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Tax White Paper Task Force
The Treasury
Langton Crescent
Parkes
ACT 2600

1 June 2015

Dear Sir/Madam

Tax discussion paper – Submission on innovation issues

In addition to the broader Deloitte response to the Tax White Paper process, please find following our position on the specific questions around innovation and R&D.

Specifically, this paper seeks to address the following questions:

29. To what extent does the tax treatment of losses discourage risk-taking and innovation and hinder businesses restructuring? Would alternative approaches be preferable and, if so, why?

39. Does the R&D tax incentive encourage companies to conduct R&D activities that would otherwise not be conducted in the absence of government support? Would alternative approaches better achieve this objective and, if so, how?

40. What other taxation incentives, including changes to existing measures, are appropriate to encourage investment in innovation and entrepreneurship?

41. What effect is the tax system having on choice of business structure for small businesses?

The comments made in this paper specifically focus on the role of the R&D tax incentive, and other potential related tax mechanisms, in encouraging and funding innovation and research.

To put our submission in context, we strongly believe that there are significant current challenges to Australian industries and jobs posed by increasing global competition in innovation, science, engineering, research and education, and as such there is a growing need to attract new investment in innovation, nurture a culture of innovation, and ensure the proper funding of research. Innovation is also crucial in providing Australian industry with the basis for international competition that moves beyond competing predominantly on labour cost.

This position has not been assisted by the recent imposition of the \$100m expenditure cap on eligible R&D expenditure, or the current changes to the rate of support that the government is promoting – which propose to reduce the net benefit of the incentive from 10% to 8.5% of eligible expenditure for entities with turnover of more than \$20 million, or from 15% to 13.5% of eligible spend for smaller entities. The latter change is also at odds with the Government's current narrative around support for small business as outlined in the recent Budget.

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The cost of providing the R&D incentive is often overstated. Many entities are not aware that any reduction of income tax liability that arises through an R&D claim directly reduces the ability of the entity to frank dividends. This reduction is equal to the reduction in tax paid by the entity. In that context, many dividend paying entities believe the incentive does not provide a sufficient benefit to justify the cost of claiming as they are only receiving a timing benefit.

As such we believe that direct taxation policies surrounding innovation and research are, among others, critically important and pervasive tools for a government to use to endorse and promote innovation and its commercialisation in Australia.

The taxation policies that will be announced and pursued in the medium term as a result of both the Senate Innovation Inquiry and the Tax White Paper process will be vital to underpinning a strong and dynamic innovation culture, and need to be perceived as strong indicators that Australia is serious about encouraging innovation. The Government's Innovation and competitiveness Agenda released in 2014 afforded a central role to R&D in Australia's new industry policy framework. It is critical that the taxation system is supportive of this position.

We urge the government to take advantage of this opportunity to strengthen Australia's competitive advantage in attracting its share of global innovation investment.

The pace and scale of innovation worldwide now demands active collaboration across firms, industries and economies, and there remains a significant role for government in promoting innovation through direct funding support, tax incentives, public procurement and the co-production of innovation. Direct action to reshape and extend the tax policies supporting Australia's innovators to continue to invest in R&D in Australia and its commercialisation will help underpin the Australian innovation eco-system and generate the proven spill-over benefits to the wider Australian economy.

Should you wish to discuss our submission in greater detail, please do not hesitate to contact me on (03) 9671 7376.

Yours faithfully



Serg Duchini
National Leader of R&D and Government Incentives

Director
Deloitte Tax Services Pty Ltd

Annexure: Deloitte submission on innovation issues

Before we respond to the direct questions asked in the Tax discussion paper, we would like to reiterate our continued support for the R&D tax incentive program in Australia, and set out some of the objective global evidence demonstrating the correlation between government support for innovation and attracting R&D investment to a country.

The recent history in Australia of examining its domestic innovation policy spans from Backing Australia's Ability in 2001 to the 2008 Cutler Innovation Review recommendations for the broader national innovation system¹, the subsequent 2009 white paper Powering Ideas, and the 2012 Plan for Australian Jobs. The 2014 Innovation and Competitiveness Agenda highlighted the issue, and the Senate Inquiry into Innovation is currently also due to report back in mid-2015.

This recent history reflects that, despite the presence of a fundamental domestic framework, there is a continuing need to examine the effectiveness of Australia's national innovation policy within a global context. This continues to be the case today, particularly given Australia's current status as a high-wage economy with relatively low productivity growth.

As is the case in many other areas of income tax, it is imperative to view Australia's innovation tax policy decisions within the context of globally mobile flows of labour and capital; with the increasingly important knowledge-based forms of R&D being a prime example of mobility.

