute more to taxation revenue than it ever cost.

Despite this clear evidence, some still stay that the Incentive does not encourage businesses to invest more in R&D because much of that R&D would have occurred anyway, and that this is particularly the case with larger companies. The changes since 1985 and in 1996 show this claim to be unjustified. Further, such comments reflect a misunderstanding of the additionality argument. MJA has repeatedly submitted to a number of Government enquiries that additionality is primarily about the increased amounts of R&D that companies perform on R&D projects that they had already decided to undertake; it is far less about enabling the R&D projects that companies had previously rejected as being marginal or not viable on internal risk/return criteria. By reducing project costs, the Incentive enables more R&D to occur in approved projects while also bringing in some R&D that would otherwise have not occurred.

We submit that all areas of the Federal Government need to measure the value of the Incentive as an investment that returns tangible and intangible benefits to the community rather than as a cost to revenue that needs to meet a predetermined target. If the program is working, its cost will rise and more benefits should accrue and these benefits can and should be measured when evaluating program performance.

Further, if the justification for the program is based around proving that specific R&D occurred due to the availability of the Incentive in isolation, then the program is doomed. The truism that no company does R&D for a tax break alone is a correct one. The program actually works by reducing the relative cost of doing risky activities and its performance has to be assessed in the context of all the variables that influence a company in undertaking innovation. We see this as the fundamental issue in understanding the role of the Incentive.

MJA interprets the Incentive as a dividend remitted by the Government to Australian companies that undertake desired innovation activities. In other words, the Government pays a premium for the assumption of technical risk by companies. Viewed through this prism, it becomes immediately apparent that a stable and inclusive program is required to enable companies to safely factor the Incentive into their innovation investment portfolios.

5. Why Is The Incentive Bent Out Of Shape?

Unfortunately, despite the irrefutable evidence of the need for program certainty and stability, the Incentive has been subject to constant change since it was first delivered in draft form by the Treasury in December 2009. The undoubted improvements associated with the new 45% R&D Tax Refundable Offset have been offset by this reality and by the complications for larger claimants associated with program features like the dominant purpose test and the feedstock provisions. More recently, the current Government has sought to introduce significant cost savings measures in a completely non-consultative way which goes to further undermining the private sector's confidence in the Government's willingness to be a legitimate partner.

We shall first look at the cuts to the Incentive. We will then provide commentary on some of the key aspects of the Incentive over the first four years of operation. We submit that the program has become severely distorted and needs a holistic overhaul to get the policy settings back on course.

We will conclude by making some positive recommendations for potential reforms and we look forward to actively participating in the conversations that will occur around the Paper's focus on innovation support going forward.

5.1. Bent Out Of Shape - Reducing Innovation Support:

- **Case For Cost Containment**
- **Review Fatigue**
- **Proposed Rate Cuts**
- **Legislated Expenditure Cap**

5.1.1.The Case For Cost Containment

As soon as the Incentive commenced operation in July 2011, the program has been subjected to continuous scrutiny along the lines that it is too generous and expensive. The debate is focused on the perceived cost to revenue and lacks sophistication as it pays no regard to the economic outcomes (including tax revenues) associated with the successful commercialisation of supported products and processes. As will be discussed, this constant review has generated great insecurity regarding program certainty and stability and has led to a sense of review fatigue amongst stakeholders. At the time of writing, the cumulative effect of the associated changes sees the program's credibility and, possibly its viability in question.

MJA is not opposed to the debate about cost control. We have consistently submitted that the program needs to provide sufficient incentive to directly impact private sector innovation investment decisions, yet remain affordable to the taxpayer.

We believe that the Incentive should be applicable to all companies for all eligible R&D activities and expenditures and that it should be anchored by an industrial definition of R&D. Allied to this structure, there should be a rate of offset that achieves the desired innovation behaviours and is stably maintained in the medium term.

When the support needs to be reviewed and a requirement to contain costs is identified, the best way to achieve that result is to alter the offset rates accordingly and to do so against detailed evidence in a public manner with sufficient consultation with all stakeholders. Changes should then be made with prospective effect to preserve the integrity of private sector R&D decisions made in the context of the current offset rates.

MJA believes that the continuous review process analysed below has obviated all these reform principles, culminating in two very large retrospective program cuts that are the result of no public consultation without substantive evidence being offered in support of the changes.

This represents a major challenge to the integrity of the Incentive and requires urgent attention.

