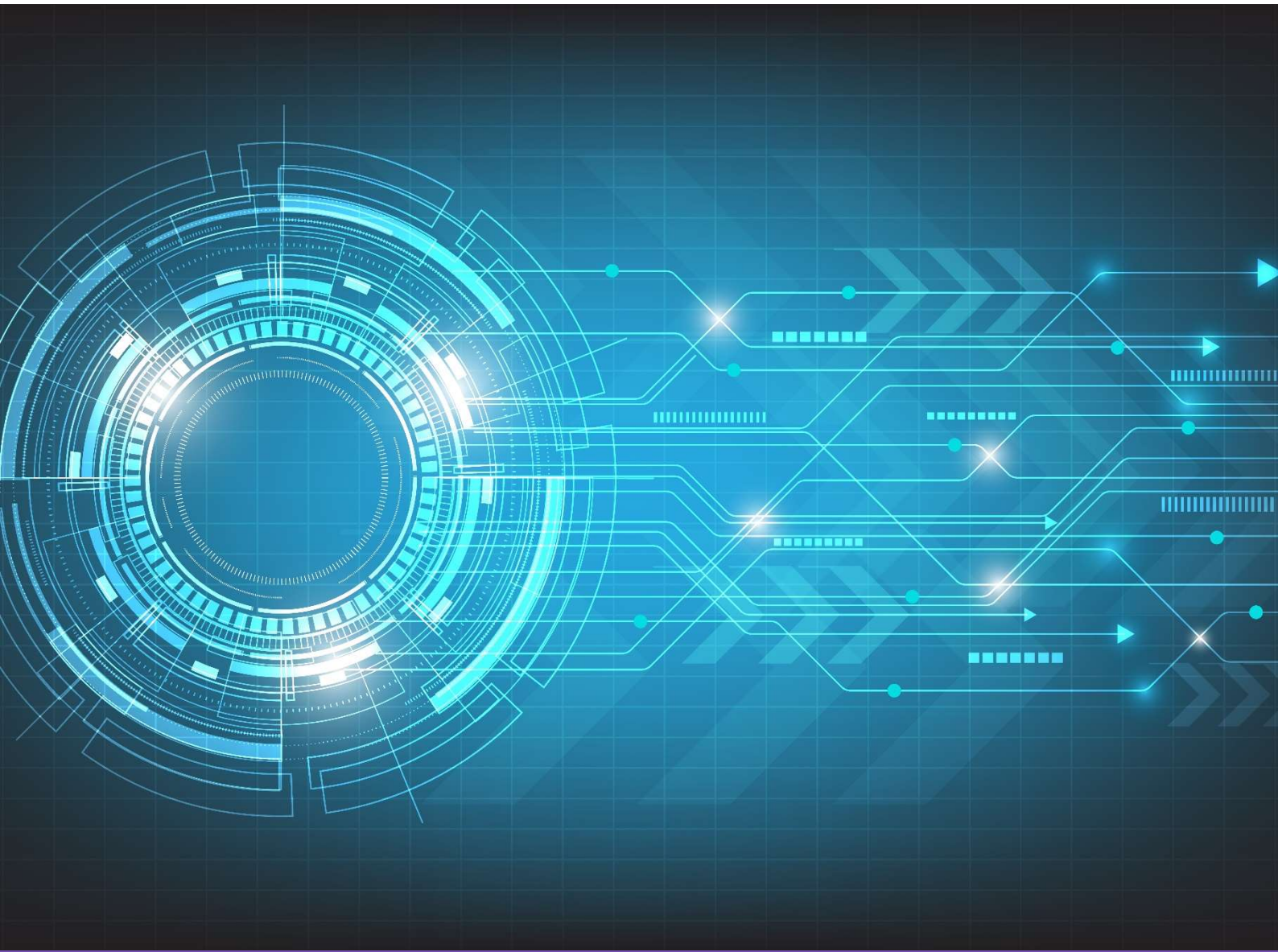
Submission on Consultation Paper: Reforming the R&D Tax Incentive



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1 About Xenith IP

Xenith IP Group Limited ("Xenith") is an Australian public company (ASX: XIP) and is the owner of a group of leading specialist intellectual property (IP) and related advisory firms, including:

- Griffith Hack
- Shelton IP
- Watermark, and
- Glasshouse Advisory

Collectively, the operating businesses within the Xenith group provide a uniquely comprehensive suite of specialist IP and ancillary services across the innovation landscape, assisting clients to capture and maximise value from their innovations, IP and other intangible assets.