In a global rather than domestic context, Australia is not alone in offering the critical operational prerequisites to successfully conduct cost-effective innovation and R&D activities. A significant number of countries worldwide now offer multi-national groups access to growing markets and customer bases, human capital talent, intellectual property protection, a stable economy and government, and an information technology infrastructure.

Indeed, an increasing number of countries, especially within Asia, are actively promoting themselves as an optimal location for the relocation of R&D operations as part of their innovation-led economic development strategies. R&D tax incentives are an important component of all of these strategies which are now also being supported by complementary 'patent box' models (see below) to support the resulting commercialisation of the R&D undertaken. This is supported by the correlation between tax based incentives and both the level of business investment and total R&D spend as a percentage of GDP across a number of major countries.

A 2013 Committee for Economic Development of Australia (CEDA) report² painted a compelling picture of the problem whereby Australia has been dropping in global competitive rankings and the growth in R&D spending appears not to be translating into improved innovation outcomes.

Furthermore a recent European Commission study, EU Industrial R&D Investment Scoreboard 2014³ ranked the world's top 2,500 companies by their R&D investments and highlighted the substantial contribution that is made by large business in innovation and R&D in the US and Europe. Australia was again represented by only 15 companies in the top 2,500 (15 out of 2,000 in 2013) and the lack of any Australian company in the Top 100 worldwide demonstrates the need for Australia to increase its visibility in the global innovation arena.

A similar study published in November 2014 by Thomson Reuters⁴ compiled the fourth annual list of the Top 100 Global Innovators which represents a cross-section of industries including semiconductors, computer hardware, automotive, telecom and pharmaceutical.

For the first time since the inception of the report, Asia surpassed North America. The report noted that Japan's representation in 2014 jumped by 39% over 2013, increasing from 28 to 39 organisations in just 12 months. Mainland China achieved its inaugural spot on the 2014 list, and both S. Korea and Taiwan increased their representation. There is no mention of Australia in the report.

In 2014, both the U.S. and France dropped in their previous standings, from 45 to 35 and 12 to seven respectively, possibly related to the higher presence of Asian companies on the list. In 2014, France continued to be the European country with the highest number of companies on the Top 100 list, whilst the UK, with a similar sized economy,

¹ *Venturous Australia: A Review of the National Innovation System - Chapter 8: Tax and Innovation*

² *Australia Adjusting: Optimising national prosperity, CEDA, November 2013, Section 3.1*

³ *The 2014 EU Industrial R&D Investment Scoreboard*

⁴ *Thomson Reuters 2014 Top 100 Global Innovators*

continues to have none (now absent for three consecutive years to 2014). This is attributed in large part to the presence of R&D tax credits and other government innovation stimulus in France, a position that the UK is currently seeking to rectify with increased R&D incentives, but which is yet to be reflected in these statistics.

Japan's improvement and the rise of Asian countries in 2014 were found to be reflective of the focused innovation strategies in these countries and the percentages of GDP spent on R&D, which is higher for S. Korea and Japan, at 3.6% and 3.4%, respectively, than the 2.8% in the U.S. In contrast, figures released by the Australian Parliamentary Library show that science and innovation spending in Australia for 2014 was 0.56% of GDP, the lowest in 25 years (since 1989-90).

Additionally, China's success was attributed to the fact that it has increased its investment in research in the last decade and extended its R&D tax credit to all firms working in key areas of technology (biotechnology, information and communication technologies, and other high-technology fields), even for firms outside the specially designated new technology areas.

These findings continue to support the observation on the geographical analysis in the October 2013 Thomson Reuters' third annual report which revealed on page 6 that:

"There is a direct correlation between a government's commitment to innovation and its R&D tax policies to its ability to attract and retain innovative organisations."

On a more positive note for Australia, the most recent Global Innovation Index produced on an annual basis by INSEAD and the World Intellectual Property Organisation (WIPO) indicates that Australia is starting to recover its ranking with the most recent Global Innovation Indices being as follows:

- 2014 – 17th
- 2013 – 19th
- 2012 – 23rd
- 2011 – 21st
- 2010 – 18th

A 2014 report by the Organisation for Economic Co-operation and Development⁵ (OECD) suggests that well-designed direct support such as grants, payroll credits and refundable tax incentives may be more effective in stimulating R&D than previously thought, especially for "young firms." The report recommended that all countries review aspects of their tax incentive programs including the scope of eligible R&D, eligible firms that qualify for the incentives and the treatment of large R&D performers.

The OECD analysis also concluded that countries would benefit from reforming or creating incentives for knowledge-based capital discovery, as innovation is increasingly being driven by knowledge-based capital such as skills, systems, data, software, designs and intellectual property assets.

This change in focus towards business model innovation is also discussed in the CEDA report in terms of the shift in policy emphasis that is occurring in advanced national innovation systems towards non-technological innovation in jurisdictions such as Finland and Canada (and discussed further below).

