

# **RSM Australia Response to: The Tax Expenditures Statement – Consultation Paper**

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RSM Australia (RSM) is one of the largest nationally owned accounting firms and forms part of RSM International, which is the sixth largest international accounting and consulting organisation worldwide. In Australia, RSM is one of the fastest growing mid-tier firms with over 115 Directors and Principals and over 950 employees operating from 28 locations throughout Australia. Our staff operate across a range of industries, public, private, Government and not-for-profit-sectors.

RSM appreciate the opportunity to make a submission in response to the *“The Tax Expenditures Statement – Consultation Paper”* (TES Paper).

RSM provides audit, tax, corporate finance and various specialist services. This includes R&D Tax services for a broad array of industries and technologies, and assisting entities ranging from start-ups to SMEs through to multinationals.

RSM has previously made submissions discussing budget/TES cost issues to Government R&D Tax Reviews as follows:

- Treasury’s “Re:Think” Tax Discussion Paper (Re:Think Paper);
- The Chief Scientists STEM report (STEM Report);
- The FFF Review of the R&D Tax Incentive prior to the report being completed;
- The FFF Review of the R&D Tax Incentive subsequent to the report being released (3F Response Paper); and
- Senate Economics Legislation Committee regarding the Budget Savings (Omnibus) Bill 2016 (Omnibus Bill).

A number of submissions were made by industry to the 3F Review regarding the R&D Tax budget/TES cost over-statement issues relating to the R&D Tax Incentive by the following professional firms/industry bodies:

- RSM;
- Deloitte;
- PWC;
- EY;
- Michael Johnson Associates;
- Swanson Reed; and
- Ausbiotech.

Unfortunately, all industry submissions to the 3F Review regarding R&D Tax budget/TES cost over-statement issues have been ignored by Government over time, and continue to be ignored with the release of the recent 2017-18 Science, Research and Innovation Budget Tables (2017-18 SRI budget tables) that show the budget cost of the R&D Tax Incentive as \$3.1 billion for 2017-18.

According to the 2017-18 SRI budget tables this represents 30.5% of the total SRI budget.

RSM has presented full detailed information in its attached 3F Responses Paper, including analysing the method of calculation of the budget cost of the R&D Tax Incentive, which utilises TES and other calculations, and described the errors and issues that have resulted in the gross budget cost over-statement.

RSM also detailed in its 3F submission reasons that “Revenue Gain” in addition to “Revenue Forgone” is an appropriate method in calculating the budget cost of the R&D Tax Incentive.

As detailed in RSM’s 3F Response Paper, part of the purpose of the *Charter of Budget Honesty Act* is “*facilitating public scrutiny of fiscal policy and performance.*” Presenting the budget cost of the R&D Tax Incentive as not fiscally sustainable at \$3 billion per annum in 2013-14 and rising quickly over forward estimates does the opposite of this, putting extreme pressure on the program, and influencing all stakeholders including Government to believe that significant change must be made to ensure fiscal sustainability of the program. It should be noted that even with Treasury’s existing budget/TES cost calculation method that this strong rise in program cost has not eventuated with the budget cost now \$3.1 billion for 2017-18.

RSM’s detailed response to a number of the questions posed in the TES Paper is as follows:

#### **RSM Response to Questions:**

*House Recommendation 1: That Treasury devote fewer resources to estimating smaller, technical tax expenditures. This could involve reviewing them less frequently and reporting them as a range.*

*Government Response: The Australian Government supports the recommendation. Estimates for smaller, technical tax expenditures will be reviewed every three years on a rolling basis and reported in size ranges.*

Question 1: What is an appropriate annual threshold below which expenditures could be updated less frequently and reported as ranges?

The TES Paper states “*the majority of public debate around the TES focuses on the magnitude of a handful of the largest tax expenditures.*”

While this statement in the TES Paper may be true, there are other tax expenditure estimates such as the R&D Tax Incentive, where the budget/TES cost of the program is the subject of extensive public debate, scrutiny and is highly controversial.

The cost of the R&D Tax Incentive for the TES is calculated based upon two components:

- The 43.5% Refundable R&D Tax Offset (Refundable R&D Tax Offset); and
- The 38.5% Non-Refundable R&D Tax Offset (Non-Refundable R&D Tax Offset).

These two components are costed separately for both the budget and TES. The figures calculated for the Non-Refundable R&D Tax Offset are used in the budget, whereas the TES calculation for the Refundable R&D Tax Offset produces a negative cost, and is only one component of the calculation of the budget cost.

The combined R&D Tax budget cost is \$3.1 billion for 2017-18. If this was the figure calculated in the TES for the R&D Tax Incentive then it would be a “*large measured tax expenditure*” in the TES, however due to the difference between the budget and TES cost for the Refundable R&D Tax Offset, and that the two components are costed separately in the TES, the flagship program support for R&D in Australia would potentially not be considered a significant expenditure program.

The likely outcome of this Government recommendation for the R&D Tax Incentive is that it would be considered a *smaller, technical tax expenditure*, despite the budget cost associated with the

program. This would then result in minimal resources being devoted to modelling the cost of the R&D Tax Incentive, less frequent review of the budget/TES cost and the reporting of a range. This would be inappropriate given the scale, flagship nature, and critical importance of the program to industry.

The opposite is required. Given the flagship nature of the program, level of public debate, scrutiny, stakeholder interest and consistent feedback from all the major accounting firms that the current method of calculating the budget cost of the R&D Tax Incentive is grossly over-stating the cost of the program, significant additional Treasury modelling effort is required to review the budget/TES method.

**RSM Recommendation 1: The R&D Tax Incentive should not be subject to infrequent, range based modelling.**

**RSM Recommendation 2: Significant additional modelling effort be undertaken by Treasury in relation to the R&D Tax Incentive, due to the public debate regarding its true cost, criticality of the program to industry, and its flagship nature.**

*House Recommendation 7: That Treasury:*

- *Incorporate the capital gains tax exemption for the main residence into the benchmark;*
- *Develop a transparent process and criteria to assist consideration of benchmarks which reflect the practical possibility of a tax concession being abolished; and*
- *Consult with stakeholders on the benchmarks used in the Tax Expenditures Statement.*

*Government Response: The Australian Government considers it appropriate to continue reporting the capital gains tax exemption for the main residence as a tax expenditure as this exemption departs from the comprehensive income tax benchmark.*

*It would not be appropriate to assess benchmarks against the 'practical possibility of a tax concession being abolished' as this would involve a judgement about potential future decisions of the Executive Government and the Parliament.*

*The Australian Government supports consulting stakeholders on the benchmarks used in the TES.*

Question 4: Do you have any concerns about the benchmarks currently used in the TES? How can they be improved?

RSM and industry as discussed above, have concerns regarding the budget/TES cost of the R&D Tax Incentive. This include both:

- The current calculation method using Revenue Forgone; and
- The non-use of the more appropriate Revenue Gain method.

The substantial issues with the current Revenue Forgone method that are resulting in the gross over-statement of the Refundable R&D Tax Offset are described in detail in the attached 3F Response Paper, therefore will not be repeated in full here. **However, it should be understood that if the same benchmark used for the Non-Refundable R&D Tax Offset was used for the Refundable R&D Tax Offset, the budget cost reduction for the program was estimated at \$4.8 billion over forward estimates in the 3F Response Paper.**

The use of the current calculation method using Revenue Forgone for the Refundable R&D Tax Offset is preventing the true cost of the Refundable R&D Tax Offset being understood, and is impacting Government policy to the extent that the 3F Review believed the Refundable R&D Tax

Offset is not fiscally sustainable. Details of the current Revenue Forgone method used to calculate the cost of the Refundable R&D Tax Offset for the budget, can be summarised as follows:

- Step 1 - Actual expenditure incurred under the Refundable R&D Tax Offset x 45% (representing the full gross cost of the Refundable R&D Tax Offset). This is included in the budget, but not the TES calculation; plus
- Step 2 - Negative cost calculated as actual expenditure incurred x 30% (representing the inability for R&D Tax claimant companies to also claim normal business tax deductions). This is included in the TES calculation; plus
- Step 3 - Cash payments from Government x factor (likely 30%). This represents a cost the Government believes it incurs because payments made under the R&D Tax Incentive are exempt from tax. It should be noted that all "returns of tax" to companies are exempt from tax. This is included in the TES calculation.

**The highlighted line – Step 3 above is the part of the Government’s budget/TES calculation method that is resulting in the budget gross over-statement of the Refundable R&D Tax Offset. It is double counting the cost because payments from Government have already been included in the calculation of the full gross cost of the Refundable R&D Tax Offset in Step 1.**

Recommendations were produced by the 3F Review to cap the Refundable R&D Tax Offset payments at \$2 million per annum, and introduce a minimum intensity threshold of 1-2% of total business expenses for the Non-Refundable R&D Tax Offset, based upon this flawed understanding of the total program budget cost. Therefore, the current benchmark and calculation method used for the Refundable R&D Tax Offset has had a significant impact upon Government policy.

If these proposed changes are implemented it will have a very substantial impact upon the level of R&D undertaken in Australia and the ability of the country to remain internationally competitive for undertaking R&D based projects.

**RSM Recommendation 3: Government to review and amend the budget/TES calculation method for the Refundable R&D Tax Offset, particularly the double counting of the cost in the TES calculation resulting from considering tax exempt payments from Government as creating a cost. Removing this additional cost would align with the benchmark used for the Non-Refundable R&D Tax Offset.**

A detailed discussion exists in the 3F Response Paper supporting the additional modelling of the R&D Tax Incentive using the Revenue Gain method in the TES. This will therefore not be repeated here.

It should be understood from the 2017-18 SRI budget tables that the combined total cost of the R&D Tax Incentive would make it the 6th largest tax expenditure, if the cost of the Refundable and Non-Refundable R&D Tax Incentives were combined. It is also certainly a tax expenditure involving substantial public debate. Therefore, Revenue Gain calculations should be undertaken for both the Refundable and Non-Refundable R&D Tax Offsets in the TES, which would present the true net cost (or revenue) of the R&D Tax Incentive.