5.1.2. Review Fatigue

The Incentive was the result of the 2008 Cutler Review of the Australian Innovation System which went on to underpin the Federal Government's innovation policy announcements in May 2009. Cutler clearly identified and articulated the need to encourage more businesses to do more R&D and thereby help create a better future for Australia as a vital plank of the Government's policy on innovation, science, research and technology. This included all Australian company groups.

However, since the Incentive opened for business in July 2011 some three and a half years after the Cutler work commenced, the program has not been given a moment's peace as a series of initiatives and reviews have sought to reduce the available support.

In 2012, the Business Tax Working Group (BTWG) visited the issue of excluding company groups from the Incentive based on size of turnover but it ultimately recommended that such a change should not be made without a comprehensive consideration of the impacts.

In February 2013, the then Labor Government introduced a Bill to exclude company groups with an annual Australian assessable income of $20 billion from participation in the program. Unable to secure passage in the Greens-controlled Upper House, the Bill remained in limbo until it was adopted by the incoming Coalition Government.

A further short term cut in support was announced in the May 2014 Federal Budget with the dropping of the rates of offset from 45/40% to 43.5/38.5% from 1 July 2014 in anticipation of a lower corporate tax rate of 28.5% for all taxpayers coming into effect on 1 July 2015.

The measure was contained in the *Tax & Superannuation Laws (2014 Measures No. 5) Bill 2014.* The bottom line consequence of the rate cuts would have been a reduction in the permanent difference for companies with a greater than $20 million turnover from 10 cents to 8.5 cents. For smaller revenue companies, the fall would have been from 15 cents to 13.5 cents.

Alarmingly, the policy announcement that this was to represent a one year saving was not echoed in the Treasury papers that suggested that the saving was permanent, leading commentators to suspect that an across-the–board cut in company tax was not forthcoming.

The Bill meant that all R&D tax claimants were to be subjected to three different regimes of assistance in three consecutive financial years. Space precludes detailing the complications associated with this but they were considerable and represented a deadweight loss to all 12,000 companies accessing the program.

Both proposed amendments set a dangerous precedent in terms of the process by which changes can be made to Australia's largest innovation support program. There was a clear lack of financial modelling and data to justify the changes and to outline the expected impacts on R&D spend and the various tax revenue dimensions.

These changes were also being made in the context of no outcome data having been made available as to what the impact of the Incentive regime was having on R&D behaviour in any Australian company. The program was being denied a chance to "strut its stuff". In addition, the R&D Tax Incentive Advisory Committee, which was established to conduct the promised reviews of program performance was disbanded, without delivering any outputs at all.

The muted response in the marketplace to the proposed cuts reflected a "review fatigue" amongst stakeholders as it seemed the program was never going to be allowed to settle and changes were going to be made, irrespective of the views of the program users. Fundamental program tenets of stability and certainty were seen to have been disbanded and the Government seemed to be pressing on with its cuts regardless. A lack of stakeholder engagement was characterising the more recent consultative processes as the number of submissions from the private sector and its representatives dwindled.

The cumulative effect of the constant reviews and changes was that by the middle of 2014 (six and a half years after Cutler began), legislation was on the table to reduce program support by approximately one third using best estimates with no clear timetable by which the changes would be implemented.

As 2014 moved into 2015, the drive to cut program costs became tangible in two ways – the introduction of a company group R&D expenditure cap of $100 million (replacing the $20 billion exclusion clause) and the introduction of a second Bill to reduce the R&D Tax Offset rates (after the first Bill was rejected by the newly-constituted Senate).

We will analyse the rate cuts issue first in the light of our submission that this is the optimal way of containing program cost.

5.1.3. The Cuts To The R&D Tax Offset Rates

In late May 2015, the Government introduced the *Tax and Superannuation Laws Amendment (2015 Measures No. 3) Bill 2015* which legislates cuts of 1.5% in the Incentive Offset rates, applying to income tax years that commence on or after 1 July 2014.

As a result, the Refundable R&D Tax Offset rate falls from 45% to 43.5%. The Non-Refundable R&D Tax Offset rate falls from 40% to 38.5%. For groups with a turnover of $20 million or more, the net after-tax benefit will be reduced by 15%: for every $100,000 of R&D expenditure, they will only get an $8,500 net benefit instead of $10,000. For smaller businesses it will be reduced by 10%: a $15,000 benefit will be reduced to $13,500. For a start up, this represents a 3.33% reduction in vital cash flow to sustain the business during its early R&D phases, an expected $45,000 offset payment having being reduced to $43,500.

