

Manager  
Small Business Entities & Industry Concessions Unit  
The Treasury  
Langton Crescent  
PARKES ACT 2600

24 July 2018

Email: [RnDamendments@treasury.gov.au](mailto:RnDamendments@treasury.gov.au)

Dear Sir/Madam

### **Glasshouse Advisory's response to the consultation on the draft Treasury Laws Amendment (Research and Development Incentive) Bill 2018**

Glasshouse Advisory welcomes the opportunity to provide feedback and input into the R&D Tax Incentive draft legislation as tabled by the draft Treasury Laws Amendment (Research and Development Incentive) Bill 2018.

Below are our comments on the draft legislation in the context of the specific questions raised for consultation and response. Glasshouse Advisory has also taken into consideration how effectively the draft legislation, and the R&D intensity provisions specifically, align with both the Government's 2018-19 Budget measure of 'better targeting the research and development tax incentive', and the objective of the Research and Development Tax Incentive ('R&DTI') program to incentivise innovation in Australia.

As an intellectual asset advisory firm, Glasshouse Advisory assists businesses to manage their intellectual assets. We work with businesses and industry to develop ideation, accelerate innovation and commercialise intellectual property. Given our unique service offering, Glasshouse Advisory sits at the cross section of business, innovation and intellectual property and has a strong understanding of how policy impacts business behaviour. As such, Glasshouse Advisory is uniquely positioned to understand the impact of the R&DTI draft legislation on individual businesses, industry trends and the effectiveness of the R&DTI as tax policy.

We strongly support attempts to focus the Federal Government's innovation spend to ensure best prospects of additionality. Such a process makes logical sense. Having said this, it is our view that a number of the changes proposed in the Exposure Draft pose inconsistencies with principles of good taxation and good policy in general – equity, simplicity and certainty. In failing to adhere to such principles, the policy risks rejecting the favourable along with the unfavourable, by creating disincentives for innovative businesses to pursue R&DTI claims and thus invest in additional R&D.

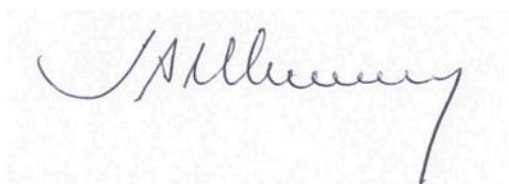
Curiously, many aspects of the R&D intensity test in the Exposure Draft contrasts with measures proposed in previous reviews to promote additionality (i.e. to reward R&D expenditure at a set and predictable rate once expenditure exceeded a certain threshold). This includes findings and recommendations made in both the 2016 'Review of the R&D Tax Incentive' and the 2018 Innovation and Science Australia 2030 Strategic Plan. In addition, key recommendations such as the promotion of increased collaboration between research

institutions and industry have not been acknowledge or actioned. This leaves us with the lasting impression that the proposed changes to the R&D Tax Incentive are primarily intended to achieve budget savings at the expense of meaningful investment and support to industry innovation.

If the Government's main objective is to reduce overall public spend on R&D in Australia, there is no question that the proposed amendments to the R&DTI will achieve this. However, if the objective is to focus the Federal Government's innovation spend to ensure best prospects of additionality, while maintaining equity, simplicity and certainty in the program, then further work is needed.

In the attached submissions we have provided suggestions as to ways in which the Exposure Draft could be improved to achieve these objectives while also reducing the cost of the program for the Federal Government.

On behalf of Glasshouse Advisory

A handwritten signature in black ink, appearing to read "Tracey Murray", written over a light grey rectangular background.

Tracey Murray

Director - Innovation Incentives & IP Economics

**Consultation Question 1:** Do you foresee any implementation and ongoing compliance challenges arising from the proposed calculation of R&D intensity?

