

5 March 2020

Senate Standing Committees on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

By email: economics.sen@aph.gov.au

Dear Senators

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

CPA Australia represents the diverse interests of more than 164,000 members working in 150 countries and regions around the world. We make this submission on behalf of our members and in the broader public interest.

The Senate Economics Legislation Committee Inquiry (**the Inquiry**) into the *Treasury Laws Amendment (Research and Development Tax Incentive) Bill 2019 (the Bill)* provides the opportunity for Parliament to reconsider the proposed amendments to the research and development tax incentive (**R&DTI**). We note that the provisions remain largely unchanged from their previous incarnation in the *Treasury Laws Amendment (Making Sure Multinationals Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018 [Provisions]*. There was a significant effort by the profession in making submissions to the 2019 Senate Economics Committee Inquiry and we suggest that these views are revisited during this Inquiry.

In 2016-17, one million companies paid a total of \$74 billion in corporate income tax¹. Of these, 1297 companies utilised \$2.7 billion in non-refundable research and development (**R&D**) tax offsets and 10,638 companies claimed \$2.5 billion in refundable tax offsets. This relatively small number of claimants suggests that R&D activities are undertaken by few Australian businesses.

The data indicates that the government has some way to go to encourage business innovation and that policy changes should focus on improving access to and enhancing the benefits of undertaking R&D in Australia. We suggest that the Senate Committee primarily consider the provisions in the context of creating a domestic culture of R&D with its attendant spill over effects and making Australia a major R&D hub to attract R&D activities from overseas.

R&D policies are generally designed to provide government support for activities with a high social rate of return by contributing to economic growth and ensuring competitiveness. By their very nature, R&D incentives come at a short-term, direct cost whether through tax or transfer mechanisms.

The government should be cautious not to restrict or impede R&D in Australia simply because of the direct short-term impact on the budget, especially where it is explicitly seeking to develop an innovative, high-tech economy with a deep pool of science, technology, engineering and maths (**STEM**) labour. Changes that increase barriers to R&D and reduce level of business expenditure on R&D in Australia should be identified and reconsidered given the potential negative effects on skilled employment and development of valuable Australian intellectual property.

It is our view that:

- the Bill constrains and complicates the R&D investment landscape and innovation ecosystem by further limiting access to funds through R&D tax incentives for smaller businesses while either reducing or removing access to the R&DTI for key large Australian businesses and industries via the proposed intensity test
- the \$4 million cap on refundable tax offsets inhibits R&D expenditure and may jeopardise the viability of early stage ventures
- the exemption from the \$4 million cap for clinical trials could be seen as discriminatory and does not acknowledge value in other R&D activities
- the revised proposed intensity threshold tiers and benefits do not address the recommendations of the Senate Economics Legislation Committee on the 2018 Bill to 'better target' or 'refocus' the R&DTI and may continue to lead to unintended consequences such as the exclusion of many significant Australian industries
- the additional complexity imposed by the feedstock adjustments and clawback amounts increases compliance costs and uncertainty
- the estimated additional \$26.3 million annual cost of compliance² is reflective of provisions that make the R&DTI more expensive to access for a reduced number of eligible recipients
- the administration of the R&DTI by the Department of Industry, Innovation and Science (**AusIndustry**) and the Australian Taxation Office (**ATO**) has ongoing challenges that may be exacerbated, rather than rectified, by the proposed increase in powers, and
- the publication of R&DTI claimant details sets an unnecessary precedent for all recipients of government expenditures and does not achieve its stated purpose to facilitate information transfer between agencies.

We recommend that:

- the Bill not proceed given the potential negative economic consequences resulting from a reduction in R&D activities, the current inability to properly assess the net benefit of the R&DTI due to incomplete modelling and the seemingly discriminatory nature of the intensity threshold which impacts certain industries and business structures significantly more than others
- issues around software R&D are addressed by amending definitions in line with the Review of the R&DTI³ by the Australian Small Business and Family Enterprise Ombudsman (**ASBFEO**) and 2015 update to the OECD Frascati Manual⁴
- AusIndustry and the ATO are provided with greater resources to ensure that the existing provisions are administered properly and to better use their available powers to deal with non-compliance, and
- the details of R&DTI recipients are not published given the commercially sensitive nature of R&D and the precedent set by making information on recipients of government expenditures publicly available.

If the Bill does proceed, we suggest that:

- the \$20 million threshold be increased to \$50 million to align with the company tax base rate entity threshold, instant-asset write off threshold and *Corporations Act* definition of small proprietary company
- the \$4 million cap on refundable tax offsets be reconsidered due to its importance in assisting cashflow, especially for start-ups
- the clawback and feedstock rules be simplified to reduce complexity and compliance burden
- the definition of 'total expenses' uses the total of subsection 355 100(1) amounts and amounts that are deductible for an income year instead of 'expenses' in subsection 355-115(2), and is refined to remove the effects of capital, financing and other non-operating expenses, and
- the transparency provisions are removed.

