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Dear Sir/Madam

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***Submission: Review of R&D Tax Incentive Report***

Swanson Reed has previously emphasised the important role of the R&D Tax Incentive for encouraging investment in R&D activities within previous consultation submissions:

- 2016 R&D Tax Incentive Review;
- 2015 Tax White Paper (Re:Think);
- 2014 Senate Inquiry into Australia's Innovation System.

Enclosed is our submission regarding the R&D Tax Incentive Review. The content of this submission is focussed specifically on the review report and six proposed recommendations.

***About Swanson Reed***

Swanson Reed is a leading specialist R&D tax advisor 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 May 2009, Swanson Reed has conducted over 250 workshops on the R&D Tax Incentive and Concession. The workshops have identified that many small and medium-sized enterprises (SMEs) are of the view that the programme 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 R&D must be maintained to give companies confidence to invest in long-term innovation strategies. The R&D Tax Incentive is still in its infancy and any significant changes made would be premature and reduce confidence in the programme. Swanson Reed urges any changes to the R&D Tax Incentive to be minimised and carefully considered, so as to not disrupt the programme's effectiveness to encourage additional R&D.

### ***Summary of Findings and Recommendations***

A long-term commitment to the stability of the R&D Tax Incentive is the best way to enhance the effectiveness of the programme. Companies must be able to invest in the expectation that legislated entitlements will remain available.

The review panel found the programme fell short of meeting its stated objective of additionality and spillovers. Swanson Reed considers that the programme provides a high level of encouragement for companies to undertake R&D activities they may not otherwise have conducted. While Swanson Reed generally supports *most* of the recommendations within the review report, we urge any changes to be carefully considered as:

- The R&D Tax Incentive Programme is still in its relative infancy;
- The programme has already been the subject of two recent cuts:
  - *Tax Laws Amendment (Research and Development) Bill 2013*;
  - *Budget Savings (Omnibus) Bill 2016*;
- Many companies and stakeholders have expressed fatigue at proposed changes to the programme and a reluctance to invest in long term projects due to the expectation of further cuts.

Our major findings and concerns in respect of the R&D Tax Incentive Review's recommendations are as follows:

1. We support the retention of current definitions of eligible activities and expenditure;
2. We support the introduction of a collaboration premium;
3. We support the introduction of a cap on the refundable R&D Tax Offset, however:
  - A transition period should be allowed before it is introduced;
  - A commitment must be made that there will be no further rate reductions or caps applied to the refundable R&D Tax Offset in the foreseeable future;
4. We strongly oppose the introduction of an intensity threshold for claimants of the non-refundable R&D Tax Offset as such a measure would:
  - Greatly diminish the incentive for large companies to conduct R&D activity;
  - Increase the complexity of the programme;
5. We support the extension of the \$100M R&D expenditure cap if such a measure were:
  - Not to be funded by the intensity threshold;
  - Only to apply to companies able to justify that their R&D activities would have large spillover benefits (biotechnology etc.);
6. Changes to the administration of the R&D Tax Incentive should be investigated to enhance efficiency and transparency. However, any changes must uphold the integrity of the programme and provide greater clarity on cost and benefits.

***Recommendation 1 - Retain the current definition of eligible activities and expenses under the law, but develop new guidance, including plain English summaries, case studies and public rulings, to give greater clarity to the scope of eligible activities and expenses.***

Swanson Reed supports this recommendation as stability of the programme will maximise its effectiveness.

As noted in our earlier submissions in respect of the definition of eligible activities:

- Companies are now (relatively recently) familiar with the established definition;
- In a number of cases, long-term investment decisions have been made based on the established definition;
- The R&D Tax Incentive is still in its relative infancy and it would be too soon to implement significant structural changes to the definition of eligible activities and expenditure.

In respect of guidance material:

- The case studies previously published by AusIndustry are generally quite helpful in communicating the scope of eligible activities to companies. Further material could be published to provide more examples of activities that are specifically not eligible, in addition to those activities that are;
- The ATO's fact sheets are generally helpful. Consideration should be given to resourcing the reintroduction of the ATO's Innovation Tax support service. When previously operational, this service was valuable for assisting companies and tax agents resolve technical issues on complex R&D Tax-specific matters that general ATO support staff may not be able to sufficiently address.