**Consultation Question 2:** Does the proposed method of calculation of R&D intensity pose any integrity risks?

The introduction of the intensity test in its current form will likely result in a material reduction in the R&D tax benefit for operators in certain sectors and industries. This will particularly be felt by larger businesses that invest in R&D, and Australian based multinationals in particular. This reduction in innovation support has a very real potential to promote knock-on impacts for businesses operating in competitive international markets.

In addition to economic effects, there are a number of complexities associated with the operation of the intensity test which could create challenges for businesses. We have discussed a number of these below.

### **Interaction of the \$150 million cap on expenditure and the R&D intensity calculation**

We welcome the removal of the sunset clause in relation to the expenditure threshold limit as doing so reduces uncertainty for large companies. Increasing the expenditure threshold limit to \$150 million is also a welcome change.

However, having an expenditure threshold limit in the first place appears inconsistent with the concept of linking the marginal net benefit to the intensity premium: the intensity premium calculation should achieve the policy objectives of incentivising companies to conduct additional R&D activities without arbitrarily excluding very large tax payers from the higher rates of reward within the program.

The existence of a \$150 million cap on eligible expenditure, in combination with the proposed intensity test, will likely prevent large multinationals from ever accessing the higher rates of benefit achieved through higher intensity. In fact, our analysis indicates that of the ASX200 Top 20 Innovators, only nine will be able to access the top 12.5% R&D benefit. This effectively presents a double penalty for large claimants due to the inability to claim more than \$150 million in expenditure via the R&D premium (despite the fact that such a business may be spending more than this on eligible R&D activities), as well as only having the ability to claim eligible expenditure up to the cap at a lower R&D premium rate (due to the fact that the business' total expenditure may be very high).

For example, any entities with total expenditure greater than \$1.5 billion can never achieve an R&D intensity of more than 10%. This is because \$150 million represents the maximum R&D spend that can be claimed by this entity and used in the intensity calculation. As such, these entities can never access the top R&D premium rate (12.5%).

The result is that any entity that cannot achieve more than 10% intensity will not be able to access an R&D premium rate of more than 7.5 cents per \$1 on eligible R&D (a material reduction compared with the original RDTI benefit of 10 cents per \$1 for large entities).

**Recommendation:** Eligible R&D expenditure in excess of the threshold limit should contribute to the calculation of the intensity percentage. The excess eligible expenditure remains eligible for a notional deduction, albeit at the relevant corporate tax rate, both under

the existing law and under the proposed changes. Removing the excess eligible expenditure from the intensity calculation unfairly penalises large companies for being large. The expenditure threshold limit already caps the maximum benefit available, therefore not including all eligible expenditure in the intensity calculation serves as a second reduction to benefits.

### **Lack of predictability of benefit for businesses**

The introduction of an intensity test for R&D claimants will promote greater uncertainty and a lack of predictability for businesses seeking to access the RDTI and will potentially undermine any efforts by companies to achieve higher rates of return via investment in additional R&D. In particular, a key limitation with respect to the concept of R&D intensity is that the outcome will be to correlate an entity's benefit from R&D investment to its total expenditure and therefore to expose the return on investment to numerous factors that are beyond the company's control – e.g. commodity prices, foreign exchange fluctuations, etc. Accordingly, a company's R&D intensity is subject to fluctuation regardless of its intentions to increase R&D investment given that total expenditure can vary significantly year on year, and is only able to be calculated at the completion of a financial year.

If companies are unable to predict the R&D intensity that can be achieved at the beginning of the year, they are less likely to commit to the same level of R&D expenditure and projects, as it will not be possible to accurately calculate an internal rate of return on these R&D activities. The use of four intensity tiers contributes to this complexity and unpredictability.

**Recommendation:** There are two possible ways in which this issue could be addressed, while still maintaining the intended targeting of benefits to businesses with higher R&D intensity:

1. Reduce the number of intensity tiers. Adopting a two-tier intensity test would undoubtedly simplify the intensity and R&D tax offset calculations, thus lowering compliance burden. It would also provide certainty for claimants around the contribution that the RDTI could make to their investment in R&D.
2. Alter the operation of the intensity provisions, such that once R&D intensity reaches a threshold percentage, all of a business' R&D expenditure is eligible for a premium at a rate that accords with that intensity (as opposed to the stepped approach used in the Exposure Draft).