The measures in this Bill were previously rejected by the Senate. The previous Bill's premise was that the reduction in the offset rates was a one-off cut in the net after-tax benefit in preparation for the reduction in the general corporate tax rate to 28.5% from 1 July 2015. Under the current Bill, it now has the look of being a permanent reduction in the R&D benefit with the exception of companies with a turnover of less than $2 million who will be the only recipients of the mooted company tax rate cut from 1 July 2015.

This initiative is an example of a process undertaken with no apparent consultation, contrary to suggestions in the Bill's Explanatory Memorandum, and where no evidence is proffered of how much support is lost and what are going to be the expected impacts on R&D behaviour. The case for setting rates prospectively against a consultative evidence-based inquiry is surely made out as these impacts need to be understood and, if necessary, sold through.

In addition, failing to undertake appropriate consultative processes can lead to results that are embarrassing for the Government due to flaws in the proposed R&D legislation causing negative outcomes that are not being picked up in the drafting process.

For example, the current Bill has made an error in its approach to R&D expenditure clawbacks.

Under the Incentive, where R&D expenditure includes expenditure on making tangible products for testing, the cost of the materials used to make these products is clawed back where the resulting products are sold for a profit. Also, where the project is partly funded by a government grant, the Incentive benefit is clawed back for the amount of the grant and the matching expenditure. Similarly the balancing adjustment on the disposal of a depreciating asset is adjusted where the asset was used or partly used in R&D activities. These three adjustments all correct the Incentive on the assumption that the Incentive provides a net 10% benefit over the corporate tax rate. This represents an over-correction where the minimum R&D tax benefit is less than 10% over the tax rate as is the case with participants in the 38.5% Non-Refundable R&D Tax Offset under this Bill.

Following on from the example above, a group with an annual turnover greater than $20 million will need to repay $10,000 against an $8,500 net R&D tax benefit in clawback situations. This results in an effective rate of tax of 31.5% on the relevant expenditure. This means that these taxpayers have to pay more tax for the privilege of doing R&D in Australia than an otherwise equivalent competitor who does no R&D.

This issue has been previously raised with government, yet the Explanatory Memorandum states that:
"Targeted confidential consultation was undertaken on exposure draft legislation with affected stakeholder bodies. No concerns were raised during consultation."
The results of the "targeted confidential" process speak for themselves.

MJA submits that the case for cost containment be subject to immediate review to determine the affordable Incentive rates, currently set at 45% and 40%. We submit that the rates should be determined by a holistic, consultative and evidence–based process and the review could be conducted in a sufficiently quick timeframe that enables the rates to be applied to financial years beginning on 1 July 2015 onwards.

5.1.4. The $100 million R&D Expenditure Cap

On assuming power, the Coalition experienced the same difficulties as Labor in getting the $20 billion exclusion Bill through an Upper House that now was controlled by non-Greens crossbenchers.

Towards the end of 2014, the Palmer United Party (PUP) proposed an amendment that eventually resulted in the *Tax Laws Amendment (Research and Development) Bill* being passed in February 2015.

The Bill has introduced an expenditure "cap" on the amount of eligible R&D expenditure that attracts the Incentive. The basic methodology underpinning the imposition of the $100 million cap on R&D expenditure involves the application of the R&D Tax Offset at two rates to company groups with an annual group R&D expenditure of more than $100 million. The first rate will apply to the first $100 million of R&D expenditure at the R&D Tax Offset rate appropriate to the business group. This almost certainly will be the 40% Non-Refundable rate for most affected company groups. Once total group R&D expenditure in a year exceeds $100 million, the R&D Tax Offset rate falls to the corporate tax rate which is currently 30%. (The rate will be 28.5% for groups with a turnover of less than $2 million from 1 July 2015).

The calculation of the available Incentive benefit is complicated if the business needs to make feedstock adjustments, government funding clawbacks or depreciating asset balancing adjustments. The new provisions have unavoidably added complexity in attempting to deliver a solution that ensures that an 10% additional tax is not imposed on the component of R&D Offset claims that are only claimable at the corporate tax rate, in other words, on the expenditure in excess of $100 million.

This legislation was introduced with retrospective effect to income years commencing on or after 1 July 2014 and the accompanying explanatory material justified the changes in large measure on the premise that the Incentive was subsidising the R&D of large organisations that are unresponsive to R&D tax incentives.