**RSM Recommendation 4: Include Revenue Gain method estimates to model the budget/TES cost of the Refundable and Non-Refundable R&D Tax Offsets, which will include the strong behavioural responses, to better and more fairly represent the true cost of the program.**

*House Recommendation 8: That Treasury consider ways of increasing the visibility of warnings in the Statement to better draw the attention of readers to the Statement’s limitations.*

*Government Response: The Australian Government supports the recommendation.*

Question 10: What options are there to improve the visibility and accessibility of caveats in the TES?

Question 11: What options or strategies are available to mitigate, or reduce the misunderstanding of figures published in the TES?

As is detailed in the 3F Response Report, information regarding the method for calculating the budget/TES figures for the Refundable R&D Tax Offset is extremely hard to find and understand. Only by taking information from the 2016-17 SRI budget (excel workbook), and information from the TES 2011 was it possible to determine the method used.

Detailed information should be presented for the R&D Tax Incentive, and in particular the Refundable Tax Offset explaining how the TES and budget figures are calculated, and why they are currently different.

In addition, it is understood that the ATO has changed the way the R&D Tax Incentive is reported in its 2015-16 Annual Report. Rather than reporting actual R&D expenditure, which has been the case for a number of years, the ATO Annual Report now only shows R&D tax offsets “claimed and used.” This prevents the type of budget vs actual expenditure analysis RSM performed to show that the budget cost (that includes TES calculations) of the R&D tax incentive is being grossly over-stated. This change by the ATO has significantly reduced transparency, public scrutiny and will increase misunderstanding of figures published in the budget/TES.

**RSM Recommendation 5: Present detailed explanatory information for the R&D Tax Incentive in the TES, and in particular the Refundable Tax Offset detailing how the TES and budget figures are calculated, and why they are currently different.**

**RSM Recommendation 6: The ATO again publish actual R&D expenditure incurred for both the Refundable and Non-Refundable R&D Tax Offsets, as this aggregated tax information is now not publically available.**

Question 16: Would the value of the TES be enhanced by including appendices that focus in more detail on particular topics (varying each year) relevant to tax expenditures? What topics should be prioritised?

As discussed above, RSM has recommended that significant additional modelling effort be undertaken by Treasury in relation to the R&D Tax Incentive, due to the public debate regarding its true cost, criticality of the program to industry, and its flagship nature.

A large number of submissions have been submitted by industry, including the major accounting firms highlighting gross cost over-statement issues with the current Revenue Forgone method, and appropriateness of also including Revenue Gain estimates. This has been ignored over time by both Government and Treasury, and an appendix evaluating the issues raised should be a priority.

**RSM Recommendation 7: That an appendix and relevant modelling evaluating the budget/TES cost issues raised by industry for the R&D Tax Incentive, be completed by Treasury as a high priority.**

If you wish to further discuss any of the above, please contact me on (08) 9261 9154.

Yours sincerely

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# **Attachment 1**

## **RSM Australia Response to: Review of the R&D Tax Incentive**



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RSM Australia (RSM) is one of the largest nationally owned accounting firms and forms part of RSM International, which is the sixth largest international accounting and consulting organisation worldwide. In Australia, RSM is one of the fastest growing mid-tier firms with over 115 Directors and Principals and over 950 employees operating from 28 locations throughout Australia. Our staff operate across a range of industries, public, private, Government and not-for-profit-sectors.

RSM appreciate the opportunity to make a submission in response to the R&D Tax Review Report (FFF Review) by the Ferris-Finkel-Fraser panel (The Panel).

RSM provides specialist and extensive R&D Tax services for a broad array of industries and technologies, and assist entities ranging from start-ups to SMEs through to multinationals. RSM is also actively and strongly involved in the “innovation community” through:

- Co-working spaces;
- Award programmes;
- Associations;
- Industry peak bodies;
- Sponsorships; and
- Pitch events.

RSM has previously made submissions regarding Government R&D Tax Reviews in response to the following:

- Treasury’s “Re:Think” Tax Discussion Paper (Re:Think Paper);
- The Chief Scientists STEM report (STEM Report);
- The FFF Review of the R&D Tax Incentive prior to the report being completed; and
- Senate Economics Legislation Committee regarding the Budget Savings (Omnibus) Bill 2016 (Omnibus Bill).

RSM’s previous submissions are included as attachments.

RSM has provided a response to the specific recommendations made in the FFF Review. However, prior to commenting on these recommendations, there are a number of systemic issues and weaknesses in the FFF Review that have led to incorrect conclusions and recommendation being made, which are addressed below.

Please note that our response refers to the R&D Refundable Tax Offset at 45%, and the Non-Refundable R&D Tax Offset at 40%. From 1 July 2016 onwards these rates have been reduced to 43.5% and 38.5% respectively.

#### **Executive Summary:**

A summary of RSM’s response and recommendations are provided below:

*An Improper Process was Conducted by the Panel as Follows:*

- The FFF Review was tasked with a pre-defined outcome;
- Submissions by industry and professional services firms were ignored regarding the gross budget cost over-statement;
- The current fiscal sustainability of R&D Tax Incentive as detailed in industry submissions was ignored;
- The FFF Review demonstrated a fundamental lack of understanding of tax and the nature of the R&D Tax Incentive;
- Selective data and benchmarks were used to present the R&D Tax Incentive in the poorest light and justify the pre-defined outcomes; and
- There was an excessive focus on “additionality” and “spillovers” with little consideration of international competitiveness.

*RSM Key Recommendations are as Follows in Regards to the Improper Process:*

- Re-consider submissions by industry and properly consider the term of reference regarding the historical and projected cost of the R&D Tax Incentive;
- Correct the gross budget cost over-statement of the R&D Tax Incentive, including:
  - Double counting the budget cost for the Refundable R&D Tax Offset relating to cash payments using the existing revenue forgone method;
  - Include dividend imputation impacts in the revenue forgone modelling, reducing the net cost for the Refundable and Non-Refundable R&D Tax Offsets; and
  - Use the revenue gain method for modelling the budget cost of the Refundable and Non-Refundable R&D Tax Offsets, which will include the strong behavioural responses, better and more fairly representing the real cost of the program.
- Evaluate the fiscal sustainability of the R&D Tax Incentive after the gross budget cost over-statement has been corrected;
- Government determine fully costed options for any proposed changes based upon the revenue gain method;
- Re-calculate costs and benefit:cost ratios based upon the understanding that the R&D Tax Incentive is akin to a non-interest bearing loan with permanent benefits, but costs recouped by Government;
- Re-calculate benefits and benefit:cost ratios based upon additionality rates and spillover rates of return from the quantitative ABS data, and average spillover rates from existing literature; and
- Undertake further work and properly considers international competitiveness as an economic rationale for the R&D Tax Incentive.

*RSM Key Recommendations in Response to the FFF Review Recommendations are as Follows:*

- Do not implement a minimum intensity threshold for the Non-Refundable R&D Tax Offset, as this will ultimately result in failure of this part of the program;
- Do not place a cap on the cash rebate of the Refundable R&D Tax Offset, as if modelled correctly, the program is currently fiscally sustainable. Also, there is little economic rationale for this change;
- Do not provide a premium collaboration R&D Tax Incentive. If the Government wishes to encourage greater collaboration with public funded research projects, this should be done through reassessing how the public funding mechanism for those projects currently succeeds, or fails to achieve appropriate collaboration;

- Do not increase the R&D expenditure threshold to \$200 million without an appropriate economic rationale supported with quantitative economic evidence;
- Provide AusIndustry with more resources to increase their compliance activities relating to the current legislative definition; and
- Do not make unnecessary administrative changes to the R&D Tax Incentive such as having a single agency, single application process, or publishing the names and expenditure of claimants.

### **Improper Process Undertaken to Produce the FFF Review**

An improper process was undertaken by the FFF Review as detailed below.

#### *FFF Review was Tasked with a Pre-Defined Outcome*

The Government commissioned the Panel to “*identify opportunities to improve the effectiveness and integrity of the R&D Tax Incentive, including by sharpening its focus on encouraging additional R&D spending.*”

Tasking the Panel to improve effectiveness and integrity, including by sharpening its focus on encouraging additional R&D spending, includes a presumption that the program is not currently achieving acceptable levels of effectiveness and integrity and that there is a need to encourage additional R&D spending.

Commissioning the FFF Review with pre-defined outcomes has ensured that it makes recommendations to cut cost from the system, with little regard for the impact upon current claimants of the R&D Tax Incentive, or more broadly upon the economy.

The Panel did not have an open mind as to whether the R&D Tax Incentive was currently achieving acceptable levels of effectiveness and integrity. The Panel should have been tasked with determining the current effectiveness, efficiency and integrity of the R&D Tax Incentive, and whether any need for change was necessary.

#### *Submissions by Industry and Professional Services Firms Ignored Regarding Gross Budget Cost Over-Statement*

Five professional services firms and industry body Ausbiotech in submissions to the Panel for the FFF Review, described that the budget cost of the R&D Tax Incentive is being incorrectly modelled and grossly over-stated. The FFF Review ignoring this issue and the scope, or terms of reference has had drastic policy implications for the R&D Tax Incentive with the FFF Review recommending a \$2 million cash rebate cap to the Refundable R&D Tax Offset, and a 1-2% minimum intensity requirement for the Non-Refundable R&D Tax Offset.

RSM has discussed the budget cost issue at length in the following submissions to Government, and yet it continues to be ignored, as it is an inconvenient truth that the budget cost of the R&D Tax Incentive is being grossly over-stated:

- Re:Think Paper;
- STEM Report;
- FFF review (prior to report completion); and
- Omnibus Bill.

Analysis by RSM has shown that there has been no cost blowout between the final full year of the R&D Tax Concession and 2013-14, which is the most recent year that actual expenditure data is

available for the R&D Tax Incentive. RSM has also shown that there will be no cost blowout in the future if the budget cost of the program is correctly modelled.