Detailed comments are included in the Attachment. If you have any queries, contact Elinor Kasapidis, Tax Policy Adviser at elinor.kasapidis@cpaaustralia.com.au or 03 9606 9666.

Yours sincerely



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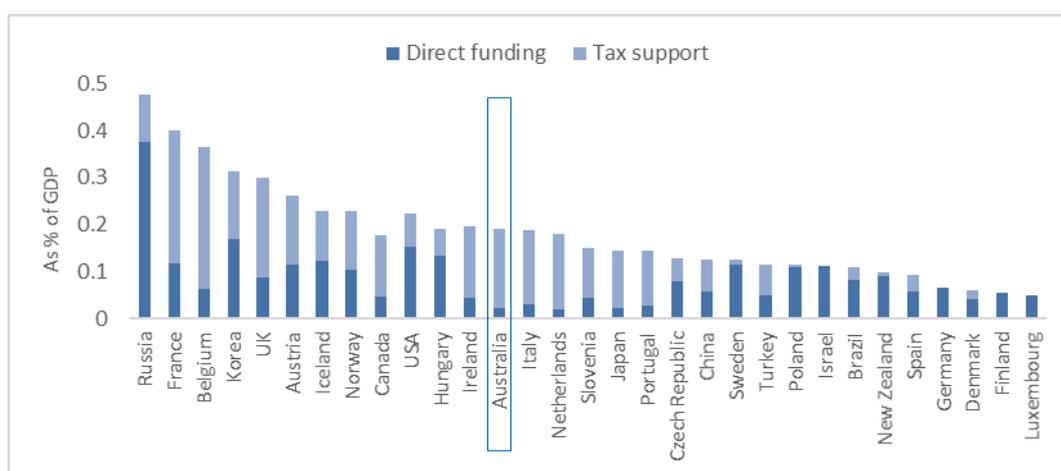
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Australia's policy framework needs to be internationally comparable and globally competitive

Australia's policies to encourage research and development have been considered in multiple reviews and consultations since the current form of the R&DTI was introduced in 2011^{5,6,7,8,9,10}.

As a percentage of total GDP, Australian government R&D support lags behind the US, UK and Canada but is ahead of Japan, Germany and New Zealand^a (*Figure 1*). Australia is unlike many other OECD member countries in that it provides minimal direct spending on R&D. Government support for R&D is primarily through the R&DTI as Australia provides only 13 cents of direct funding for each dollar of tax support, second lowest to the Netherlands out of the OECD member countries^{b,11}.

Figure 1: Direct government funding and government tax support for business R&D as a percentage of GDP (2017)



Note: 21 OECD member countries with R&D to GDP of less than 0.1 per cent excluded from chart

Source: OECD R&D Tax Incentive Database, <http://oe.cd/rdtax>, December 2019

Australia is in the mid-range of OECD member countries in terms of the implied tax subsidy for R&D. While there appears to be little empirical relationship between corporate tax rates and R&D tax subsidies across jurisdictions (*Figure 2*), we are informed by CPA Australia members that the R&DTI is a mitigating factor against Australia's comparatively very high corporate income tax rates. The OECD data suggests that member jurisdictions with higher tax subsidy rates, as a rule, have lower statutory corporate tax rates than Australia.

When the tax subsidy is compared to GDP, OECD member jurisdictions reflect a steady increase in the average tax subsidy as a percentage of GDP over time. In contrast, despite the large increase in 2012 following the introduction of the current R&DTI policy, Australia tax relief as a percentage of GDP has fallen to below the OECD average (*Figure 3*). This suggests that Australia is now falling behind its OECD counterparts in R&D, a situation further exacerbated by the fact that the R&DTI is the primary Australian policy tool for R&D unlike other jurisdictions which also provide direct funding.

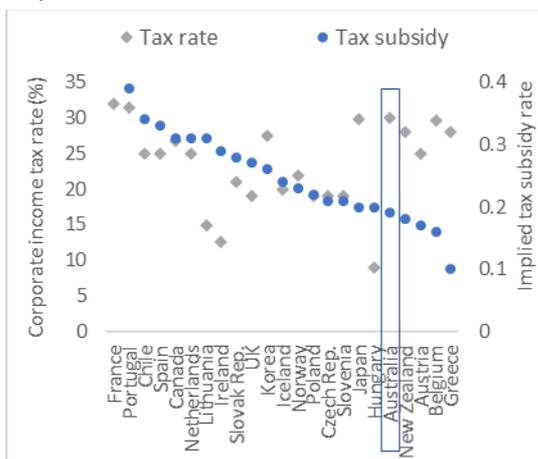
Therefore, changes to the R&DTI need to be carefully designed and modelled prior to implementation given the potential adverse ramifications changes may have on businesses' capacity to undertake future R&D activities and

^a New Zealand recently modified its R&D tax credit regime to allow for refundability of the tax credit from the 2020-21 income year. New Zealand's new R&D program of 15 per cent is immediately ahead of the current Australian program for almost all companies. Many large businesses will receive almost four times the benefit if the intensity threshold is introduced in Australia. New Zealand may exceed Australia in terms of tax support for business R&D as a percentage of GDP from 2020-21.

