

26 July 2018

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

Delivered via email to: R&Damendments@treasury.gov.au

Dear Sir/Madam,

Re: Feedback and Comments on the draft *Treasury Laws Amendment (Research and Development Incentive) Bill 2018* and Explanatory Materials.

Michael Johnson Associates Pty Ltd (MJA) is pleased to provide a submission in relation to the draft legislation, the *Treasury Laws Amendment (Research and Development Incentive) Bill 2018*, and the accompanying Explanatory Materials (EM).

Summary Comments

The recent release of the Consultation Paper, accompanying the draft legislation and EM associated with the 2018/19 Budget measure – '[Better targeting the research and development tax incentive](#)' - sees the Government asking a series of six questions associated with the implementation of the proposed changes.

The questions seek feedback on matters associated with compliance challenges, integrity and unintended consequences with respects to three aspects of the R&D Tax Incentive (the Incentive) reforms, specifically:

- Calculation of R&D Intensity – total expenditure
- Clinical Trials exemption under the \$4 million refund cap
- New arrangements for Clawback for recoupments and feedstock revenue (an aspect not announced at Budget time and which seeks to clean up some anomalies in the current legislation and to reduce the value of affected claims in the hands of smaller taxpayers).

The questions come from an expected viewpoint that the changes are a *fait accompli* and they are administrative and technical in nature.

MJA is disappointed that the Consultation Paper is not asking more fundamental questions about the Australian corporate community's views about the policy impacts of the changes to the Incentive including:

- Do you accept the need for a \$2.4 billion reduction in innovation support in the next four years at a time where BERD is falling in Australia and the overall cost of the Incentive is falling?
- Are the changes the best way to deliver this Budget cut or are there alternatives?
- What are the expected impacts of the changes on your business?
- Do the changes reduce or increase the incentive for you to carry out R&D?
- Do the changes make it less likely or more likely that you will do R&D in Australia compared with overseas?
- Do the changes increase or reduce your expected compliance costs associated with claiming the Incentive?
- Will you continue to claim the Incentive going forward? and, finally,
- Do you agree with Senator Michaela Cash, the Minister for Jobs and Innovation, when she says, *"By better targeting R&D investment, these changes will lead to new ideas, products, services and jobs"*?

The proposed cuts to the Incentive are being made in an environment where the cost of the Incentive is falling (due to the combined effect of the \$100 million annual claim cap and the 1.5% offset rate cut over the past 4 years) and where Business Expenditure on Research & Development (BERD) is falling (12% in 2015/16 according to the ABS figures).

It is apparent that the Government believes that further "reform" is necessary to reward additional investment in R&D while also ensuring the integrity and fiscal affordability of the Incentive. And the Government has been very overt that this "reform" is designed to save an additional \$2.4 billion in the next four years. So, in other words, the Government is seeking to make a huge cut in innovation support, which is tantamount to legislating a further fall in BERD, while somehow providing incentive to "larger" Australian companies to increase their commitment to R&D. The inherent conflict in this proposition is palpable.

And we have been down this pathway before. In 1996, the then Coalition Government more than halved the R&D Tax Concession (the Concession) by reducing the concessional R&D rate from 150% to 125%, along with the introduction of the feedstock offset provisions. The result was the first drop in BERD in more than 20 years and a dramatic reduction in program participation from more than 4,000 companies to less than 3,000 over the course of the next three years. The advent of Prime Minister Howard's Innovation Summit and Action Plan at the turn of the millennium successfully arrested the decline but not before there had been real damage done to the Australian innovation community.

The 1996 changes dropped the rate of R&D support from 18 cents in the dollar to 9 cents. By way of comparison, for most Non-Refundable Offset companies under the draft legislation, the benefit reduces from 8.5 cents to 4 cents. The impact is likely to be calamitous for those taxpayers. This should be avoided at all costs. In our recommendations section, we summarise that the same fiscal savings can be achieved by offset rate adjustments and examination of the terms of access (ie. minimum eligible spend requirements). This approach to fiscal restraint is simpler, clearer and more equitable. The experiences of 1996 should be avoided and they can be.

The measures announced are seeking to give voice to the 2016 Review Of The R&D Tax Incentive (the '[Triple F' report](#)) with a passing nod to the recent Innovation and Science Australia report, "[Australia 2030 Prosperity Through Innovation](#)". It is interesting to note that the Treasury has indicated the Budget

savings will be returned to consolidated revenue as opposed to their redirection to other innovation measures recommended in the Triple F Report. Further, the Triple F's legacy recommendation of a collaborative premium for Non-Refundable R&D Tax Offset companies has been completely ignored.