The Xenith group collectively is one of the leading filers of patents and trademarks in Australia, on behalf of a global client base comprising more than 11,000 clients, ranging from major multinational corporations, domestic and foreign corporations, research institutes and educational institutions, through to a broad base of SMEs and entrepreneurs. Through Glasshouse Advisory, we provide a spectrum of complementary advisory services pertaining to IP economics including intangible asset valuation, innovation incentives including R&D tax incentives, IP strategy and IP analytics.

Given that our core services and expertise revolve around R&D, IP and innovation, we welcome the opportunity to provide a submission to Treasury on the proposed changes to the current RDTI, acutely aware that government innovation policy in general, and innovation incentives in particular, have a significant impact on how our country capitalises on its innovation strategy and on its competitive position, when compared to its peers in the global innovation ecosystem.

2 Australia's Performance on Innovation

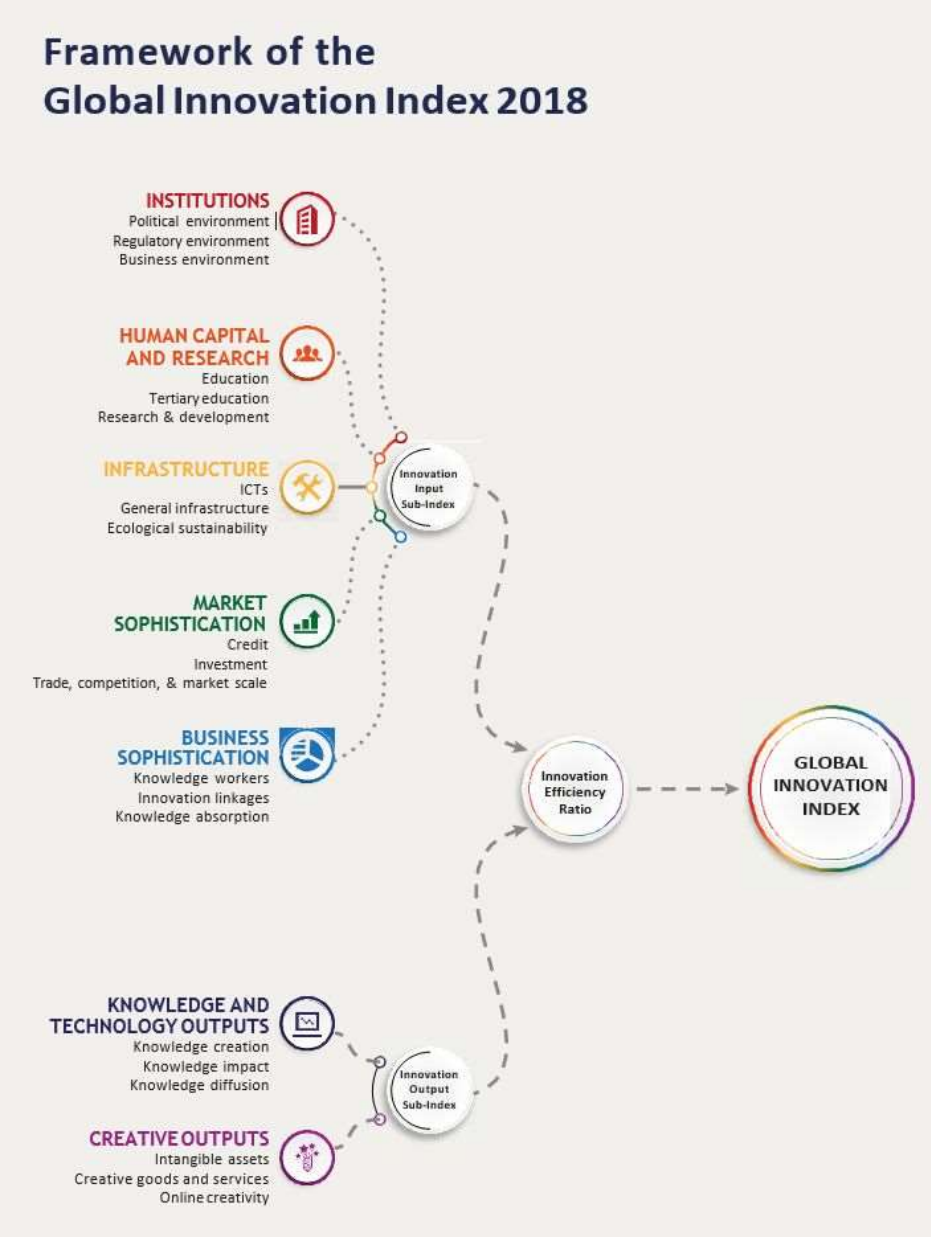
There is no shortage of information and studies that analyse the effectiveness of Australia's innovation policies and how Australia compares to other countries in terms of innovation. The most recent of these reports was the *2018 Global Innovation Index (GII) Report*. The Global Innovation Index creates and analyses a range of metrics through which innovation activity can be measured and compared, using a consistent set of input and output parameters.

