TCF Services' submission in response to the R&D Tax Incentive exposure amendment draft

SUBMISSION IN RESPONSE TO THE REQUEST FOR CONSULTATION ON THE DRAFT TREASURY LAWS AMENDMENT (RESEACH AND DEVELOPMENT TAX INCENTIVE) BILL 2018 EXPLANATORY MATERIALS dated June 2018.

1 – Respondents

1.1 This submission is prepared by TCF Services Pty Ltd of Level 2, Suite C, Level 2, 55 Mentmore Avenue, Rosebery, NSW 2018. The primary contact for feedback in relation to the contents of this submission is Mr Gerry Frittmann (gerry@tcf.net.au). Telephone 02 82194900 or 0413 647664.

1.2 TCF Services provides a full-spectrum advisory service to firms undertaking innovative activities in Australia, who in turn seek to leverage the Research & Development Tax Incentive (RDTI) and other Government-provided incentives to industry, predominantly via the CDIC Defence industry and associated grants, Automotive Transformation scheme (ATS), Export Market Development Grants scheme (EMDG). Please view www.tcf.net.au for further information.

1.3 TCF Services directly employs 17 people, with over 63% of our staff holding innovation-specific or tax and legal related qualifications, as follows: 12 x Registered R&D Tax Agents with the Tax Practitioners Board with the following degrees – 3 x Certified Practicing Accountants with CPA Australia, 1x Bachelor of Science PhD in Chemistry, 1x Bachelor of Science (Hons) PhD in Physics, 1 x Bachelor of Mechanical Engineering PhD in Process Engineering, 2 x Bachelor of Business & Commerce (Accounting), 1 x Bachelor of Mechanical Engineering and 1 x Bachelor of Electrical Engineering, 2 x Masters of Business administration.

1.4 This submission has been developed following a roundtable workshop to consider the consultation draft and explanatory materials which drew on the collective experience of 12 TCF Services consulting staff associated with the delivery of R&D support to industry

totalling 101 years and associated with the current provision of research & development tax incentive advice to over 250 active clients per annum.

1.5 TCF Services has previously lodged a submission in response to the 2016 R&D Tax Review and the prior Senate Economics Reference Committee inquiry into Australia's Innovation System.

2. Summary responses to policy amendments

2.1 In terms of the current draft exposure bill, TCF Services wishes to submit the following responses to the policy amendments:

2.2 The exposure draft reads like the passing of this legislation has already taken place which is quite alarming given the Turnbull's broader Innovation agenda and former openness in embracing the fast-moving age of technology and all things innovative.

2.3 The proposed increase in the "annual R&D expenditure threshold" from $100m to $150m is a tease given the real effect of the proposed incremental intensity test whereby the vast majority of claimant's benefits with annual revenue of $20m or more will decrease from a previous 10% when the "new" RDTI commenced in 2012, down to 8.5% in 2017 and now a mere 4%. It is disingenuous to refer to a measure which has the impact of reducing benefit for almost all companies over $20m turnover a 'premium'. To add further insult to injury, the manner, in which the proposed intensity test tiering operates means that claimants achieving a very creditable 5% R&D intensity will only derive a higher 6.5% return on R&D expenditure incurred over and above the initial 2% intensity, resulting in an approximate 5.4% return overall. Instead, we believe the intensity test should be used to incentivise R&D firms to achieve the next level of intensity whereby they are rewarded with higher return rate across their total R&D expenditure, this would then have the effect of driving additionality not stifling it. Thought should also be given to at least carving out this option for firms who meet the definition of being a SME, with up to 199 staff, $50m in annual revenue and up to $10 in assets, these are the companies most in need, who employ the vast majority of workers across many industry sectors in Australia and are most under threat and open for change.

2.4 As it is, the incremental intensity decision can only be seen for what it really is, a cash grab fiscal decision which totally ignores the policy intent of the scheme and renders the program defunct for the majority of claimants over $20m in turnover. All this during the most important historical transitional period ever seen whereby all countries are looking over their shoulders and competing in the race to fully integrate to a technology-based economy.