The unasked questions set out above have not been put to the Australian innovation community in the Consultation Paper yet they merit the Government's immediate attention. MJA has consulted extensively with its client base, other companies and various stakeholders and the resounding consensus is that there are profound problems associated with the Budget package, in particular, the proposed tired Non-Refundable Offset and the consensus is that the Government should urgently reconsider its position.

The bottom line is that, if the changes go through in the current format, then the vast majority of taxpayers eligible for the Non-Refundable Offset will receive the lowest offset rate of 34%, down from the current 38.5% as they will have an R&D intensity of less than 2% based on the announced calculation method. In other words, their permanent difference will fall from 8.5 cents in the dollar to 4 cents. This is a historic low for the Australian program (previously 7.5 cents) and it is our understanding that it would be a new record for the lowest rate of R&D tax benefit offered globally.

As one iconic Australian company put it to [MJA](#), moving from 8.5 cents to 4 cents is not a halving of support as it first appears. When you take into account the expected increased compliance costs (which this company estimated as 2 cents), it is a "more than two-thirdsing". And this is a company currently doing government-approved R&D, recognised as world-leading, in the tens of millions but with a domestic expenditure base in the billions so its R&D intensity is sitting at about 0.02%. There is no possibility for them to ever be eligible for more than the baseline 34% offset rate so they feel totally unsupported by the new regime and are seriously considering exiting the program going forward. This company is not an isolated case. This is the reality that will confront most Non-Refundable Offset claimants.

And it must be emphasised that the Government's position that the changes apply to large organisations, defined as those with a group turnover in excess of a mere \$20 million, make this a blunt policy instrument that regards a \$21 million company group as behaving in the same manner as the very largest corporates operating in the Australian environment.

So what does this mean in terms of the questions not asked in the Consultation Paper set out above?

The potential damage to the Australian innovation system may clearly be seen.

For many companies in the Non-Refundable Offset space, the consequences will include:

- Reduction of commitment of resources to existing R&D projects
- Relocation of R&D activities to overseas jurisdictions
- Decision to not undertake potential R&D projects at all
- Withdrawing from participation in the Incentive program

In summary, the R&D culture built around the Incentive over the past 30 years will be in serious retreat as taxpayers desert the program as they did in 1996 when the Coalition reduced the R&D Tax Concession rate from 150% to 125%.

[MJA](#) believes that the Non-Refundable Offset in its current form will be the single worst change in the more than 30 year history of the program. Under the R&D intensity test, a company group will need to have an intensity level of greater than 13.125% to match the 8.5% received from the first dollar of

eligible R&D under the current provisions (leaving the increase in the annual expenditure cap to \$150 million to one side as this is a consideration for a very small number of taxpayers). Companies in that situation will be the privileged few.

A taxpayer's R&D intensity level will always be primarily determined by the group's overall expenditure which is influenced by a myriad of factors like industry margins, company lifecycle and external cost variables, most of which are largely (or entirely) out of the group's control. That is why most companies most of the time don't have the ability to increase R&D intensity significantly and the new provisions certainly don't offer much incentive to get to a higher R&D intensity bracket as the premium R&D tax incentive rates only apply to the incremental dollars.

The greatest frustration held amongst stakeholders is that there are clearer and simpler alternatives to achieve the desired Budget savings, assuming the Government will not sway in this regard, than the complex, uncertain and destabilising package of measures contained in the draft legislation. These alternatives are focused on offset rates and terms of access and will be briefly canvassed later in this submission. And if the Government was fixated on the introduction of an R&D Intensity measure, the damage would be minimised if the bottom tier was removed from the Non -Refundable Offset schedule so the initial base rate became 6.5 cents. **This is one stroke of a pen or one tap of a keyboard.**

We respectfully submit that the Government institute a true consultation process regarding reform of the Incentive and put this package under a public enquiry microscope to ensure that the program can continue to underpin the success of the Australian innovation community over the past 30 years.

About MJA

MJA is a national professional services firm that specialises in assisting Australian companies in accessing Federal Government support programs for innovation with a particular focus on the Incentive. Our specialist team of engineers, scientists, miners, IT professionals, accountants, tax experts and lawyers have 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 200 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, Innovation and Science, AusIndustry, Treasury and the Australian Taxation Office (ATO). MJA was instrumental in the consultation process in setting up the R&D Tax Concession program back in 1985 and we have continued this tradition through our participation in the 2008 *National Innovation Review* and the 2009-2011 Incentive design process.

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.

Our academic credibility is reflected by the fact that MJA is responsible for writing the CCH *Master Tax Guide* on the R&D Tax Incentive.

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

What are the Policy Impacts of the Draft Legislation?

Since the publication of the Triple F Report, there has been no opportunity for public consultation on its findings or any subsequent pronouncements such as the commentary in the Australia 2030 Report. Certainly, this is the first opportunity to formally submit on the draft legislation that has followed the 2018 Federal Budget announcements.

