RSM Australia Submission to: Treasury Laws Amendment (Research and Development Incentive) Bill 2018 and Explanatory Materials

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RSM appreciates the opportunity to make a submission in response to the "*Treasury Laws Amendment (Research and Development Incentive) Bill 2018 and Explanatory Materials*" ("Bill").
RSM provides audit, tax, and a wide variety of corporate financial and advisory accounting services. This includes R&D Tax services for a broad array of industries and technologies, and assist entities ranging from start-ups to SMEs through to multinationals.

RSM has previously made submissions to the many Reviews, Reports and Papers that have formed the underlying context from which this Bill has been prepared:

- The Tax Expenditures Statement – Consultation Paper (TES Paper);
- Treasury's "Re:Think" Tax Discussion Paper (Re:Think Paper);
- The Chief Scientists STEM report (STEM Report);
- The FFF Review of the R&D Tax Incentive prior to the report being completed;
- The FFF Review of the R&D Tax Incentive subsequent to the report being released (3F Response Paper); and
- Senate Economics Legislation Committee regarding the Budget Savings (Omnibus) Bill 2016 (Omnibus Bill).

Many of the issues that we (and others) have addressed in the above responses appear to have not been taken into account in the 2018-19 Budget Announcement that forms the basis for the Bill.

The Consultation Paper for the Bill states:

> *"The 2016 Review of the R&D Tax Incentive and the 2018 Innovation and Science Australia 2030 Strategic Plan found the R&DTI did not fully meet its policy objectives, particularly in inducing business research and development expenditure beyond business as usual activities. The Government's response acknowledges these reports' findings with a package of reforms to enhance the additionality, integrity and fiscal affordability of the R&DTI.*
>
> *…*
>
> *the Government will amend the R&DTI to better target the program and improve its integrity and fiscal affordability in response to the recommendations of the 2016 Review of the R&D Tax Incentive."*

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We disagree with the conclusions reached by the Government that there are currently integrity, fiscal affordability, and additionality challenges regarding the current R&D Tax Incentive, and that there is a need for significant change. The FFF review selectively presented information, including the overstated Government budget data to build a case for making substantial changes to the R&D Tax Incentive. Please refer to previous submissions for the details, in summary:

- The actual cost to the economy and budget of the current R&D Tax Incentive has not been modelled to a complete extent, which if correctly modelled would demonstrate that the program has the nature of a loan made through the tax system from Government to companies claiming R&D tax. This loan is repaid by companies over time through forgone tax losses, and shareholders through reduced availability of franking credits. There is no fiscal affordability issue with the current program, which is a point that has been made repeatedly by all major accounting firms involved in the R&D tax incentive. Specific issues that should be taken into account in the modelling include:
    - net tax benefit (R&D offset rate less corporate tax rate) should be modelled for both refundable and non-refundable R&D tax offsets, versus the current practice of using close to the full R&D rate cost (43.5%) for budget cost of the refundable offset;
    - franking impact due to R&D Tax claims resulting in shareholders paying higher amounts of tax. This is as a result of reduce availability of franking credits;
    - revenue benefits to the budget and economy from companies conducting R&D in Australia versus overseas (considering that a company can cost effectively conduct R&D anywhere in the world); and
    - the long term revenue loss to the economy and budget that will result from a national reduction in BERD and loss of productivity gains that would have been produced by the R&D tax incentive has not been modelled.
- While it has been found that there have been a small number of incorrect R&D Tax claims, and the ATO and AusIndustry are dealing with these, there has been no evidence or data presented to suggest that broad integrity issues exist, on the contrary the authors of the FFF review have agreed in published statements on multiple occasions that there is no evidence of significant rorting;
- The concept of encouraging additional R&D expenditure fails to take into consideration that in the current global economy significant support is required to just maintain the status quo level of R&D in Australia due to international competition. Companies should be encouraged and supported to do any R&D in Australia as it enhances productivity. For large companies, some of what the Government terms “business as usual” R&D may happen anyway, but in the absence of a reasonable level of support through the R&D tax incentive will likely happen overseas;
- “Business as usual R&D” needs to be removed as a concept in Government R&D tax policy. The term is an unhelpful Government construct that does not reflect the reality of how companies select or progress projects. Any R&D activity undertaken although ultimately for commercial gain is high risk with potential knowledge spillover benefits that deserves Government support; and
- There is a lack of transparency in modelling of any proposed changes on various Australian industry segments as well as any detailed analysis of international innovation competition from other Governments in either tax or grant form that Australian Policy should consider, when making changes to Australia’s most practical and utilised innovation support program.

