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Senate Standing Committee on Economics
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Parliament House
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By email: Economics.sen@aph.gov.au

RE: Treasury Laws Amendment (Research and Development Tax Incentive) Bill 2019

Dear Senators

I write in response to your invitation for submissions regarding the *Treasury Laws Amendment (Research and Development Tax Incentive) Bill 2019* (the Bill).

While the State Government of Victoria will not provide a formal submission at this time, as the relevant Minister with portfolio responsibilities for Jobs and Innovation I am pleased to write to convey the concerns already raised by several Victorian industry stakeholders.

The R&D Tax Incentive (RDTI) provides vital tax relief for Victorian industry, driving growth through innovation and the incentive to conduct world class research and development locally. Victoria's priority industries may be particularly exposed to the proposed changes to the RDTI, particularly given it is a state with strong research-intensive industries including pharmaceuticals, financial technologies, food and ag-tech, and software development, as well as a growing and ambitious startup ecosystem.

The Bill's attempt to improve the effectiveness and integrity of the RDTI is welcome, and I acknowledge that the proposed amendments have been, in part, drafted in response to the *Review of the R&D Tax Incentive (2016 Review).*

However, I would like to convey and reinforce the concerns of Victorian industry stakeholders regarding the Bill. These relate to the anticipated reduction in the total tax concessions flowing to business, some perceived complexities and ambiguities in the Bill, and important omissions.

Reduction of total concessions and refunds

The Bill implies effective reductions in the tax benefit for a significant number of companies, including SMEs, reflected in the budgetary savings expected from the Bill. For instance, the proposal to fix the refundable R&D tax offset to 13.5 per cent above a company's tax rate represents an effective reduction from 43.5 per cent to 41 per cent for companies with a turnover of less than $20 million.

Industry associations have argued that research-intensive industries like the life sciences sector will be more severely affected by these reductions than other industries. A recent report by AusBiotech stated that 61 per cent of those surveyed reported the proposed changes would not only affect their expenditure but threaten the sustainability of their businesses.

Financing is a challenge for these and other tech-focused sectors, and diminishing sources of finance risks sending intellectual property and commercialisation activities offshore. The refundable concessions are particularly vital to SMEs that are yet to become cash-flow positive. I support the call from industry bodies for more extended and considered consultation and modelling on the sector-specific effects of the proposed amendments, or even the quarantining of specific sectors.

R&D Intensity Premium

While acknowledging that the intensity premium was a central recommendation of the *2016 Review* and was intended at better incentivising additional R&D, stakeholders have raised serious concerns about potentially unforeseen adverse effects. The method of calculation of 'R&D intensity' may have the perverse incentive to send non-R&D expenditure activities, such as manufacturing, offshore.

In particular, leading multinational companies in Victoria undertaking R&D as well as other activities, such as manufacturing, sales and technical support, report that the application of the proposed R&D Intensity Premium will dramatically increase their relative R&D costs in comparison with alternate international locations.

There are also concerns that the introduction of the intensity premium inherently makes future tax concessions more uncertain, given that the calculation of the expected effective tax rate is made more complex and made contingent on future non-R&D expenditure.

Collaboration Premium

In comparison with other OECD countries, Australian businesses are much less likely to undertake R&D in collaboration with the research sector – a significant forgone opportunity given the strength of our research institutions. The *2016 Review* identified the opportunity for the RDTI to lever these strengths through the introduction of a 'Collaboration Premium' – a further concession on R&D conducted in collaboration with publicly-funded research organisations. It also recommended that it should apply to the cost of employing STEM PhD or equivalent graduates. This is a glaring omission from the Bill, and one that stakeholders in the tertiary sector have raised as a concern.

Definition and interpretation of R&D

Stakeholders involved from various industries involved in software development, including the startup sector, have argued that the definition of eligible R&D activities is not capturing legitimate R&D and is inconsistent. The perception that their software R&D is not eligible, as well as the financial risk of having to appeal decisions or pay back RDTI funding, is currently a deterrent to legitimate software R&D occurring in Australia. The current Bill does not seek to resolve this issue.

I support calls from stakeholders in the software and startup sectors that the legislation explicitly name software development as an eligible R&D activity, as well as recommendations from the Small Business and Family Enterprise Ombudsman that greater clarity should be provided on the definition of eligible activities to reduce uncertainty and return confidence to businesses claiming the concession.

Clinical trials exemption of $4 million cap on cash refunds

The life sciences sector has welcomed the exemption of clinical trials on the cap on cash refunds, however, there are concerns about the definition and scope of the exemption. The Medical Technology Association of Australia recommends that the definition be widened to include trials for medical devices, biologicals and in-vitro diagnostics, or covers the range of therapeutic goods regulated by the Therapeutic Goods Administration.

AusBiotech and the BioMelbourne Network have similarly raised concerns on the lack of clarity around the definition of clinical trial expenditure and have recommended further clarity to improve confidence and financial certainty around the application of the RDTI.

Thank you for this opportunity to represent some of the concerns of Victorian priority industries about the *Treasury Laws Amendment (Research and Development Tax Incentive) Bill 2019*.

Yours sincerely

[redacted]

THE HON MARTIN PAKULA MP
Minister for Jobs, Innovation and Trade

19 MAR 2020

Attachment 2

Design of R&D Tax Incentive and current rules

a) The Commonwealth's Research and Development (R&D) Tax Incentive is a broad program providing companies with tax-credit incentives to invest in R&D in Australia. The R&D Tax Incentive is available to companies in all industry sectors that are resident in Australia for tax purposes, provided they are not controlled by income tax-exempt entities.

b) The level and nature of the incentive depends on business size, profitability, expenditure on R&D and length of R&D programs. For eligible R&D since 1 July 2016, it provides a:

- refundable 43.5 per cent tax offset for small companies with an annual turnover of less than $20 million
- non-refundable 38.5 per cent tax offset for larger companies with a turnover over $20 million for R&D up to $100 million, with expenditure over this threshold receiving a tax offset at the corporate rate.

c) R&D expenses can ordinarily be deducted at the standard company tax rate of 30 per cent (28.5 per cent for small businesses with annual turnover under $2 million). The tax offset therefore delivers a total net benefit of:

- 8.5 cents in the dollar for large companies for up to $100 million of R&D expenditure
- 13.5 cents in the dollar for companies with annual turnover of less than $20 million
- 15 cents in the dollar for firms with annual turnover under $2 million.

d) The refundable offset for smaller companies means that, where a company's tax liability is smaller than the value of the R&D tax offset, they receive the full benefit as an immediate cash refund rather than carrying the offset forward against future tax liabilities. This is of particular assistance for the R&D of small companies with constrained cash-flow before they generate significant profit.