We expect that most submissions will include commentary on the policy impacts of the package, beyond simply responding to the six tax technical questions contained in the accompanying Consultation Paper and MJA is no exception.

Definition of R&D Activities and R&D Expenditure

The Budget contained no changes to the definitions of R&D activities and R&D expenditure. This is consistent with the recommendation in the Triple F Report that these should be unchanged at least until 2021.

MJA supports this position. If there were no changes made until 2021, this would establish a 10 year time horizon that will have provided a key plank of stability in the program. This stability becomes very important where we consider the current regulatory environment in our discussion with respect to the Integrity measures announced in the Budget (which we note did not lead to any questions in the Consultation Paper).

Non-Refundable Offset

Changes

The Triple F Report concluded that the Incentive was not achieving its objective of encouraging additionality so it put forward a proposal to link the level of R&D tax benefit to the 'R&D intensity' of the company groups eligible for the Non-Refundable R&D Tax Offset known as the R&D Intensity Threshold test. It also proposed extending the annual eligible claim limit from \$100 million to \$150 million.

The Australia 2030 Report softened the intensity proposal by positing an R&D Intensity Trigger test and supported the annual claim limit being lifted to \$150 million.

Neither group sought public submissions about their proposals.

The Budget announced a third iteration of the R&D intensity test with its tiered benefit structure, along with the lifting of the R&D expenditure cap to \$150 million. Both measures were slated to take effect from 1 July 2018.

The new regime is to apply to Non-Refundable R&D Tax Offset company groups, being those with an aggregated annual turnover of \$20 million or more.

The regimen of available tax benefits available are the claimant's tax rate for the year plus:

- 4 percentage points for R&D expenditure between 0 per cent and 2 per cent R&D intensity (inclusive);
- 6.5 percentage points for R&D expenditure above 2 per cent to 5 per cent R&D intensity (i.e. not including R&D expenditure falling within the first 2 per cent of the claimant's total expenses for the year);
- 9 percentage points for R&D expenditure above 5 per cent to 10 per cent R&D intensity (i.e. not including R&D expenditure falling within the first 5 per cent of the claimant's total expenses for the year); and
- 12.5 percentage points for R&D expenditure above 10 per cent R&D intensity (i.e. not including R&D expenditure falling within the first 10 per cent of the claimant's total expenses for the year).

Based on the Consultation Paper, the Government is not seeking feedback on the impacts of the current version of the R&D intensity test. MJA feels compelled to provide such feedback nonetheless.

Analysis

In the Budget announcement, the Government provided a worked example:

“A company with a 30 per cent tax rate that has \$120 million of R&D expenditure for the year and \$300 million of total expenditure will have an overall R&D intensity of 40 per cent. It claims R&D tax offsets at a rate of 34 per cent for the first \$6 million of R&D expenditure, 36.5 per cent for the next \$9 million of R&D expenditure, 39 per cent for the next \$15 million of R&D expenditure and 42.5 per cent for the final \$90 million of its R&D expenditure. It also benefits from the increased \$150 million R&D expenditure threshold as it can claim concessional R&D tax offsets for its R&D expenditure that exceeds \$100 million, rather than claiming these offsets at the company tax rate.”

The worked example is a great place to start. It considers a company with an R&D intensity of 40%. Let's call that company Unicorn Pty Ltd. You don't meet companies that spend \$120 million on R&D that often and you meet those who do so on a total expenditure budget of \$300 million even less often. What can't be denied is that Unicorn will be better off under the new regime compared with the current flat rate of 8.5% with an annual claim cap of \$100 million.

But what if Unicorn had an intensity of “just” 10% (ie. \$30 million over \$300 million), a measure that would see it regarded as a very high tech R&D spender? Because the new measures attach the benefits to the various tiers of support, Unicorn gets 2% of its spend at a 4% tax benefit, 3% at 6.5% and 5% at 9%. As a result, a \$30 million spend generates a permanent tax benefit of \$2.175 million under the new provisions. Under the current regime, the tax saving is \$2.55 million so Unicorn is worse off, even at a comparatively high R&D intensity of 10%.

In fact, in order to be better off under the new provisions, your intensity must be greater than 13.25%. Most of the approximately 4,000 companies currently claiming the Non-Refundable Tax Offset are nowhere near that level of intensity. In fact, based on an examination of our client base and on discussions with other stakeholders, it is seen as likely that the vast majority will be in the less than 2% R&D intensity range. The 4% on offer is below the minimum viable rate of 5% that has historically driven discussions about the affordable level of support. When you factor in compliance costs, an offer of an incentive rate of 4% is, in fact, no incentive at all.

