

The Manager
Small Business Entities & Industry Concessions Unit
The Treasury
Langton Crescent
PARKES ACT 2600

25 July 2018

Consultation on the Draft Treasury Laws Amendment (Research & Development Incentive) Bill 2018 and Explanatory Materials

Dear Sir/Madam,

CharterNet Services Pty Ltd appreciates the opportunity to provide commentary regarding the recently released Draft Treasury Laws Amendment (Research & Development Incentive) Bill 2018 and Explanatory Materials.

The release of the aforementioned literature is a welcome contribution to public discussion regarding the pivotal role Government has in encouraging industry to conduct R&D activities that might not otherwise occur, and its multiplier effect on the Australian economy.

In the following pages we will address each of the six questions posed in the Consultation on the Draft Treasury Laws Amendment (Research & Development Incentive) Bill 2018 and Explanatory Materials, providing our position and detailed rationale for the queries put forward.

We would also be pleased to provide further information regarding our position on each of the queries posed, as well as any other relevant issues, at any time.

Yours faithfully,



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Calculation of R&D Intensity – Total Expenditure

1. Do you foresee any implementation and ongoing compliance challenges arising from the proposed calculation of R&D intensity?

At a high level, it is positive that the implementation of the R&D intensity measure will not impact companies claiming the refundable R&D tax offset. However, we submit that the R&D intensity measure, as it is currently proposed, is not aligned with generally accepted principles of good taxation measures. That is, taxation measures should provide simplicity and certainty for taxpayers, and ease of administration for the regulatory authorities.

We foresee challenges arising in relation to the calculation, implementation, and industry understanding of the R&D tax offset intensity premiums. Using Example 1.2 on page 10 of the Exposure Draft Explanatory Materials, relating to Contrast Industries, we will provide our rationale.

In the case of Contrast Industries, the claimant entity has notional deductions of \$160m in the 2018-19 income year, thereby exceeding the \$150 million expenditure threshold. In the same income year, Contrast Industries has expenditure of \$1 billion, and aggregated turnover in excess of \$20 million.

Using this example, the taxpayer is entitled to the non-refundable R&D Tax offset but is required to undertake the following calculation in order to determine the actual offset amount.

Firstly, Contrast Industries needs to use the R&D intensity formula to determine that it has an R&D intensity of 15%, that is by initially capping its \$160 million of notional deductions to \$150 million then dividing it by \$1 billion.

Secondly, Contrast Industries needs to perform five separate calculations of:

- 2% (tier one) of \$1 billion which equals \$20 million;
- 3% (i.e. tier two 5% less tier one 2%) of \$1 billion which equals \$30 million;
- 5% (i.e. tier three 10% less tier two 5%) of \$1 billion which equals \$50 million;
- 5% (i.e. tier four of 15% less tier three 10%) of \$1 billion which equals \$50 million; and
- \$160 million less \$150 million threshold which will result in \$10 million of notional deductions having an offset rate equivalent to the corporate tax rate of 30%.

Thirdly, Contrast Industries then needs to apply the R&D premium for each of the intensity ranges to the notional deduction for which it applies. This will result in:

- 4% R&D premium plus 30% corporate tax rate applied to \$20 million of notional deductions resulting in a \$6.8 million offset;
- 6.5% R&D premium plus 30% corporate tax rate applied to \$30 million of notional deductions resulting in a \$10.95 million offset;
- 9% R&D premium plus 30% corporate tax rate applied to \$50 million of notional deductions resulting in a \$19.5 million offset;
- 12.5% R&D premium plus 30% corporate tax rate applied to \$50 million of notional deductions resulting in a \$21.25 million offset; and
- Corporate tax rate of 30% applied to the \$10 million excess resulting in a \$3 million offset.

As a fourth and final step, the offset amounts are summed to produce a total offset amount of \$61.5 million. For the example of Contrast Industries, the proposed R&D intensity measure can be summarised in the table below.

Tier	Intensity Range	R&D Premium	Notional Deductions Applied	Offset Amount
Tier 1	0-2%	4%	\$20m	\$6.8m
Tier 2	2-5%	6.5%	\$30m	\$10.95m
Tier 3	5-10%	9%	\$50m	\$19.5m
Tier 4	10+%	12.5%	\$50m	\$21.25m
Excess	N/A	Nil	\$10m	\$3m
Totals:			\$160m	\$61.5m

Using the example of Contrast Industries, we foresee considerable challenges with the implementation and understanding of the calculation methodology associated with the proposed R&D intensity threshold.