***Recommendation 2 - Introduce a collaboration premium of up to 20 per cent for the non-refundable tax offset to provide additional support for the collaborative element of R&D expenditures undertaken with publicly funded research organisations. The premium would also apply to the cost of employing new STEM PhD or equivalent graduates in their first three years of employment. If an R&D intensity threshold is introduced (see Recommendation 4), companies falling below the threshold should still be able to access both elements of the collaboration premium (Section 4.2, p. 35).***

Swanson Reed supports this recommendation as an effective measure to encourage businesses to collaborate with research organisations.

An enhanced rate of R&D Tax Offset for expenditure incurred from Research Service Providers (RSPs) and universities was supported within our original submission.

Businesses and research organisations have not traditionally collaborated well together. Introduction of a premium R&D Tax Offset rate would promote collaboration between the two and in many cases, enhance the quality of R&D undertaken by business.

However, it is important that collaboration with research organisations should not be introduced as a mandatory requirement for access to the programme. Negotiating commercial arrangements with research organisations can often take time, if businesses were required to demonstrate collaboration before qualifying for the R&D Tax Incentive, it would reduce a key programme benefit of easy access.

***Recommendation 3 - Introduce a cap in the order of \$2 million on the annual cash refund payable under the R&D Tax Incentive, with remaining offsets to be treated as a non-refundable tax offset carried forward for use against future taxable income (Section 4.3, p. 37).***

**Swanson Reed supports this recommendation.**

Swanson Reed supports this recommendation if it is used to ensure the long term stability of the refundable R&D Tax Offset.

While not having a cap on refundable R&D Tax Offsets is an attractive feature of the programme, particularly for biotechnology companies and intensive ICT start-ups, the introduction of a cap is a reasonable measure to sustain the programme for future years.

Swanson Reed agrees with the review findings that the small number of companies affected by a cap would primarily include listed entities with greater access to capital than SMEs. A cap on refundable R&D Tax Offsets for such companies (while still allowing a cash refund up to the cap and a non-refundable offset for excess expenditure), would be an appropriate measure if used to secure the stability of the programme.

We do, however, note that a cap on the refundable R&D Tax Offset would be a further cut to the refundable R&D Tax Offset, in addition to the recent rate reduction from 45% to 43.5% (*Budget Savings (Omnibus) Bill 2016*). To minimise a reduction of confidence in the programme, the implementation of a cap must be managed carefully, and we would recommend the following transition measures:

- A sufficient period of implementation should be allowed for companies to progress projects where previous investment decisions were made on the basis of there being no cap;
- Any companies with previously approved findings from Innovation Australia for expenditure in excess of the cap, should be able to claim the approved expenditure for the period of their finding;
- A bipartisan commitment should be made that no further rate reductions or caps are applied to the refundable R&D Tax Offset for a reasonable future period (in the order of 5-10 years).

Swanson Reed has previously emphasised the importance of a reliable and stable R&D Tax Incentive to encourage companies to make long-term investment decisions. While cost control measures may be necessary to ensure the programme is sustainable, the implementation of such measures must be carefully considered. The mechanisms for measuring the cost of the refundable R&D Tax Offset must also be appropriate, and this is discussed further within our findings on Recommendation 6.

***Recommendation 4 - Introduce an intensity threshold in the order of 1 to 2 per cent for recipients of the non-refundable component of the R&D Tax Incentive, such that only R&D expenditure in excess of the threshold attracts a benefit (Section 4.4, p. 39).***

Swanson Reed strongly opposes this recommendation as it would increase the complexity of the programme and likely cause large companies to reduce their R&D expenditure.

Requiring large companies to spend in excess of 1-2 per cent of their total business expenditure before qualifying for the R&D Tax Incentive would reduce their incentive to conduct R&D activities.

While we are of the view that the programme should primarily support SMEs, a sufficient level of R&D incentive must remain for larger companies who are often able to choose to conduct their R&D activities in other countries. We note that the introduction of an intensity threshold for large companies would be a further cut to the non-refundable R&D Tax Offset, in addition to two recent cuts:

- \$100M Cap on annual expenditure (*The Tax Laws Amendment (Research and Development) Bill 2013*);
- Reduction in the tax saving for non-refundable offsets from \$0.10 to \$0.085 (*Budget Savings (Omnibus) Bill 2016*).

An intensity threshold would also unfairly disadvantage companies in industries that have large total business expenditure, such as those with high-cost, Australian based manufacturing operations. Such companies have large total business expenditure relative to those in other industries such as ICT. An intensity threshold would require such companies to spend a greater amount on eligible R&D activities before qualifying for an R&D tax benefit. This would lead to distortions in the level of incentive offered to certain industries, which reduces a key programme benefit of broad-based access.