We believe that the unintended consequences will be larger than anticipated. Many affected companies will cease claiming the R&D Tax Incentive as the costs of compliance and preparing applications will make the level of benefit simply uneconomical, we hope this is not the desired intent.

2.5 The linking of the 13.5% benefit for claimant's under $20m in annual revenue to future corporate tax rate decreases makes sense but only if the corporate tax rate reductions are in fact delivered. Therefore, the timing of the implementation should be rolled out contemporaneously with the reduction in the tax rate.

2.6 The capping of the annual cash return to $4m with revenues under $20m reduces the ability for high intensity R&D firms in Australia to attract further investment in R&D to Australia. Carving out "clinical trials" from the proposed annual $4m cash refund cap makes

sense if a cap needs to exist at all, but it does not provide other high intensity R&D firms with the ability to lodge a "national benefits" case demonstrating the flow on benefits that could be derived from providing an uncapped benefit. Firms undertaking deep technology in Quantum Computing is a good example, where research is deep, lead times are long and investment is heavy before commercialisation is potentially achieved, the proposed cap does not align with R&D Tax Incentive policy intent nor its rhetoric about supporting additionality.

2.7 Another issue overlooked once again was recognition for SME R&D firms with turnover of $20m to $50m who receive no incentive from the programme as they don't pay tax due to either trading in loss (sometimes due to expenditure on R&D) or through carrying over accumulated tax losses from prior trading years. Many of these are medium sized firms/employers potentially under threat in their marketplace and in most need to undertake R&D activities to survive. This anomaly should be addressed so to allow SME's the ability to cash out their R&D benefits in the same manner as companies under $20m albeit at the same rate delivered for R&D claimants over $20m. This is yet another area that could have a profound effect on producing evidence based "additionality".

2.8 One of the proposals is an increase in the number of APS staff available to audit claims and increasing the degree to which the powers vested in the ISA's boards can be delegated to public servants, While we support increased levels of compliance activity to keep the R&D Tax Incentive program robust against specious claims we are concerned that any new staff (especially with potentially increased powers) are trained appropriately such that they can exercise their delegated powers fairly and effectively. We note that R&D consultants are required to be registered tax agents. Therefore, staff assisting ISA should only have delegated powers if they are subject to the same or equivalent requirements that registered tax agents have met. Appropriate competency-based training toward gaining delegated powers exists elsewhere in the APS. For example, IP Australia require trainee patent examiners to do approximately three months of full time training and period of supervised on the job training before being granted delegation to accept a patent after around 12 months.

We appreciate the challenge of training large numbers of new personnel and would suggest that AusIndustry considers engaging with the R&D Tax consulting community (perhaps through State Reference Group) to run joint training sessions on R&D Tax for would be delegates. This would give the new recruits an opportunity to engage with other perspectives and a forum for AusIndustry to discuss areas of compliance concern. Based upon recent experience with AusIndustry officers it seems blatantly apparent that they are simply rolling out their own "interpretation of the scheme" which does not reflect any legislative understanding or basis.

We are concerned that by further empowering the state officers they will each run with their own individual interpretations, cause delays and confusion and put claimants under pressure by holding up the process unless claimants agree to minimise their claimed expenses is the same manner experienced in Canada – pls see article attached.

Improved guidance material on eligibility issues worked up in conjunction with the consulting community would assist AusIndustry as much as it would claimants.

2.9 Extending the general anti-avoidance rules in the tax law to specifically mention R&D tax offsets directly is something of a concern in that the principles of Part IVA are somewhat at odds with the intent of what is supposed to be a beneficial piece of legislation designed specifically to influence company behaviour (i.e. get companies to do R&D they wouldn't have otherwise done in order to receive a tax benefit). This change impugns the R&D Tax Incentive and implies that all claimants are engaged in a scheme. It does nothing to

strengthen integrity. Improved enforcement of the current rules would be more effective. Whether a company meets the requirements of the program and can show that its activities are eligible core or supporting activities and an appropriate nexus of incurred costs to those activities should be the primary questions. Provision of fraudulent or misleading answers on those questions should come into consideration when considering penalties.