There is no evidence that larger organisations were historically less responsive under the previous Concession. In fact, a number of arguments can be put to counter the assertion that small companies are more innovative than large companies and that they are more responsive to R&D incentives. These include the advantages afforded large companies through scale, deep access to supply chains and connections to research communities. The competitive environment regarding innovation outputs is one where large companies are the preferred medium to establish and compete in international markets of global dimension.

To curtail the Incentive from these organisations will not only reduce the R&D being performed directly by these groups, it will threaten the basis on which these organisations engage in collaborative R&D with smaller companies, Co-operative Research Centres (CRCs), universities and other research institutes. The predisposition of large organisations to be involved in joint ventures, partnerships and the like will be compromised by the absence of the Incentive beyond a certain level of R&D investment as the interests of the relevant parties will be defined to some extent around the tax benefits available. For example, if the operator of a joint venture is effectively excluded from the Incentive, it is far less likely to assist other venturers in the meeting of their obligations required to successfully claim the Incentive.

The Cutler Review emphasised the need to fully integrate all the components of the Australian innovation system and an attractive R&D incentive was seen as playing a key role in this integration. The company groups likely to be excluded from the Incentive are often the customers of the smaller companies that the Government is seeking to assist. These smaller companies often supply research inputs to the R&D projects that the very large companies conduct. Demand for these inputs will fall in line with the drops in the R&D spend of their largest domestic customers.

The change in circumstances may well lead the excluded companies to source their R&D inputs and collaborations in overseas jurisdictions.

Given that large corporates are highly mobile in the location of their R&D, it stands to reason that Australia will be put at a distinct competitive disadvantage by failing to offer sufficient incentive to conduct R&D locally.

The recent trend, particularly in the Asian region, has been to increase the value of the available R&D tax incentives. Evidence can be put forward that the presence of an R&D tax incentive does impact on decisions regarding location of R&D and the associated knowledge-based workers to carry out the projects.

The timing of the dramatic reduction of the support of affected company groups seems particularly ill-advised as Australia seeks to establish our points of difference in the 21st century Asian economy.

Further, the cap institutionalises a bias to R&D projects being done in smaller organisations which might lead to a sub-optimal portfolio of projects from a national perspective. For example, an SME looking to do a collaborative project with a large venture partner is only able to pitch the favourable R&D tax treatment to those organisations below the $100 million threshold which could see the project ultimately being carried out with a partner less suited for the work on a range of key criteria such as market access, technical qualification and relevant research facilities.

MJA is deeply concerned by the impact of the cap on R&D behaviour of the affected company groups, projected to be at least 25 of Australia's leading investors in R&D.

Firstly, it needs to be understood that the cap acts as a 'cliff' in that no tangible R&D tax benefits accrue to R&D expenditures above $100 million. For those groups that inevitably spend well above the cap each year, they can only receive a maximum benefit of $10 million (or $8.5 million if the current Bill passes). This doesn't restrict the Incentive for the affected company groups. **It removes the Incentive completely.**

The ability of the Incentive to influence the location and depth of company-wide R&D budgets is completely lost as these companies will exceed the $100 million maximum no matter what decisions are made in this regard. The Incentive no longer plays into processes such as the determination of project budgets and capital expenditure approvals.

As a result, the Incentive truly becomes an after-the-fact accounting task which will drive the company to secure the R&D benefit for the least administrative cost necessary to secure a $100 million claim.

MJA has been in direct talks with affected company groups who fear the impact on their innovation cultures that had been driven in large part by the unrestricted amount of R&D claimable under the Incentive. In other words, the availability of the Incentive has underpinned company-wide initiatives such as corporate innovation plans, R&D results sharing and the awarding of the R&D tax benefit as some form of credit to the participating business units.

With the onset of the cap, the need to have an organisation-wide response is completely removed for groups who traditionally exceed the $100 million cap figure. For example, if a company group spends $300 million on R&D with three business units incurring $125 million and seventeen responsible for the $175 million balance, then a secure claim can be achieved by only involving the three largest spending units in the claim process. The other units are effectively disenfranchised and, once freed from the responsibilities of claiming, they are likely to be lost to the program permanently.

The impact on Australia's innovation culture associated with the cap was never considered. There was no consultation or modelling of this major change. The fear is that these large innovators have been pushed out of meaningful participation in Australia's innovation flagship program and, as a result, they will locate much of their future R&D activity elsewhere.