Part of the scope of the FFF Review was “*What is the historical and projected cost of the R&D Tax Incentive? What drives the costs?*” A term of reference of the economic consultant the Centre of International Economics (CIE) was “*Can the cost of the R&D Tax Incentive programme be better understood and estimated?*”

Neither the FFF Review, nor the CIE considered the submissions of industry and professional services firms supported by detailed calculations showing that the current budget cost modelling of the R&D Tax Incentive is incorrect. Despite this, the FFF Review continues to assert that “*the administered cost of the programme has risen strongly since its introduction in 2011.*”

In addressing the term of reference, the CIE report states “*the greatest cost of the R&D TI (from the perspective of government) is the forgone tax revenue and refunded tax offsets. While this is subject to some uncertainty, this dollar cost is directly related to the amount of subsidy provided to recipient firms; a lower dollar cost would imply a lower subsidy, and therefore lower benefits.*”

Neither the FFF Review, nor the CIE appropriately addressed the term of reference relating to the historical and project cost of the R&D Tax Incentive. Specifically, there was no attempt at the following:

- Evaluating Treasury’s current budget cost method to determine whether it is appropriate and accurately reflects the actual historical and projected cost;
- Determining if the budget cost is being over-estimated using the current method, and if so, the extent of over-statement over forward estimates;
- Determining whether the actual historical and projected cost could be better estimated using alternative modelling methods; and
- Correcting historical and projected budget costs.

Instead the very minor reference to “*some uncertainty*” in the CIE report is the extent to which this key issue of the budget cost of the R&D Tax Incentive is considered by the CIE, or by the FFF Review.

The lack of transparency in the process regarding modelling is demonstrated by Dr Finkel’s response in the Senate Estimate - Economics Legislation Committee on 20 October 2016 (Senate Estimates) when questioned regarding “*what modelling you used to inform you recommendations*” to which the partial response was “*none of that has been published in the report or made publicly available.*”

Therefore, no proper process has been undertaken by the FFF Review in considering “*What is the historical and projected cost of the R&D Tax Incentive? What drives the costs?*” This is a critical point because the budget cost of the R&D Tax Incentive, particularly the growth in the cost of the Refundable R&D Tax Offset is considered to be causing financial sustainability issues for the R&D Tax Incentive. For example the FFF Review states “*the considerable growth in the cost of the refundable component – discuss in Section 3.5 below – is impacting the programme’s long-term fiscal sustainability.*”

**RSM Recommendation 1: That the Panel consider submissions by industry and properly consider the term of reference regarding the historical and projected cost of the R&D Tax Incentive.**

**RSM Recommendation 2: Government correct the gross budget cost over-statement of the R&D Tax Incentive.**

### *Current Fiscal Sustainability of R&D Tax Incentive Ignored*

The policy implications of the gross over-statement of the budget cost of the R&D Tax Incentive, particularly the Refundable R&D Tax Offset, is that Government could then not use fiscal sustainability as a justification for placing a cap on cash rebates. If modelled correctly in accordance with budget requirements, the Government would have to acknowledge that the program is fiscally sustainable in its current form.

The FFF Review has taken a disingenuous approach to the R&D Tax Incentive budget cost issue in not properly addressing the terms of reference, and considering the views of industry regarding gross budget cost over-statement issues that exist with the current cost calculation method. In doing so, the FFF Review has set up the R&D Tax Incentive for failure, as even if the proposed changes are legislated, over time the budget cost of the R&D Tax Incentive will again grow with continued increased uptake, particularly of the Refundable R&D Tax Offset, and there will again be questions regarding the fiscal sustainability of the program.

Given the repeated submission to Government regarding the over-stated budget cost of the R&D Tax Incentive by professional services firms and industry since May 2015 and Treasury's involvement in the FFF Review, it could be argued that Treasury is in breach of the *Charter of Budget Honesty Act* in not correcting the budget cost of the program over forward estimates. Part of the purpose of this act is "*facilitating public scrutiny of fiscal policy and performance.*" Presenting the budget cost of the R&D Tax Incentive as not fiscally sustainable at \$3 billion per annum in 2013-14 and rising quickly over forward estimates does the opposite of this, putting extreme pressure on the program, and influencing all stakeholders to believe that significant change must be made to ensure fiscal sustainability of the program. As an example of the policy impact of the budget cost gross over-statement in recent Senate Estimates, Dr Finkel from the FFF Review Panel stated regarding the R&D Tax Incentive that "*..it is already a big scheme, representing about 30 per cent of a \$10 billion commitment, so one does have the sustainability of the program in the back of one's mind.*"

The FFF Review has also made no attempt to provide any budget costings of Government savings from the proposed changes. This is supported by comments made by Dr Finkel in recent Senate Estimates that there was "*nothing that I could table*" when questioned as to whether he had "*ATO or Treasury data to sustain these recommendations.*"

Given ensuring fiscal sustainability is the stated driver for at least some of the recommendations, why have no details of modelling of budget cost savings been provided? It is difficult to comment on the proposed recommendations with no indication of the level of net revenue that the Government will "gain" through the proposed changes.

Details regarding the percentage of companies claiming the Refundable R&D Tax Offset in a tax loss position has been provided by the FFF Review. In a following section RSM has revised its estimate of the extent of budget cost over-statement using this Government data.

**RSM Recommendation 3: Government determine the fiscal sustainability of the R&D Tax Incentive after the gross Budget cost over-statement has been corrected.**

**RSM Recommendation 4: Determine fully costed options for proposed changes based upon the revenue gain method.**

### *Fundamental Lack of Understanding of Tax and the Nature of the R&D Tax Incentive*

The CIE report has a section titled "Revenue Cost of the Scheme." This section states "*some concerns have been raised among the public that the government's estimate of the cost of the scheme (in terms of refunded or offset tax revenue) is overstated (see, for example, Loussikian 2016).*"

*A lower amount of forgone tax revenue implies a lower subsidy to recipients, which will lower both the benefits (determined by the additionality and spillover rates) and the costs (through the deadweight loss of taxation) of the programme.”*

The above statements demonstrate a fundamental lack of understanding of tax and the nature of the R&D Tax Incentive. Industry submissions to the FFF Review and the Loussikian article described that the budget cost of the R&D Tax Incentive is being grossly over-stated using the current revenue forgone method.

It should be understood that a lower amount of tax revenue forgone by the Government does not imply a lower subsidy to recipients, or lower the benefits received. This is because the tax system in Australia effectively renders the R&D Tax Incentive as akin to a loan.

The industry submissions to Government and Loussikian article detailed that for the Refundable R&D Tax Offset 30% of the 45% Refundable R&D Tax Offset is recouped. However, for companies in a tax loss this does not happen immediately. It may take a number of years before the Government is able to recoup the 30% timing benefit. Meanwhile the benefits in terms of additionality and spillovers have been generated for the economy. Given the FFF Review has stated that 60% of companies claiming the Refundable R&D Tax Offset are in a tax loss position, this issue is significant. It is not appropriate in this situation to reduce both the cost and benefit, as the benefit is created prior to the cost being recouped.

This lack of understand of the tax system is replicated in the FFF Review, with box 3.2 and figure 3.1 misrepresenting the “net benefit” that a SME in a tax loss receives as 45% of R&D expenditure. The net benefit is 15% regardless of whether the company is in a tax profit, or tax loss. The lack of understanding of tax by the FFF Review has real implications because it leads into a discussion regarding whether the 45% cash rebate for tax loss SMEs is too generous.

Similarly the net benefit of 15% for the Refundable R&D Tax Offset, or 10% for the Non-Refundable R&D Tax Offset is substantially recouped by Government at the time an unfranked or partially franked dividend is issued. The benefits in terms of additionality are created through the company receiving the benefit, but the cost is later recouped from shareholders. This has been termed the “super efficiency” of the scheme in historical papers by the Business Council of Australia in relation to the R&D Tax Concession. It is the reason tax incentive are particularly appropriate from a Government perspective in Australia.

This budget cost issue needs re-examining and benefit:cost ratios need re-calculating on the basis that the R&D Tax Incentive is akin to a loan.

**RSM Recommendation 5: Re-calculate costs and benefit:cost ratios based upon the understanding that the R&D Tax Incentive is akin to a non-interest bearing loan with permanent benefits but costs recouped by Government.**

*Selective Use of Data and Benchmarks to Present the R&D Tax Incentive in the Poorest Light and Justify the Pre-Defined Outcomes*

The FFF Review selectively used data and benchmarks to present the R&D Tax Incentive in the poorest light to support its claim that the “programme falls short of meeting its stated objectives of additionality and spillovers.”

The R&D Tax legislation (act) states “the object of this Division is to encourage industry to conduct research and development activities that might otherwise not be conducted because of an uncertain return from the activities, in cases where the knowledge gained is likely to benefit the wider Australian economy.” The stated objective is not additionality and spillovers but only to R&D activity

that “*might not otherwise be conducted.*” Given the wording of the object of the act, the FFF Review has excessively focussed on additionality and spillovers.

Despite industry submissions little effort was made in properly understanding the international competitiveness aspects of the R&D Tax Incentive except to dismiss this factor as a legitimate reason for supporting industry R&D.

Additionality is used as a key measure of effectiveness in the FFF Review. The additionality figures are based upon those from the CIE report, which are derived from qualitative survey data. The additionality figures calculated by the CIE are 0.3 to 1.5 dollar increase in R&D expenditure per dollar of incentive provided.

The additionality based upon quantitative analysis from Swinburne University of Technology (Swinburne) was 0.8 – 1.9 dollar increase in R&D expenditure per dollar of incentive provided. Swinburne’s analysis “*uses new data from the ABS Expanded Analytical Business Longitudinal Database (EABLD). The data is considerably more comprehensive than has been used in previous analysis on the same question. The EABLD allows us to analyse almost the entire population of R&D-active firms for the years 2005 to 2012.*” Swinburne state that “*the dataset comprises information from company Business Income Tax returns and Business Activity Statements provided to the Australian Taxation Office, as well as information collected by the ABS from their Business Expenditure on Research and Development survey.*” In addition, the Swinburne report states “*...the limitations of basing conclusions on subjective survey results are well-known.*” Unfortunately this is exactly what the CIE report does, calculating rates of additionality and benefit:cost ratios from the survey results and drawing conclusions.