The problem is compounded by the weak impact of moving to a higher R&D intensity bracket. As a simple example, if an R&D spend of \$1,000,000 gives you an R&D intensity equal to 2%, the

\$1,000,000 attracts the 4% support. A spend of \$1,000,001 puts you in the next bracket involving the 6.5% support rate. However, you get a blended outcome where \$1,000,000 receives the 4% and only \$1 attracts the 6.5%. No-one we have spoken to has been able to articulate how this translates into a genuine incentive to lift your R&D intensity in the face of all the institutional factors described in this submission.

The Government needs to urgently reconsider the offer it is making to this sector. At 4% for most of the cohort, you won't be driving innovation behaviour. You will be driving companies out of the program.

In our submission to the Discussion Paper that preceded the Triple F report, we pointed out the fundamental problems with the R&D intensity requirement.

To summarise:

- The Triple F's assertion that R&D intensity delivers better innovation outcomes is unsubstantiated. A start up can spend 100% of its expenditure on R&D. If it never commercialises, its R&D intensity delivers nothing sustainable. It appears the concept is being used as a way of masking a deep budget cut affecting all but a rarefied elite of huge R&D spenders.
The assertion that more R&D intense companies necessarily deliver better innovation outcomes than their corporate peers was the central premise offered by the Triple F Report in support of the introduction of the R&D intensity test (or, at least, the one proposed two versions ago).
The supporting evidence offered was scant and has been subject to much public critique.
- The application of the R&D intensity measure to companies with a turnover of \$20 million is based on a false premise that this turnover threshold defines larger companies. Even the ATO regards SMEs as having a turnover of \$250 million or less. Again, the only intended significance of the \$20 million turnover threshold legislated in 2011 was to limit eligibility for the cash back aspect of the Incentive. That's it. This makes the new regime a very blunt policy instrument covering a range of organisations who actually share little in common.
- To expect R&D intensity levels above 2% from many companies is fantasy, given the nature of their industries such as mainstream manufacturing and their positioning in terms of maturity and life cycle. Many of these companies could double or triple their R&D spend and still fall way short of a 2% intensity test. And at a 4% tax benefit, they are not being offered a true government incentive to encourage a lift in R&D effort.
- You cannot design a behaviour incentive that is dependent on a factor that you can't incentivise ie. Australian operating expenditure. Companies cannot control many aspects of their costs at all (eg. inputs such as raw materials; third party costs such as power; government imposts etc.) As such, the Incentive loses its value as a planning tool, condemning it to be an after-the-fact tax calculation with all the attendant uncertainties.
In simple terms, you can double R&D spend in a fiscal year but still end up with a lower level of R&D intensity because a range of factors outside your control.

Essentially, one factor alone – R&D intensity – determines what level of support the Government will provide to individual taxpayers in the Non-Refundable space. This seems to institute a highly discriminatory effect in a program known historically for its inclusive nature.

Overall, we are confident that a base offering of 4% would be the least attractive offering available by any R&D tax regime globally. It has been highlighted by others that the two regimes offering an

Incentive based on a notion of R&D intensity – Belgium and Japan – do so on an opt-in basis to incentivise companies over and above a viable base rate. The key expression here is opt-in.

The 2008 National Innovation Review, commonly known as the Cutler Report, described the Australian innovation system as a doughnut which needed policy measures to fill the hole to deliver a true innovation network. The introduction of the R&D Intensity measure will just mean that we will be building a bigger hole as thousands of Australian companies face effective exclusion from the government support framework. And this would be happening at a time where Business Expenditure on R&D (BERD) is falling (12% in 2015/16) and the overall cost of the R&D Tax Incentive is declining.

In other words, this proposal is legislating a significant decline in BERD which will see Australia slipping further behind in the global innovation drive.

Refundable Offset

Changes

From 1 July 2018, the Government intends to:

- Introduce a \$4 million annual cap on cash refunds for R&D claimants with aggregated annual turnover less than \$20 million. Amounts that are in excess of the cap will become a non-refundable tax offset and can be carried forward into future income years;
- Exclude R&D tax offsets for clinical trials from the \$4 million cap on cash refunds, recognising the critical role of R&D expenditure on clinical trials in developing life changing drugs and devices; and
- Amend the Refundable R&D Tax Offset so it is a premium of 13.5 percentage points above the claimant's company tax rate for that year.

Analysis

Prior to the introduction of the Incentive in 2011, MJA advocated for an annual cap on cash rebates available under the Refundable R&D Tax Offset to maintain a degree of discipline in the program. Our concern has been that an uncapped offering is too generous and doesn't place sufficient pressure on start ups to make the hard-nosed commercial decisions about completing/continuing/failing the funded R&D activities. The \$4 million cap appears reasonable and generous and it is pleasing to see the confirmation that excess amounts can be carried forward into future years.