### **Arbitrarily targeting businesses with high operational costs**

Another issue that the intensity premium creates is that in using total expenditure as the denominator in the equation, companies that sell products with low margins/high volumes are penalised. Companies in those industries may spend significant amounts on eligible R&D, however they will only qualify for the lower marginal net benefit due to their high cost of sales. Conversely, a business with a lower cost base is likely to have a higher R&D intensity on the basis of R&D spend as a proportion of total spend, without necessarily undertaking a higher intensity of R&D activity. This issue has been addressed in other areas of tax law, such as concessional treatment for calculating aggregated turnover of those engaged in the sale of retail fuels (those same rules already apply when calculating aggregated turnover for R&D entities), acknowledging the inequity of such a scenario.

The impact of this issue is evidenced by comparing a business that manufactures on its own behalf using its own raw materials, to a contract manufacturing arrangement where a business provides raw materials to a third-party manufacturing service provider. Both businesses may undertake exactly the same level of R&D activity as a proportion of manufacturing activity for the year (measured, for example, by units of output). However, because the contract manufacturer has significantly lower expenditure than a full manufacturer (as it does not incur expenditure on raw materials), it will achieve a significantly higher R&D intensity. This is due to the fact that the entity's R&D spend as the proportion of total expenditure is significantly higher for that toll manufacturer, providing the toll manufacturer with a higher R&D intensity, compared to a full manufacturer.

**Recommendation:** We would welcome this issue being addressed so that the program applies fairly to all R&D entities, with consideration being given to how the clawback for feedstock expenditure impacts these inconsistencies.

One option may be to consider the removal of costs that attract no benefit under the RDTI (such as raw material and energy inputs where an output is sold) from the calculation of 'total expenses' used to calculate R&D intensity. This may achieve a better outcome in terms of better matching the calculation of the intensity denominator (total expenses) with the numerator (R&D expenses).

Another option would be to totally exclude cost of goods sold from the denominator of the calculation, which would have no adverse impact on the Government's attempts to incentivise companies to spend more of their discretionary expenditure on R&D activities.

### **Penalising diversification**

Diversified corporate structures will also see their R&D tax claims unfairly diluted if the proposed changes to the RDTO are enacted. For example, if a business has several divisions, one of which is undertaking eligible R&D, with others focused on non-R&D or very low R&D intensive activities (such as holding investments, or non-technical operations), the business conducting the R&D activities will achieve a lower level of intensity than if each division were a separate, unconsolidated company. This means that unconsolidated large companies doing the same level of activity as consolidated entities will have access to a higher level of R&D incentive. A similar issue arises where businesses invest significantly in marketing or sales in a given year in that, though their R&D spend and intensity of activity remains constant, they are effectively penalised for increasing marketing spend.

Whilst the changes to the RDTI are aimed at better targeting support for R&D, it seems unreasonable that two companies conducting the same level of R&D activities should receive significantly different incentives despite the same scenario and same level of R&D spend. A tax system should generally aim not to influence business decision making through departures from tax neutrality not required to serve a particular policy objective. This principle is based on the idea that business decisions should be made on their economic merits rather than for tax reasons. The implementation of an intensity test, and the fact that it will impact diversified business groups (consolidated or not consolidated) differently dependent on their structuring choices, will in turn impact structuring decisions. Such distortion in behaviour will contribute to a business environment where economic decisions are made on the basis of a tax advantage.

**Recommendation:** The Government should give further consideration as to the most appropriate entity basis on which to assess R&D intensity. There is no doubt this is a

complex issue as assessing on a company by company basis (as opposed to a consolidated basis) could result in similar distortion of business decisions.