2.10 TCF Services has previously submitted that dual-agency administration of the current RDTI involves unnecessary uncertainty (in relation to eligibility and benefits) and additional costs to claimants. In its place, we recommend the nomination of a single lead administration agency built around the 'Task Force' concept now being employed by government in the current review to co-ordinate inputs from other related agencies.

2.11 We strongly submit that it is unfair that the costs of 'cultural' differences between two government organisations raised to provide industry benefits and administration of the taxation system should be borne by RDTI claimants. It is the government's responsibility to structure industry assistance programmes so that they can be delivered and administered as efficiently as possible.

3 – Technical responses to proposed eligibility amendments - Questions 1 – 6

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?*

Combining tax definitions with accounting definitions of expenditure will lead to confusion and opportunities to manipulate the benefit. It appears from the suggested method where the denominator in the intensity ratio is taken from the tax return that a company could increase its ratio by capitalising more of its R&D and non-R&D expenditure. (i.e. from the accounting standard a capitalised expense is no longer an expense but an asset).

However, any incentive for abuse of the intensity rule is largely offset by the pitiful level of support being offered to companies over $20m in turnover even at high levels of R&D intensity. In addition, since the increasing levels of benefit only apply incrementally there is no risk of companies bothering to game the system by manipulating the intensity into a higher tier as the base amounts are still at the lower rate.

In order to increase the R&D intensity for a particular year a company may decide to delay or bring forward all of its R&D costs into a particular year.

In fact, we believe that many companies will simply not bother to claim the R&D incentive, as the administrative costs of record maintenance and the cost of preparation severely impact upon the 4% level of benefit. From a cynical point of view, this may be what the government intends, but we believe it will have subsequent negative impacts upon the government's BERD calculations when compared with other OECD countries.

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

The major risk to integrity is that the changes undermine the objectives of the program. The provision of the R&D tax incentive is to provide an incentive for companies to increase their R&D spend. The intent is to stimulate the conduct of additional R&D, not provide a reward for what a company would do anyway. Having this intensity threshold worked out at the end of the year makes it very difficult for a company to factor the R&D benefit into investment decisions. The fact that the benefit is uncertain and that there is a cost of compliance in terms of setting up records to substantiate R&D in addition to the administrative overhead of application it is likely many companies over $20m turnover will simply not bother to claim.

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

The problem relates to large company groups that may have a revolving door of incorporating new entities whilst also selling or dissolving existing entities, thus making this calculation very complex given the timings invloved.

It would be very difficult for a subsidiary which is part of a consolidated group for taxation purposes to understand how its own performance and the expenditure of other related entities (both R&D and non-R&D) will impact the benefit to the group from R&D tax.

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?

This seems fine at present but the effectiveness of the legislation should be reviewed regularly to ensure that this continues to meet the needs of the biotech industry and achieve the objectives of the legislation.

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 have several comments to make on this.

- There is no inherent issue with creating additional compliance requirements for companies who receive over four million dollars of taxpayer funds in a year.
- The simplest process may be to audit the clinical trial activities claimed by any company who exceeds that threshold every year that the threshold is exceeded. This need not be an onerous process. A simple requirement that a company produces invoices, trial reports and scopes of work on request would be sufficient.
- Care needs to be taken to ensure that any additional finding processes have clear guidelines and an enforceable timeline for regulators for to make a decision. Existing advanced and overseas finding processes are cumbersome and do not meet customer expectations in terms of clarity of feedback and timeliness of response.

- A similar process to certify contract or inhouse research facilities that are eligible used for Registered Research Agencies may be appropriate. Integrity measures including penalties and potential deregistration as a registered clinical trial organisation should be in place as a deterrent from supplying documentation that trys to claim expenses related to activities other than clinical trials as defined.

Feedstock and clawback calculation

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

The consequences are simply that the calculation is so complex that it will be too complicated for many companies that claim the R&D offset without assistance. For those that do attempt to claim it, there is a strong likelihood that errors may be made.

Again, for companies over $20 million turnover, the complexity of this calculation, compared to the minimal additional benefit of the R&D incentive will cause companies to ignore claiming the R&D tax incentive for any expenditure subject to the feedstock or clawback adjustments.