We have felt the open-ended refund has been a real issue in the biotechnology sector and we are fascinated by the fact that clinical trials have been specifically excluded from the cap because, in the Government's words, it recognises "the critical role of R&D expenditure on clinical trials in developing life changing drugs and devices".

A strong feature of Australia's R&D tax regimes since 1985 has been that they have clearly excluded certain activities from eligibility and, beyond that, they have been technologically agnostic. If the clinical trials exclusion is legislated, it can be argued, for the first time, that a moral dimension has been introduced to the program. In other words, it appears to run the argument that the Government thinks R&D to save lives is more meritorious than getting 3% out of the cost of your blast furnace by technical innovation. The risk is that you put the program on a slippery slope because you start to legislate additions and exceptions to the support mechanism based on the perceived "goodness" of the work.

Enshrining these forms of institutional bias can translate into unintended consequences such as inferences in risk assessments and audits from the regulators (ie. AusIndustry and the ATO) that certain types of R&D – software developed by small companies and financial institutions; mining and minerals process; and building and construction – are ‘risk’ areas that to be viewed less favourably in terms of eligibility because they are not biotech or medical, rather being assessed on their compliance with a technologically agnostic definition of R&D activities.

Finally, there has been some confusion about the final aspect announced regarding the amendment that sets the tax benefit to 13.5% above the prevailing company tax rate. This means that the offset rate is no longer a set number (currently 43.5%). A Refundable Offset taxpayer’s rate is the addition of its company tax rate plus the 13.5%. So, refundable claimants with a 30% company tax rate (currently group turnover of \$10-20 million) continue to have a rate of 43.5% while those with a company tax rate of 27.5% (\$0-10 million) will now have a rate of 41% so the eligible cash back on claimed R&D spend will be lower than currently. MJA understands the thinking behind this move as, ultimately, the Incentive should be considered as a cost that reflects the “permanent difference” in the long run for a recipient that ultimately starts paying tax. Ironically, Treasury never takes this view when they cost the Refundable R&D Tax Offset but this is not the forum for that discussion.

Integrity Measures

Changes

The Budget announcements were as follows;

Integrity: strengthening anti-avoidance rules in the tax law so the ATO can ensure taxpayers do not avoid paying their fair share of tax by using tax schemes involving the program;

Enforcement: additional resourcing so the Government can help ensure that ineligible R&D claims are denied;

Transparency: publishing company names claiming the Incentive and the amounts of R&D expenditure they have claimed, to improve public accountability for R&D claimants;

Guidance: enabling Innovation and Science Australia to produce public findings similar to the ATO, and provide more effective, binding guidance on the scope of what is eligible R&D. This will help ensure taxpayers do not unintentionally misinterpret the meaning of the law; and

Administration: imposing a three month limit on extensions of time available from when applications, registrations and reviews are due.

Analysis

The initial reaction is that the Government is spending additional money on compliance resources for a program they are seeking to shrink by \$2.4 billion over the next four fiscal years and we note that is their prerogative. However, the trouble is that the online government presence for many years now around the Incentive has had a strong theme of ‘Comply Or Die’ and there has been scant evidence of any promotion of the benefits of the program. Add to this, the genuine concerns about the current performance of both regulators in the marketplace, then the announcements have a strong sense of further crackdowns on both those who misuse the program and those who are in genuine error. To be fair, there is no clear announcement of any resources to promote the program and encourage more R&D from the Australian corporate community so it is hard to avoid the negative connotations of the measures.

One area of immediate concern is the intention to publish annual R&D expenditure claimed by all company groups. For most Australian taxpayers, this will be the only part of their tax affairs that will be

a matter of public record. And it is information that is regraded as being commercially sensitive and a source of competitive advantage. The concerns are compounded by the fact that the understanding of the wider community including investors and shareholders as to the actual eligibility criteria underwriting the amount of claimable R&D expenditure is varied. Many shareholders are adverse to risk and the publishing of claim figures may be seen as a way of the Government pushing companies into claiming less than they are entitled to for fear of negative feedback from stakeholders. It is unclear what the thinking is behind this measure. MJA hopes that it is not a backdoor method of putting downward pressure on claimants who interpret this as a measure akin to 'name and shame'.

As stated earlier in this submission, the Government has followed the sensible recommendation from the Triple F report to not change the definitions of eligible R&D activities and R&D expenditures that were legislated in 2011. It is imperative that all stakeholders come together now in the name of program integrity to re-confirm the understanding of what R&D is supported by those definitions. From this, improved, commonly agreed guidance can help inform the market place about the parameters of the program.

This is currently not happening. A well-publicised concern in recent times is the eligibility of software development where both regulators are seemingly taking a more restrictive view of eligibility some seven years after the laws were introduced and after thousands of claims have been made on an apparently different basis. There is a litany of companies who are complaining of their treatment in the current regulatory environment. These concerns must be addressed as an urgent priority under the proposed integrity measures.