Although the CIE noted Swinburne’s significant higher additionality results, it relied upon its survey based data with lower additionality results in determining the average rate of additionality of all firms at 0.82. This average additionality rate of 0.82 based upon using a rate of 0.5 for large firms and 1 for SMEs, was used by the CIE in all benefit modelling scenarios instead of the quantitative based Swinburne data. This is very significant because the CIE alternative scenarios found “*that the annualised present value of spillover benefits from the R&D TI range from \$0.63 billion to \$4.53 billion.*” These benefit estimates are based upon the lower figures from the qualitative survey data and present the current performance of the R&D Tax Incentive in the worst possible light. **The very wide range of potential benefits makes the outcome almost redundant, as the result ranges from very poor to better than would be achieved with other tax cuts.**

The CIE benefit:cost analysis states “*based on the central estimate of the additionality rate (0.82) and the range of benefit profiles estimated, the annualised present value of net benefits (benefits minus costs) of the programme could vary from –\$0.4 billion to +\$3.5 billion, and the benefit–cost ratio from 0.6 to 4.4. The benefit–cost ratio for small firms is greater (0.7 to 5.2). The results are highly sensitive to the additionality rate and spillover effects assumed.*” **The benefit:cost analysis is also based upon the lower additionality results from the qualitative based data, which poorly represents the performance of the R&D Tax Incentive.**

The CIE also states that “*there is significant value in increasing the average additionality rate under the programme (\$77 million to \$566 million for every 0.1 increase in the additionality rate).*” **Given the materiality of the additionality rate, using the Swinburne determined additionality rates would have a substantial impact upon the benefits generated and benefit:cost ratios. The performance of the R&D Tax Incentive would be significantly improved by using the Swinburne additionality rates.**

In evaluating spillovers the CIE has used the estimates of the Productivity Commission in 2007. However, the R&D Tax Incentive was only legislated in 2011. **Therefore, the spillover estimates relate to the prior program the R&D Tax Concession. It is not appropriate to use spillover estimates relating to the prior program.** The Australian Industry Report (AIR) 2015 produced by the Office of the Chief Economist noted that *“the data provides evidence of significant knowledge spill over benefits for Australian firms engaged in R&D activity.”* Also that *“R&D is not persistent enough to be sustained over the long term without strong turnover or external stimulants such as spillovers and tax incentives, and it would rapidly fall to zero if not supported by other means such as strong sales or Government assistance.”*

The CIE report does not appear to consider the spillover data and conclusions available in the AIR 2015 report that is based on R&D Tax Concession data from 2001 – 2011. This is obviously a more current dataset than was available to the Productivity Commission in 2007. It is uncertain why this is the case.

Yale Economist William Nordhaus estimated that as much as 98% of the benefit from R&D is captured by consumers, suppliers, and competitors. The CIE details in its report that *“the reviewed literature found spillover rates of return for market-oriented R&D from 0% up to 150%, with an average of 100%.”* However, in quantifying the benefits and benefit:cost ratio for the R&D Tax Incentive, the Productivity Commission report from 2007 is used that according to the CIE *“has a spillover rate of return of around 65%.”* **Again it appears that the R&D Tax Incentive is being presented in a poor light by not collecting spillover data directly related to the R&D Tax Incentive, or at least by using an average spillover rate of return from the literature.**

The CIE report states that *“the required benefit–cost ratio to be equivalent to tax cuts would be in the range of 3:1 to 5:1, which is achievable, but probably difficult for the R&D TI.”* Whilst it may be difficult to determine ranges of additionality and spillovers, using the additionality rates based upon quantitative analysis and estimates of spillovers that actually relate to the R&D Tax Incentive rather than the prior program would assist in fairly presenting the performance of the R&D Tax Incentive.

It is uncertain whether the R&D Tax Incentive would outperform tax cuts in the majority of scenarios if higher levels of additionality and spillovers were used. Certainly given that tax cuts are much blunter instruments than tax incentives that specifically target R&D and lower the cost of undertaking this activity, it is possible that with increased additionality and spillover inputs R&D tax incentives would outperform general tax cuts. It should also be questioned why the R&D tax incentive needs to outperform general tax cuts given that it has a very different policy objective.

The FFF review comments that some stakeholders believe the *“45 percent refundable offset is overly generous for companies in tax loss, compared with the effective 10 percent non-refundable rate for larger companies and 15 percent refundable rate for profitable smaller companies.”* However, whilst this may be the view of certain stakeholders, there is no analysis by the CIE or Swinburne regarding the additionality and or spillovers created by large versus SME claimants in different tax positions. The authors of the Swinburne report subsequently stated in an article titled *“R&D Tax Incentives Need to be Simple and Underpin Investor Confidence,”* that *“capping the refundable element will save the government money, but the economic justification in terms of improving the efficiency or performance of the scheme is not strong.”* **In other words, there is little economic rationale for capping the Refundable R&D Tax Offset, and as detailed above, the actual cost of the Refundable R&D Tax Offset is much less than its current budget cost.**

It is not possible for the FFF Review to determine that the *“programme falls short of meeting its stated objectives of additionality and spillovers,”* given the basis of the calculation of additionality and spillovers, lack of understanding of tax and nature of the R&D Tax Incentive, and that the wording of the object does not specifically require additionality and spillovers.



**RSM Recommendation 6: Re-calculate benefits and benefit:cost ratios based upon increased additionality rates and spillover rates of return, taking RSM recommendation 5 into account.**

*Excessive Focus on “Additionality” and “Spillovers” with Little Consideration of International Competitiveness*

While it is acknowledged that creating or maintaining the international competitiveness of undertaking R&D in Australia is not part of the object of the act, it is a significant benefit that the R&D Tax Incentive provides and should have been seriously considered as part of the FFF Review. RSM reiterates its contention from its submission to the Re:Think Tax Discussion Paper process that maintaining international competitiveness for R&D activity should be part of the object of the R&D Tax Incentive.

The role of the R&D Tax Incentive in international competitiveness was only superficially examined by the FFF Review, which is of significant importance as a company of any size can easily relocate R&D activity. The review has ignored the increasing mobility of global R&D and that Australia’s base of “business as usual” R&D could easily cease, reduce or move offshore. The FFF Review lacks real world understanding that Australia is competing internationally to host R&D activity and jobs.

The Secretary of the Treasury detailed in Senate Estimates on 19 October 2016 regarding corporate tax rate cuts that *“I think what drives me on tax is that, first and foremost, it is a competitive world. It is a competitive world for not only capital but also for individuals and, if we ignore tax competition, then we ignore it at our peril.”* Also that *“the corporate tax rates, as the minister has indicated, should and will encourage greater investment. They will encourage greater investment both by domestic and by foreign companies. We should bear in mind that we have a number of countries, major competitors for us, with higher corporate tax rates, many of whom are moving to even lower corporate tax rates. The United Kingdom have already signalled they will take their corporate tax rate down to 15 per cent. They have announced 20 per cent. We have had the United States Congress—I know they are in a bit of flux at the moment—talking about reducing their corporate tax rate. As for the modelling, it has limits on it. I think unequivocally that lowering the corporate tax rate will bring benefits.”*

**Comments by the CIE that creating jobs and attracting industries to Australia are not theoretically valid reasons for Government intervention is absurd at a time when the Government is considering large scale corporate tax cuts, from 30% down to 25%, which are primarily aimed at increasing Australia’s competitiveness.**

Regarding benefit:cost modelling the CIE report states *“the analysis conducted for this review was consistent with the recommendations in the Handbook of cost–benefit analysis (Department of Finance and Administration 2006) and the Cost–benefit analysis guidance note from the Office of Best Practice Regulation (OBPR 2014). The handbook and other best practice guides to cost–benefit analysis recommend that analysts assume that labour is fully employed and therefore any jobs created by a project or policy will be filled by people currently employed in other positions. Under this assumption, there would be no net increase in employment due to the R&D TI. Individuals would be enticed to new jobs through higher wages (a benefit to workers but a cost to firms).”* **Given the unemployment rate in Australia is significantly over 5% it seems an absurd proposition that benefit:cost modelling of the R&D Tax Incentive is undertaken with the presumption of full employment, with the consideration that there would be no net increase in employment due to the R&D Tax Incentive. Modelling the benefits in this manner ignores the real economic benefit produced through job creation in an economy where unemployment does exist.**

The CIE quote the Productivity Commission “..that increasing the competitiveness of industry, creating jobs or transforming industry are weak rationales for government R&D programmes. The achievement of those aims is primarily governed by market forces, and there is no role for government intervention.”

While it is true that job creation and industry international competitiveness is governed by market forces, the tax policy environment in a country impacts those market forces and decision making. It is for this reason that the Government is currently pursuing an objective of lowering the corporate tax rate.

The CIEs specifically find regarding international competitiveness that “by lowering costs to firms, the R&D TI increases the competitiveness of firms relative to a situation without the R&D TI. However, other measures (such as reducing the corporate tax rate) could be more effective at increasing international competitiveness.” The policy of lowering the corporate tax rate and R&D Tax Incentives do not achieve the same outcomes, and neither do they perform a similar function in terms of international competitiveness. **While international competitiveness may be improved in a general sense by lowering the corporate tax rate, it will do little to maintain and attract R&D activity to Australia, which can only be done in a substantial and meaningful manner through the R&D Tax Incentive.**

It should be understood that large multinational companies such as Roche have stated publically that the R&D Tax Incentive is more important to it than a 5% reduction in the corporate tax rate, which underlines the importance of the R&D Tax Incentive in Australia’s international competitiveness.

The analysis by the FFF Review of the R&D Tax Incentive in terms of international competitiveness has been superficial and relied upon historical comments such as those from the Productivity Commission. The analysis lacks real world understanding of business and that the R&D Tax Incentive plays a significant role in maintaining existing “business as usual” R&D in Australia and attracting international R&D to Australia. The modelling assumptions used such as full employment in dismissing the job creation and related economic benefits of the R&D Tax Incentive, as an economic rationale for the program are also not based in reality.

**RSM Recommendation 7: The Panel undertakes further work and properly considers international competitiveness as an economic rationale for the R&D Tax Incentive. This would include an analysis of competitor country R&D Tax Incentives to at least maintain Australia’s competitive position.**

### **Calculation of Budget Cost Over-Statement**

#### *Using Current Revenue Forgone Method*

RSM has previously provided details of the budget cost over-statement in numerous submissions, as described above. The submission made in relation to the Omnibus Bill is included as an attachment, which includes the prior RSM submissions. The following is a re-calculation of the quantum of budget cost over-statement, based upon additional data provided in the FFF Review.