^b The Review noted that Canada and the Netherlands are most similar to Australia in terms of the ratio of direct funding to tax support. However, Canada's latest OECD statistics show a ratio of direct funding to tax support of 0.35.

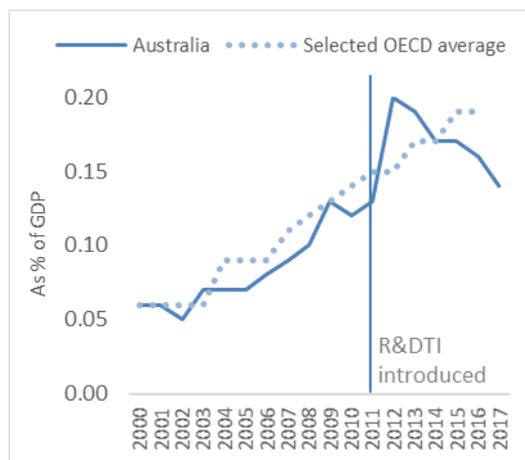
on R&D and innovation measures in Australia. This is particularly important at a time when Australia needs to widen its breadth of activities to maintain a strong economy into the future.

Figure 2: Implied tax subsidy rates and statutory corporate income tax rates



Source: Implied tax subsidy rates on R&D expenditures and Table II.1. Statutory corporate income tax rate, OECD.Stat, 2019

Figure 3: Tax relief for business R&D expenditure as a percentage of GDP (2000-17)



Source: OECD R&D Tax Incentive Database, <http://oe.cd/rdtax>, December 2019.

There is a significant amount of research on the effectiveness of R&D tax incentives in other jurisdictions^{12,13,14,15,16}. While outcomes are mixed and dependent on the methodology and available data, there are generally demonstrable positive effects from government R&D policies. As noted in ISA's February 2020 Report *Stimulating Business Investment in Innovation*¹⁷, large and small firms that invest in innovation outperform firms that do not. Analysis of additionality effects from the Australian R&DTI is limited with only a January 2016 Working Paper from Swinburne University identified¹⁸. Using a difference-on-difference approach, this study found a 13.6 per cent increase in R&D spending in the sample of firms following the introduction of the R&DTI in 2011. This equates to approximately an additional \$1.90 on R&D by Australian firms for every dollar of tax revenue foregone, one of the highest returns found in world-wide studies. This indicates that concerns about the R&DTI crowding out private funding of R&D are yet to be proven and that both large and small businesses benefit from the R&DTI.

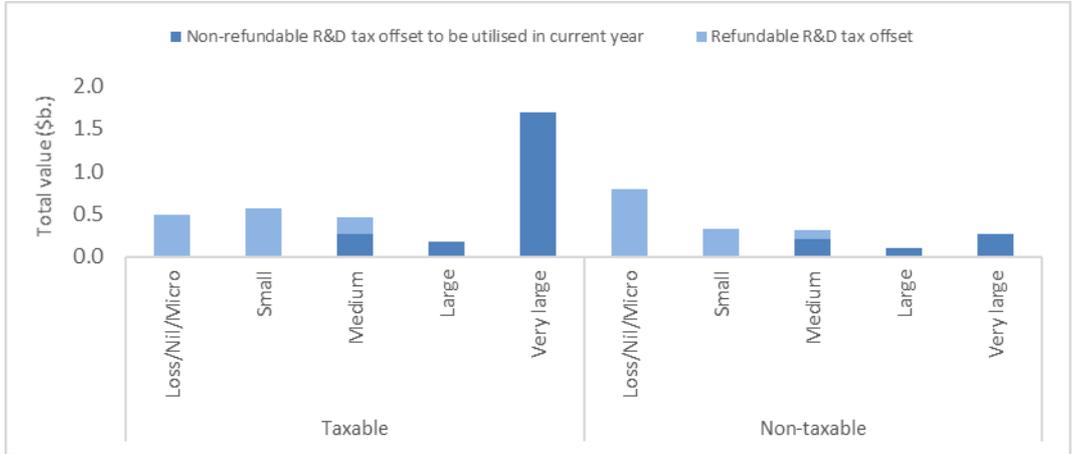
Due to the global mobility of R&D activities, R&DTI policy adjustments may make Australia uncompetitive internationally and lead to increased outsourcing and offshoring. In addition to reducing economic opportunities, changes, incentive reductions or complexity may compromise government policies to enhance employment opportunities for STEM graduates and to develop a knowledge-intensive workforce.

The value of R&DTI claims is relatively stable

Current government policy is to encourage R&D primarily through the R&DTI, against the backdrop of a lack of accessible grants and other transfer mechanisms available to a wide range of Australian businesses. The R&DTI broadly represents total federal government investment in R&D.