As the CEDA report firmly acknowledges, the pace and scale of innovation worldwide now demands active collaboration across firms, industries and economies, and there remains a significant role for government in promoting innovation through direct funding support, tax incentives, public procurement and the co-production of innovation. The Australian Government must also be conscious of the direction of government support for innovation and R&D in other countries, and ensure our policy settings are keeping pace. It is fair and reasonable to expect Australian businesses to operate at world class standards. It is important for Government to ensure our policy settings reach this benchmark.

The initiation of an Innovation inquiry and the inclusion of innovation as part of the wider tax reform discussion both confirm that the Government accepts the key role that R&D government incentives do play in delivering productivity gains and economic growth derived from basic and applied research, and the long held understanding that the social return of such investment is higher than the private return to the investing firm.⁶ Now is the time for the government to

⁵ OECD, *Supporting Investment in Knowledge Capital, Growth and Innovation*, 10 October 2013

⁶ Institute of Fiscal Studies, *August 2001*

critically and objectively review its national innovation policy to date, and ensure that the foreshadowed review process does not waste a golden opportunity to reform and reshape Australia's innovation system.

Responses to specific questions:***29. To what extent does the tax treatment of losses discourage risk-taking and innovation and hinder businesses restructuring? Would alternative approaches be preferable and, if so, why?***

This paper focusses specifically on matters that pertain to innovation and the R&D tax incentive. In that context, this section focuses on changes that might be possible to improve tax policy in areas related to tax losses and the ability to carry forward R&D tax credit entitlements, rather than commenting more broadly on tax losses and risk taking generally.

We believe that there are a number of improvements that could be made to the taxation rules surrounding innovation and loss making companies as follows:

Amend application of Continuity of Ownership Test (COT) and Same Business Test (SBT) rules for innovative start-ups

Excess non-refundable 40% R&D tax offsets are carried forward to be potentially utilised in future income years when they are deemed to have to satisfy the tax loss utilisation tests. Essentially this occurs where a change in ownership of the company arises and the continuity of ownership test (COT) cannot be satisfied. In these circumstances the company must comply with the same business test (SBT) in order not to lose the benefit of its carry forward losses or R&D tax credits.

However, for many start-ups and smaller businesses which have engaged in innovation and R&D, there are significant practical implications in satisfying these loss utilisation tests. Many small businesses and start-ups face the need to issue equity to raise capital during the innovation phase. Depending on the level of the dilution that arises from a sale or issue of equity the company is likely to be at risk of failing the same-person, same-share test. Such entities are also likely to be at risk of also failing the SBT when they start to commercialise the product of their R&D, and they risk losses they cannot offset prior period losses against the revenue they receive from commercialisation of their product. Further they run the risk of losing the benefit of any R&D claims made in past periods. This matter acts as a disincentive to the raising of capital by innovative companies, and increases the real cost of obtaining external investment funding.

This situation also compares unfavourably to tax losses transferred into a tax consolidated group (discussed immediately below) since there is no refreshment of such tax attributes when transferred to the head company.

We recommend that the Green Paper explore the extent to which these issues will arise in practice and whether there are any legislative solutions that could be introduced to ensure that innovative SMEs do not inadvertently lose the benefit of R&D tax incentives that have been accumulated during their start-up phase.

In summary, the ability to carry forward and utilise R&D tax credits despite changes in investors or progression to commercialisation would encourage access to investment funding and aid the growth of innovation-focussed corporate entities.

Legislatively address transfer of excess R&D offsets into tax consolidated groups

As alluded to above, there is a legislative anomaly that can hinder this business restructuring. This includes where larger groups seek to acquire innovative but loss-making businesses which have been making claims for the R&D tax incentive rather than accumulating tax losses.

The existing income tax legislation is currently silent on the issue of transferring carried forward excess non-refundable R&D tax offsets to the head company of an Australian tax consolidated group (either upon the formation of or the joining of an Australian tax consolidated group).

Such tax attributes are deemed to have to satisfy the loss utilisation tests to be utilised, and are therefore subject to COT or SBT. However as confirmed in ATO ID 2015/6, these tax attributes must rely on the entry history rule to be transferred to the head company of an Australian tax consolidated group (rather than deemed to be losses for this purpose, and transferred and refreshed under the loss transfer rules).

This technical deficiency means that the current rules are potentially unworkable for significant M&A transactions, with the potential loss of significant amounts of transferred R&D tax offsets that cannot satisfy COT or SBT in the context of such a transfer.

This situation also demonstrates a significant lack of consistency and equity in the utilisation testing of two similar tax attributes. Had the R&D tax concession continued, the enhanced deductions would have created an enhanced tax loss

rather than a tax offset. As such, the R&D benefits, being an enhanced tax loss, would ultimately have been refreshed on joining a tax consolidated group.