This problem should be redressed immediately.

MJA submits that the $100 million cap should be removed with retrospective effect from 1 July 2014. We do so in the understanding that lower rates of R&D tax offset may come

into effect prospectively if the case for program cost containment is successfully put in a holistic, consultative and evidence-based review.

5.2. Bent Out Of Shape - Areas Of Concern:

- **Uncapped Refunds**
- **Promoter and R&D Tax Agent Practices**
- **Franking**

5.2.1.Uncapped Refunds

MJA has consistently held the position that the uncapped nature of the cash refund for eligible loss-making companies under the 45% Refundable R&D Tax Offset is far too generously struck.

By definition, the companies eligible for this form of cash support are in significant loss and are undertaking inherently risky R&D. It is accepted that some of the recipients will never commercialise for reasons such as technical R&D failure and loss of investor support. In these cases, the cash leakage associated with the full value of the applicable notional deductions will never be recouped through subsequent tax collections from generated income. As such, there is a need to strike a balance between the benefits of providing cashflow for start up companies performing R&D against a measure of reasonable affordability.

The uncapped nature of the refunds under the Incentive was a response to the absurd conditions attached to the R&D Tax Rebate available under the Concession which provided refunds of up to $375,000 as long as the company had an annual R&D aggregate under $1 million. This eliminated many R&D start ups from the cash option entirely and was a modest benefit at best to those who were eligible.

In addressing those shortcomings, the Incentive has become far too generous in this regard. We have seen numerous public announcements of R&D tax refunds in the many millions, one as high as $54 million. The associated R&D is in technically risky areas such as biotechnology, exploration and crypto currency research. The ongoing payment of these cash benefits appears unsustainable and further hampers the Government's ability to provide a balanced incentive program to all.

There is also a high degree of tax administration risk associated with the refund mechanism which has led to the concerns expressed recently by the ATO about the practices of certain promoters and R&D tax agents. This tax administration risk underpins MJA's consistent position that the Incentive should not move to a quarterly payments regime.

MJA submits that a cap on the Incentive cash refunds be introduced. Above the cap, taxpayers should be able to carry forward any remaining notional deductions.

We submit that the level of the cap should be determined by a holistic, consultative and evidence–based review which could be conducted in a timeframe that enables the cap to apply to financial years commencing from 1 July 2015 onwards.

5.2.2. Promoter and R&D Tax Agent Practices

The rapid growth in program participation, particularly around the cash refund aspect of the Refundable Offset, has apparently led to a proliferation of R&D tax agents and consultants offering advice in the area.

A recent note from the ATO headed 'Shared Compliance Concerns – Promoter Penalties' indicated its belief that certain consultants are marketing R&D arrangements that have the character of tax avoidance. Further, the concern was expressed that some tax agents and accountants are accepting claims prepared by R&D consultants without conducting due diligence on the claims.

It is unsurprising that aberrant "advisory" behaviour is occurring around a program offering cash payments from the Government based on a self-assessment regime. Program integrity measures must always be in place and rigorously maintained to prevent misuse of the program.

MJA is a founding member of the NRG and has recently joined the new SRGs in Brisbane, Melbourne and Sydney. We are keen participants and supporters of these mechanisms and would encourage a more collaborative approach from AusIndustry and the ATO in taking these forums forward. Currently, the approaches and concerns of the regulators are not comprehensively communicated and MJA has consistently submitted that the NRG has not achieved much of note against the contemplated roles contained in its Charter.

Recent accounts of highly negative taxpayer assessments, particularly involving the ATO, seem attributable in part to the lack of program information on areas of concern such as promoter practices and the fact that scant education resources exist for tax agents and accountants that are not R&D specialists.

MJA submits that a more comprehensive approach is needed to educate all stakeholders to maximise program outcomes and eliminate cases of misuse. The NRG could be commissioned to design the approach and this should involve input from a wide range of stakeholders.

5.2.3. Franking

The Incentive suffers from two structural issues that can mean a number of generally smaller R&D entities are not incentivised by the program to undertake R&D activities. This is as a result of effect of franking and how the different rates operate.

To understand the issue that franking can create for the Incentive, it is important to understand the growth patterns of new and emerging businesses.