We believe that the calculation methodology is arduous and does not provide claimant entities with a simple and easy to understand structure to aid its R&D activities, and in turn, foster Australian innovation.

Furthermore, we believe that the calculation methodology would be difficult to regulate and implement. In particular, we foresee significant issues relating to its calculation in the R&D Tax Incentive Schedule.

As such, we propose that the R&D intensity calculation is simplified so as to abandon the cascading calculation and provide the claimant entity with access to the R&D premium rate, based on the R&D intensity formula, for all notional deductions up to \$150 million.

Using the same example of Contrast Industries and applying the simpler calculation, the claimant entity will be entitled to a 12.5% R&D premium which can be applied to the \$150 million of notional deductions, with the remaining \$10 million having the corporate tax rate of 30% applied.

This would then result in:

- 12.5% R&D premium plus 30% corporate tax rate applied to \$150 million of notional deductions resulting in a \$63.75 million offset; and
- Corporate tax rate of 30% applied to the \$10 million excess resulting in a \$3 million offset.

The offset amounts are summed to produce a total offset amount of \$66.75 million.

Using this example, we believe that the R&D intensity calculation should be simplified for the following reasons:

1. The proposed R&D intensity calculation is difficult to understand, explain, and implement. The amended calculation that we have suggested results in the tiered R&D system being simpler to understand, and in turn, calculate;
2. The proposed R&D intensity calculation would be difficult for the regulatory authorities to administer. By diminishing the available offset by having in place a tiered system, companies are more likely to deliberately adopt favourable line item classifications so as to minimise its total

expenditure. The amended calculation that we have suggested would be easier for the regulatory authorities to explain, implement, and utilise in the R&D Tax Incentive Schedule, thereby making it more likely for companies to comply;

3. The proposed R&D intensity is not aligned with generally accepted principles of good taxation measures. That is, taxation measures should provide simplicity and certainty for taxpayers, and ease of administration for the regulatory authorities. Our suggested amended calculation would be better aligned to the underlying premise of the R&D Tax Incentive, which is to incentivise companies to conduct greater amounts of R&D onshore by providing a simpler and fairer tax system; and
4. The proposed calculation methodology could result in numerous claimant entities opting out of claiming the R&D Tax Incentive and potentially offshoring its R&D activities. Based on the simplicity of our suggested calculation methodology, we foresee that there will be fewer claimants opting out of the R&D Tax Incentive program due to the relative simplicity of the calculation.

2. Does the proposed method of calculation of R&D intensity pose any integrity risks?

The proposed method of calculation does indeed pose integrity risks. The main risks are associated with the establishment of separate entities, as well as the misclassification of expenses, both of which would result in a claimant entity achieving an artificially inflated R&D intensity. These key areas of integrity risk are discussed further below.

The key integrity risk from a company structuring perspective would be associated with the establishment of a separate entity where only R&D activities are conducted, and in turn, R&D expenditure is processed. This would result in the entity having greater than 10% R&D intensity, thereby allowing the entity to access R&D premiums that exceed the current 8.5% permanent after tax benefit available for the majority of non-refundable R&D tax offset claimants.

Although there are general tax anti-avoidance and R&D integrity provisions that could uphold the integrity of the proposed R&D intensity percentage, there are often genuine commercial reasons for having a separate R&D entity so as to segment a company's operations from its R&D activities, or to have the firm's intellectual property protected by structuring the entities in such a manner where the R&D activities are separate to that of the business operations.

Furthermore, there is the potential for claimant entities to misclassify line items so as to minimise its total expenditure figure. This would result in an artificially inflated R&D intensity that would allow companies to achieve a tax outcome that could potentially be greater than the current 8.5% permanent after tax benefit available to the majority of non-refundable R&D tax offset claimants.

In conclusion, the integrity of the R&D Tax Incentive program is of paramount importance. We do not wish to see claimant entities navigating through the proposed implementation of the R&D intensity threshold so as to gain an artificially inflated tax advantage. However, the main reason a claimant entity would want to act in this manner is if they feel as though that the calculation methodology is too difficult to implement, or if it deems that the tax benefit available under the tiered system is significantly less than its previous R&D claims. As such, we suggest imposing a simpler to understand and easier to implement calculation methodology.

3. Could total expenditure be aggregated across a broader economic group? Would this create any implementation and ongoing compliance challenges?

To prevent the circumvention of the proposed amendments to the legislation, total expenditure could be aggregated across a broader economic group. However, this does create a significant administrative and compliance burden on the claimant entity, thereby deviating from the underlying intent of the R&D Tax Incentive legislation, which is to promote and foster innovation in Australia.