A tax saving of \$0.085 for eligible R&D expenditure beyond 1-2 per cent of total business expenditure is also likely to be considered a barrier to entry into the programme and insufficient inducement for companies to undertake additional R&D activity. A diminished tax benefit for the non-refundable R&D Tax Offset would impede a key programme objective of additionality.

In a globally competitive market, Australia must retain an attractive, stable and broad-based R&D Tax Incentive for large companies to choose to conduct and maintain their R&D activities within Australia.

***Recommendation 5 - If an R&D intensity threshold is introduced, increase the expenditure threshold to \$200 million so that large R&D-intensive companies retain an incentive to increase R&D in Australia (Section 4.4, p. 41).***

Swanson Reed does not support the intensity threshold within Recommendation 4; and, if an increase to the \$100M R&D expenditure cap were to be funded by the intensity threshold's introduction, we would also not support Recommendation 5.

Extending the \$100M R&D expenditure cap should, however, be considered to encourage certain companies with highly technical R&D activities and large spillovers to increase their R&D expenditure. Large biotechnology companies such as CSL and Cochlear would be suitable candidates for such an increased R&D expenditure cap. If discretionary increases to the R&D expenditure cap were implemented, a specific criteria and process similar to a Finding Application should be developed for companies to claim beyond the \$100M R&D expenditure cap. Eligibility criteria to qualify for an increased R&D expenditure cap may include:

- Demonstrable spillovers from activities to be claimed such as high-skilled job creation;
- Domiciling of IP within Australia;
- Collaboration with industry and academia;
- Downstream benefits such as Australian manufacturing jobs or royalty streams.

Companies in certain industries or where they are unable to meet the above criteria should be subject to the existing R&D expenditure cap, due to lack of spillovers from their R&D activity. Industries that should be excluded from qualifying for an increased R&D expenditure cap may include:

- Large mining companies;
- Construction companies;
- Major Banks.

***Recommendation 6 - That the Government investigate options for improving the administration of the R&D Tax Incentive (e.g. adopting a single application process; developing a single programme database; reviewing the two-agency delivery model; and streamlining compliance review and findings processes) and additional resourcing that may be required to implement such enhancements. To improve transparency, the Government should also publish the names of companies claiming the R&D Tax Incentive and the amounts of R&D expenditure claimed (Sections 5.1- 5.5, p. 45).***

Swanson Reed supports this recommendation, if the proposals were to be carefully considered and implemented. A summary of the main considerations is outlined below:

*Single Agency and Application Model:*

A single agency administration and application model may provide efficiency benefits, however care must be taken to ensure appropriate resourcing for assessment of the distinct areas of compliance:

- Assessment of whether companies' R&D activities are eligible;
- Assessment of the reasonableness of companies' R&D expenditure along with a number of complex tax issues, including:
  - Assessment of the capital nature of expenditure;
  - Assessment of whether expenditure has been incurred and paid;
  - Determining entity grouping and associated threshold issues;
  - Adjustments for feedstock and clawback;
  - Determining whether activities are undertaken on behalf of the R&D entity.

If a single agency administration and application model were to be considered, our proposal for the operation would be as follows:

- AusIndustry remains the primary administrator of the programme and responsible for participant education and governance;
- Companies are still required to register activities with AusIndustry and submit R&D Schedules within their company income tax returns;
- ATO staff with knowledge of R&D-specific tax issues are deployed to AusIndustry to form two separate teams:
  - 'R&D Activity Compliance Team' that will fulfil the same function already served by current customer service managers;
  - 'R&D Expenditure Compliance Team' that will fulfil the function of current ATO staff. This team should be given direct access to all companies' R&D Schedules upon lodgement;
- AusIndustry 'R&D Activity Compliance team' conducts desk, activity and finding compliance reviews in the same format as currently operates;
- AusIndustry 'R&D Expenditure Compliance team' conducts compliance activity based on:

- Issues identified during their own review of a companies' R&D Schedules;
- Issues referred by AusIndustry 'R&D Activity Compliance team' rendering the need for investigation;
- Issues referred by ATO rendering the need for investigation, which may have been identified during compliance of other areas of a company's tax compliance;
- AusIndustry 'R&D Expenditure Compliance team' should be adequately resourced to allow them to:
  - Liaise with ATO to conduct integrity reviews of refundable offset claims prior to release of funds, particularly for first time claimants;
  - Derive any company tax information from ATO that is required to assess R&D expenditure compliance;
  - Provide a support level to advisors and companies similar to that of current AusIndustry staff or the former ATO Innovation support service;
- Both teams liaise with each other before engaging with companies on compliance activity. This may reduce any duplication of compliance processes.

