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Tax White Paper Task Force
The Treasury
Langton Crescent
PARKES ACT 2600

1 June 2015

Dear Sir/Madam

Submission: Tax Discussion White Paper "*Re:think*"

Please find enclosed, our submission in relation to the Tax Discussion White Paper "*Re:think",* addressing questions 39 and 40 concerning innovation policy and the R&D Tax Incentive.

Swanson Reed – Specialist R&D Tax Advisors

Swanson Reed is a leading specialist R&D tax provider that services a wide spectrum of clients in various locations throughout Australia.

In addition to chartered accountants, Swanson Reed's team includes technical personnel with backgrounds in engineering, science and law.

Since its introduction in May 2009, Swanson Reed has conducted over 200 workshops on the R&D Tax Incentive and Concession. The workshops have identified that many small and medium size enterprises (SMEs) are of the view that the program will be subject to further cuts in future which reduces the willingness of SMEs to invest in R&D and innovation.

Swanson Reed is of the view that stable and generous support for innovation must be maintained to give SMEs the confidence to invest in long term innovation strategies. This will also have spill over benefits for Australia as our economy transitions from being resource driven to knowledge driven

Summary

This submission outlines our view in response to the Australian Federal Government's Tax Discussion White Paper "*Re:think"*

Re:think contains two questions concerning innovation:

> *Question 39: Does the R&D tax incentive encourage companies to conduct R&D activities that would otherwise not be conducted in the absence of government support? Would alternative approaches better achieve this objective and, if so, how?*
>
> *Question 40: What other taxation incentives, including changes to existing measures, are appropriate to encourage investment in innovation and entrepreneurship?*

Australia faces many challenges at present with drastic reductions in commodity prices, high labour costs and competitive challenges from currency exchange.

Unlike the United Kingdom, the United States and most of the developed world, Australia has no current innovation strategy or policy.

If we don't act quickly to develop and implement a plan to support innovation, SME's in the manufacturing sector particularly, will lose confidence to invest in long term projects that are key to Australia's economic development and competitiveness.

Below is a summary of our points of emphasis within this submission:

- It is the responsibility of Government to plan and incentivize Australia's economic development.
- To maintain our high standard of living and be competitive in a future global economy, Australia needs to become a world class innovator.
- Red tape should be minimised and appropriate incentives should be maintained to encourage a culture of innovation
- A stable and certain R&D tax incentive and taxation system is needed to give companies confidence to invest.

- 'Silicon Valley' style technology hubs are key to driving economic growth.

Our Response: Question 39

A principal innovation driver will be a stable and certain R&D tax incentive and taxation system

The R&D tax incentive is the Australian Government's primary incentive program for innovation. Since its recent introduction in FY12, the program has been subject to a number of proposed changes:

- *Proposed legislation not passed by Senate:* a proposal to allow companies to receive quarterly refunds of their entitlements was not passed as law;
- *Proposed legislation not passed by Senate:* a proposal to remove access to the R&D tax incentive for very large companies with turnover greater than $20 Billion was not passed. This cut to the program for large claimants was later restructured and introduced in an amended form;
- *Enacted legislation passed through Senate:* from 1 July 2014 for FY15, a cap of $100 Million has been placed on the R&D Tax Incentive to limit the eligible expenditure of large claimants; and
- *Proposed legislation not yet introduced to Senate:* from 1 July 2014 for FY15, it has been proposed that a uniform 1.5% decrease will apply to the rate of R&D tax offsets.

The multiple changes to the R&D Tax Incentive over such a short time are very harmful to confidence and Australia's reputation of being able to offer stable incentives for local and international investment in innovation.

Swanson Reed is particularly concerned about the new proposed 1.5% cut to the R&D Tax Incentive since:

- The basis for the change was included within the government's May 2014 Budget, which also included a proposed uniform reduction in the corporate tax rate to 28.5%. However, as proposed in the May 2015 Budget, the corporate tax rate reduction is now proposed to apply only to very small companies with turnover less than $2M. This means companies with turnover greater than $2M will be subject to a drop in the value of their R&D claims. This contradicts the May 2014 Budget documents which emphasised that the R&D tax offset rate was reducing only because of the uniform reduction in corporate tax rate.

- The reduction in the R&D tax offset is due to apply for FY15, whereas the drop in company tax rate for very small companies is due to apply for FY16 (i.e. the R&D tax offset rate reduces one year earlier than the corporate tax rate). This again contradicts the original rationale for the reduction in the May 2014 Budget documents which pledged to "preserve the relative value" of the R&D Tax Incentive.

As a consequence of the proposed changes, many R&D tax claimants have become hesitant to implement long term innovation strategies. Companies should be able to have a reasonable understanding of R&D tax offset and corporate tax rates if they are to be able to make effective planning decisions.

The OECD has also recently warned against R&D tax *policy reversals*:
"For countries that have experienced a large number of R&D tax policy reversals, the impact of R&D tax credits on private R&D expenditure is greatly diminished. It is therefore important that governments do not repeatedly tinker with such policies to minimise policy uncertainty for firms."