### **Disadvantaging Australian based multi-nationals**

As drafted the proposed method of calculating the intensity of R&D activities unfairly disadvantages Australian-based multinationals, compared to foreign based multinationals. By limiting the inclusion of total expenditure to only those of the 'R&D entity' itself means that Australian-based multinationals in consolidated groups must include all expenditure (including expenditure from overseas operations), whilst foreign-owned multinationals that have a presence in Australia are only required to include the expenditure incurred in Australia. This provides an incentive for foreign-owned multinationals to increase their R&D activity in Australia (in order to achieve an increased R&D benefit) and provides a disincentive to Australian multinationals to do the same (which may be viewed as a disadvantage and may drive such R&D activities offshore to more stable and R&D friendly jurisdiction such as New Zealand).

The concept of an R&D premium (i.e. 125% and 175%) was abandoned when the R&D tax incentive replaced the R&D tax concession. Arguments as to the reason the R&D Tax Concession should be changed focused on the method of calculating premium amounts and the fact that this methodology presented increased difficulty in achieving the policy objectives (of increasing R&D spend, and providing stability of benefits over time). Under the R&D tax concession, many claimants artificially inflated or deflated their R&D spend in particular years so as to obtain a windfall gain from the premium calculation in subsequent years. It is conceivable that large companies with the resources and ability to manipulate the timing of expenditure will do so around the time of balance date, to take advantage of the increased rate of reward that would flow.

### **Consultation Question 3: Could total expenditure be aggregated across a broader economic group? Would this create any implementation and ongoing compliance challenges?**

The calculation of total expenditure should be calculated fairly across all groups undertaking R&D activities, whether they are consolidated or not, and regardless of the fact that they are based in Australia or overseas. There should not be a disadvantage to those groups who consolidate for tax purposes. There should also not be a disadvantage to Australian based multinationals compared with their overseas counterparts.

The current Exposure Draft does not take into account expenditure of companies that are related to the R&D entity but are not part of its consolidated group. This could provide an incentive for those R&D entities to reduce their total expenditure by moving it to other related entities, thereby artificially inflating R&D intensity. A simple way to correct this anomaly would be to apply the same grouping rules to the calculation of expenditure, that are currently applied to the calculation aggregated turnover.

Under the current draft legislation, Australian multinationals would be required to include their global expenditure in calculating their R&D intensity. Conversely, foreign multinationals with an Australian subsidiary conducting eligible R&D in Australia would not be required to include their global expenditure in the calculation of total expenditure of the R&D entity. This would result in Australian subsidiaries of foreign multinationals receiving greater benefits for conducting eligible R&D activities in Australia than those multinationals based in Australia,

also conducting R&D activities in Australia. To ensure that both Australian and foreign multinationals are put on an equal playing field, foreign multinationals should have their intensity calculated based on the total global expenditure of the group that they belong to, using the same grouping rules for aggregated turnover or the total expenditure calculation should be limited to total Australian based expenditure.

#### **Consultation Question 4: Does the definition of clinical trials for the purpose of the R&DTI appropriately cover activities that may be conducted now and in the future?**

The definition to be used for clinical trials covers most of the eligible R&D activities associated with those trials. However in using the Therapeutic Goods Administration's definition, we have concerns as to how narrow an interpretation will be applied when findings are made. These include to what extent supporting activities will be included as part of the clinical trials, as well as whether subsequent findings will be necessary if the clinical trials take a different direction (or require significantly more or less resources) because of new knowledge generated early in the clinical trial phase.

#### **Consultation Question 5: Does the proposed finding process represent an appropriate means of identifying clinical trials expenditure for the purposes of the \$4 million refund cap?**

In our view, the proposed finding process does not represent an appropriate means of identifying clinical trials expenditure for the purposes of the \$4 million refund cap. In general the process of obtaining a finding is onerous on the R&D entity, and often involves lengthy delays. It is not unusual for a finding to take between three and twelve months to obtain a finding, which provides clarity regarding the eligibility of activities and expenditure. The level of substantiation documentation required for this process is typically more comprehensive than an AusIndustry review, and whilst this is reasonable (given that the R&D entity is seeking significant benefits), when combined with the process currently in place for obtaining advance and overseas findings (which are often necessary when it comes to clinical trials) the compliance burden is significantly higher than that experienced by much larger companies making much larger claims.