A new and successful start up business that has succeeded, at least in part, as a result of the Incentive will generally go through the following phases:

1. Formation
   Based on a created idea, the people who will eventually form the R&D entity will do some preliminary work and some early R&D activities. Currently, these activities receive no Incentive assistance and it is hard to develop a program framework that could support anything at this stage.
2. Promotion
   At some point, the idea will be less amorphous and the business will start to take shape. Unfortunately, too often, the owners are advised to form a trust rather than a company. At this point, the Incentive is lost as the R&D activities are not conducted for an eligible entity. Once the process has commenced to form the company that is the R&D entity, then the R&D activities will be claimable.
3. Start Up Phase
   In the start up phase for an R&D entity, there is great uncertainty and no income. The business will have next to no assets and will be accumulating losses and debts. They will seldom have sufficient cash or assets to secure any commercial loans. At this point, the R&D entity is cash strapped and reliant on the 45% R&D Tax Refundable Offset in its cash back form. The company debts will often be paid from the cash offset as soon as it is received.
4. Commercialisation Phase
   As soon as the base R&D has been completed, the business will switch to commercialisation so it can pay its debts and start profiting from the successful R&D at that point. R&D will often be ongoing but will be less intensive. Once the business is in profit, it will be interested in distributing all its profits as fully franked dividends to its owners.
5. Maturing Business
   Eventually, the company starts to take on a life of its own which is separate from its owners. At this point, it will start to seek to retain earnings for future development and growth. The necessity for the business to fully frank all profit and distribute these as dividends will not be so important. At this stage, the program should encourage R&D activities as a normal part of business.

The issue in regards to franking is that during the fourth phase, the business gets no benefit from conducting R&D and therefore no incentive to continue to conduct R&D.

There are two reasons for this:

A. Deferred franking debits -
   Initially, this is because the R&D entity is not able to accumulate any franking credits until it has recovered all the deferred franking debits as a result of the R&D activities being conducted for the entity: and

B. Tax passed on to owners -
   Once the R&D entity has used all its tax losses and carried forward its franking debits, it will not want to conduct R&D and claim this because it will be at the owner's personal expense.

A. Deferred franking debits

The deferred franking debits are an essential tool to prevent the business from having to pay a franking deficit tax as a result of receiving the Incentive and we are not advocating their removal.

The issue is due to the fact that the way they operate is complex and, we believe, little understood. Often, businesses are not aware of the necessity to track deferred franking credits and that these must be recognised and applied before the R&D entity can create any franking amount able to be applied to dividends. The inability to frank dividends as soon as the business starts to pay tax means that the Incentive is being paid for by the increased tax payable by the owners.

Example: Impact on franking of deferred franking debits on tax paid
Innovative Start Up Pty Ltd is formed at the beginning of 2015. It incurs $300,000 of eligible R&D expenditure and has no income for this first year. It will receive a $135,000 tax offset in cash and has no carried forward tax losses. In the next year, the R&D was successfully commercialised and it paid tax on $450,000 taxable income. At the same time, Copier Start Up Pty Ltd made a loss of $300,000 in its first year and paid tax on $450,000 of taxable income. Both businesses are seeking to distribute all the taxable income to its owners fully franked.

From a franking point of view, Innovative Start Up will not be able to frank the $450,000 due to the deferred franking credit. The $135,000 received in 2015 will not create a franking deficit because it is deferred to 2016. In 2016, it will not be able to create a franking balance on the payment of the tax on $450,000 (30% × 450,000 = 135,000) so, if a dividend of $315,000 ($450,000 less tax paid) is paid, it must be unfranked. The owners will get no benefit from the fact that the business has paid tax on its profits before they paid the dividends.

This contrasts with Copier Start Up. Copier Start Up will pay the same amount of tax ($135,000) on its taxable income but will be able to fully frank the $315,000 dividend. The owners will, therefore, receive a benefit from the tax paid on its profits before they paid the dividends.

Please note this is not an error or an unintended result. It is due to operation of the R&D offset payment, being based on the full 45% amount. It means that the R&D entity has no carry forward tax losses on its R&D expenditure so it will start paying tax earlier than an equivalent business. The equivalent business will not start paying tax until it has used up all its carry forward tax losses. In this example, Copier Start Up will have had to have made a profit of $750,000 in 2016 to be required to pay tax on a taxable income of $450,000 due to its carry forward losses. However, it leads to the issue that franking can merely pass on the responsibility to pay tax from the R&D entity to the owner when the business is in Phase 4.

