

R&D TAX INCENTIVE REVIEW

Submission to Innovation and Science
Australia in response to the Review Issues
Paper

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**RESEARCH
AUSTRALIA**

AN ALLIANCE FOR DISCOVERIES IN HEALTH



ABOUT RESEARCH AUSTRALIA

Research Australia is an alliance of 160 members and supporters advocating for health and medical research in Australia. Research Australia's activities are funded by its members, donors and supporters from leading research organisations, academic institutions, philanthropy, community special interest groups, peak industry bodies, biotechnology and pharmaceutical companies, small businesses and corporate Australia. It reflects the views of its diverse membership and represents the interests of the broader community.

Research Australia's mission is to make health and medical research a higher priority for the nation. We have four goals that support this mission:

- A society that is well informed and values the benefits of health and medical research.
- Greater investment in health and medical research from all sources.
- Ensure Australia captures the benefits of health and medical research.
- Promote Australia's global position in health and medical research.

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R&D TAX INCENTIVE REVIEW

SUBMISSION TO INNOVATION AND SCIENCE AUSTRALIA IN RESPONSE TO THE REVIEW ISSUES PAPER

INTRODUCTION

Health and Medical Research represents a significant proportion of the scientific research undertaken in Australia and *Medical and Health Sciences* is the fourth largest area of reported R&D expenditure for the R&D Tax Incentive.¹ Health has been identified as a National Science and Research priority by the Australian Government and medical technologies and pharmaceuticals has been identified as an industry sector of competitive strength and strategic priority. Despite this prominence, the sector suffers from many of the problems afflicting scientific research more generally, including a shortage of capital for the commercialisation of research findings. The R&D Tax Incentive is an important component of the Government's response to this issue, and Research Australia welcomes the opportunity to make this submission to the review of the R&D Tax Incentive.

While Research Australia proposes some possible minor amendments to the R&D Tax Incentive, we submit that on the whole the R&D Tax Incentive is already performing well against the Review's criteria of effectiveness, integrity and additionality. Any changes to the R&D Tax Incentive at this point in time should be limited to improving the way it is administered.

In particular, Research Australia is mindful of how important it is that potential beneficiaries of the R&D Tax Incentive are able to be confident of its continued availability and have certainty about the benefits it will deliver. This is crucial for a scheme that requires an investment by companies in anticipation of a future tax benefit. Uncertainty about whether the benefit will be available can adversely affect decision making and mean that R&D activities are reduced, are not undertaken at all, or are undertaken elsewhere. The Issues Paper alludes to this issue on page 7:

The impact of any definitional change also needs to be weighed against the negative impact on programme stability (and participants' confidence to rely on the programme when considering their R&D investment decisions in future years).

Research Australia submits that the potential impact on participants' confidence needs to be a primary consideration in any proposed changes to the R&D Tax Incentive.

A more comprehensive assessment of the economic benefits of the R&D Tax Incentive will only be possible when the scheme has been in place for a longer period. Any significant amendments to the R&D Tax Incentive should be considered upon completion of such an investigation.

¹ Australian Government, Innovation Australia Annual Report 2013-14, page 23, data for 2012-13. Medical and Health Sciences accounted for 4% of expenditure behind Technology (5%), IT (25%) and Engineering (56%).

EFFECTIVENESS- AN INTERNATIONAL PERSPECTIVE

The Issues Paper provides evidence that, by international standards, the R&D Tax Incentive is already effectively targeted.

The Issues Paper makes the point that the greatest additionality comes from small companies:

International studies generally agree that additionality is greater for SMEs than for larger firms. This is borne out in CIE's findings that the R&D Tax Incentive has a higher influence on R&D spending decisions by SMEs – 54 percent of R&D decisions were materially influenced by the programme, compared to 34 percent for large entities. (page 6)

In its analysis of the R&D Tax Incentive, CIE found additionality of between 0.3 and 1.0 additional dollars of R&D per dollar of tax forgone for large firms, and between 0.9 and 1.5 per dollar of tax forgone for SMEs. (page 6) The Issues Paper also refers to analysis by the OECD which shows that Australia's tax subsidy is:

- *8 cents per dollar of R&D registered for large firms, just below the OECD average of 9 cents per dollar.*
- *20 cents per dollar of R&D registered for small firms, more generous than the OECD average of 15 cents per dollar. (page 4)*

This focus of the R&D Tax Incentive on small firms is consistent with OECD advice on best practice.

The OECD (2015) argues that R&D tax incentives should be designed to primarily meet the needs of young innovative firms and stand-alone firms without cross-border tax planning opportunities. (page 4)

The emphasis on small firms has increased since the scheme's inception, with the Issues paper reporting that '(T)he actual cost has been significantly more than forecast, largely due to growth in the cost of the refundable component for businesses with a turnover of less than \$20 million.' (page 3) The refundable R&D Tax Incentive, paid to small companies, has increased from 57% of total scheme expenditure in 2011-12 to 67% in 2015-16.²

Research Australia submits that, by international standards, the R&D Tax Incentive would appear to be well designed and effectively targeted. While this doesn't mean that the R&D Incentive Scheme is perfect or incapable of improvement, it does suggest that even major changes to the scheme may yield only marginal improvements in its performance.