In the most recent Global Innovation Index, there were some interesting, and in many respects concerning, findings regarding Australia's performance in the Global Innovation economy. These included:

- In the 2018 GII, Australia improved its overall innovation ranking by 3 positions to 20th position overall, moving just past New Zealand, Austria and Iceland.
- However, with a score of just 38.3 out of 100 and a ranking of 30th position in relation to innovation *outputs*, Australia is a long way behind many of its key trading partners such as Switzerland, Netherlands, Sweden, UK, Germany, US, Luxembourg, Finland, China, Israel and Korea, but is also behind countries such as Estonia, Malta, Slovenia, New Zealand and Cypress.
- Australia has slipped from 27th to 28th place in terms of 'business sophistication'.
- In terms of patenting activity, Australia's position (relative to GDP) is significantly behind New Zealand, Canada, the UK, US, Japan, South Korea and many other competing countries.
- While Australia improved its overall ranking (i.e. 20th), it continues to languish in a seriously concerning 76th place (the same position as last year) in terms of its 'innovation efficiency ratio', which is essentially a measure of how much innovation *output* Australia achieves, in return for its innovation *inputs*.

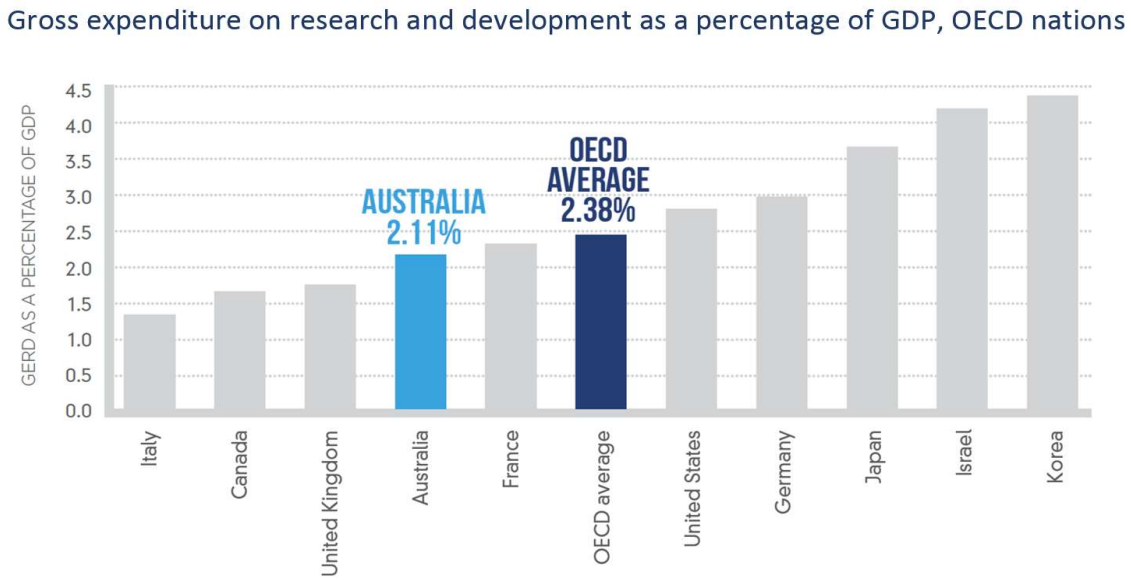
Figure 1

This figure outlines the framework for determination of *Innovation Efficiency* in the Global Innovation Index.



In addition to the 'snapshot' of Australia's contributors to innovation efficiency provided in the 2018 GII, an analysis of recent OECD data also provides guidance as to how Australia is performing from a research and development perspective, relative to other countries. For example, Figure 2 below identifies that Australia's gross expenditure on research and development as a percentage of GDP is 2.11%, well below the OECD average of 2.38%.