MJA has worked in this field since the Concession began in 1985 and we have not experienced such a difficult and confusing risk assessment/audit environment. We support any initiatives to crackdown on companies and tax agents doing the wrong thing. But why is it that bona fide companies, many of whom prepare their own claims, are being found to be deficient in some aspect of the claims and the price they pay is that their claims are being rejected outright and they are facing the likes of repayments, interest and penalties?

It used to be the case that AusIndustry and the ATO would work with these companies to get them compliant. We have been approached by a large number of claimants and their tax agents for our opinion on rejected claims and we see no evidence that the regulators are looking to help these companies get compliant. Rather, the claims are being rejected outright with the evidence of the taxpayers being blanketly rejected without analysis or refutation. Further, these companies are being actively discouraged from continuing to participate in the program.

Program integrity is a two-way street. We would like to think the focus of the new integrity measures create an opportunity for all stakeholders to come together, review their performance and obligations under the Incentive and work toward the common goal; ensuring eligible R&D conducted by Australian companies gets the full support available.

Responses to the Questions Posed in the Consultation Paper

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

The addition of complexity to what should be a straight forward and predictable incentive will create compliance challenges. The program is already quite complex in its operation and in the calculation of attributable expenditure in a way that is readily verifiable.

Implementation compliance challenges

As per S 355-1 and 355-5 of the Tax Act, the objective of the Incentive is to encourage businesses to conduct future R&D that they may not otherwise have conducted due to the risk and uncertain returns from this expenditure. The intensity measure is new and is very different from that proposed in 2016 in the Triple F Report. This means that the proposal has not been subject to any public consultation. This follows broad, nearly universal rejection of the previously proposed alternative R&D intensity measures in the Triple F and Australia 2030 Reports.

From an implementation point of view, we are already in the tax year that the proposal is supposed to commence. The earliest these changes can be passed is the Spring session of Parliament. The changes propose a very significant drop in the net value of the tax offset for medium-sized and large businesses. Together with this, there is uncertainty about whether just the base rate or how many of the three premium rates will apply when the first year's R&D calculations are made. As this is still subject to public consultation, whether these changes will be implemented as per the Exposure Draft should not be considered certain if this process is valid. Affected businesses may be asked to comply with new laws long after they have commenced planning and conducting R&D activities encouraged by the existing law. These businesses will have no certainty of the value of the offset or whether it will be different from what was considered when they planned their R&D activities.

Ongoing compliance challenges

The ongoing compliance challenges are that the proposal will create uncertainty and complexity in returns. This will create additional deadweight losses with uncertain returns in a program meant to overcome issues around said uncertain returns. It does this without actually providing a mechanism to achieve a key legislative goal - the encouragement of more R&D in Australia.

A multi-tier rate, based on the proportion of R&D expenditure in total expenditure, has many of the same flaws as with the previous 175% Premium Concession introduced in 2001. This premium failed to achieve its similar goals and was removed by the Rudd Government in 2011. The key failings are that levels of total expenditure and changes in other business activities and outcomes that have nothing to do with R&D may prevent businesses that are currently driven to conduct R&D in Australia from accessing any of the three premium levels. If they are subsequently found to be eligible for one or more of the premium levels, this may not be able to be determined in advance. The inability to reliably forecast the R&D tax offset rate means that, rather than increasing the likelihood of businesses to increase R&D efforts in pursuit of the higher rates, this uncertainty may discourage businesses from conducting R&D in Australia. They may prefer to conduct R&D in countries that have more stable and certain R&D encouragement programs.

The combination of:

- the drop in the base R&D tax offset rate to less than half its current rate,
- introduction of three step premium rates based on factors that are not related to the R&D effort i.e. total incurred accounting expenditure, and
- the mismatch between the tax-based calculation method for the R&D notional deduction and the accounting based method for total expenditure

means there is a significant increase in complexity and unpredictability of the R&D Tax Offset, coupled with a lower return for all medium and large businesses who spend less than 13.125% of total expenditure on R&D. These will only increase the compliance challenges for businesses required to make the R&D intensity calculation.

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

Integrity in the design and implementation of tax law is reliant on the equity of the tax law changes, the ability of the changes to achieve their stated objectives and on how these laws can be effectively administered.