The use of non-refundable tax offsets is, as expected, skewed towards large taxable companies while loss-making, micro and small companies receive most of the refundable tax offsets. A further \$4.3 billion in non-refundable R&D tax offsets were carried forward to 2017-18. (Figure 4)

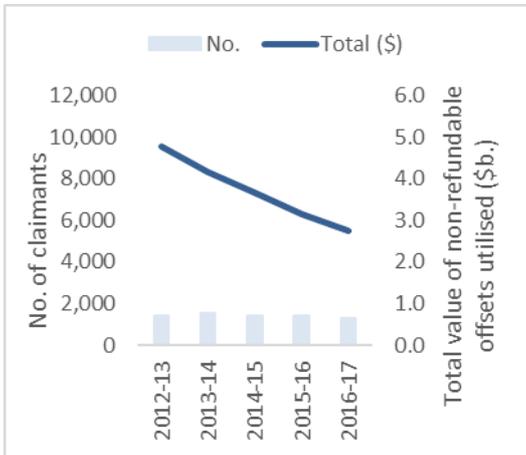
Figure 4: R&D tax offsets by company turnover and taxable status 2016-17



Source: Company Table 6A, 2016-17 Taxation Statistics, data.gov.au, 2019

Taxation statistics show the value of non-refundable R&D tax offsets utilised has been decreasing (Figure 6) while the total value of refundable R&D tax offset claims has remained relatively stable and the number of claimants has increased (Figure 7). Given fiscal affordability and R&DTI integrity are the key policy drivers behind the proposed changes, these decreases counteract the modelled fiscal savings and diminish the integrity arguments underpinning the Bill.

Figure 5: Total value and number of claimants of non-refundable R&D tax offsets utilised



Source: Company Table 1B, 2016-17 Taxation Statistics, data.gov.au, 2019

Figure 6: Total value and number of claimants of refundable R&D offsets



Source: Company Table 1B, 2016-17 Taxation Statistics, data.gov.au, 2019

R&DTI modelling needs to consider timing and benefits, not just revenue forgone

As long as Australian government policy continues to almost entirely incentivise innovation and R&D through tax incentives, then analysis of the revenue forgone from the R&DTI needs to be balanced against the fact that there is almost no other federal funding or incentives available for R&D activities. Australia’s policy approach is unlike other jurisdictions, especially for investment in technical digital driven innovation, as noted by the ISA¹⁹. The reasoning for a R&DTI, as opposed to transfer payments, is that the private sector can make more informed and efficient choices about the allocation of R&D expenditure than government programs, resulting in smaller deadweight losses and improved outcomes.

The ongoing debate about the 'cost' of the R&DTI and the premise that the Bill is needed to contain the cost of the R&DTI means that detailed cost-benefit modelling which includes future benefits and indirect effects is required. Revenue modelling should also incorporate flow-on effects such as income tax on R&DTI-related employment and future profits, GDP created by additionality and spill over effects, the tax on royalties from or capital gains tax on disposal of intangible assets, and productivity gains.

Limitations of the revenue forgone method currently utilised by Treasury to estimate the annual program cost have been highlighted in submissions to previous reviews. Suggested improvements to enhance the estimation of the R&DTI program include²⁰:

- addressing the double-counting of the refundable R&D tax offset relating to cash payments and removing costs based on the premise that received refunds are not taxable income, whilst usually a grant would be, in the existing revenue forgone method
- including dividend imputation impacts in the revenue forgone modelling
- using the revenue gain method for modelling the budget cost of the refundable and non-refundable R&D tax offsets which will include behavioural, additionality and spill-over effects
- re-calculate costs and benefit:cost ratios based on the premise that the R&DTI is akin to a non-interest-bearing loan with permanent benefits where costs are recouped by Government
- re-calculate benefits and benefit:cost ratios based upon additionality rates and spill-over rates of return from quantitative ABS data, and average spill over rates from existing literature, and
- inclusion of international competitiveness as a variable in models, given the ability of R&D to move across borders resulting in economic and social benefits accruing to other jurisdictions.

Further, to maintain support for Australian R&D, there should be no net gain to the revenue from the proposed changes. Savings from improved targeting should be redistributed to alternative recipients or activities to improve the efficacy of the R&DTI and enhance innovation investment. The estimated \$1.8 billion revenue gain is, in effect, a reduction in government funding for R&D over the forward estimates^c and it is difficult for the proposed changes not to be perceived as a cost-saving measure.

The previous Committee's recommendations should be considered

In the previous Parliament, the Senate Economics Legislation Committee considered 75 submissions and held three public hearings on the 2018 Bill and recommended in its February 2019 report²¹ that:

- [the bill] would benefit from some finessing to ensure that R&D entities that have already made investment commitments are not impeded unintentionally (paragraph 2.101)
- the intensity measure should be re-examined in order to ensure that Australian businesses are not unfairly disadvantaged (paragraph 2.103)
- the bill should not proceed until there is further consideration of the R&D tax incentive measures (paragraph 2.110).