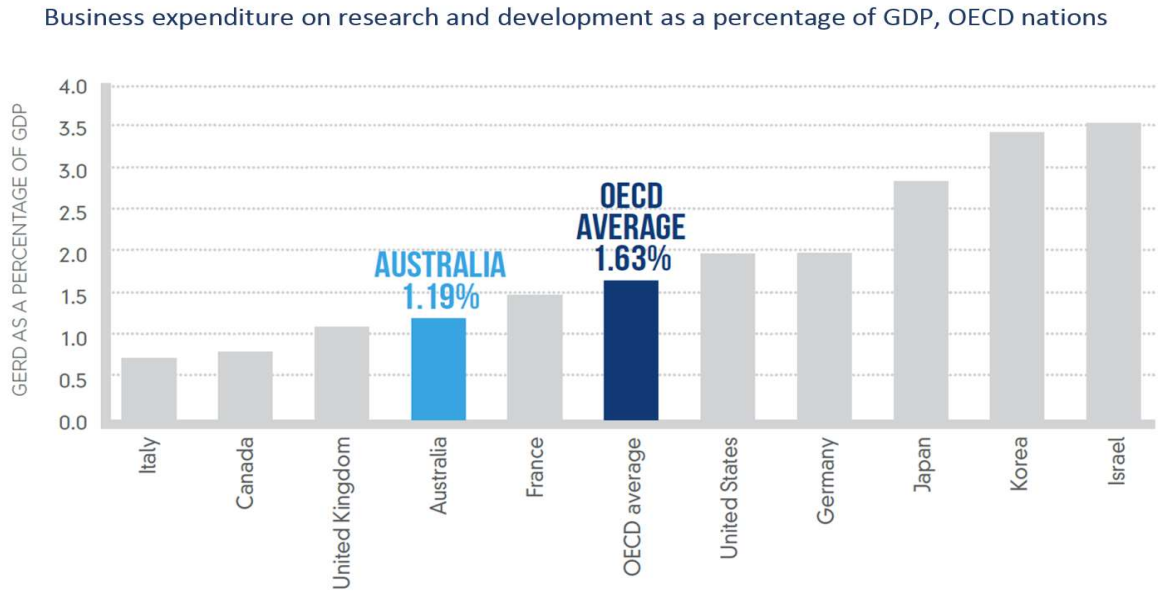
Figure 2



Source: Compiled from OECD Statistics, Main Science and Technology Indicators. Data is for 2014 or latest available year.

Figure 3 below also indicates that Australia's business expenditure on research and development as a percentage of GDP is well below the OECD average of 1.63%, with Australia's rating of 1.19%.

Figure 3



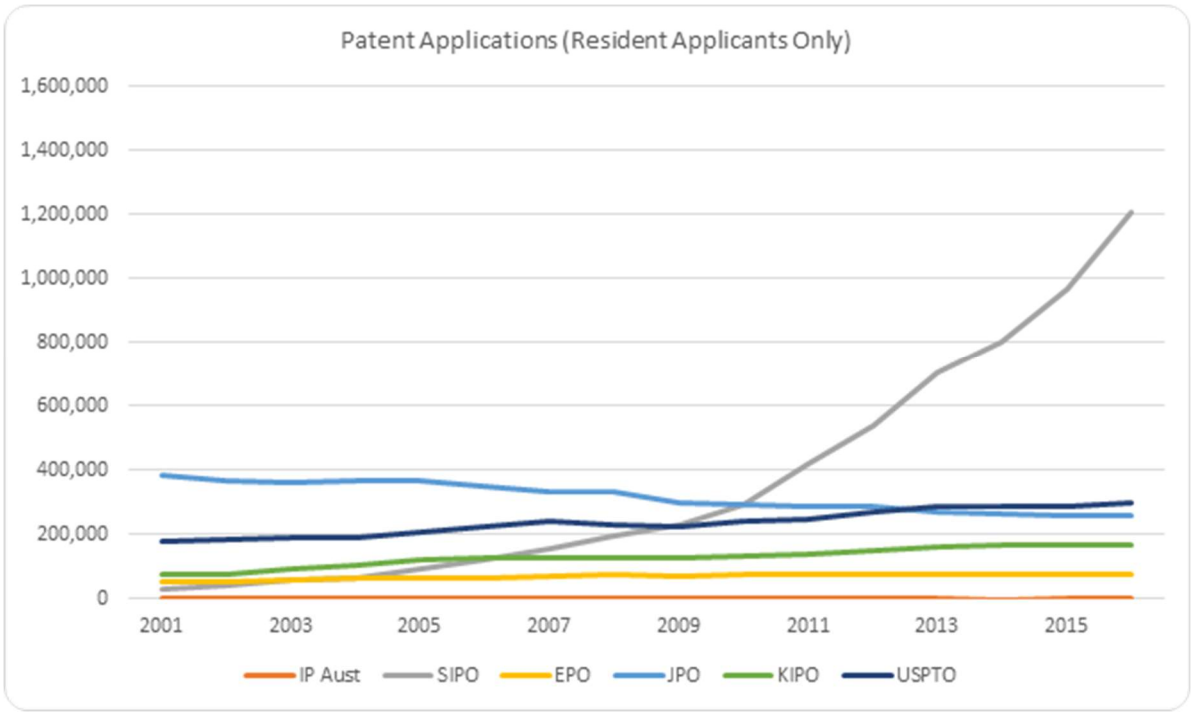
Source: Compiled from OECD Statistics, Main Science and Technology Indicators. Data is for 2014 or latest available year.

