Submission to

Research & Development Tax Incentive Amendments

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Disclosure

I run a small company that benefits from the R&D Tax Incentive. I am also a member of the R&D Tax Incentives Committee of Innovation and Science Australia.

Questions Raised in Consultation Paper

Calculation of R&D Intensity – total expenditure

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

This is a challenging area as I see there are many compliance challenges. Some examples are:

A large Australian entity could create an R&D subsidiary which would then be paid a license or for subcontracted effort which would lead to a very large proportion of that entity's income being artificially R&D. This is the example mentioned in the consultation paper.

A large foreign entity could create an R&D subsidiary totally separate to its other trading subsidiaries in Australia. Alternatively this entity could have no other subsidiaries in Australia. Such an R&D subsidiary could make profits through a license to its parent and then claim a very high R&D intensity to offset its tax.

In a more complex case, a large entity could get out of R&D altogether but subcontract R&D with risk transferred to a small entity. The small entity conducts the R&D, claims the refundable deduction and then transfers it to the large entity by way of a discount on the work done.

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

The method of calculation requires a standardised view of eligible R&D expenditure (already used to determine R&D notional deductions) and total expenditure. There is an integrity risk if an applicant is able to reduce its total expenditure and thereby increase its R&D intensity.

The most straightforward way of doing this would be for an R&D subsidiary to be formed as outlined above. This would be straightforward and likely to be done.

A second problem relates to moving expenditure between years via various financing structures. This could result in some applicants achieving a higher benefit through more creative accounting.

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

This is clearly a reasonable response to the issues outlined above, on first blush. The challenge will relate to the breadth of aggregation. For example:

a) A diverse conglomerate might have a business in genetic testing. This business turns over $50M per annum with EBITDA of $10M and conducts $3M of R&D but the total

conglomerate has expenses of $1B. Under the rules above the business spins off a subsidiary which earns license fees equal to the R&D expenditure. In this case it would be fair to aggregate this R&D subsidiary up to the level of genetic testing business (producing an R&D intensity of 3M/(50M – 10M) = 7.5% but it would not be fair to aggregate up to the conglomerate level producing an intensity of 3M/1B = 0.3%.

b) Two businesses with slightly different shareholdings operate as a manufacturer and a distributor of a unique product. The manufacturer normally provides packaged product to the distributor and the cost of packaging sits on the manufacturer's P&L as an expense. The manufacturer normally spends about 4% of its expenses on R&D. By shifting the packaging cost to the distributor the manufacturer increases its R&D intensity to 6% without impacting the operations of the group.

Clinical Trials exemption under the $4 million refund cap

4. Does the definition of clinical trials for the purpose of the R&DTI appropriately cover activities that may be conducted now and into the future?

The definition is problematic as it contains a number of terms that are ambiguous or extremely broad. The definition is:

> "*A clinical trial is a planned study of the safety or efficacy in humans of an intervention (including a medicine, treatment or diagnostic procedure) with the aim of achieving at least one of the following:*
>
> – *the discovery, or verification, of clinical, pharmacological or other pharmacodynamic effects;*
>
> – *the identification of adverse reactions or adverse effects;*
>
> – *the study of absorption, distribution, metabolism or excretion*."

The relevant terms are:

Planned study	an experiment
in humans	this is the only part of the definition that actually limits the scope. The experiment must be conducted on humans.
intervention	this can be anything that can be done to a human. It could be an educational methodology, an exercise regimen or a meditation technique.
Clinical effect	A number of authors (e.g. https://www.ncbi.nlm.nih.gov/pmc/articles/PMC3719483/) have pointed out that "There is no clear consensus on a single definition for clinically meaningful differences in randomized controlled trials"

As a result the definition proposed can be re-stated as:

> "*A clinical trial is an experiment of the safety or efficacy in humans of an intervention with the aim of achieving at least one of the following:*
>
> – *the discovery, or verification, of effects;*
>
> – *the identification of adverse reactions or adverse effects;*
>
> – *the study of absorption, distribution, metabolism or excretion*."

This version of the definition makes it clear that almost any core R&D activity conducted on humans could be defined as a clinical trial.

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

The finding process will work after the initial period of implementation. The issues identified above with the definition along with the fact that the finding process can only operate slowly means that there will be a period (which could be two years, in my opinion) where there is uncertainty about the clinical trials expenditure exclusion from the refund cap.

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

I do not believe they create unintended consequences apart from reducing the likelihood of an applicant making a claim under the program for feedstock.