The findings of the Senate Committee have not been addressed in the reintroduced Bill. The proposed new Bill does not reconsider the R&DTI in the context of integrity, additionality and fiscal affordability. It also has not reformulated the intensity measure to ensure that Australian businesses are not unfairly disadvantaged. We suggest that the Bill should incentivise and encourage all forms of R&D on an industry-agnostic basis in Australia. The R&DTI is increasingly uncompetitive against foreign regimes and a key concern raised in submissions to the previous inquiry was the contrast between cuts to the Australian R&DTI while there is increasing availability of more attractive incentives in other jurisdictions, including New Zealand.

Of the changes, the reduction in the number of tiers from four to three is not supported by CPA Australia members. Industry modelling indicates that most claimants will be worse off under the revised offset intensity premiums.

^c We note that the revenue estimates do not factor in loss of revenue through the flow-on effects noted above or erosion of Australian-based R&D due to increased off-shoring.

The R&DTI should be independent of the corporate tax rate

When developing the R&DTI policy, the policy position articulated in the Powering Ideas report²² argued that one of the reasons that the tax credit would induce more R&D was because it would increase certainty by uncoupling the level of R&D support from the corporate tax rate. At the time, the value of the pre-R&DTI tax concession had been eroded due to decreases in the corporate tax rate. Therefore, companies were getting less benefit for the same level of R&D expenditure, so the change to an offset was to maintain benefit levels and stop any further R&D benefit erosion that could occur. This position was confirmed in the *Tax Laws Amendment (Research and Development) Bill 2010*²³. We note that the Review did not recommend a recoupling of the R&DTI to the corporate tax rate and in fact noted that, the lower the corporate tax rate, the greater the net benefit of the program²⁴.

Paragraph 1.6 of the Explanatory Memorandum to the Bill states that '*as the corporate tax rate has been lowered from 30 per cent for some taxpayers, the value of the incentive component of the R&D tax offsets has increased for these entities*'. However, in its summaries of the Review and the new law, no further explanation is given as to why the enhanced value of the R&DTI for some entities necessitates recoupling the R&DTI to the corporate tax rate. Arguably, this outcome is the intended result of the R&DTI given the incentive was intentionally designed to shield claimants from changes in the corporate tax rate in order to provide certainty for R&D investments.

From a competitiveness and international perspective, a single rate for the refundable offset is preferable as certainty is important for investment decisions, particularly for international companies. Further evidence should be provided to justify the basis of the policy change, given that there is limited analysis to demonstrate that the reduced company tax rate is a driver of increased R&D investment.

Uncertainty and complexity deter R&D investment

R&D activities are inherently uncertain endeavours and the role of government, amongst other things, is to support businesses manage cashflow or reduce financial risk during early stage innovation. Investments in R&D for both inbound and outbound investing companies are carefully considered due to their high-risk, and factors such as access to the R&DTI are critical in deciding whether to proceed or even to be headquartered in Australia or other jurisdictions. The legislative framework and administrative environment therefore are required to be transparent, consistent, globally competitive and certain in order to enable longer-term commitments to R&D activities and promote and reward local innovation amidst looming productivity challenges and continued falling business expenditure on R&D.

The ongoing reviews and proposed changes at both the political and administrative levels around the R&DTI has led to businesses reconsidering undertaking R&D in Australia or even creating headquarters in Australia and, for those with activities underway, a high level of uncertainty about ongoing access to the R&DTI and concern about retrospective changes, adversely impacting prudent business financial management and forecasting.

The Bill is based on the recommendations arising from the 2016 Review of the R&D Tax Incentive²⁵ (**the Review**) however the report itself recognises important factors that are not addressed by these provisions including:

- enhancing the focus on novelty may increase spill overs from the program
- at the intensive margin, large companies tend to spend more on new projects than small and medium enterprises (**SMEs**), which tend to instead scale up existing projects
- SMEs in tax loss were found to have the greatest additionality
- high-potential new entrants, and R&D-intensive companies, tend to attract other sources of government funding, and
- for some large companies the location of their R&D is very flexible and removing support altogether could have a substantial (negative) inducement effect.

Given that many R&D projects take years to undertake, the 1 July 2019 start date is problematic for affected claimants who cannot shift or cease activities. We suggest that active projects be grandfathered, or some form of consideration is given to businesses who are dependent on the R&DTI in its existing form to complete R&D. Alternatively, given the current global economic environment, the proposed measures and intensity model may arguably no longer be sound policy for the future stability, prosperity and growth of Australia's innovation ecosystem.

We also note that the ongoing tendency of bills to contain retrospective start dates, often back to the date of announcement, is problematic. Taxpayers and their advisors cannot operate based on announcements or exposure drafts but rather the bill as passed by both Houses of Parliament. Backdated changes have a particularly large impact on R&DTI recipients due to the requirement to retrospectively amend tax returns and repay monies. Companies are currently submitting R&DTI claims for the 2019 income year and have already undertaken eight months of their 2020 income year R&D activities. Their expenditures have been based on the existing form of the R&DTI. If the Bill is passed, many claims are likely to require amendment with the impact being particularly damaging for smaller companies receiving refundable offsets to support cashflow. While we recommend that the Bill not proceed in its current form, if it is progressed, we suggest that the start date is changed to 1 July 2020 at the earliest.