Further, the OECD has suggested that stable government incentives increase innovation:

"The available evidence shows that R&D tax incentives do increase business expenditure on R&D, with the effects typically being larger in the long run than in the short run. The evidence also suggests that smaller firms seem to be more responsive to the R&D tax incentive than larger firms, typically because these firms are much more credit-constrained. The stability of the R&D tax incentive scheme over times also plays an important role. Expectations that R&D incentives are permanent strengthen their impact on R&D investment."

A robust tax and certain incentive program will be the key to increase our country's innovative capacity through encouraging companies to undertake R&D activities. However, companies need a stable legislative platform to provide them with the confidence to make long term decisions in anticipation that support will be available.

Australia needs to develop a well-executed innovation strategy that involves full and fair stakeholder consultation

Manufacturing in Australia has been steadily declining. This trend can be attributed primarily to manufacturers in the developed world experiencing increasing pressure from their competitors in the developing world, where labour costs are lower. In order to fill this gap, there needs to be increased investment in high skill areas, such as innovation and R&D.

Innovative capacity is crucial to the success of a strong economy and is required for Australia to remain a leader in an increasingly competitive global environment.

Australia has not had a major innovation plan since Howard's "*Backing Australia's Ability"* five year strategic plan of 2001.

An innovation plan involving full and fair stakeholder consultation will be crucial to driving growth, employment and improving living standards. Demand for new skills, knowledge and flexible competencies for globalised economies will require system-wide innovation and reform. As emerging economies in developing countries continue to grow, Australia will need to increase its global competitiveness through utilising its intellectual capacity. Ground breaking innovations will be required to keep us economically prosperous, improve the nation's gross domestic product (GDP) and build a more sustainable future.

Our Response: Question 40

Australia needs to explore Patent Box incentives as a matter of urgency

As demand increases for new skills, knowledge and flexible competencies within a globalised economy, Australia requires system-wide innovation reform to ensure that it remains competitive with international innovation policy.

The Australian Government must address Patent Box incentives to increase confidence, maintain and attract investment in innovation within Australia. Investment in innovation strategies such as Patent Box will be crucial to driving growth and employment within Australia.

Patent production is a key element in promoting economic growth indirectly by stimulating the accumulation of inputs from R&D and physical capital. Investing in intangible assets alongside physical capital and infrastructure should be a priority for maximising future economic growth and competitiveness. In 2005, Australia accounted for only 0.76% of the world share of triadic patent families. This particular type of patent is filed jointly with international patent offices to initiate the process to seek intellectual property (IP) protection worldwide. Therefore triadic patents are often a more accurate indication of the international impact of an economy as they reflect invention and innovation on a global scale. This low level of patenting coupled with Business Enterprise Research and Development (BERD) decreasing as a proportion of GDP reflects Australia's structural characteristics. While there are large resource and agricultural sectors, the weaker manufacturing sector remained the largest contributor to total BERD in 2011-12 with $4,474 million or 24%. Additionally, Australia has weaker patent collaboration than many other countries in the G20. According to the OECD, “linkages are weak with only around 9% of innovating firms co-operating with an external partner for their innovation activities; only a small number and proportion of patents are developed with co-inventors”.

What is Patent Box?

"Patent Box" systems provide an incentive for companies to increase their patent production and pursue formal IP strategies. Patent Box encourages companies to locate all associated activity, such as manufacturing and exploitation of that IP, in the home country where the patent was developed by making this an eligibility requirement for access to the tax incentives. Presently, Patent Box exists in nine European countries and China.

Why does Australia need a Patent Box solution?

Patent Box incentives would encourage Australian and foreign companies to invest and locate high-value jobs associated with the development and exploitation of patents in Australia. This has the potential to positively impact and strengthen industries such as manufacturing, which have been facing a steady pattern of decline. With the introduction of a Patent Box system in many developed countries around the world, Australia is in immediate danger of losing large and innovative manufacturing companies to overseas economies where companies can benefit from the reduced corporate tax rates or targeted incentives.

Next Steps...

In order to encourage competition and innovation in Australia, stable policy with a strong emphasis on fostering innovation is required. Policies to promote innovation need to reflect the ways in which innovation takes place and practically equip us with the right tools to thrive in a highly competitive world. Such activity has flow on effects for high skilled jobs and becomes an essential element of our free-enterprise, market-based system.

1. We need to develop an innovation strategy involving full and fair stakeholder consultation.
2. We should explore *'patent box'* like grant programs and/or tax incentives that reward individuals, companies and other organisations for producing patents and pursuing formal IP strategies.
3. We need to explore ways that make it easier for small technology companies to form and prosper.
4. We need a commitment to a stable tax and R&D Incentive system that will allow companies to confidently invest in long term innovation strategies.

Please do not hesitate to contact me on (07) 3221 1499 if you would like to discuss any aspect of this submission.

Damian Smyth
Chief Executive Officer
Swanson Reed