Australia's GII performance, coupled with its performance against other OECD nations with respect to investment in research and development, presents a relatively unimpressive score card, especially when placed in a global context.

Of particular concern is Australia's ability to create knowledge (i.e. patent applications by origin, scientific and technical publications, PCT international applications by origin, etc) where Australia ranked 38th, and its ability to diffuse knowledge (i.e. intellectual property receipts, high tech exports, foreign direct investment new outflows), where Australia ranked 92 in the GII.

From a global perspective, innovation activity and knowledge creation are growing at significant rates, as evidenced by the information in Figure 4 below.

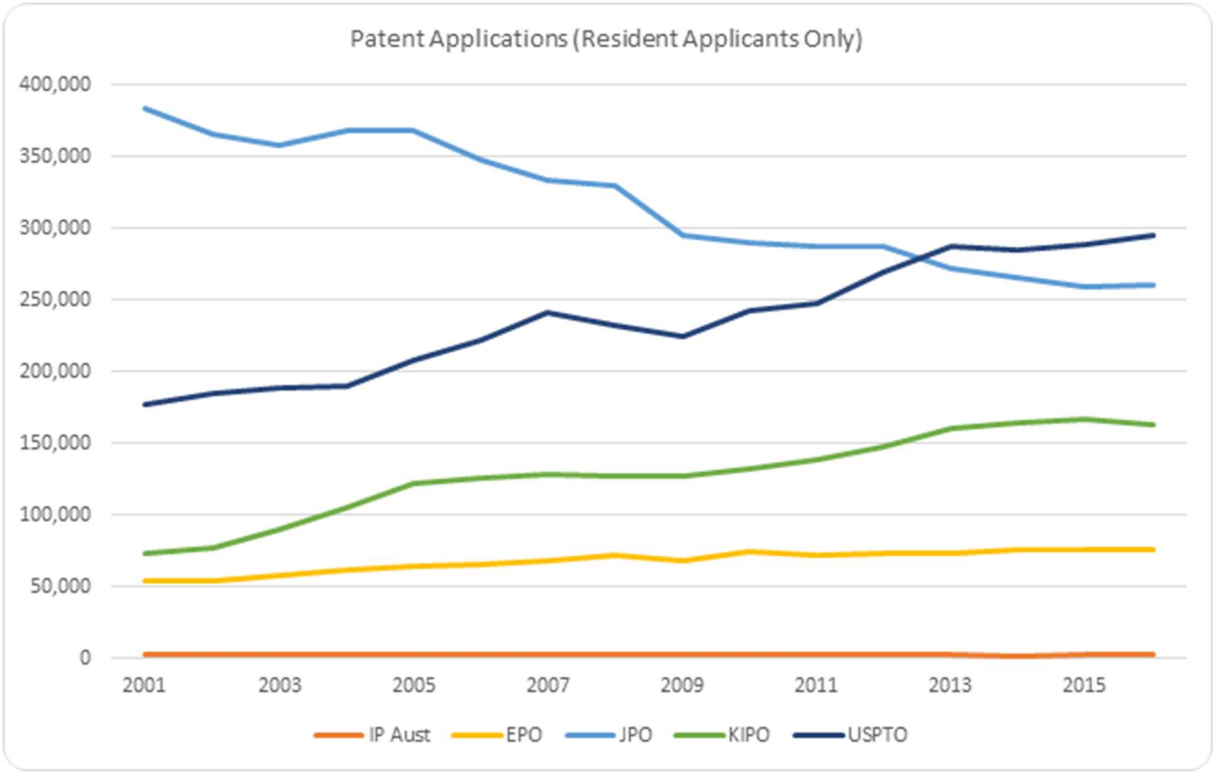
Figure 4a



The patent filing data for *resident* applicants essentially excludes foreign-originating patent applications in each jurisdiction and is therefore a reasonable proxy for local innovation activity On this scale, Australia is difficult to discern from the zero axis.

The data in Figure 4a above is somewhat overshadowed by the patent filing volumes in China and therefore the chart below in Figure 4b depicts the same data, on a different scale, but with China excluded. Even on this enlarged scale, Australia barely registers.

Figure 4b



It seems clear from this data that Australia is progressively losing ground to our OECD competitors. This is quite likely due, at least in part, to the fact that Australia is the only country in the OECD without a clearly articulated and well-resourced science or technology strategy.