The equity issues that arise in the calculation of R&D intensity relate to the treatment of different taxpayers:

Moving between the \$20 million cut-off

Step changes such as when businesses move between the two levels of the R&D Tax Offset can result in severe equity issues affecting the integrity of a tax system. For example: Two almost identical tax payers in the same industry, each exploring different methods to resolve the same knowledge gap at the same level of expenditure should be treated equitably by the tax system for the proposed calculation to have integrity. If both businesses spent every dollar of taxable income and the only difference between the two taxpayers is one spent a total of \$19,999,999 in the year and the other, \$20,000,000, the proposed calculation method for R&D intensity further increased the existing inequity. If both businesses incur an R&D intensity of 2% (i.e. \$400,000 R&D expenditure), then the effective marginal tax rate of that extra dollar of expenditure moves from its existing 2 million percent to 3.8 million percent. In dollar terms, the effect of that \$1 extra of expenditure moves from reducing the \$54,000 net tax benefit to \$34,000 to now reducing this to \$16,000. This is a very expensive dollar.

It has always been a design element of the program to direct more benefits to smaller taxpayers, but the calculation method proposed increases the tax design flaw above and further reduces the integrity and equity of the system. This will be more problematic for businesses that cyclically move above and below the cut off between the proposed Company Tax Rate (CTR)+13.5% refundable rate and the proposed CTR+4% non-refundable rate.

Accounting expenditure

The basis of the calculation is to compare a notional tax deduction with expenditure as it is incurred as measured by the accounting standards:

355-115 Working out an R&D entity's expenditure

- (1) An *R&D entity's expenditure for an income year is the sum of the amounts covered by subsection (2).
- (2) The following amounts are covered by this subsection:
 - (a) the expenditure incurred by the *R&D entity for the income year worked out in accordance with the *accounting principles;

This results in two integrity issues:

1. Mismatches between allowable notional tax deductions and expenditure as incurred as measured by accounting standards. The two different bases can create significantly different results. For example, there can be huge differences between net profit before tax and taxable income for a wide variety of reasons, most of which are nothing to do with R&D intensity. This mismatch can have different unintended consequences for different taxpayers.

2. The proposed wording in the exposure draft is that expenditure must be **incurred** for the income year. This ties the calculation to expenditure that the business has a legal obligation to pay. This will often be different from expenditure **expensed** in the year. Expenditure incurred within each that is capitalised will need to be included as incurred in the base. However, R&D expenditure that is for tangible capital items must be depreciated over its effective life. This means the R&D amount is reduced whilst the accounting base is the full cost as incurred. This will artificially reduce the measured R&D intensity.

Industry and cost structure differences

The R&D intensity calculation is based on the flawed assumption that the intensity can be simply measured in the same way for all medium and large businesses. This assumption means the calculation lacks integrity because it does not take into account differences between:

- Businesses with Australian head offices as opposed to businesses that are branches of overseas groups,
- Diverse businesses that are multi-faceted and spread across many sites or industries as opposed to those focused, limited site and single industry businesses,
- Premium service industries (e.g. professional services) as opposed to low mark-up high turnover (e.g. supermarkets) industries or industries like manufacturing.

The cost structures of an Australian branch of an overseas group can be very different to an Australian business. It is worthwhile to encourage overseas organisations to establish and maintain R&D teams in Australia with the Incentive. However, it is an integrity failure if similar encouragement is not provided to Australian equivalent businesses because their expenditure necessarily includes many costs not applicable to the overseas-owned Australian R&D branch. Alternatively, if the calculation is based on world-wide expenditure, then this will discourage overseas businesses from establishing R&D hubs here.

Similarly, the calculation lacks integrity when it compares a high intensity R&D business that is a stand alone business with a high intensity R&D business that just happens to be a division of a diverse group. This is more likely to happen since the introduction of Tax Consolidations as, previously, the separate divisions may have been separate taxpayers.

Whilst a developer of a bionic ear may be able to reach the top premium intensity rate, a business in retail petroleum sales is extremely unlikely to ever be able to reach the bottom premium intensity rate (ie. 6.5 cents). This is simply as a result of cost structures and not necessarily as a result of additional encouraged R&D intensity. There is no integrity in the assumption that a medical device developer will do more medical device development because they naturally easily reach the higher rates but a retail distributor business with a new focus on R&D, encouraged by the current Incentive, will now be less encouraged by the program to do more R&D.

The impact on manufacturing with high feedstock inputs is that these industries continue to have less encouragement for R&D than in mining or software R&D. All R&D costs incurred that involve mining ore or creating new software do not have any clawback mechanisms where the ore or software is sold. However, for a manufacturer, the expenditure on materials transformed or processed in R&D activities and the energy used to transform or process these materials are adjusted back. The legislation is silent on how the premium rate at which the clawback should apply but the example in the Explanatory Memorandum applies this at the top marginal rate applicable to the R&D entity. Applying the clawback this way further disadvantages manufacturers. Not only are they the industry that must reduce their net benefit when they sell items made in R&D experiments, but they lose the benefit at their highest

premium rate. This is despite the fact that the expenditure on feedstock inputs occurs before the experiment occurs.