The additional data is that 60% of companies claiming the Refundable R&D Tax Offset are in a tax loss position. The budget cost-overstatement estimates are now entirely based upon Government data, including:

- 2016-17 Science Research Innovation Budget Tables (2016-17 SRI Budget Tables);
- ATO Annual Report detailing actual expenditure incurred for the Refundable and Non-Refundable R&D Tax Offsets;
- FFF Review detailed the percentage of companies claiming the Refundable R&D Tax Offset that are in a tax loss position; and
- Failure rate of young firms from the Australian Small Business, Key Statistics and Analysis, December 2012” (Small Business Statistics Report).

Detailed information has been provided by RSM previously to the FFF Panel regarding the gross budget cost over-statement, however, the below estimates are updated based upon Government data that 60% of companies claiming the Refundable R&D Tax Offset are in a tax loss position. Budget figures based upon the 2016-17 SRI Budget Tables, and actual R&D expenditure from the corresponding ATO Annual Report are provided below.

Program	SRI Budget Cost (2013-14) (\$millions)	R&D Expenditure Claimed by companies (2013-14) (\$millions)
Refundable R&D Tax Offset	\$1,866	\$5,200
Non-Refundable R&D Tax Offset	\$1,000	\$14,200

The Non-Refundable R&D Tax Offset in the SRI Budget Tables is transferred directly from the Treasury, Tax Expenditure Statement (TES). Currently the TES cost of the R&D Tax Incentive is calculated using the revenue forgone method. This is the standard method used in the Tax Expenditure Statement (TES).

In contrast, the Refundable R&D Tax Offset in the SRI Budget Tables is not taken directly from the TES. The 2016-17 SRI Budget Tables (excel workbook) provides information regarding how the Refundable R&D Tax Offset is calculated.

The notes column of the 2016-17 SRI Budget Tables excel worksheet mastertable (cell V260) states *“the calculation of the R&D Tax Offset and the refundable component of the R&D Tax Incentive given in the table is the sum of the ATO’s administered payments for the Offset and the calculation of the tax expenditure in the 2011 Tax Expenditure Statement produced by the Treasury. This calculation is only a proxy for the benefit provided to taxpayers by this measure rather than an exact representation. An exact calculation cannot be constructed as taxpayers future tax positions cannot be calculated at this point. The future tax positions is integral to calculating the value of deductions forgone by receiving the Offset.”*

According to the TES 2011, the tax expenditure of the Refundable R&D Tax Offset is calculated by the following method *“as the R&D refundable tax offset is an expense item, it does not appear as a tax expenditure in its own right. However, a tax expenditure arises because payments made under the R&D refundable tax offset are exempt from tax. In addition, companies that claim the R&D refundable tax offset are unable to claim deductions for the R&D expenditures concerned. The absence of these deductions constitutes a negative tax expenditure and explains why the estimates are negative.”*

The above combined method statement for calculating the cost of the Refundable R&D Tax Offset, can be summarised as follows:

- Step 1 - Actual expenditure incurred under the Refundable R&D Tax Offset x 45% (representing the full gross cost of the Refundable R&D Tax Offset); plus
- Step 2 - Negative cost calculated as actual expenditure incurred x 30% (representing the inability for R&D Tax claimant companies to also claim normal business tax deduction); plus
- Step 3 - Cash payments from Government x factor (likely 30%). This represents a cost the Government believes it incurs because payments made under the R&D Tax Incentive are exempt from tax. It should be noted that all “returns of tax” to companies are exempt from tax.

**The highlighted line – Step 3 above is the part of the Government’s calculation method that is resulting in the budget gross over-statement of the Refundable R&D Tax Offset. It is double counting the cost because payments from Government have already been included in the calculation of the full gross cost of the Refundable R&D Tax Offset in Step 1. This is preventing the real cost of the Refundable R&D Tax Offset being understood and is impacting Government policy to the extent that the FFF Review believes the Refundable R&D Tax Offset is not fiscally sustainable. This has resulted in the FFF Review producing its recommendation 3.**

Without Step 3 of the above calculation method, the Government would be modelling the cost of the Refundable Tax Offset based upon the net benefit of 15%, which would be similar to the method for the Non-Refundable R&D Tax Offset. Step 3 of the calculation method should be removed so that proper policy analysis of the Refundable R&D Tax Offset can be undertaken by the FFF Review.

**The overall result is that the budget cost calculation is predominantly based upon 45% of the total R&D expenditure claimed under the Refundable R&D Tax Offset, rather than the 15% net benefit.**

By removing Step 3 above, modelling the Refundable R&D Tax Offset based upon the 15% net benefit, and growing the actual R&D expenditure claimed under the Refundable R&D Tax Offset at 15% annually, the extent of budget cost over-statement over forward estimates is shown in the table below. It should be noted that the cost of the Non-Refundable R&D Tax Offset is accepted from the 2016-17 SRI Budget Tables and 2015 TES.

Program	Year			
	2015-16	2016-17	2017-18	2018-19
	<b>Cost (\$ millions)</b>			
Total Budget Cost R&D Tax Incentive (budget)	3,190	3,151	3,500	3,500
Calculated Total Cost R&D Tax Incentive (RSM est.)	1,882	2,046	2,214	2,419
<b>Difference</b>	<b>1,309</b>	<b>1,105</b>	<b>1,286</b>	<b>1,081</b>
<b>Total Program Cost Over Statement</b>	<b>4,780</b>			

**Using the Government’s own modelling method for the Refundable R&D Tax Offset, corrected by removing the double counting of R&D expenditure relating to cash payments, produces a \$4.8 billion budget cost over-statement. Simply making this correction results in the fiscal sustainability of the R&D Tax Incentive.**

Comments in the 2016-17 SRI Budget Tables excel worksheet that the budget cost calculation for the Refundable R&D Tax Offset is “*only a proxy for the benefit provided to taxpayers by this measure rather than an exact representation*” is highly concerning and demonstrates the lack of accuracy in the budget cost calculation. Actual data including aggregate data is available from the ATO to enable Government to make accurate budget cost calculations.

RSM propose below a more reasonable and representative budget cost calculation for the Refundable R&D Tax Offset that uses a more effective proxy for future tax positions, is similar to the SRI budget calculation for the Non-Refundable R&D Tax Offset, but takes account of the fact that there is a minority of companies receiving a 45% cash rebate that will fail.

RSM has used the actual R&D expenditure from the ATO claimed by companies, as detailed in the ATO Annual Reports (see below) to calculate the current SRI budgeted effective cost per dollar of actual R&D expenditure.

Program	R&D Expenditure Claimed by companies (2013-14) (\$millions)
Refundable R&D Tax Offset	\$5,200
Non-Refundable R&D Tax Offset	\$14,200

In summary, the cost of the Non-Refundable R&D Tax Offset is a factor related to the R&D expenditure claimed:

$$\text{Cost (in millions)} = \$14,200 \text{ million} \times \text{Factor} = \$1,000 \text{ million}$$

$$\text{Factor} = 7\%$$

Therefore, the cost is 7.0 cents for each dollar of R&D expenditure a company claims under the Non-Refundable R&D Tax Offset. This would appear reasonable as the net tax benefit a company receives under this program is 10% (which is the difference between the Non-Refundable R&D Offset rate of 40% and the general corporate tax rate of 30%), and budget modelling of the cost may take into account other issues that reduce the cost, such as some companies in tax losses not becoming tax payable and never causing a cost to Government related to the R&D claim. Also, carried forward tax offsets can also be lost due to companies failing continuity of ownership/same business tests.

Using the above methodology, the budget cost of the Refundable R&D Tax Offset is:

$$\text{Cost (in millions)} = \$5,200 \times \text{Factor} = \$1,866 \text{ million}$$

$$\text{Factor} = 35.9\%$$

**This means that for each \$1 dollar of expenditure claimed under the Refundable R&D Tax Offset the budget cost is being calculated by Government at 35.9 cents. This demonstrates that the cost of the Refundable R&D Tax Offset is predominantly based upon the gross 45% rate, rather than the net tax benefit of 15% rate (45% offset – 30% corporate tax rate). This is substantially different to the calculation of the Non-Refundable R&D Tax Offset. This budget cost modelling is inappropriately aggressive and without further clarification is unsupportable as a basis for reductions to the Refundable R&D Tax Offset. Following is an RSM estimate of the actual and more reasonable budget estimate.**

It is our experience that only a small minority of companies will receive the full gross cash rebate of 45% of their R&D expenditure and never become profitable, RSM proposes that the budget cost of these companies should be modelled separately to all other situations.

Although the current budget cost calculations grossly over-state the cost of the Refundable R&D Tax Offset, a specific set of circumstances where it could be argued that it is reasonable to model the budget cost at the full gross 45% rate. As described above, this will occur where a company has received the 45% R&D Tax cash rebate but will never become profitable. This requires that a company is in a tax loss position (receiving a full 45% cash rebate) AND will never make a profit (will fail). **In all other situations, 30% (or 28.5% for small companies with a turnover under \$2 million) of**

**the R&D expenditure, claimed for the 45% Refundable R&D Tax Offset, is a timing benefit recouped by Government when a company becomes profitable (which is immediately for profitable companies).**

**Based upon the Small Business Statistics Report data the percentage of companies that claiming the Refundable R&D Tax Offset that are both in a tax loss and will fail is very small. Therefore, the vast majority of R&D expenditure claimed under the Refundable R&D Tax Offset should be budget cost modelled based upon the net benefit rate of 15%, rather than the gross cost of 45%.**

The cost to the budget of all other companies should be modelled at the net benefit rate of 15%. RSM proposes that the following formula would much better represent the real cost of the Refundable R&D Tax Offset using the revenue forgone method:

Refundable R&D Tax Offset Cost = (Total Claimed R&D Expenditure x 45% x Y percentage of companies that are in tax losses and will never make a profit) + (Total Claimed R&D Expenditure x 15% x (1-Y) percentage of companies that are tax profitable and tax loss companies that will become profitable)

$$\text{Refundable R\&D Tax Offset Cost} = \$5,200 \times 45\% \times Y + \$5,200 \times 15\% \times (1-Y)$$

Based upon Government data and RSM analysis both detailed below, has estimated that (Y) is only 8.4% of R&D expenditure claimed under the Refundable R&D Tax Incentive should be modelled at the full 45% rate, which represents companies receiving a 45% cash rebate that will never become profitable.