Given the presence of excess non-refundable R&D offsets since 2012 and the potential scope of M&A activity, we recommend that this technical deficiency be reviewed by the Green paper and a proper legislative solution be considered.

Reviewing the \$20m threshold rules at which the refundable R&D tax offset can be accessed

The below comments should be reviewed in the context of our earlier remarks in the covering letter regarding the real benefit of the incentive to companies, and the net cost to taxpayers of providing the incentive. These comments refer to the net benefit of the incentive (as opposed to the headline 40 or 45% rate of the credit) and its impact on the ability of the company to pay franked dividends, which can reduce the benefit of the incentive to a mere timing difference for entities paying out dividends to shareholders.

While noting the above, it is recognised that the refundable R&D tax offset benefits loss-making start-up companies significantly, since they are able to bring forward the benefit of the incentive by ‘cashing out’ the 45% R&D tax offset. In our experience those entities often reinvest the refund received into additional R&D activities. This ability to access cash in this critical stage of business development is of far greater benefit to company development and survival than merely accumulating tax losses or non-refundable tax offsets (that may be lost in the future). It is also conducive to the conduct of further R&D activity as the benefit can be obtained during the period when innovative activities are being conducted, rather than providing a later tax benefit when revenue flows might be derived.

The \$20m aggregate turnover eligibility threshold limits currently restricts the number of entities that can benefit from the refundable 45% R&D tax offset (disregarding the concept of exempt entity ownership, discussed below). It also increases the number of entities that may have excess offsets to carry forward. It can be argued that the threshold level is too low on a range of grounds. The current threshold has been in place since the 2012 year of income, and has not been indexed to keep pace with the inflation adjusted level of turnover.

There are two inter-related issues, where changes to either or both could be beneficial to start-up and small entities:

- Firstly, it is important to note that the \$20m defined threshold level is significantly lower than the \$50m which was the threshold recommended in the Cutler Innovation Report.⁷ Further, a turnover based limit, while having the advantage of simplicity, is not truly reflective of a company’s ability to invest cash in R&D activities. Many companies with turnover above this threshold have a low margin on sales, very limited profit, and are therefore unable to devote cash resources to badly required innovation and product improvement activities that could promote growth and employment.

It is also notable that \$50m is also the aggregate turnover threshold to define start-up companies for the purposes of the employee share option plan rules. Such companies also need to be unlisted, be incorporated less than 10 years before the share or option is granted, and not be part of a corporate group in which any other company has been incorporated for more than 10 years, and be Australian resident.

- Secondly, the impact of the R&D “grouping” rules makes it difficult for some entities to satisfy the \$20m threshold, especially those start-ups acquired by a larger group part-way through an income year. There are also significant problems where venture capitalists and angel investors have interests and holdings in one or more start-up entities. Separate interests by high net worth individuals can cause two otherwise unrelated entities to be connected for the purposes of the R&D grouping rules and endanger the availability of a refundable R&D tax offset.

Clearly these issues directly interact as increasing the threshold makes it more likely that larger groups can satisfy the requirement. Conversely, amending the grouping rules for certain start-ups could also make it easier to fall under the existing threshold.

As such, we recommend that the Green Paper consider increasing the \$20m threshold. The introduction of a supplementary threshold permitting a refundable credit for entities with turnover in excess of the turnover threshold that have low profit margins and would be broader, more comprehensive measure around how individual companies are performing, Reviewing the grouping rules under which start-up entities and other small businesses can claim a

⁷ *Venturous Australia: A Review of the National Innovation System - Chapter 8: Tax and Innovation*

refundable R&D tax offset would also provide clarity regarding the specific entity seeking to claim R&D support. Consideration could be given to linking specific start-up rules to the definitions contained within the employee share option plan provisions.

The subsequent availability of the refundable tax credit to an increased number of eligible R&D entities could serve to put R&D credits 'above the line' in fiscal budgets, induce higher levels of expenditure by medium sized firms, and ultimately encourage more R&D expenditure to be undertaken in Australia. The powers that the ATO have had since 2012 to withhold tax refunds in certain circumstances would also address the increased risk implications of providing refundable tax offsets to an increased number of entities.

In addition to encouraging more innovation in companies in the earlier stages of growth where cash resources are limited, these outcomes would also serve to reduce the level of excess R&D tax offsets that would need to satisfy the COT or SBT in the future. This includes the situation where they may need to be transferred to the head company of a tax consolidated group (see separate discussion sections above).

39. Does the R&D tax incentive encourage companies to conduct R&D activities that would otherwise not be conducted in the absence of government support? Would alternative approaches better achieve this objective and, if so, how?

Firstly, we believe that this question must be considered in the context of the global mobility issues discussed above.