² Australian Government, Department of Industry and Science, 2015-16 Science, Research and Innovation Budget Tables, derived from Table 4, comparing expenditure in the refundable and non-refundable components

COMPLIANCE COSTS

One way to improve the effectiveness of the R&D Tax Incentive would be to reduce the compliance costs associated with registering for and claiming the R&D Tax Incentive. The Issues Paper refers to estimates by CIE that the compliance costs for participating firms participating were around \$437 million per annum. This figure represents around 14% of the total value of benefits provided by the scheme in 2013-14. These costs appear to be a suitable target for efforts to improve the effectiveness of the scheme. Understanding how and where these costs could be reduced requires a more detailed analysis than is provided in the Issues Paper, including:

- whether costs are significantly higher in the first year due to the initial registration process.
- whether costs differ between the refundable and non refundable schemes, and why. It is possible, for example, that larger firms with significant production activities incur greater costs in segregating R&D expenses from the normal costs of production.
- the division of costs between the registration process (AusIndustry) and claiming the R&D Tax Incentive from the ATO
- the costs associated with separating core and supporting activities.
- the extent to which costs associated with substantiating claims for R&D activities are additional costs to those that would be incurred anyway in the normal course of undertaking R&D activities. It is reasonable to expect, for example, that any experimentation and development activities would be documented together with the expenditure on various items, and that documentation relating to these activities would be retained even in the absence of the R&D Tax Incentive.

As a general principle the cost of compliance imposed by the R&D Tax Incentive scheme should be proportionate with the potential losses to the scheme arising from non-compliance. In 2012-13, 71% of all claims for the refundable tax offset related to R&D expenditure of less than \$500,00 and only 1% related to claims for R&D expenditure in excess of \$5 million. Conversely, 23.4% of claims for the non-refundable tax offset related to research expenditure of less than \$500,000 and 24% of claims related to R&D expenditure in excess of \$5million.

Research Australia submits that efforts to reduce the compliance costs should be targeted at the refundable R&D Tax Incentive as this is where the bulk of registrations are made, the claims are smallest and where compliance costs are likely to be greatest as a percentage of the financial assistance provided. It is also where the greatest additionality is likely to be achieved by allowing more funds to be directed to R&D activities.

Collaboration with researchers

R&D collaboration between industry, universities and research organisations is generally considered an important channel for R&D to benefit the broader economy. For the 2013-14 income year, 9.5 percent (3,033 projects amounting to around \$2.7 billion worth of R&D) of total projects registered under the programme indicated they involved collaboration with another organisation. This reflects Australia's low rates of collaboration between research and industry sectors, which is currently the lowest in the OECD. A priority of the National Innovation and Science Agenda is improving collaboration in Australia. (Issues Paper, page 6)

Research Australia shares the Government's commitment to increasing the levels of R&D collaboration, and collaboration with a research organisation provides some assurance that the R&D is genuine and will have spillover benefits.

Research Australia submits that in considering the design of the registration and claims processes for the R&D Tax Incentive, consideration should be given to how the processes can be changed to encourage and support collaboration. This could involve, for example, reduced requirements in the initial or subsequent registration process and/or the claims process. Another incentive for companies that collaborate could be earlier access to Refundable R&D Tax Incentive payments. These measures provide the opportunity to provide incentives for collaboration that do not require additional Commonwealth expenditure.

CONCLUSION

While international comparisons suggest the design of the R&D Tax Incentive is effective, the real measure of effectiveness is the degree to which it has caused additional R&D in Australia that results in additional economic benefits. This will always be difficult to determine as there are many factors that affect the level of R&D undertaken in any country at any time, of which the R&D Tax Incentive is only one. In addition, the R&D Tax Incentive has only been operating since 2011 and R&D is typically a long and time consuming process. It can take many years for products to make it to market and generate revenue; consequently, the R&D Tax Incentive has not yet been operating for a sufficient period to determine its economic impact.

Research Australia submits that there should not be any major changes to the R&D Tax Incentive at this point in time. Any such changes should only be made after an appropriate evaluation of the economic impact of the R&D Tax Incentive has been able to be made and this will not be possible for several years.

In the meantime, there are some opportunities to improve the effectiveness of the R&D Tax Incentive and to reduce compliance costs. Further targeted consultation with the users of the R&D tax Incentive could be useful in identifying process changes that would improve the administration and reduce compliance and administration costs. There is also the opportunity to make changes which will encourage collaboration between companies and research organisations.

Research Australia welcomes the opportunity to provide further information and/or discuss any aspect of this submission further.

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