The Small Business Statistics Report from the Department of Industry, Innovation, Science, Research and Tertiary Education, states *“it is frequently claimed that a very large share of all start-ups fail within the first few years. These claims are usually exaggerated.”* This report determined a rate of 14% of young firms that terminate. Also that *“around 76 per cent of young firms reported no financial loss upon termination.”*

For the purposes of our budget cost estimation for the Refundable R&D Tax Offset we will set the following assumptions:

- Percentage of companies in tax losses = 60% (from FFF Review Report);
- Percentage of companies that will fail (not become tax profitable) = 14% (from the Small Business Statistics Report; and
- Therefore, the percentage of companies that access the full 45% rebate that will never become tax profitable = 60% x 14% = 8.4%.

Thus, Refundable R&D Tax Offset Actual Cost =  $\$5,200 \times 45\% \times 8.4\% + \$5,200 \times 15\% \times 91.6\% = \$911.04$  million.

*Note: this does not take into account that companies making tax losses tend to spend less than an average company and franking account impacts on reducing the cost to Government.*

Below we have compared the cost of the R&D Tax Incentive in 2013-14, using our Refundable Tax Offset cost estimate, against the 2010-11 R&D Tax Concession cost, it shows that the cost of the program has only grown 15.5%.

Program	Year	
	2010-11	2013-14
	Cost (\$millions)	
R&D Tax Concession <sup>1</sup>	1,655	
Refundable R&D Tax Offset – 45% (as per our estimate)		911
Non-Refundable R&D Tax Offset – 40% (as per budget)		1,000
<b>Total Program Cost</b>	<b>1,655</b>	<b>1,911</b>

There are a number of reasons for the low level of cost increase between the R&D Tax Concession in its final full year in 2010-11 and the R&D Tax Incentive in 2013-14. Some factors increase the cost such as the increase in base rates under the R&D Tax Incentive while others decrease it. The reasons are:

- The R&D Tax Incentive has a higher base rate (133%/150% equivalent deduction vs 125% under the R&D Tax Concession);
- The 175% Australian and Foreign Owned R&D deduction has been abolished, which is a significant cost saving under the R&D Tax Incentive;
- The previous R&D Tax Offset under the R&D Tax Concession has been abolished; and
- The quantum of total R&D expenditure is similar under the R&D Tax Concession and R&D Tax Incentive.

Given the above factors it should therefore not be surprising that the cost of the R&D Tax Incentive for 2013-14 (the most recent year that actual R&D expenditure claimed information is available), does not significantly exceed the cost of the R&D Tax Concession in 2010-11.

**There has been no real “cost blowout” in moving from the R&D Tax Concession to the R&D Tax Incentive, and in applying the same assumptions to budget forward estimates there will be no “cost blowout” in the future. There is no budget cost driver for significant change to this program and correctly modelling it would result in very significant budget repair for the Government.**

The following table estimates the size of the impact of the cost over-statement of the Refundable R&D Tax Incentive upon the Federal budget over forward estimates using RSM’s budget cost method:

Program	Year			
	2015-16	2016-17	2017-18	2018-19
	Cost (\$ millions)			
Total Budget Cost R&D Tax Incentive (budget)	3,190	3,151	3,500	3,500
Calculated Total Cost R&D Tax Incentive (RSM est.)	2,055	2,246	2,443	2,682
<b>Difference</b>	<b>1,135</b>	<b>905</b>	<b>1,057</b>	<b>818</b>
<b>Total Program Cost Over Statement</b>	<b>3,915</b>			

The table above shows a \$3.9 billion over-statement of the budget cost over forward estimates for the R&D Tax Incentive. The budget cost is based upon the 2016-17 SRI Budget Tables for 2015-16 – 2016-17, with the total program cost of \$3.5 billion from the Issues Paper of the Panel for 2017-18, which has been maintained for 2018-19. This likely significantly understates this budget cost over-

<sup>1</sup> Based upon most recent updated 2016/17 Budget Data. A downwards adjustment was made to the cost of the prior programs R&D tax offset, for consistency with the R&D Tax Incentive due to the R&D Tax Offset of the R&D Tax Concession also being over-stated.

statement as the budget cost of the Refundable R&D Tax Offset is being increased substantially each year by Government due to the modelling issues outlined above. The above also highlights the lack of transparency and availability of budget cost data, particularly for the Refundable R&D Tax Offset.

The RSM cost assumptions for the forward estimates in the table above remain the same for the Refundable and Non-Refundable R&D Tax Offsets as for 2013-14, however, the actual amount of R&D expenditure claimed under the Refundable R&D Tax Offset is grown at 15% annually. If this growth rate is not achieved the size of the budget cost over-statement will be larger.

The revenue forgone method has been the basis of the budget calculation for the Refundable R&D Tax Offset since 2001 (including under the old R&D Tax Concession program). Arguments could be made that for comparability purposes the budget cost modelling method should not be altered. However the real cost of the Refundable R&D Tax Offset is being increasingly misrepresented and over-stated because:

- Under the R&D Tax Concession the Refundable R&D Tax Offset was a small part of the total program, representing only 15.8% of the total R&D tax program cost in 2010-11, the last full year of the R&D Tax Concession. This is because claimant companies under the Refundable R&D Tax Offset for the R&D Tax Concession were limited to claiming a maximum of \$2 million of R&D expenditure. Therefore, the scale of the budget cost over-statement was small due to the program size and expenditure being claimed also being small; and
- Due to the increased value of claiming (45% tax offset) and uncapped nature of the Refundable R&D Tax Offset as part of the R&D Tax Incentive, there has been an increase each income year in the amount of R&D expenditure claimed under this program. Based upon ATO annual reports the actual expenditure claimed increased from 2011-12 to 2012-13 (33% growth), and 2012-13 to 2013-14 (17% growth). Although much smaller than the Non-Refundable R&D Tax Offset in terms of R&D expenditure claimed (for 2013-14 it was \$5, 200 million versus \$14,200 million) each additional dollar of R&D expenditure claimed under the Refundable R&D Tax Offset is being modelled as costing the budget 35.9 cents versus 7.0 cents per dollar for the Non-Refundable R&D Tax Offset. This is the true cause of the budget “cost blowout.”

It would therefore be incorrect and highly inappropriate to not correct the modelling errors for compatibility purposes.

**RSM Recommendation 8: Government review and amend the budget calculation method for the Refundable R&D Tax Offset, particularly the double counting of the cost resulting from considering tax exempt payments from Government creating a cost.**

#### *Budget Cost Impact of the Dividend Imputation System upon the R&D Tax Incentive*

As discussed by RSM in its prior submission to the Panel, due to the interaction of the R&D Tax Incentive and dividend imputation a super efficiency is created. The impact of franking credits is a competitive advantage that the Australian Government has over almost all other OECD countries, as it is able to utilise its tax system to incentivise R&D, while recouping at least some of the “additional, or net” cost.

It should also be noted that Australia is one of a few OECD countries to have both an R&D tax scheme and a classic dividend imputation scheme. This further reduces the cost of both the Refundable and Non-Refundable R&D Tax Incentives below the net 15% and 10% rates, as at least some of the net benefit is returned by shareholders, due to franking credit impacts. This impact renders some of the “additional” benefit a temporary timing, rather than permanent difference. As an example CSL Limited (CSL) claimed a significant R&D benefit in 2014-15, however, it issued an



unfranked dividend. A significant amount of the “net” benefit provided through the R&D Tax Incentive to CSL would be recouped by the Government from shareholders.

The 2015 TES in section B.6 “Notes on the methodology used to estimate certain tax expenditures – Treatment of Imputation” states that *“the value of some concessions reported in this statement is partially offset as a result of the imputation system. For example, concessions that reduce company tax may be clawed back through the subsequent taxation of dividends in the hands of shareholders. The estimates in this statement generally make no allowance for this clawback owing to the practical difficulties of doing so.”*

Given that currently the budget cost is based upon figures from the TES for the Non-Refundable R&D Tax Offset, and in the case of the Refundable R&D Tax Offset predominantly 45% of the actual R&D expenditure claimed under that program, it is highly likely that there is no cost reduction made in the budget cost due to the reduced level of franking credits available for distribution to shareholders.

This has significant budget cost impacts for both the Refundable and Non-Refundable R&D Tax Offsets, impacting the fiscal sustainability of both programs.

**RSM Recommendation 9: Government review and amend the budget cost calculation method for the Refundable and Non-Refundable R&D Tax Offsets to take franking credit impacts into account, reducing the net cost for both programs.**

#### **Further Budget Cost Reduction from Moving to the Revenue Gain Method**

Although not a legislative requirement, the R&D Tax Incentive is designed to elicit behavioural responses from companies in terms of encouraging the undertaking of “additional” R&D activity and creating spillovers. As discussed above from the FFF Review and in previous submissions it has been highly successful in achieving this objective.

A critical issue for the R&D Tax Incentive is that the financial impacts of the behavioural response of the R&D Tax Incentive, including companies undertaking additional R&D and spillovers being created is not being included in the budget cost, or TES cost modelling undertaken.

As discussed, the current budget/TES cost method used is revenue forgone, which does not model any behavioural responses resulting from the program. As detailed above not only are the behaviour responses not modelled but the costs using the revenue forgone method are also over-stated. This presents a highly negative and unfair picture of the R&D Tax Incentive, as the economic benefits created by the R&D Tax Incentive are very substantial.

Additional R&D and spillovers results in the creation of additional gross domestic product (GDP) in the Australian economy. This includes the creation of new jobs, products, services and productivity improvements. From the additional GDP created significant additional Government tax revenues are generated, which are not included in the budget cost, or TES.

According to the 2015 TES the revenue gain method *“involves estimating the impact of abolishing a tax expenditure taking account of the potential changes in taxpayer behaviour, unlike revenue forgone estimates.”* Also, *“significant differences can arise between revenue forgone and revenue gain estimates, particularly because the latter attempts to take account of behavioural change by taxpayers.”* Therefore, a revenue gain calculation for the R&D Tax incentive would also include negative behavioural responses, such as the financial impacts of degrading the R&D Tax Incentive.

Examples would include R&D activity ceasing, reducing, moving offshore and the associated loss of Government tax revenue from this behaviour.

The TES undertakes revenue gain calculations for “10 large tax expenditures,” which does not include the R&D Tax Incentive. The Non-Refundable R&D Tax Offset is included in the list of large tax expenditures, but revenue gain modelling is not undertaken for this program.