To undertake clinical trials in Australia, companies are required to participate in either the Clinical Trial Notification scheme or the Clinical Trial Exemption scheme. Given that companies undertaking clinical trials already operate in one of the most heavily regulated and monitored industries, we would suggest that it would be simpler to provide any company undertaking clinical trials under these schemes with an automatic finding that they are undertaking clinical trials.

It should be obvious from the details provided in the application for registration each year as to whether the project includes activities that would meet the definition of clinical trials. R&D tax claims from companies undertaking clinical trials are already subject to the risk-based approach audit regimes and requiring them to obtain formal findings is a waste of resources for both the taxpayer and Innovation Australia.

**Recommendation:** We therefore suggest that formal findings for clinical trials are not necessary and should not be a requirement of the program. We take this position despite the fact such a change would likely generate more fees for consultants such as Glasshouse

Advisory as we support our clients through what is typically a complex and onerous application process.

### **Consultation Question 6: Do the draft feedstock and clawback provisions give rise to any unintended consequences that need to be addressed?**

The policy reasons behind the changes made to the feedstock and clawback provisions were to simplify the calculation process and bring clarity as to what does and does not constitute feedstock. The draft legislation does nothing to further that policy intent. The legislative provisions that define what is feedstock have been restated almost verbatim, with an additional complex calculation introduced.

We welcome the new formula for calculating the increase to assessable income as a result of receiving feedstock revenue in that it effectively reverses the benefit initially received. This is an improvement on existing measures for large companies which see the value of the increase in assessable income being greater than the benefit received. We note that the permanent difference for R&D entities between the benefit received and the increase in assessable income has been removed.

#### **Other matters**

##### **Cuts to the marginal net benefit**

When the R&D Tax Incentive was introduced, the program was designed with a marginal net benefit of 10% for large companies, and 15% for SME's. This was achieved through the 40% and 45% tax offsets respectively.

When the tax cuts for SME's were introduced, there was one year in which the marginal net benefit for some SME's was 16.5% (due to the fact that the tax offset remained at 45%, but the corporate tax rate for those entities fell to 28.5%). The following the year, the R&D Tax Offset was reduced to 38.5% for large companies, and 43.5% for SME's, with an intention to also reduce the corporate tax rate. This was done with the intent of maintaining the 15% marginal net benefit of the program, however a failure to appropriately change the rates at the right point in time meant that this outcome was not achieved, to the disadvantage of R&D claimants, particularly SME's.

In altering the way in which the benefit is calculated for SME's to be 13.5% above the corporate tax rate, a reduction of the net benefit of the R&D Tax Offset to those SME's results. This is not consistent with the original policy intent of maintaining the 15% marginal net benefit and is a reduction.

We welcome simplifying the method of calculating the R&D Tax Offset to be calculated using the corporate tax rate plus the marginal net benefit. However, a reduction in the marginal net benefit is not necessary to achieve this. We would recommend maintaining the original 15% marginal net benefit for SME's.

##### **Retrospective nature of the changes**

As the first income year to which the changes will apply has already begun, the Exposure Draft seeks to change the law retrospectively. It is our view that this is a poor policy decision,



given that the main policy aim is to encourage additional investment in R&D: that is, companies will not be incentivised to make additional investment if they do not know what that incentive will be, due to the retrospectivity of the legislation.

Another policy intention is to provide certainty for businesses to facilitate decision making. It is difficult for an R&D entity to decide how much resources to devote to R&D when they do not have certainty as to how much benefit they will receive, such as where an intensity test applies (which relies upon factors not related to R&D activities).