Finance

Have you had a review of your SR&ED claim that didn't go well? There are options for claimants

ITBusiness Staff @itbusinessca
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By Susan Mattice

The SR&ED tax credit program is odd in that from a tax policy viewpoint it is an incentive program, nudging companies to carry out more R&D in Canada and develop innovative products and processes.

However, because the program is administered by CRA, one must deal with tax auditors, which is intrinsically a disincentive.

To be fair, CRA is tasked with administering the Act, including any incentives in the Act. This partly means protecting the integrity of tax collection. Those old enough to remember the SRTC program, forefather to SR&ED, know how such a program can be abused quickly.

Under the SRTC program, well over a $1 billion of tax credits flowed out before CRA could examine the underlying R&D projects, many of which were bogus. This program lasted for only a few years with significant damage inflicted on the R&D ecosystem.

As the SR&ED program now has been around for over 30 years, CRA has seen

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its fair share of questionable SR&ED claims. However, the turning point came in 2012, when a body of literature appeared in various news outlets covering suspect SR&ED projects. The government at the time provided CRA with $10m in funding to hire and retrain SR&ED auditors to prevent any perceived abuse.

The result has been the administration of SR&ED by CRA as a program prone to abuse and not as an incentive program with a lighter touch on audits. We now have more intense and frequent audits of SR&ED claims, supported by the following stats:

1. In 2015, roughly 23,000 SR&ED claims were filed in Canada, down from roughly 25,000 from the prior year. This figure appears to be trending downward each year.
2. In 2015, ITC's claimed were roughly $3.8 billion, down from $4.3B the prior year.
3. Nationally, nearly 60 per cent of all SR&ED claims were referred to a local office for further review and of that 27 per cent resulted in a site review.
4. Upon a detailed site review, 60 per cent of all SR&ED claims were reduced.

The chance of having your SR&ED claim audited at least once every 5 years is over 90 per cent. This is a very high audit rate for an incentive program. Countries with similar R&D tax credit programs like the UK, Netherlands, and Australia have much lower audit rates.

The SR&ED audit process: CRA's "Audit Culture"

Anecdotally, companies that have gone through an audit of their SR&ED claim by CRA can tell you why and how their claims are diminishing. They feel the definition of what is eligible is more restrictive and more detailed documentation is required to support the claim; despite SR&ED legislation remaining unchanged.

CRA has service standards to process claims except when a review or audit takes place, then all bets are off. Many companies experience long delays, waiting several months after the initial meeting with CRA before they get any indication of a reviewer's determination on their SR&ED eligibility. The burden on the claimant is also increasing as reviewers are asking companies to respond to multiple requests for information or to add to their current contemporaneous documentation systems by summarizing their existing documentation; documenting their documents as it were.

Due to this high audit/review rate, many CRA reviewers have large file loads with increasing difficulty to process the files in a timely fashion. Sometimes it feels like reviews end up dragging for so long that it becomes difficult to imagine that a reviewer can recall the facts when so much time has passed since the first review meeting took place.

A Lack of Consistency

Currently, there is no centralized control over the specific practices used across the country. The Headquarters in Ottawa issues high-level policy documentation and leaves interpretation specifics to the Regional Offices. As a result, there is a wide discrepancy when it comes to results among districts. For example, in 2015 the national average of ITCs adjusted on a site review was nearly 23 per cent. However, a number of large district offices reported adjusted ITCs of twice this amount. Overall, this leads to inconsistency and unpredictability.

What Can Claimants Do?

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SR&ED claim preparation

It really helps if you have a process like RDP's Innovation Connection Program (ICP) to identify, capture and document SR&ED projects, activities, and costs. If you follow this process, you will be ahead of the numerous companies who file SR&ED without a formal process.

Here are a few pointers on filling out the SR&ED claim forms especially the project descriptions:

1. Make sure you describe the technological uncertainty at the right level and clearly separate it from routine development. This is easier said than done, but often the uncertainty is either too vague (described at too high level) or described at so low a level that it appears routine.
2. Make sure you do your due diligence and set a baseline for the technology. CRA will check online to see if a solution to your Technological Uncertainty is public knowledge. If they find information online, even if it is only vaguely related, CRA will interpret it as known and try to deny the claim.