Recommendation 12 of the recent House of Representatives - Standing Committee on Tax and Revenue – “The Tax Expenditures Statement” is “that Treasury gradually expand the number of revenue gain estimates that it calculates for the Tax Expenditures Statement, with a focus on larger tax expenditures and those relevant to public debate. Stakeholder consultation may assist in this process.” It should be noted from the 2016-17 SRI budget tables that the combined total cost of the R&D Tax Incentive would make it the 7<sup>th</sup> largest tax expenditure, if the cost of the Refundable and Non-Refundable R&D Tax Incentives were combined. It is also certainly a tax expenditure involving substantial public debate. **Therefore, revenue gain calculations should be undertaken for both the Refundable and Non-Refundable R&D Tax Offsets in the TES, which would present the real net cost (or revenue) of the R&D Tax Incentive.**

It is noted in Report 414 of the Joint Committee of Public Accounts and Audit – “Review of Auditor-General’s Reports tabled between August 2007 and August 2008” that “the Committee noted one of the key findings of the audit was the differing methods of economic modelling used in preparing the Budget Papers and the TES. The Budget Papers are prepared using the revenue gain method, while the TES is prepared using the revenue foregone method.” **This is a key point because the cost of the R&D Tax Incentive should be calculated for the budget using the revenue gain method, which would include all the behavioural responses significantly reducing the budget cost.**

RSM is not able to project the cost saving impact of including all the behavioural responses in budget cost modelling. However, it is noted that Report No. 44 1995 “Industry Commission – Research and Development” showed that the loss in GDP by removing the then R&D Tax Concession was greater than the cost of the program. “This contraction (GDP) is slightly more than the initial \$290 million reduction in tax expenditures (in 1990–91 dollars) on the R&D Tax Concession.” **The detailed modelling implies that the tax revenue gained by the Government (saving) from removing the then 150% R&D Tax Concession was entirely offset by tax revenue losses resulting from GDP reductions. This is a key point because the FFF Review is recommending a number of negative changes, however, no modelling has been done to support the recommendations.**

The table supporting the lack of change in Government spending is shown below:

**Table QC3: Projected macroeconomic effects of eliminating the tax concession (percentage deviations from control)**

Real GDP	-0.08	Real GNP	-0.07
Real household consumption	-0.03		
Real investment	-0.12	Capital stock	-0.10
Real government spending	0.00	Real pre-tax wage	-0.14
Export volume	-0.31	Real post-tax wage	-0.02
Import volume	-0.05	GDP deflator	-0.01

## **Response to FFF Review Recommendations:**

Our above discussion provides a significant level of information that is taken into consideration when we assess the FFF Review Recommendations. The following are our comments regarding the FFF Review Recommendations and additional comments to those raised above.

### **FFF Review 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.*

### **RSM Position on FFF Recommendation 1: Agree.**

Specific comments as below:

- Changes will make it more difficult for businesses to understand the eligibility criteria again. Stability in the eligibility definition is of key importance;
- There is no quantitative evidence to support a change to the legislation. Any change would increase uncertainty for claimants, which in turn will lead to claimants requiring consultant assistance, resulting in Government raising “integrity issues” of consultant fees again in future reviews;
- Additional guidance should be produced. A “Guide to the R&D Tax Incentive” should be developed similar to the joint ATO and AusIndustry guidance produced for the R&D Tax Concession. A single high quality guide that is jointly produced would improve the consistency of interpretations of regulators and R&D Tax Consultants. Over time this would lead to improved consistency;
- Suggest that AusIndustry continues with the recent style of examples and information that it has provided, such as the “Bread Project” example;
- Guidance developed should be done in consultation with industry and R&D Tax Consultants. The guidance produced should reflect actual case law rather than internal Government opinions; and
- Government should understand that aggressive, unpredictable and inconsistent positions taken by Government increases the uncertainty of the scheme for claimants. The lack of consistency and predictability of Government creates a lack of trust by claimants and is a significant driver of the use of R&D Tax consultants. Improving internal review processes within Government to increase consistency and predictability of outcomes for companies will reduce uncertainty and compliance cost.

### **RSM Recommendation 10:**

- Provide AusIndustry with more resources to increase their compliance activities relating to the current legislative definition, as follows:
  - Current AusIndustry compliance provides very positive results in both identifying inappropriate behaviour as well as educating companies on eligibility;
  - Any concerns with integrity of the program will be addressed with an increase in compliance reviews; and
  - This would also provide more support for companies that do not want to use R&D Tax advisors.

## FFF Review Recommendation 2:

*Introduce a collaboration premium of up to 20 percent 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*

## RSM Position on FFF Recommendation 2: Disagree

Specific comments as below:

- The current object of the R&D Tax Incentive relates to private sector research, not encouraging collaboration with Universities. Why should the R&D Tax Incentive be modified to address a problem that does not relate to private sector research, and was never the intent of the program?;
- The 20% collaboration Premium Non-Refundable R&D Tax Offset will be insignificant for most claimants and is unlikely to generate significant impacts;
- The extent of cultural issues within publicly funded research organisation in terms of capability for commercial research is highlighted by the \$11.2 billion of Federal grant funding received by Universities 2014 (Australian Government – Department of Education and Training – Financial Reports of Higher Education Providers) for the creation of 5 spin out companies (Australian Government – Department of Industry, Innovation and Science – National Survey of Research Commercialisation 2012-2014). That is \$2.2 billion per spin out company. This has declined from the 21 spin out companies in 2013 (Australian Government – Department of Industry, Innovation and Science – National Survey of Research Commercialisation 2012-2014)?;
- The conclusion of the AIR 2015 is correct when it states that *“Government agencies and institutes of higher education can play a potent role in stimulating private R&D by shifting more focus to basic types of research in line with the institutes of higher education and research centres. Then firms will be able to base their applied research on the outcomes of the research conducted by the Government, as well as that conducted by Universities, in generating their own line of innovations.”* **In other words the best contribution that Universities can make in collaboration is in undertaking their core competence of basic research;**
- Companies that fail to meet the 1-2% minimum intensity threshold will have no interest in going through a process to obtain a very small benefit on collaboration expenditure with Universities. These companies will have no process in place to claim R&D Tax benefits, therefore, the 20% collaboration premium will be entirely ineffective for the majority of Australian medium-large businesses that do not meet the 1-2% minimum intensity requirement;
- RSM agrees with the authors of the Swinburne report who subsequently stated in an article titled *“R&D Tax Incentives Need to be Simple and Underpin Investor Confidence,”* that *“More granular policy treatment, such as encouraging collaboration, is probably better handled by other incentive programs such as loan programs; industry R&D boards and collaboration bodies; research council grants; subsidies for industry groups and trade mission tours”*; and

- If a collaboration premium is to be provided it should be available as both a refundable and Non-Refundable offset depending on eligibility for the general scheme. There will be little interest from current pre-revenue claimants of the Refundable R&D Tax Offset to claim a 20% non-refundable tax offset. For these companies little additionality will be created from this premium offset.

**RSM Recommendation 11: Do not provide a premium collaboration R&D Tax Incentive. If the Government wishes to encourage greater collaboration, this should be done through modifications to existing public research grant programs.**

**FFF Review 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*

**RSM Position on FFF Recommendation 3: Disagree**

Specific comments as below:

- In accordance with RSM analysis above, there is no theoretical economic or budget cost rationale for making this change. The improper process of the FFF Review has led to this recommendation;
- RSM agrees with the authors of the Swinburne report who subsequently stated in an article titled "R&D Tax Incentives Need to be Simple and Underpin Investor Confidence," that *"capping the refundable element will save the Government money, but the economic justification in terms of improving the efficiency or performance of the scheme is not strong;"*
- Sectors such as biotechnology and information technology will be heavily detrimentally impacted, reducing their ability to spend on R&D in future years. Reductions in additionality, spillovers, jobs, GDP/tax revenues created will all be impacted;
- Companies that are impacted by this cap are very likely to have the capability to shift the R&D from Australia to a country more supportive. RSM regularly hears from companies that intend to shift operations if the R&D Tax Incentive is degraded or removed;
- The review states *"...the refundability of the tax offset for SMEs improves their cash-flow by bringing forward the tax benefit for those companies in a tax loss. This may partially explain why SMEs in tax loss were found to have the greatest additionality."* Given the very strong economic rationale for incentivising SMEs to undertake additional R&D activity, why is the Government proposing to cap the ability to obtain cash refunds;
- What quantitative data is available, or modelling has been undertaken to assess the number of companies impacted, the size of claims of these companies, likely reduction in claims, economy wide benefit:cost impacts?;
- This proposed cap effectively penalises companies that are conducting large scale innovation. There is no evidence to suggest that less additionality, or spillovers are created by expenditure over \$4.5 million per year; and
- This proposed cap could result in companies having to slow R&D expenditure down between financial years to spread their costs out to remain under the cap.