The provision of authority to Innovation and Science Australia (**ISA**) to issue determinations has raised concerns amongst our members given the already-identified challenges with the administration of the program. The ASBFEO report identified a series of recommendations for improved behaviour and practices by the regulator, which need to be considered prior to the ISA being provided with the power to make determinations. There is concern that ISA determinations will reflect current, rather than improved practice, and that such increased authority will lead to contentious, incorrect or inconsistent binding advice. We also note that the ATO has a significant amount of resources devoted to their public guidance with ongoing consultation and stakeholder contribution. The ISA will require increased funding to recruit the expertise required to develop and manage such a body of work prior to enabling the Board to issue determinations, given the fundamental concerns of regulator administrator practices as outlined in the ASBFEO report.

Unfairly disadvantages business

The proposed changes may undermine the government's intent to make Australia an R&D-friendly destination. It is difficult to determine the combined effect of the Bill's multiple changes (e.g. non-refundability, intensity thresholds and new feedstock/clawback rules), however CPA Australia members' modelling and analysis demonstrates that overall the new rules will disadvantage both SMEs and large businesses.

Australian labour costs, particularly for already scarce STEM expertise, are comparatively high globally. Such expenses often form a significant portion of R&D investments and the R&DTI is an important policy tool to support the development, recruitment and retention of a deep skills pool and the establishment of productive, innovative businesses in Australia. The government's intent to encourage innovation in Australia and invest in Australia's future while disincentivising R&D is counter-intuitive.

Complexity is a significant barrier for businesses who require simplicity and certainty with respect to tax incentives when making business decisions as to where to locate or whether to undertake R&D. It is anticipated that the number of SME claimants will decline from the 10,600 claiming refundable tax offsets in 2016-17²⁶, once the R&DTI costs and benefits are fully considered. For many, the tax benefits are countered by the administrative cost of preparing an R&D tax incentive claim, the complexity and uncertainty introduced by this Bill's changes, the consistency of administrative interpretations and the associated compliance burden. The \$4 million limit for refundability is a particular issue for start-ups who are often dependent on the R&DTI for cash flow in the first year. The shift toward non-refundable offsets does not consider the operating environment, especially for businesses that are not yet at the stage where venture capital or alternative funding sources are accessible. Australia must maintain competitiveness in R&D and innovation, and in the practical administration of its R&D policies.

For simplicity and consistency, we recommend that the \$20 million turnover threshold be increased to \$50 million to align with the company tax base rate entity threshold, instant-asset write off threshold and the consolidated revenue threshold for small proprietary companies in the Corporations Act. This will support the approximately 1200 medium-sized entities²⁷ which would otherwise be classified as 'large R&D entities' and potentially would be impacted by the introduction of the intensity premiums, while being treated as small or medium entities in other regulatory regimes.

Finally, businesses make multi-year investments in R&D and need certainty from the outset. Retrospective application of changes and the lack of grandfathering provisions for existing R&D activities create major issues for businesses with significant sunk and fixed costs in their R&D. For both small and larger businesses, the benefits of

locating R&D in Australia or headquartering in Australia are diminishing and the proposed changes are increasing the pressure to relocate such activities offshore or to headquarter in a neighbouring jurisdiction.

Intensity calculation

The issues around the proposed intensity calculation have already been clearly articulated in submissions to the inquiry into the 2018 Bill. Many of these submissions expressed policy, complexity or administration concerns around a tiered intensity test model for calculating Australia's primary program to incentivise innovation and R&D. In addition, analysis shows the inclusion of an R&D intensity calculation does not fundamentally support the objectives of *Schedule 1 - Better Targeting the R&D Tax Incentive*²⁸.

The proposed changes have the potential to introduce unnecessary complexity into the R&DTI that may result in anomalous outcomes and will cause a significant compliance burden for companies seeking to access the R&DTI, as well for the ATO in administering the R&DTI. It is likely that Australian innovation spending and Australia's business enterprise expenditure on research and development (**BERD**) will also be negatively impacted.

Further, at a general level, the premise that R&D intensity is reflective of the 'innovativeness' of a company or that a vertically integrated company with strong R&D investment cannot be generating R&D of similar value to a business whose majority of expenditure is comprised of R&D, is questionable.

In the case of consolidation, a dedicated R&D entity is likely to satisfy the proposed higher intensity threshold levels on a standalone basis. However, when subsumed into the accounting and tax structures, its intensity is diluted by the expenses incurred by the full group and is no longer able to access the R&DTI at a commensurate level. Capital-intensive businesses, particularly those in manufacturing and mining or those with high revenues, are anticipated to have a far reduced R&DTI benefit due to the introduction of intensity thresholds. Businesses with high cost of goods or a relatively high level of selling, general and administrative expenses may also fall short of the higher thresholds.