Working as professional advisers in this area since 1986, we have observed that the former R&D Concession and now R&D Incentive has had a positive influence on the level of R&D activity that otherwise would not have occurred. The financial support provided by the R&D incentive can impact the nature, scale and timing of the R&D activities undertaken. The concept of additionality can and does vary from organisation to organisation, and is influenced by size, industry, access to capital and funding, its culture, ownership/group structure and the nature of the R&D activities.

The further question that we believe is relevant is whether companies would conduct R&D activities in Australia in the absence of an R&D Tax incentive regime. The global mobility of R&D activities referred to earlier means that Australia must be conscious of losing activity to offshore markets if the incentive setting is not appropriate. This question of mobility is immediately relevant to large businesses with established global innovation programs but is increasingly becoming more relevant for domestic medium and small businesses that plan to access global markets. The Australian government's own innovation policies clearly recognise that a country is able to attract foreign R&D investment onshore from other countries. The expansion of the R&D tax incentive rules from 2011 enables Australian companies and branches to conduct R&D activities on behalf of their foreign parent companies.

In this context therefore, we strongly agree that the presence of the Australian R&D tax incentive encourages companies to undertake activities that may not otherwise be carried out in Australia.

In terms of objective evidence as to the success of the program more generally, under the current R&D tax incentive which has been in operation since 1 July 2011, AusIndustry reported that as at 30 June 2014, 11,936 companies (some of which were grouped for tax purposes) had registered \$19.69 billion of R&D expenditure for the 2012-13 income period.

Compared to R&D registrations received during the same period in the previous income year, this was an increase of more than 1,200 R&D-performing entities. Additionally, over 2,700 companies were new to the program and 74.2% of registrations received for 2012-13 were from companies with an aggregated turnover of less than \$20 million.

As at 28 February 2015, more than 7,300 companies had registered \$10.34 billion for the 2013-14 period, an increase of 850 entities and with 1,200 entities new to the program.

On the basis of these statistics, the shift in taxation policy from the former R&D tax concession has been successful in providing an effective policy framework to encourage smaller companies, (who are less likely to innovate than large firms according to CEDA⁸), to engage in innovation and R&D.

The success of targeted direct state and Federal grants should also be acknowledged as a catalyst for new innovation and technology programs in industry. They should continue to serve specific policy aims and complement a separate tax incentive.

Overall, particularly for small entities, a consistent and ongoing program delivered through the highly visible company income tax mechanism is a necessity to promote ongoing risk-taking and innovation in Australian industry.

⁸ *Australia Adjusting: Optimising national prosperity, CEDA, November 2013, Section 3.1*

40. What other taxation incentives, including changes to existing measures, are appropriate to encourage investment in innovation and entrepreneurship?

In addition to the above comments, we also believe that the following changes to existing taxation incentives could encourage increased investment in innovation and entrepreneurship in Australia:

- Reinstatement of the proposed quarterly credit system
- Removal or reduction of deferred franking debits arising on refundable R&D tax offsets
- Introduction of income tax incentives for ‘angel’ investors
- Review of the tax exempt ownership rules
- Incentivising non-technological R&D
- Introducing a post-R&D incentive to commercialise R&D that has been undertaken in Australia (akin to a modified nexus patent box approach)
- Retaining or increasing the net tax benefit of risk-taking for all or targeted segments of business

Reinstatement of the proposed quarterly credit system

In our view, it was both a premature and unfortunate decision to discontinue the implementation of the proposed R&D quarterly credit system before it was enacted. This view is supported by the interim report of the Murray Financial System Inquiry,⁹ which unequivocally states that changing the tax credit system to a quarterly system would help alleviate cash flow constraints, and recommended it as an issue to be considered as part of this Tax White Paper process.

At the start-up stage of any entity, especially those undertaking significant R&D, access to regular cash flow can be a critical issue for the viability of the business. Indeed the original explanatory memorandum introducing the draft legislation, at para 1.13, stated that:

“Allowing taxpayers with an expected entitlement to the R&D refundable tax offset to receive their anticipated refund in quarterly instalments during the year provides additional cash-flow for them to reinvest in their R&D activities and so deliver wider benefits to the Australian economy.”

The arrangements set out in the draft legislation that had been introduced before the announcement in November 2013 were much improved from those originally proposed in the earlier consultation paper, and reflected many of the suggestions made by Deloitte in our submission of 31 August 2013. We continue to believe that the proposed legislation reflected an excellent balance between simplicity and a necessary focus on integrity issues.

We are therefore of the view that the decision not to proceed with the quarterly system has affected numerous entities that undertake R&D work with little or no turnover in their early years. Although they are receiving no revenue, they may be incurring considerable expenditure on their research and would benefit significantly from an improved cash flow which would allow them to bring forward, or increase, their expenditure on R&D.