In the following we will provide answers to the questions that have been posed in the Consultation Paper for the Bill.

Before we answer the questions, we would like to request that the amendment to the $4 million refund cap (“cap”) be reassessed. In addition to our comments above, we are concerned that the cap will detrimentally affect Australian innovation as:

- Companies have already raised investment funding to conduct eligible R&D under the basis that their future cashflow projections include R&D refunds, companies impacted by the cap will now have to either reduce their R&D spend, or find new sources of funding to fill the cash gap that this amendment will create, or shift their R&D overseas;
- In order to exceed the cap a company must for all intents and purposes be a high R&D intensity entity, the kind of company that can be the basis of future Australian economic growth;
- Affected companies will immediately begin global reviews of where the R&D above the cap can be either carried out cheaper, or conducted with support from other Governments; and
- We do not believe sufficient economic modelling has been carried out to determine the true long-term cost that this change will have on Australia.

Based on the above we suggest either:

- Remove the cap; or
- Include transitional legislation where companies can seek a Finding or Ruling that if they can demonstrate they raised funds prior to the 2018-19 Budget Announcement to conduct R&D activities that would otherwise be impacted by the cap, they will receive an exemption for approved activities from the cap.

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

The proposed calculation method is extremely challenging as it combines tax and accounting definitions. This presents additional compliance challenges and costs for companies.

The suggested improvement is to make the "total expenditure" based purely on tax concepts.

The lowest levels of R&D benefit provide a significant reduction in total net R&D benefit that will be received by companies. This is an implementation issue as most companies that are having their net R&D benefit reduced by over 50% will stop claiming R&D tax.

Specific industries such as mining and manufacturing that have low R&D intensities will stop claiming and due to the structural nature of the industries there is very little ability to increase R&D intensity.

Over time this is going to have a significant impact because although these industries have low R&D intensities, it is easy for them to move the R&D activity to other countries with more attractive incentives.

A compliance challenge resulting from the intensity calculation will be what the ATO and AusIndustry are going to do with the additional resources they are proposed to be given to regulate the R&D tax incentive, given the likely large reduction in non-refundable claimants.

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

Yes, the proposed R&D intensity calculation poses a significant integrity risk as:

- It combines tax and non-tax accounting concepts that will be challenging for companies to apply and the ATO to regulate;
- It will provide an unfair playing field for different industries as there will be a wide variance of accounting concepts to take into consideration between industries, for instance manufacturing, mining and capital intensive industries will have many accounting issues to take into consideration; and

- Smaller companies that may not have the corporate requirements to currently apply the Accounting Standards will have an additional compliance cost to apply them if they intend to make R&D Tax claims.

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

Calculation of the total expenditure amount across any form of group will add significant additional cost and compliance challenges for companies and the ATO. This would include:

- Timing issues across group entities that could result in the R&D entity not being able to make R&D Tax claims until all group members are able to provide necessary data;
- Group entities that make mistakes with the data that the R&D entity requires will have an impact on the R&D entity;
- Group entities that are not under any obligation to provide the data that the R&D entity requires will result in the R&D entity not being able to lodge its R&D claim;
- Currently group entities only need to consider whether aggregate turnover is above, or below $20 million rather than undertake an arduous process of determining a precise figure. The requirement to group costs would add significant compliance cost for no additional benefit and would be a significant disincentive to claim; and
- Benefit rates for specific R&D intensities would need to be adjusted to ensure that a similar level is received to that currently proposed. It is uncertain how this is possible as the situation and grouping of each R&D entity is different.

Question 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?

There are concerns that the definition does not cover all appropriate activities and costs related to clinical trials. For instance:

- More substantial details are required to ensure that medical devices are included;
- More substantial details are required to ensure that both registered and non-registered therapeutic products are included;
- More information is required to understand the scope of clinical trials against the definition of core activities;
- More information is required to understand if supporting activities that are directly related to clinical trial core activities would be included under the clinical trial exemption; and
- More information is required to determine what costs are included that are related to clinical trial core and supporting activities.

