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R&D Tax Incentives

November 1, 2018

Dear Sir/Madam,

Re: Submission to The Treasury Laws Amendment (Making Sure Multinationals Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018 [Provisions].

This is to do with the “Other Measures” i.e. Amendments to the R&D Tax Incentive scheme

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.

However, 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

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).

I believe 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.

Most of the approximately 4,000 companies currently claiming the Non-Refundable Tax Offset are nowhere near that level of intensity. In fact, 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



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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 adherents, you won't be driving innovation behaviour. You will be driving companies out of the program.

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. The \$20 million turnover threshold seems purely arbitrary.

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.

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.

It has always been a design element of the program to direct more benefits to smaller



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taxpayers, however the intensity measure will be doing the exact opposite.

Recommendations.

1. Tie the Non-Refundable turnover limit to the company base tax rate. At least this will give a semblance of logic and connection to a company's tax return. From 2018-19 onwards, this would be \$50m.
2. The damage to Australia's R&D effort would be minimised if the bottom tier of the intensity measure 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.

I appreciate the opportunity to make this submission.

Sincerely



R&D Tax Consultant