While most of Australia's major trading partners demonstrate strong growth momentum in innovation activity, Australia's performance over the past decade has been relatively flat, and in fact on some measures is actually declining, as evidenced in Figure 5 below.

Figure 5

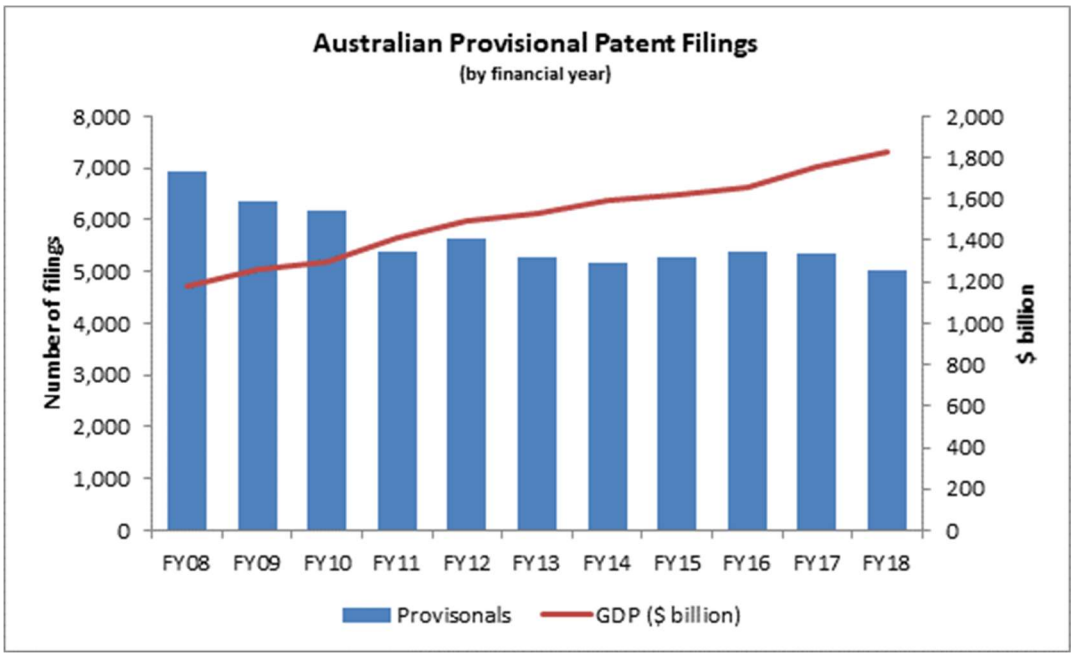


Figure 5 shows the number of Australian provisional patent applications lodged year-on-year, over the last 10 years. This is a proxy for Australian innovation activity and is seen to be progressively declining both in absolute terms, and even more markedly relative to GDP. Consistent with the GII report, this does not speak well of Australia's ability to effectively capture and commercialise innovation.

It is also relevant to note that patent filings typically lag real time R&D expenditure, leading to a delay between economic spend and economic return. If R&D spend is down, then patent filings will typically follow and this situation will not quickly correct itself.

So, there is a very obvious question that needs to be addressed. If there are strong correlations between R&D expenditure, patenting activity, successful commercialisation, and returns on R&D investments, why don't Australian businesses simply increase their spend on R&D activities?

The answer to this question is complex, but does involve issues associated with risk, state of economy and the availability and access to Government incentives.

3 Australia's history of R&D Tax Incentives

Before turning to Australia's history of R&D Incentives, there are some findings that warrant consideration, to put the rationale for reviewing Australia's R&D Tax Incentive scheme into context.

There has been a multitude of reports into the effectiveness of Government incentives on business innovation over the years, many of which have been commissioned by various Government bodies in various countries, and many of which have been commissioned by the OECD.

In a series of articles commissioned by the OECD Science, Technology and Industry Working Paper Division, Dominique Guellec and Bruno van Pottelsberghe have investigated the correlation between public R&D expenditure on incentivising business R&D expenditure. In one of the articles entitled "*The Impact of Public R&D Expenditure on Business R&D*", (which quantified the net effect of Government funding on business R&D in 17 OECD countries over a 20-year period which included Australia), they noted a number of major factors, including (amongst other findings): -

- Tax incentives have a positive (although short lived) effect on business financial R&D.

- Direct funding, as well as tax incentives are more effective when they are stable over time: firms do not invest in additional R&D if they are uncertain of the durability of the Government support.

- Direct Government Funding and R&D tax incentives are substitutes: increased intensity of one reduces the effect of the other on business R&D.