In regards to the response on compliance, the biggest issue to be discussed is the lack of certainty. There is one group that will have certainty. The combination of the \$150 million R&D expenditure cap and the first premium rate (ie. 6.5 cents) commencing at 2% of total expenditure means that businesses with \$7.5 billion total expenditure or more will always be restricted to the base rate. The structure of the calculation means that these businesses will never be encouraged to do more R&D in Australia. This is especially so, given that the +4% rate is internationally very, very low. It will be much more attractive to do R&D in most other nations other than Australia. This will just exacerbate the adverse impact of the R&D expenditure cap on R&D by very large businesses.

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

No. That it applies to the head company of potentially diverse groups already means that the R&D intensity measure is too widely focused. It will already mean that a high intensity R&D division may be locked out from being encouraged to more R&D in Australia. Expansion of the total expenditure across broader economic groups to include overseas expenditure or expenditure incurred by connected entities will only further discourage R&D in Australia.

There are strong arguments that the total expenditure should be limited to non-cost of sales expenditure in the R&D team's division/business unit rather than the inclusion of more unrelated expenditure from other entities. The objective should be to encourage increases and recognition of the intensity of that R&D team in that team's business. It should not be to find new ways to reduce the incentive by broadening the base so the incentive is further watered down.

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 appears in the Explanatory Memorandum as follows:

1.127 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 items missing from this definition are the pre-clinical research and ethics approval phases (sometimes grouped as the Phase 0 experiments). The full set of experiments required to conduct human clinical trials in Australia should include the pharmacokinetics and pharmacovigilance safety and tolerability experiments and not just the pharmacodynamics. Often there can be high costs to develop processes to manufacture new molecules or compounds above lab scale, so they can be made in usable forms in quantities required for the clinical trials.

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

Yes. Expanding the ability of Innovation and Science Australia (ISA) to be the sole determinant of whether activities are registered and how they should be classified or re-classified to include the determination of whether that activity or part of that activity are clinical trials is consistent with the rest of the law. An improvement would be to make it explicit that if there are questions about whether an activity registered by ISA is properly classified as core, supporting, clinical trials or not R&D, that the Commissioner must refer this to ISA. This is because it is only the ISA that can re-classify all or part of a registered activity as one of these four types of activities in a way that binds the Commissioner.

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

The process of calculating, claiming and then clawing back 100% of the net benefit received succeeds in correcting a systemic error that has been present in the legislation since the program commenced in 2011. This error has been exacerbated by changes in the company tax rate, but more importantly, by the reduction in the net benefit for medium and large business below the 10% clawback and adjustment rates. The correction of the damaging over-correction is long overdue. However, the issue here is that the proposed unified process completely claws back expenditure in relation to grant-funded R&D and recoveries from the sale or own use of feedstock outputs. It just does this in a needlessly complicated way compared to allowing an exclusion in section 355-715 to simply never include this expenditure in the first place.

Our reading is that a business that received a net 13.5% or 16% benefit from prior year R&D activities that sells the items produced in R&D activities for more than the cost of the attributable feedstock inputs, energy and depreciation would lose the previously retained 3.5% or 6% after adjustment. However, this is probably not an unintended consequence.

It should be pointed out that there remains an unresolved issue regarding the similar overcorrection or incomplete corrections for income or R&D notional deductions for balancing adjustments on the disposal of depreciating assets used, at least in part, in the conduct of R&D activities at some point in its life.

Recommendations

MJA urges the Government to rethink these Budget measures and conduct a public enquiry into the best method of achieving the fiscal savings associated with the desired funding cut to innovation.

The second part of our submission has highlighted a number of issues and complexities associated with the implementation of the legislation in its current form and this public consultation process needs to lead to improvements to the measures as they stand at the very least.

More profoundly, the introduction of the R&D Intensity test to the Non-Refundable R&D Tax Offset will do untold damage to large sections of the Australian innovation community and is the wrong way to achieve the desired fiscal outcomes. MJA calls for a public enquiry into the most effective way of delivering this Budget cut. We believe that a combination of lower offset rates across the board, combined with a reasonable increase in the terms of access – minimum eligible R&D expenditure; determining whether the minimum spend should attract the R&D Tax Offset – can achieve the same fiscal result without tearing at the fabric of Australia's innovation culture.

And if the Government was fixated with the introduction of an R&D Intensity measure, the damage would be minimised if the bottom tier was removed from the Non-Refundable Offset schedule so the initial base rate becomes 6.5 cents. **This is one stroke of a pen or one tap of a keyboard.**

MJA appreciates the opportunity to make this submission. Should you wish to discuss any aspect of the material contained herein, please do not hesitate to contact Kris Gale on 0411 171 596 or kris.gale@mjassociates.com.au

Yours sincerely,

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