We recommend that a quarterly refund system be reintroduced as previously proposed, and that it be augmented by the following compliance issues:

- *An exception from any history rule requiring an R&D claim (possibly in 1 of the last 5 income years) for private companies in their first year of operation where they satisfy all of the other requirements (somewhat akin to the exception to the FDT offset penalty component in subsection 205-70(5) as introduced in 2005).*

Such a rule would ensure that genuine start-ups can access the quarterly refunds at least a year earlier than under the original proposal. These are the very entities who most require access to increased cash-flow and who are intended to be targeted by the R&D tax incentive program.

- *A Commissioner’s discretion to waive GIC if quarterly refunded amounts were varied beyond acceptable levels and this was due to events beyond the control of the company (akin to subsection 205-70(6)).*

⁹ Financial System Inquiry Interim Report, July 2014, p.2-68

Removal or reduction of deferred franking debits arising on refundable R&D tax offsets

Under the current refundable R&D tax incentive program, the refund of an excess R&D tax offset is legislatively defined to be a 'refund of income tax'. To prevent an R&D tax offset refund creating a potential liability to franking deficit tax (FDT) and a repayment of a refund, a franking debit does not immediately arise in the franking account, as would normally occur.

Rather this debit is deferred to reduce future franking credits that would otherwise arise on the payment of income tax in the future. That is, the deferred franking debits are recovered from future income tax payable before franking credits can continue to be accumulated.

This mechanism is in direct contrast to the former R&D tax offset that could be claimed under the R&D tax concession program, and which gave rise to no franking consequences.

It is critical to recognise that, over time, a small company that has sought refundable R&D tax incentive offsets in its early years of operation will mature and generate profits to be returned to investors who have been proactive in supporting an entity willing to take on the risk associated with investing in innovation.

The current system of deferred franking debits means the benefit of the R&D tax incentive is clawed back through the dividend imputation system. When the company achieves a profit-making position, it is unable to provide shareholders with the advantage of imputation credits despite payment of income tax (potentially for a significant period of time). This puts it at a disadvantage compared to other businesses.

This in turn means that any investors will pay their full marginal rate of income tax on dividends received without the benefit of franking credits, currently at a rate of 49% given the increase in the Medicare levy and the temporary debt levy.

As noted earlier in this submission, the impact of the deferred franking debit means that the R&D tax incentive provides cash-flow to many claimant entities, but the overall cost to tax revenue for many companies is neutral.

This aspect of the refundable R&D tax incentive was not well understood or communicated on the launch of the R&D tax incentive program. Now that this issue is starting to be recognised by investing entities, it is likely to discourage investments into entities undertaking R&D in their start-up phase, the very point in time that such investment is vital.

We recommend that to encourage small business owners/directors to claim the refundable R&D tax offset, it would be appropriate to:

- *Change the definition of a refundable R&D tax offset, to ensure it is not viewed as a refund of income tax for franking purposes; or*
- *Apply an 'available fraction' type concept to the deferred franking debits that arise to reduce future franking credits. Such an approach could provide a limited form of permanent tax benefit for claiming a refundable tax offset.*

Introduction of income tax incentives for 'angel investors'

Again from the perspective of an investor rather than the company itself, we believe that more can be done to provide incentives to 'angel investors' who risk their capital in start-up business.

Key examples are the enterprise investment schemes that exist in the UK which are designed to assist smaller high-risk companies raise finance by offering tax relief to the investors who acquire equity in these ventures. Both an income tax relief and a capital gains tax relief are available in these schemes which promote risk-taking and innovation.

Similarly, an excellent more recent example of this is the announcement by the Irish government in May 2015 that allows entrepreneurs to claim back up to 41% of their capital investment in a new business.

The Irish scheme will operate as a refund of income tax paid by the person starting the business in the six years prior to the commencement of the business. Certain income tax paid during that six-year period can be refunded up to the 41% limit of the total capital invested in starting the business.

We recommend that this type of tax incentive be considered in Australia to stimulate new business growth and the economy more generally.

Review of the tax exempt ownership rules

Consideration of innovation and risk-taking issues must include the consideration of funding and procedures of Australia's publicly-funded research agencies, universities, and other stakeholders in the innovation system. This should include potential governance and funding models for Australia's research infrastructure and agencies, policy options to diversify science and research financing; and the effectiveness of mechanisms within Australian universities and industry for developing research pathways, particularly in regards to early- and mid-career researchers.

In this regard we believe that there is a hurdle inherent in the current R&D tax incentive provisions, because there is an ownership threshold above which an entity cannot claim a refundable R&D tax offset regardless of aggregate turnover.

This threshold considers the control of the R&D entity by (unrelated) exempt entities, and is currently set at exactly 50%, which we believe is too restrictive from a commercial perspective.

We recommend that start-up entities be able to be financed at least 50% by an exempt entity, with the threshold set somewhere greater than 50%.