B. Tax passed on to owners

As in the above example, and whilst ever the owners of the R&D entity wish to fully distribute all profits as earned by way of dividend, the franking system results in the owners paying the net 15% benefit received by the R&D entity in their personal tax payments. This is because the R&D entity is unable to frank profits by paying tax when it receives this net 15% benefit. This means that the business is not incentivised to carry out any R&D and the cost of the R&D program to the Government is overstated by the amount of additional tax paid by owners in receipt of dividends not able to be franked due to the R&D tax offset.

Example: R&D benefit paid for by shareholders by the franking system
Innovative Start Up Pty Ltd and Copier Start Up Pty Ltd have matured to Phase 4 by 2020. In hindsight, the shareholders are now seriously questioning why they undertake R&D because all the franking system does is pass on the tax benefit enjoyed by the company to their personal tax.

Both businesses are now earning $4,000,000 and have allowable deductions of $3,000,000. Of this, Innovative Start Up spends $1,000,000 on R&D, whilst Copier Start Up spends this on licensed rights. Both businesses have the same accounting profit of $1,000,000.

The end result of this is that (at the current 30% tax rate):

1. Copier Start Up will pay $300,000 tax and be able to distribute $700,000 in fully franked dividends. This will give its shareholders a franking offset of $300,000. The $300,000 tax payable by the company will be offset by the $300,000 franking credit.
2. Innovative Start Up will pay $600,000 tax but receive an offset of $400,000 for a net payment of $200,000. It will only be able to distribute 466,667 fully franked dividends and provide franking of $200,000. If it distributes the remaining profit after tax ($333,333), then this will not be able to be franked. As a result, the shareholders will be required to pay $100,000 additional tax on these dividends. This means that all the Incentive does is shift the tax payable from being $300,000 by the non-R&D entity (Copier Start Up) to $200,000 by the R&D entity (Innovative Start Up) and $100,000 by its shareholders.

MJA submits the lack of R&D incentive associated with the franking issue in SMEs can be addressed by the net R&D benefit (currently the 15%) being added to the franking account so the R&D tax benefit is not neutralised by increased tax payable by shareholders.

6. Recommendations

In summary, MJA recommends that the promised review of the Incentive is necessary, given the highlighted concerns and despite the noted “review fatigue”. The review should be holistic, consultative and evidence-based.

The specific submissions that should be covered by the review are as follows:

1. MJA submits that the case for cost containment be subject to immediate review to determine the affordable Incentive rates, currently set at 45% and 40%, from 1 July 2015 onwards.

2. MJA submits that the $100 million cap should be removed with retrospective effect from 1 July 2014.

3. MJA submits that a cap on the Incentive’s payable cash refunds be introduced from 1 July 2015 onwards. Above the cap, taxpayers should be able to carry forward any remaining notional deductions.

4. MJA submits that a more comprehensive approach is needed to educate all stakeholders to maximise program outcomes and eliminate cases of misuse.

5. MJA submits the lack of R&D incentive associated with the franking issue in SMEs can be addressed by the net R&D benefit (currently the 15%) being added to the franking account so the R&D tax benefit is not neutralised by increased tax payable by shareholders.

7. Conclusion

MJA supports any process by which the Incentive can be shown to deliver improved outcomes for Australian taxpayers. We understand the need to address issues of fiscal responsibility as well as innovation policy. We pride ourselves on our participation in, and contribution to, the various processes that ultimately resulted in the Incentive.

Our opinion is not swayed by our direct business interests. For example, we always argued vigorously against the Incremental component of the old Concession even though we continuously assisted our clients in accessing these benefits. We recently made a submission regarding the (now withdrawn) quarterly credits legislation that set out our deep misgivings about the system even though we believed it would have grown our business in the short term.

The holistic review that we are advocating for, accompanied by a bipartisan five year commitment to no further changes following the legislated outcome applicable from 1 July 2015 onwards, provides the best opportunity for true program effectiveness whilst having suitable regard to the fiscal demands of the present day.

We greatly appreciate the opportunity to make this submission. We would value highly the opportunity to appear as a witness before any public forum associated with the Paper in the coming months.

Questions about this submission should be addressed to Kris Gale, Chairman, MJA or Ian Ross-Gowan, Driector, MJA on (02) 9810 7211. Alternatively, Kris Gale can be contacted by email atkris.gale@mjassociates.com.au or Ian Ross-Gowan at ian.ross-gowan@mjassociates.com.au