What to do during an audit?

The most important thing to do is to prepare. RDP recommends mock reviews as a good dress rehearsal for the real thing; to understand what needs to be demonstrated to CRA in terms of eligibility. If you go in cold there is a good chance you will get tripped up answering a question in such a way that it hurts more than it helps.

CRA will likely have prejudged your SR&ED claim before the initial meeting. They would have read your project description and developed a plan to review the claim. If they have a negative view of your submission, you have an uphill battle to change their minds. You should address these issues as soon as possible in the initial meeting. If you can find out these issues before the meeting, even better.

Ensure the key technical person is at the meeting. This person is the competent professional and will know more about the company's development work than CRA. He/she needs to believe in the technological uncertainty and stay confident so as not to be swayed by CRA during the meeting.

What happens when CRA denies your SR&ED claim?

If you have concerns about the outcome of a review or how the review was conducted, you should bring them to the attention of the CRA Reviewer and Manager. If that fails, a company can request an Administrative Second Review. Anyone of these options can resolve the concerns, but to ensure a good outcome, concerns should be raised before the report is written and the file is closed. This is the best chance for a company to influence the determination and improve the outcome. However, disappointingly, success rates for changing a determination at this stage are still relatively low.

If the issue relates to mistakes that could result in a misunderstanding or omission, undue delays, employee behavior, etc. a Service Complaint can be filed with CRA. This can be a fairly quick process as the goal is to resolve it within 30 business days. The narrow scope of a Service Complaint means it isn't the answer for issues such as disagreements with eligibility determinations.

Another option is to file an Appeal through a Notice of Objection to request

that CRA's Appeals Division reconsider the facts of the claim. On the surface, this seems like a good option, and it can be if there is an obvious error in interpretation on the part of the Reviewer(s), if there is additional (and convincing) documentary evidence to provide, or if a specific expenditure was denied within a claim that had been otherwise deemed eligible.

In CRA's Guidelines for Resolving Claimants' Concerns document, CRA states that filing an Objection is an option if a Claimant feels that "facts have been misinterpreted or the law has been incorrectly applied".

However, in practice, the review through Objection is rarely effective for a claimant. It appears that the Appeals Officers do not consider any new information unless it is a new, contemporaneous document (information through argument or explanation is not considered), making it very difficult to argue that the facts have been misinterpreted. Through Appeals, the decision-making process by CRA is not evaluated. Issues related to how the review was conducted are not within the scope of a review under this process. Worse, this process takes as long as several years to resolve and while a claimant can provide additional documentation to the Appeals Division, there is no meeting or discussion for this review.

Tax court is another option, and quite possibly a more successful one, but it does involve costs that not all claimants can afford. The benefit of taking a claim to the Tax Court of Canada is that it relies on the law rather than on CRA's administrative policies. The definition of SR&ED in the Income Tax Act has not changed so the tightening companies are seeing through CRA's administration of the law is not at play in this arena. This process is much faster than the Objection route and settlement is also an option. Not every company whose claim is denied or reduced has the time, inclination, or resources to go to the Tax Court.

Can we fix what appears to be broken?

It does not appear that the SR&ED program is high on the government's list of priorities. This is evidenced by the fact that the Government promised to review all Innovation Programs and in parallel, review the SR&ED program. Budget 2018 announced upcoming changes to many grant programs, but there was no mention of the SR&ED program whatsoever. At present, it is unclear what became of that promise. It is unclear if it would be reviewed behind closed doors and without consultation with key stakeholders and participants.

Know your rights, know your options

Irrespective of changes in the SR&ED landscape, there are still many businesses that rely on SR&ED to fund their R&D and help them remain competitive in the global marketplace. A large number of companies are still receiving SR&ED credits annually and without incident with positive and collaborative experiences with CRA's staff during reviews of their claims.

However, when things don't go well, remember that you have options.

Susan Mattice is Director of Operations, IT/Software Group at RDP Associates.

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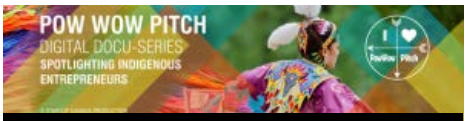

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Finance

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