Such a change would allow universities and other institutes to jointly invest in start-up entities without endangering the ability to obtain the refundable R&D tax offset.

Incentivising non-technological innovation

As alluded to above, the OECD recently concluded that countries would benefit from reforming or creating incentives for knowledge-based capital discovery, since innovation is increasingly being driven by knowledge-based capital such as skills, systems, data, software, designs and intellectual property assets.

This concept is developed further by the aforementioned CEDA report which has analysed a shift in policy emphasis that is occurring in advanced national innovation systems towards non-technological and design innovation in countries including Finland and Canada.

Australia has a steadily growing digital economy, and the digital disruption of many industries is well under way. As such there is an urgent need to incentivise industry to improve and transform our business processes and operations. Such a shift to recognising design-led and business model innovation will require a strategic repositioning to a focus on creativity and design.

From the perspective of Australia's existing innovation taxation policy, the definition of R&D activities is heavily focused on the experimental and technological nature of core R&D activities.

However this definition, whilst internationally recognised and in line with the Frascati manual¹⁰, does not easily lend itself to entities working on creative design-led innovation nor service sector innovation which is becoming increasingly critical in a transforming economy. The Frascati manual was originally drafted in 1963 as standard practice for surveys on research and experimental development and is currently in its 6th revision, the last in 2002. We understand that Version 7 is due to be released with final submissions to this process having closed in October 2013. We are not aware of the release date of Version 7. The pace and nature of innovation has changed exponentially since 2002 and we submit it is an appropriate time to reflect on the nature of R&D activities to be stimulated by government policy.

We recommend that as part of the tax reform process, the government explore the experiences of other countries such as Finland and Canada in respect of how non-technological and business model innovation is being measured and rewarded, and whether this experience should be brought to bear in Australia.

Introducing a post-R&D incentive to commercialise in Australia

The current R&D tax incentive regime has introduced provisions which encourage the conduct of R&D in Australia even where IP is held by a foreign parent. However, a gap exists in taxation or regulatory incentives aimed at taking R&D related IP to the point of commercialisation, and encouraging subsequent retention of manufacturing or value adding operations in Australia.

The previous attempt to support commercialisation through Commercialisation Australia provided limited support, and was administered on a grant application basis that many companies considered was too expensive to undertake, given there was a chance that funding would not be received.

Therefore, at present once the research phase has been completed, there are no direct taxation policies that exist to encourage companies to retain the subsequent commercialisation and manufacturing phases in Australia. There is

¹⁰ Frascati Manual, Proposed Standard Practice for Surveys on Research and Experimental development, 6th Edition

continuing and increasing pressure on local businesses to replicate the required skills offshore in low cost countries with better incentives and lower labour costs, especially where the R&D has resulted in portable knowledge-based IP.

It is clear that at these early profit-making stages, an entity would continue to benefit from a reduced tax liability in Australia on the profits generated by the recent R&D work undertaken. A direct connection to a further initiative such as the Australian Innovation and Manufacturing (AIM) concept on qualifying patents (which we understand has been proposed to the government for some time by a consortium of biotechnology companies) could assist in ensuring that additional economic activity is also localised.¹¹

To date, at least 10 countries have enacted such regimes, known as Patent Box regimes, including the UK, Ireland and China with these countries competing strongly for high-value jobs. Belgium has also introduced a Patent Income Deduction resulting in a 6.8% maximum effective tax rate.

UK filing records in late 2013 reflect a move of many Australian technology companies (including Atlassian) to reincorporate in the UK; an early indication that the Patent Box model and generous R&D tax breaks are indeed being successful in attracting its targeted internationally mobile capital to take advantage of the 10% patent box tax rate.

We recognise that the UK model has been adapted to a modified nexus approach to ensure that it does not constitute a harmful tax practice, as was highlighted by the OECD base erosion and profit shifting program. The Australian AIM proposal has similarly been modified in April 2015 to ensure that it would meet best practice.

It is important for Australian public policy settings to be innovative themselves, and to maintain pace with our global competitors. With at least 10 countries already embracing such an initiative, including a number of our trading partners and countries with whom we will be competing around foreign direct investment, the consideration of this policy in the Australian context still remains timely.

Such an Australian tax incentive aimed at commercial activities could reward innovative Australian businesses making profits from defined qualifying patents and ensure the high-value commercialisation phase of innovation and exploitation of patents remains in Australia.

In the wake of the closures around automotive manufacturing in Australia, the Federal Government has rightly identified that the future of the sector lies at the upper end of the value chain, where manufacturing activities (particularly advanced manufacturing) represent a more sustainable future for the industry locally. The AIM initiative would be a powerful policy tool to assist the local manufacturing sector in better engaging with the R&D community, and in making the transition to more viable, globally competitive activities.