It should be noted that we are concerned with why the clinical trial exemption should apply to a very small segment of the economy. There has been no transparency on why this decision has been made and what economic modelling has been carried out to support it.

Further to this concern, the clinical trial exemption is not broad enough to make an appropriate impact depending on how our above concerns are addressed. For instance, if pre-clinical phase work (e.g. toxicology testing, which satisfies both the 'directly related' and 'dominant purpose' tests as a supporting activity for the clinical trial core

activity) is not included in the above and the company therefore chooses to conduct this work overseas it will be very uncertain as to whether the clinical trial activities will then take place in Australia.

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?

With the limited definition of clinical trials that has been put forward a findings process would be unnecessary as companies must seek various medical industry approvals in order to undertake a clinical trial, thus making the findings process irrelevant. If the government wished to gain certainty of the definition of a clinical trial through legislation it would be better to reference AustraliaClinicalTrial.gov.au – a joint initiative between the National Health and Medical Research Council and the Department of Industry, Innovation and Science (a body dedicated to providing information and resources to medical research) – than Therapeutics Goods Administration (a body dedicated to the regulation of therapeutic goods).

Given the number of biotechnology companies in Australia, and likely increase in the future, it is unlikely to be an efficient use of AusIndustry resources to be reviewing and making findings on a large number of clinical trials, which are then highly likely to be approved.

Unless very large clinical trials (i.e. phase 3 clinical trials) are proposed to be undertaken in Australia (possibly greater than $500 million over 3 years) where there is a risk to revenue, then AusIndustry may wish to have a finding process in place.

In addition, the question has a false premise as the findings process would be in place to ensure the eligibility of the activities, it would then be the applicant's responsibility under the principle of self-assessment to identify the appropriate eligible R&D costs against the clinical trial and the ATO to determine that expenditure has been claimed correctly.

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

We are concerned that legislation changes are being made that are financially irrelevant due to the very small after-tax cost that both Clawback and Feedstock provisions currently generate.

We have not been provided with any economic rational that justifies the complexity and uncertainty that these changes generate. We agree that Clawback and Feedstock provisions are currently (and always have been) complicated provisions, but theses changes do not make them effectively simpler to apply.

The changes provide a further reduction to R&D benefit and the most likely consequence of these proposed changes will be for companies to exclude any Clawback and Feedstock related costs from their R&D claim completely.

As a further unfortunate complication of applying the proposed Feedstock legislation changes, we suggest that there may be a need for transitional provisions. If a company with a 30 June year end makes a claim for R&D expenditure in the 2017/18 year, what will happen if the feedstock adjustment, or entitlement to a recoupment (grant) occurs in a subsequent year?

Currently companies that receive the refundable R&D tax offset obtain a net R&D benefit while the existing feedstock and clawback provisions apply. Transitional provisions should be created such that where a subsequent feedstock adjustment occurs in the 2018/19 year, companies are still able to receive a net R&D benefit if they were entitled to one under the existing rules.

Similarly, if a company claims expenditure in 2017/18, but receives or becomes entitled to receive a recoupment (grant) in a subsequent year, then transitional rules should apply such that companies claiming the refundable R&D tax offset still receive the same net R&D benefit as under the existing rules.

The transitional rules could simply state that the existing feedstock and clawback rules apply for companies incurring feedstock and clawback related R&D expenditure prior to 1 July 2018.

As the new rules remove any R&D net benefit, companies claiming the refundable and non refundable R&D tax offset will no longer have any incentive to use these rules, as they create a complex and unnecessary compliance burden as part of a R&D claim.

AusIndustry should adopt a similar opt out policy as currently exists for feedstock, such that companies can simply state in their R&D registration that they are not registering activities with feedstock/clawback expenditure. This removes the compliance burden that provides no benefit to companies and removes unnecessary tax risk of using these provisions.

A final comment is that the changes propose to increase a company's taxable income, an unintended consequence is that this additional taxable income will need to be included in a company's Early Stage Innovation Company assessment and could push the company over the turnover eligibility threshold.

Regards

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