- The stimulating effect of Government Funding varies with respect to its generosity: it increases up to a certain threshold (about 13% of business R&D) and then decreases beyond[1]

In addition to these major findings, the report identified the various forms of Government Funding for R&D, noting that "in some countries, there are special tax breaks related to R&D for small firms. The main criticism of this instrument is that it is windfall money for firms: they do not change their R&D strategy (which is what the Government is expecting) but are refunded for it."[2]

Taking these observations into account when trying to understand the reasons behind Australia's declining local patenting activity, it is interesting to investigate whether Australia's patenting activity is correlated to the Government's R&D policies. In seeking any form of correlation or trend, it is interesting to note the history of Australia's R&D Tax Incentive regime, which is outlined below in Figure 6.

[1] The impact of Public R&D Expenditure on Business R&D " – Dominique Guellec and Bruno van Pottelsberghe, OECD Science Technology and Industry Working Papers 2000/04 OECD Publishing Paris, page 3

[2] Ibid, page 9

Figure 6

The History of changes to the R&D Tax Concession/Incentive

Financial year(s)	Company tax rate (%)	Incentive rate (%)	After tax Benefit (%)
1987-88	49	150	24.5
1988-89 to 92-93	39	150	19.5
1993-94 to 94-95	33	150	16.5
1995-96 to 96-97	36	150	18.0
1996-97 to 2000-01	36	125	9.0
2001-02 to 09-10^	30	125	7.5
2010-11 to 2014-15 (small and medium firms with turnover <$20 million)	30	150	15
2010-11 to 2014-15 (large firms with turnover >$20 million)*	30	133	10
2015-16 (Small company tax rate cut for fi with turnover <$2 million)	28.5	145	16.5 (in profit) / 45 (in loss)
2015-16 (medium firms with turnover $2 million - $20 million)	30	145	15 (in profit) / 45 (in loss)
2015-16 (large firms with turnover >$20 million)	30	140	10

As of September 2016

Small companies (turnover <$2 million)	28.5	143.5	15 (in profit) / 45 (in loss)
Medium companies (turnover $2 million - $20 million)	30	143.5	13.5 (in profit) / 43.5 (in loss)
Large companies	30	138.5	8.5

^ Various changes were implemented during the 2001-2010 period, including; the allowance for small loss-making fi to receive an early cash payment based on eligible R&D expenditure, rather than a future entitlement to a deduction; and a 175% premium concession for labour-related R&D expenditure above the fi s three-year average. From 2007-08 Australian incorporated companies belonging to multinational enterprise groups were allowed to claim up to 175% deduction on eligible expenditure. These changes were replaced by a simplified R&D Tax Incentive in 2010-11.

* In 2010-11 the R&D Tax Concession (which was an additional tax deduction) was changed to the R&D Tax Incentive (which is a refundable/non-refundable tax offset).

Proposed changes from 1 July 2018 – the new R&D Tax offsets

R&D Tax offset	Rate of offset
Refundable R&D Tax offset (companies with aggregated annual turnover less than $20 million)	The claimant's tax rate for the year plus 13.5 percentage points.
Non-refundable R&D Tax offset (companies with aggregated annual turnover of $20 million or more)	The claimant's tax rate for the year, plus:

R&D Tax Incentive Premium	Level of Intensity (eligible R&D expenditure as % of total expenditure)
4%	0% - 2%
6.5%	>2% - 5%
9%	>5% - 10%
12.5%	>10%

From the above data, there are four key factors to note: -

- Since the R&D Tax Concession's inception in 1985, the program has undergone a significant number of material changes (in terms of eligibility and level of benefit), with substantive changes occurring at least every five years over the past two decades. In contrast, the US has essentially had the same R&D tax rules since 1990. [3]

- There has been a significant erosion in the after-tax benefit of the R&D Tax Incentive program since 1985, from an after-tax benefit of 24.5% (1987-1988) down to the proposed 4% in the current draft R&D legislation.

- Recent incarnations of Australia's R&D Tax Incentive have provided special tax breaks (in the form of cash refunds) for small firms, which the above report notes is unlikely to deliver the outcomes designed or intended by the Government.

- The recently proposed modifications to the current R&D Tax Incentive are complex, do not allow businesses to predict their eligibility to a specific level of R&D benefit prior to the conduct of the R&D and offer such low levels of benefit that (according to the above noted OECD study) are unlikely to have a stimulating effect on business financial R&D.

These factors lead to an obvious question. Has the lack of stability in the Australian Government R&D program, coupled with the erosion of benefit and the complexity of confirming eligibility in advance of the conduct of the R&D activities, contributed to Australia's reducing (or at best static) locally originating patent filings?