The proposed changes are unfavourable for Australian companies which maintain integrated operations within Australia. The intensity test benefits standalone businesses with small revenues, with limited manufacturing or distribution or sales. In order to satisfy the intensity thresholds and maintain the same level of benefit under the revised R&DTI, there will be an incentive to offshore production and other non-R&D related activities. Alternatively, Australian businesses would seek to offshore R&D to more favourable jurisdictions. Conversely, this intensity threshold creates a bias against Australian businesses relative to foreign businesses, which may set up in Australia solely as an R&D hub. The intention of the R&DTI, while intended to encourage foreign investment in Australian R&D, should not exist to the detriment of Australian business. All scenarios indicate a negative medium to long term consequence for the development of industry-agnostic R&D and innovation.

If the intensity calculation model is progressed, it is submitted that the proposed denominator of 'total expenses' will be inappropriate to compare R&D expense intensity. We suggest that total expenses are adjusted to remove the effect of differentials in financing, tax, depreciation and amortisation across business. We note that the current drafting of the provision requires all 'expenses' of the entity to be considered. In our view, this would include 'below the line' expenses such as the income tax expense calculated under AASB 112. It is unclear whether this is the intention of the provisions, that is, to dilute the R&D intensity based on 'below the line' expenses.

We also disagree with the suggestion that accounting standards be used to calculate total expenses for companies that prepare financial reports. Tax law and financial reporting standards are not connected, and it is not appropriate to hybridise the two concepts. At a practical level, under section 292 of the *Corporations Act 2001 (Cth)*, a small proprietary company is not required to prepare accounts in accordance with the accounting standards. The *Corporations Amendment (Proprietary Company Thresholds) Regulations 2019 (Cth)* increased the threshold of a small proprietary company to include companies with a consolidated revenue of less than \$50 million. This will mean that a large majority of companies that conduct R&D activity may be required to apply the alternative concept, being 'commercially accepted principles of accounting'. We note that the Explanatory Memorandum provides no guidance on this term and that it will be left for the ATO and taxpayers to determine what this term means.

Significant interpretive issues also arise when calculating the total expenses for a year (section 355-155) in the context of assets that are written off across multiple years, and at different rates for tax and accounting purposes (for example, depreciating assets). We highlight that subsections (2) and (3) require a significant amount of tracing for each individual item on a year by year basis (see *illustrative diagram in Appendix, below*). While the ATO may come up with practical approaches to this issue (e.g. allow the use of grouping or global calculations), the strict application of the words of the provisions requires an item by item tracing. We are therefore concerned that when the provision is applied more broadly on an asset by asset basis, significant work will need to be done by the ATO to ensure that practical solutions do not give rise to anomalous outcomes. This, in our view, could potentially increase the cost of compliance and administration.

From a compliance perspective, the need to match expenses and timing is challenging as is the inability to predict or forecast fluctuations in expenditures on an annual basis. This creates uncertainty for taxpayers about their eligibility for the R&DTI, a disincentive to commit to R&D activities in Australia, adds unnecessary complexity, creates forecasting uncertainty and may negatively impact Australian innovation and Australia's BERD.

The following questions arise in respect of calculating the R&D intensity as currently written in the Bill:

- What are the expenses of a taxpayer not subject to accounting standards?
- Are below the line expenses included in the total expense calculation?
- How does the anti-overlap rule (subsection 355-115(3)) work?
- How will the rules apply (and thus tracking apply) when there are multiple items that have permanent and timing differences for accounting and tax purposes?
- Is a negative expense considered in the anti-overlap rule?
- What happens if the denominator is nil?

In our view, introducing a formula that relies on a concept that combines accounting and tax principles unnecessarily and significantly increases the compliance burden and level of uncertainty for taxpayers, which will require additional ATO advice and guidance products and may also lead to greater disputes with the ATO.

We recommend substituting 'expenses' in subsection 355 115(2) for the total of subsection 355 100(1) amounts and amounts that are deductible for an income year. This would provide greater clarity and remove the need for the anti-overlap rule. The expense definition should also be further adjusted to remove the distortions of financing, capital and other non-operating expenses.

Issues with transparency proposals

We question the logic that underpins the transparency provisions and their intended outcome. R&D is commercially sensitive and the value of publishing such information remains unclear. Large public and private companies have their tax affairs published and many voluntarily produce a tax transparency report. For the 10,000 micro and small businesses, the average claim is less than \$250,000, while it is under \$600,000 for medium business. Where concerns are held about advisors and the types of claims being made, consumer alerts and regulatory responses to address bad actors are preferable to full disclosure of potentially commercially sensitive information.

Section 5.5 of the Review report suggests that the purposes of publishing R&DTI information '*would further improve the sharing of tax information between the ATO and other corporate regulators, allowing enhanced administration, regulation and more considered policy discussion.*' Rather than public disclosure, this goal can be more effectively achieved through modification of the information sharing provisions in the *Taxation Administration Act 1953* to enable the ATO to disclose tax information to specified agencies.

Any precedent of publishing the details of recipients of government tax expenditures should also be carefully considered, especially given the many concessions and offsets contained within Australian tax legislation.