We recommend the inclusion of a post-R&D commercialisation incentive as part of the tax reform process to encourage more multi-national businesses to carry on the commercialisation and manufacturing aspects of their R&D activities in Australia, and retain the resulting intellectual property onshore.

We believe that it is critical that Australia takes action to remain competitive in commercialisation given that some Australian companies are already moving operations to other nations to develop IP created in Australia. This Inquiry should explore this alternative and the experiences of other countries that have implemented similar initiatives to date.

Retaining or increasing the net tax benefit of risk-taking for all or targeted segments of business

International experience demonstrates that an R&D tax incentive must be of a sufficient level to influence strategic decisions in organisations of all sizes.

An extensive practical survey of global R&D leaders conducted by Deloitte UK¹² in 2010 concluded that to have an impact, a minimum tax benefit of 10% was needed to significantly influence behaviour. This survey compiled the views of 52 multi-national companies which had in the previous year invested £5.6bn in R&D activities and employed 42,000 R&D personnel.

Within Australia, the rates of the net R&D tax benefit of 10% and 15% as introduced with effect from 1 July 2011 were welcomed, being higher than the 7.5% formerly available under the R&D tax concession. However the 45% refundable tax offset as introduced was notably less than the 50% rate recommended in the Cutler Report¹³.

¹¹ [Press Release of 29 April 2015](#) on Australian Innovation & Manufacturing Incentive

¹² *A long way to go, Deloitte UK, 2010*

¹³ *Venturous Australia: A Review of the National Innovation System - Chapter 8: Tax and Innovation*

Furthermore the 2014-15 Federal Budget announcement proposed that these net rates be reduced to 13.5% and 8.5%. Although this legislation was not passed earlier this year, at the time of writing, it appears that the Government remains committed to reintroducing legislation into Parliament to enact the reduced rates retrospectively.

This reduction is argued as necessary due to economic and fiscal pressures, despite the original intention of the R&D tax incentive to be 'decoupled' from the rate of company income tax.

The explanatory material in 2010 alluded to the likelihood of the net R&D tax benefit increasing as the rate of company income tax fell. However the proposed benefit from this decoupling has not been reached and there is no signal by the government that it intends to allow the net tax benefit to increase as the small company income tax rate is proposed to fall on 1 July 2015.

In addition, even though the reduction of the rate of small company income tax from 30% to 28.5% will generally increase the net tax benefit to 16.5% for those eligible, the benefit of the refundable tax offset for small entities in a tax loss position will permanently fall from 45% to 43.5%.

Given the recognised need to provide an internationally competitive rate of benefit to attract globally mobile innovation expenditure to Australia, we recommend that at a minimum the original rates of 10% or 15% be retained.

Going further, we would also recommend consideration of the following types of proposals over time:

- *Increasing the net tax benefits by allowing the rates to remain at 40% and 45% even in the face of proposed or further cuts in the company income tax rate; and*
- *Introducing a new set of higher rates for R&D that could apply to eligible expenditure by small start-up business or at a minimum that might apply to non-technological R&D (see above).*

Although such decisions are likely to cost more in terms of the R&D relief given in the short term, we believe that they would have the most impact on the overall success of the program by increasing the amount of innovation and R&D undertaken in Australia and ultimately achieve significant positive spill-over effects in Australia.

Alternatively, if the current economic and fiscal conditions do not allow for an immediate restoration or increase, a strong signal from the government that the rates of relief will increase when conditions allow would assist in maintaining and supporting the longer term strategies of multi-national groups, and could halt a longer term potential exodus to other, more attractive R&D regimes.

In summary, to achieve the innovation objectives in sight, we believe it is critical that companies be provided with a net tax benefit sufficiently large to impact on the strategic decisions made at board level.

41. What effect is the tax system having on choice of business structure for small businesses?

From the perspective of small businesses who are innovating or wish to innovate, the type of entity that can claim the R&D tax incentive is currently restricted to body corporates and excludes corporate limited partnerships, partnerships, sole traders and trusts that have elected to be the head of a tax consolidated group.

We therefore believe that the availability of the current R&D tax incentive to body corporates is too narrow and may force entities who wish to innovate into an unsuitable structure for the other needs of innovators and investors.

This can lead to anomalous results within a tax consolidated group and is also discriminatory for entities structured in an alternative manner. For example, a subsidiary member of a tax consolidated group could be a trust but where the head company is a body corporate, an eligible claim can be made for the R&D undertaken by the trust. In contrast, a body corporate may undertake the very same R&D activities but where the head company is a corporate limited partnership, no claim can be made by the group.

We recommend that eliminating these inconsistencies and extending the availability of the R&D tax incentive program to a range of other carefully defined entities would significantly increase the participation of smaller businesses in innovation and R&D activities.