The key compliance challenges would be sourcing the aggregated expenses, and whether the same rules that apply to calculating aggregated turnover for grouping purposes would apply to grouping expenses. Again, this creates increased uncertainty in the R&D Tax Incentive for a significant number of taxpayers, such as large multinationals, whom may very well, elect to conduct its R&D activities offshore should the Australian R&D Tax Incentive either not provide them with the desired net cash benefit, or prove too cumbersome to implement.

Clinical Trials Exemption Under the \$4 million Refund Cap

4. Does the definition of clinical trials for the purpose of the R&DTI appropriately cover activities that may be conducted now and into the future?

The definition of clinical trials for the purpose of the amended legislation does not appropriately cover activities that may be conducted now and into the future. Our main concerns with the proposed amendment are as follows:

- The proposed definition of clinical trials is fairly simple and the scope is not clearly defined which could potentially lead to misinterpretation of the activities;
- Given the broad scope of the definition of clinical trials, it is unclear as to how the Board will make findings on the eligibility of a company's R&D activities (in progress or those planned for the future). In addition, given the timeline for the development of a drug is long, the proposed amendment could lead to complicated monitoring measurements of clinical trial activities that are already underway;
- The product pipelines for life sciences, particularly in the area of human health, can be as long as fifteen or twenty years. This is largely due to the time it takes to progress through the various stages of the drug discovery process. This includes target identification, target validation, lead identification, lead optimisation, pre-clinical and clinical trial stages. Each stage is accompanied by numerous ethical, clinical and regulatory processes;
- The development costs associated with initial target identification until the pre-clinical stage can be quite significant and there is no guarantee of progressing the product successfully through clinical trials. For small life sciences firms in Australia, the R&D Tax Incentive has assisted by way of funding the R&D intensive phase being the pre-clinical phase of research. This phase is not only R&D intensive but also expensive and inherently risky. By restricting the exemption to only clinical trials, the R&D tax incentive may not support the fundamental phases of research and development;

- Australia has world-class research facilities that support the development and testing of drug products. The R&D Tax Incentive has provided companies with an incentive to collaborate with these facilities. In addition, due to the availability of funding (by way of the offset available through R&D tax incentive), companies are able to provide employment opportunities to highly skilled employees who may otherwise go overseas for more opportunity. As such, the proposed amendment could prevent companies from fostering long-term collaboration with research facilities and ensure employee retention;
- Many clinical trials commence with research and testing of the medicine, treatment or diagnostic outside of the human body. The definition currently outlined does not provide sufficient clarity on whether any of the necessary activities related to the intervention could be included as part of the clinical trial, despite this being necessary prior to the undertaking of human studies;
- The proposed definition associated with clinical trials does not scope in trial activity conducted on animals; and
- The proposed definition associated with clinical trials does not scope in any of the supporting activities that are conducted for the dominant purpose of undertaking the clinical trial.

5. Does the proposed finding process represent an appropriate means of identifying clinical trials expenditure for the purposes of the \$4 million refund cap?

We support the proposed opt-in basis for the clinical trial carve out as well as the proposed finding process as being an appropriate means of identifying clinical trial expenditure for the \$4 million refund cap.

However, we would like to bring to attention the mechanism by which clinical trial expenditure is delineated within the R&D Tax Incentive Schedule and Application for Registration of R&D Activities. For this, we would suggest the following:

1. That similar to that of an Advance/Overseas Finding Certificate Number, that Innovation and Science Australia provides R&D claimant entities that have registered clinical trials with a Clinical Trial Certificate Number that is input below the Registration Number on the R&D Tax Incentive Schedule, as well as within the Application for Registration of R&D Activities (similar to how Advanced/Overseas Finding Certificate Numbers are included); and
2. The R&D Tax Incentive Schedule is amended to include a separate section, just as there is a separate section for R&D Expenditure to Associates, where the costs of clinical trials are delineated into its various components, such as salary expenditure, contractor expenditure (RSP), contract expenditure (not RSP), other R&D expenditure, etc.

Additional Questions

6. Do the draft feedstock and clawback provisions give rise to any unintended consequences that need to be addressed?

The draft feedstock and clawback provisions do not appear to give rise to any unintended consequences. Having the updated formula and refined to be dependent upon the corporate tax rate ensures that the permanent after tax benefit related to the tainted expenditure is always clawed back at a fair rate.

However, it should be noted that although the proposed calculation would result in a fairer tax outcome, it may be more difficult for taxpayers to understand the calculation compared to the existing legislation which requires either a feedstock adjustment that resulted in a one-third add-back, or a 10% recoupment tax.