Administrative issues should be resolved prior to legislative reform

The ASBFEO's report²⁹ identifies significant areas for improvement in its administration. This highlights the need to improve the performance of the ATO and AusIndustry prior to introducing a raft of complex legislative changes and increased powers whose impacts may further compound existing difficulties. It also raises concerns about

modifying the *Industry Research and Development Act 1986* to enable the ISA Board to issue determinations and to delegate powers below Senior Executive Service levels. We recommend that government action focuses on improved consistency, transparency and fairness in the administration of the R&DTI, within the existing parameters and legislation.

CPA Australia members report that guidance material issued by AusIndustry is often changed or is unclear, and that there is inconsistent interpretation and application by AusIndustry. There is a lack of consultation with industry and stakeholders when developing guidance as well as limited opportunities for engagement on highly technical issues. It has been observed that while the legislation is unchanged, the administrative interpretation of the laws has been changing. Business investment requires not just a clear legislative framework but also trust in the administration of the framework.

The acceptance of the ASBFEO's recommendations and the intention of the agencies to address the identified issues is a positive step forward. We support further investment in technical training and resources to investigate fraud within their existing powers.

Appendix: Diagrammatic representation of timing and tracing challenges arising from intensity provisions

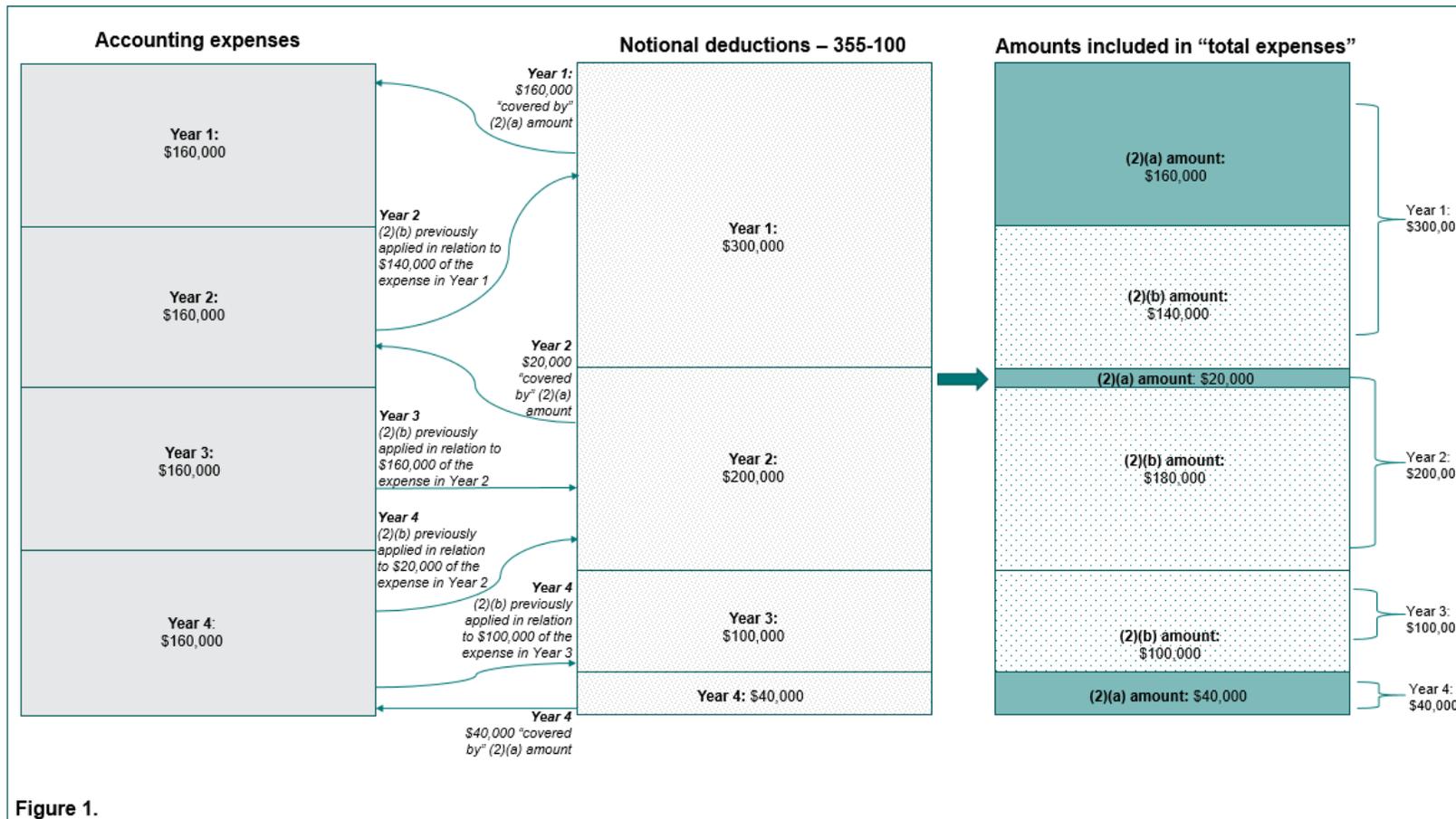


Figure 1.

ENDNOTES

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