**RSM Recommendation 12: Do not place a cap on the cash rebate of the Refundable R&D Tax Offset, as if modelled correctly the program is currently fiscally sustainable.**

#### **FFF Review Recommendation 4:**

*Introduce an intensity threshold in the order of 1 to 2 percent 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*

#### **RSM Position on FFF Recommendation 4: Strongly Disagree**

Specific comments as below:

- This recommendation is a virtual elimination of the Non-Refundable R&D Tax Offset for the majority of companies and industries in Australia. This is supported by public comments by companies such as Dulux in the Australian Financial Review on 25 October 2016 that will no longer be able to access the Non-Refundable R&D Tax Offset. The Dulux group stated that the *“proposed changes to the R&D tax rules would wipe out its tax credit.”*;
- The net effect of this change is that for most medium-large companies the price, or cost of undertaking R&D in Australia will increase by 8.5% in 2016-17. This will have economy wide ramifications;
- The Non-Refundable R&D Tax Offset is being setup for failure as the benefit:cost of a company accessing it will become too low from the company’s perspective. Most claimants will make the judgement that the benefit is too minor above a 1-2% threshold if they qualify to be worthwhile and stop claiming. As industry becomes disinterested in the program, uptake will drop along with R&D undertaken in Australia and the program will fail;
- Government’s main assumption regarding the Non-Refundable R&D Tax Offset is incorrect that Australia has a large base of “business as usual” R&D undertaken by medium-large claimants that will not cease, reduce, or move R&D activity offshore;
- This recommendation will incentivise the majority of medium-large current claimants of the Non-Refundable R&D tax offset to cease, reduce, or move R&D activity offshore, as they are currently receiving benefits under the program;
- Government does not understand the truly global nature of business and learnt nothing from the Senate inquiry into multinational tax avoidance. Companies can easily move R&D activity offshore as they can move revenue to tax havens.;
- Surrounding Asian countries not only have attractive R&D tax regimes, but they also have lower wages and lower corporate tax rates. Degrading the Non-Refundable R&D Tax Offset is just another push factor, but unfortunately specifically relates to the STEM activity/jobs that Australia could have a future in, and that the Government should be fighting to keep here;
- The proposed additional complexity and unpredictability in qualifying for the Non-Refundable R&D Tax Offset will make it similar to the Australian 175% premium under the R&D Tax Concession, which was essentially treated like a “lottery win” by companies and did very little to drive additionality;
- Based upon responses in Senate Estimates there is no economic, or quantitative modelling basis for recommending a 1-2% minimum intensity threshold. It appears that a threshold was selected by the FFF Review purely based on a desired level of budget cost reduction, despite RSM’s repeated detailed analysis of the extent of flaws of the existing budget cost modelling of the R&D Tax Incentive;
- An intensity threshold ignores the fact that industries are structurally different and have different natural levels of R&D intensity. A blanket 1-2% minimum R&D intensity threshold excessively harms certain specific industries such as manufacturing, with even the most innovative large manufacturing companies struggling to achieve a 1-2% of total company

expenditure on R&D. Conversely industries such as biotechnology have a much higher natural level of R&D expenditure. There is no evidence to suggest that the additionality and spillovers created by Government supporting the R&D expenditure of manufacturers produces less economic return than that of biotechnology companies;

- The FFF Review has not considered that there is a very large difference between an Australian SME manufacturer with a turnover of \$20 million that may be making a tax loss and a global multinational with a turnover in excess of \$20 billion. The SME manufacturer is capital constrained, and will have to reduce its level of Australian R&D expenditure due to this recommendation;
- As an example, a SME manufacturer with \$19.9 million turnover may be in a tax loss claiming the Refundable Tax Offset one year, accessing a 45% cash rebate, the next year with a turnover of \$20.1 million, but still in a tax loss unable to access any R&D benefit. This is due to the manufacturer being unable to meet the new proposed R&D intensity requirements. FFF Review claims that this company can afford to do its own R&D are unfounded and based on no data;
- Companies that do not generally meet a 1-2% R&D intensity threshold will not have processes in place to claim, or consider the Non-Refundable R&D Tax Offset. A company would have to go through a process each year to determine whether it meets the R&D intensity threshold, which it would have no appetite to do, incurring internal cost for likely no benefit. Therefore, claims by the FFF Review that a company denied R&D Tax benefits it currently receives will be incentivised to increase its R&D expenditure to obtain a benefit are entirely incorrect. No company will substantially increase R&D expenditure, and go through a new process to access what will become a minor benefit;
- Technical issues will occur with the 1-2% minimum intensity threshold. Reference is made to tax return expenditure in the FFF Review, but will this be based upon individual companies, or tax consolidated groups? It is fair to include subsidiaries in the total expenditure of a tax consolidated group that undertake no R&D? How will the Government stop companies changing their spend profile to ensure that they obtain the R&D benefit one year, but not the next?; and
- Denying R&D Tax benefits to companies through a minimum intensity threshold will also impact innovation planning within companies. Currently the R&D Tax process drives a level of planning formality and substantiation within claimants that will not exist if they are denied R&D Tax benefits.

**RSM Recommendation 13: Do not implement a minimum intensity threshold for the Non-Refundable R&D Tax Offset, as this will result in failure of this part of the program.**

**FFF Review 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.*

**RSM Position on FFF Recommendation 5: Disagree**

Specific comments as below:

- While large R&D intensive companies should be rewarded for undertaking further R&D in Australia, there is very little evidence to support that only R&D intensive companies should be further rewarded. Given the review has focussed so heavily on additionality and spillovers, where is the quantitative evidence that more additionality and spillovers will be

created by further supporting R&D intensive companies as opposed to other large companies, particularly in an Australian context. There was no analysis of this in the FFF Review;

- This recommendation benefits a very small number of large R&D intensive multinational companies that are in industries that have a naturally high R&D intensity rate. The Government is essentially picking winners, but on a sector basis as very few sectors naturally achieve both the required R&D intensity, and a greater than \$100 million expenditure in Australia;
- Recommendations 3 and 4 regarding cuts that impact SMEs undertaking R&D in Australia are essentially funding this increase in the expenditure threshold; and
- Further to RSM's comments above, increasing the expenditure threshold in the manner proposed in this recommendation could be considered if international competitiveness was part of the object of the R&D Tax Incentive. This is because for large companies spending in excess of \$100 million, the country location of their R&D activity is primarily how decision making is impacted by the R&D Tax Incentive.

**RSM Recommendation 14: Do not increase the R&D expenditure threshold to \$200 million without an appropriate economic rationale supported with quantitative economic evidence.**

#### **FFF Review 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.*

#### **RSM Position on FFF Recommendation 6: Disagree**

Specific comments as below:

##### *Single Agency*

RSM opposes a single agency approach for the following reasons:

- R&D Tax Incentive compliance reviews and audits require two very different skill sets: tax eligibility knowledge related to R&D expenditure; and R&D eligibility related to technical issues. Bringing the review role into a single agency will still require both of these capabilities. It would be highly likely that the integrity of the program would be at risk if a single agency model was adopted as it would be difficult to maintain the current high standards in the existing two agencies covering the two distinct needs;
- The objective of the two agencies is different and RSM is concerned that the starting point for all review processes may not be whether R&D activity is eligible, but related to the quantum of expenditure claimed; and
- The independent view of AusIndustry in regards to R&D eligibility issues may be difficult to maintain if it were subsumed within the ATO.

Some additional resourcing is likely required by the ATO and AusIndustry to review claims. This is of greater importance in maintaining the integrity of the system as opposed to moving to a single agency.



### *Single Application Process:*

RSM strongly opposes a single application process for the following reasons:

- There are no issues with the existing 2 stage registration and tax return process. The FFF Review stated *“One of the recurring issues raised during the consultation process was that the registration process is relative easy to satisfy and not that rigorous.”* Stakeholder do not have a problem with the current process, as this is a Government created issue due to its inability to efficiently deploy resources;
- FFF Review comments that *“the panel recommends that programme administrators investigate the minimum level of information that would be required in a single application process to balance compliance burden and the need to protect the integrity of the programme, as well as gathering information to enable policy evaluation.”* This is problematic due to the following:
  - The prior R&D Tax Concession program had less information requirements than the current R&D Tax Incentive, and it was due to the regulator’s insistence regarding perceived integrity issues that the current requirements exist. As above, consultation shows that the registration process is relatively easy to satisfy and not that rigorous;
  - A reduced or minimum level of information will create an expectation of significantly reduced substantiation requirements by companies. A large expectation gap will be created between regulators and claimants due to the reduced lodgement requirements, creating a new and unexpected integrity issues for Government. Claimants will also be very surprised with the detailed review/audit requirements in comparison to the annual lodgement requirements, and many will fail to keep necessary substantiation;
  - The current two stage process for registration and claiming R&D expenditure provides an additional integrity/compliance mechanism that would not exist if the proposed recommendation is implemented; and
  - How would a single application process work? Would companies have 4 years to make an R&D claim similar to tax return amendments, or would companies be forced to lodge through an original tax return. RSM strongly oppose companies having to claim through an original return as many eligible claimants would unfairly miss out on R&D tax benefits, reducing the level of additionality and spillovers that are subsequently created through companies spending the R&D tax benefits received.

### *Streamlining Compliance Review and Findings Processes*

Comments are as follows:

- The streaming of compliance review and findings to the extent possible would be useful;
- Ensuring consistency of compliance reviews and findings, particularly overseas and advanced findings, and a process to ensure this is occurring would be very helpful. Currently it is very hard to provide companies any feedback regarding the likelihood of success of these applications due to the level of uncertainty involved. Companies therefore place less value on the benefits from these programs, which makes it difficult for them to drive additionality and spillovers; and

- Transparency of findings could be achieved in a similar way to how the ATO currently publishes private rulings, but at a more summary level due to commercial issues regarding technology development.

*Publish the names of companies claiming the R&D Tax Incentive and the amounts of R&D expenditure claimed*

RSM disagrees with publishing the names of companies claiming the R&D Tax Incentive. Comments are as follows:

- Why is there a need for transparency? What is this achieving?;
- What will the cost be to deliver this recommendation and what benefit will it deliver?;
- Companies have a right to tax secrecy in relation to the R&D Tax Incentive, the same as all other tax matters;
- R&D Tax is not a grant programme and is in fact very different in how it operates. Grants are discretionary Government spending mechanisms that are provided to select companies, or for public research and therefore it is appropriate transparency to share the names of the recipients. The R&D Tax Incentive is a self-assessment, eligibility, program, i.e. any company that meets the requirements may therefore make a claim. This recommendation is akin to suggesting companies declare what tax deductions they are obtaining;
- A published list of companies claiming the R&D Tax Incentive and expenditure will be used as a marketing list by some consultants. These companies could be called incessantly, which would detract from utilising the scheme by some companies;
- The ATO and AusIndustry have substantial data that could be analysed to assess the R&D Tax Incentive. This recommendation has not considered the viability of how the existing data is assessed and what challenges exist with assessing existing data; and
- Given this recommendation and the importance of transparency, if this recommendation is implemented the Government should also publish the budget cost it believes each company is costing the budget by claiming the R&D Tax Incentive.

**RSM Recommendation 15: Do not make unnecessary administrative changes to the R&D Tax Incentive such as having a single agency, single application process, or publishing the names and expenditure of claimants. Streaming compliance reviews and findings may have some benefits, but are minor issues. Achieving consistency and transparent of findings would reduce uncertainty and cost associated with advanced and overseas findings.**

If you wish to further discuss any of the above, please contact me on (08) 9261 9154.

Yours sincerely

Stephen Carroll  
Director  
RSM Australia Pty Ltd