*Streamlining of Compliance and Finding Processes:*

Swanson Reed supports the principle of a single compliance review process, which may reduce complexity, cost and duplication. However, as mentioned above, such a compliance process must be equipped with appropriate resourcing for assessment of the distinct areas of R&D Tax compliance:

- Assessment of whether a company's R&D activities are eligible.
- Assessment of the reasonableness of a company's R&D expenditure, along with a number of complex tax issues.

Accordingly, making two teams within the same government department responsible for the above compliance areas may be the best approach.

In respect of the process for the granting of overseas findings, we are of the view that while the current process is time consuming, a move to a self-assessment process would not be suitable as:

- Companies may take overly aggressive self-assessment positions on the eligibility of their overseas activities;
- It is reasonable that companies be subject to a thorough assessment process (such as the current process for Overseas Findings), if the Australian R&D Tax Incentive is to provide a recoupment for overseas activities.



*R&D Tax Agent Qualification:*

Swanson Reed recommends the introduction of a dedicated R&D Tax Agent qualification for specialist advisors or accountants providing R&D Tax Services. This would mandate specific professional and experience standards, rendering them better qualified to advise on the intricacies of the R&D Tax Incentive, in addition to their general requirements under Tax Agent service legislation.

Given that the growth of the programme has largely been attributed to marketing by advisors, such a qualification may ensure new entrants to the programme are receiving suitable advice on their entitlements. A dedicated R&D Tax Agent qualification would also provide AusIndustry/ATO a direct platform to communicate programme updates and professional expectations.

*Public Register of Claimants:*

Swanson Reed supports the release of an annual register of R&D Tax Incentive claimants, similar to that published by AusTrade for claimants of the export grant.

While details to be published on such a register would need to be moderated to protect any sensitive tax or IP information, such a measure would enhance the transparency of the programme.

*Measuring the Budget Cost of the refundable R&D Tax Offset:*

As highlighted in our original submission, we have significant concerns that the cost of the refundable R&D Tax Offset is over stated and based only on the *temporary* cash outlay, which is a key design feature of the programme.

We recommend that the cost of the refundable R&D Tax Offset be calculated based on the *permanent* effect on corporate tax receipts and reduce emphasis on temporary financing benefits from factors such as:

- The forfeiture of tax losses for R&D expenditure claimed under the refundable R&D Tax Offset. These forgone tax losses have the effect of “bringing forward” corporate tax payments of claimant companies;
- Other timing adjustments arising under the R&D Tax Incentive, such as:
  - Feedstock adjustments taken up in subsequent periods;
  - Impact of dividend franking constraints arising from the claiming of R&D Tax Offsets.

An appropriate metric should be included within the cost measurement to recognise that many companies claiming the refundable R&D Tax Offset will fail and, hence, never make use of the forfeited tax losses underlying their R&D expenditure.

The refundable R&D Tax Offset must, however, be costed appropriately if changes to the programme are to be considered on the basis of sustainability and cost.

### **Conclusion**

In summary, we wish to reaffirm the importance of a commitment to the stability of the current R&D Tax Incentive.

Innovation policies and incentives have been subject to an ongoing series of reviews and proposed changes over the past decade. While such reviews have led to the introduction of the superior R&D Tax Incentive as successor to the R&D Tax Concession, a period of stability must now prevail.

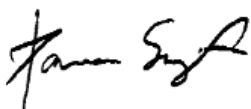
There may be opportunity to enhance the efficiency of the R&D Tax Incentive; however, any changes must not adversely impact the fundamental structure of the programme, which provides a broad-based, easily accessed and significant incentive.

This is particularly the case as scarce R&D capital is increasingly mobile, and there is intensifying global competition for R&D investment by other jurisdictions offering generous and stable incentives.

We also wish to re-emphasise our concerns that the programme cost figures within the Issues Paper appear to be significantly overstated given the apparent failure to consider forgone tax losses from refundable R&D Tax Offset claims. The basis for costing the R&D Tax Incentive must be carefully examined, so as to measure the true cost and benefits of the programme.

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

On behalf of Swanson Reed:



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