The issue of lack of stability and uncertainty in Government policy in the R&D area has been the subject of a number of research papers, with one such paper produced by The McKell Institute noting "*Policy uncertainty – relating to uncertainty within a specific policy – can be defined as a situation in which there is an information vacuum regarding that policy. Frequent reviews and announcements by Government regarding a specific policy, as has been witnessed in Australia regarding the R&D Tax Incentive in recent*

[3] Beth Webster and Russel Thomson "R&D Tax Incentives need to be simple and underpin investor confidence", The Conversation, 3 October 2016.

years, can lead to such a situation. This is because for firms, uncertainty about a tax rate creates uncertainty about the profitability of the investment (in R&D for example), increasing the risk involved in investing in such circumstances."[4]

Taking into account the information and findings from both the OECD and The McKell Institute Studies, it would be easy to conclude that the lack of policy stability and the erosion of the R&D Tax Incentive benefit (particularly over the past decades) has led to a significant level of policy uncertainty which, according to The McKell Institute Study, can lead to decisions that reduce risks associated with uncertainty, which could include a reduction or deferral in R&D activity due to uncertainty related to the cost (and therefore profitability) of such an investment. Reduced investment in R&D within Australia has a direct connection with the level of local patent filings, which could explain why Australia's local patent filings have not increased over the last decade, in stark contrast to most of our trading partners.

In reviewing the impact of Australia's R&D history on patent filings and the impact of this policy on innovation within Australia, it is interesting to note that the most recent changes to the R&D Tax Incentive Scheme (including the proposed legislation released on 29th June 2018) are beneficial to R&D entities with a turnover of less than $20 million, as opposed to R&D entities with a turnover of more than $20 million. With this information at hand, the following information is also relevant.

- According to the Australian Bureau of Statistics, more than 60% of small businesses cease to operate within the first 3 years of starting.

- In the 2016/17 year, 41% of the value of the R&D Tax Incentive was provided to entities with an aggregate turnover of under $20 million. 59% of the value of the R&D Tax Incentive was provided to entities with a turnover of more than $20million.

- According to recent discussions at the ATO/AusIndustry state consultation meetings, neither the ATO nor Treasury have conducted a study into what proportion of SME entities that received the special R&D Tax benefits for entities with turnover of less than $20million are still in operation after 3 years or, more importantly, become tax paying entities. Without this data, it is not possible to assess the success of the Government's strategy of providing enhanced R&D Tax benefits to SMEs relative to larger, more mature businesses. Data provided in the previously noted OECD report indicates that a Government strategy of providing enhanced R&D Tax benefits to SMEs does not influence the R&D strategy of the SME (which may be the Government's intention) and is viewed as 'windfall' money for the SME.

- According to IP Australia's 2018 Patent Report, more than 75% of the Australian residents that applied for patents in 2016 were private individuals or SMEs. Based on IP Australia & WIPO data, approximately 37% of the Australian provisional patent applications lodged in 2016 lapsed without being progressed to the next stage in the process. It is likely that a disproportionate percentage of these lapsed patent applications were filed by individuals or SMEs. Such decisions are often a result of funding constraints, which in many cases would be exacerbated by a reduction in R&D tax concessions.

- On the point made in the previously referenced OECD report regarding the effectiveness of special tax breaks related to R&D for small firms, (i.e. such funding does not affect the SME's R&D strategy), SMEs involved in R&D are often established in order to investigate and progress the development of a specific product or service. Given this is a predominant reason for most R&D focused SMEs coming into existence, it makes sense that the provision of an enhanced R&D Tax benefit is unlikely to change their R&D strategy. However, it may enable such SMEs to stay in business longer, and increase the probability of commercial success. Again, unless the Government conducts some

[4] The McKell Institute – " Committing to the Innovation Nation – Why the R&D Tax Incentive is so important to Australia" – www.mckellinstitute.org au February 2017.

analysis of the value of accelerated R&D benefits to SMEs as it relates to the Australian economy, it is difficult to assess if this strategy is a good policy or a poor use of public funds.

In answer to the question as to whether there is likely to be a causal relationship between the erosion of Federal Government's R&D Tax Incentive program and the progressive decline in locally originating provisional patent applications in Australia (i.e. patent applications filed by Australian based innovators), on a high-level analysis, the answer would have to be yes. Constant changes to the program, the decline in value of the benefit and its focus on SMEs appear to have led to an environment of uncertainty, where companies are unable to predict the internal rate of return of their investment in innovation, choosing instead to reduce discretionary spending on R&D activities, flowing through in turn to reduced patent activity.

4 Proposed Changes to the R&D Tax Incentive and the potential impact on innovation in Australia

Having establish that there appears to be a link between the Federal Government's R&D Tax Incentive policy and the level of innovation in Australia, it is now worthwhile considering if the proposed changes to the R&D Tax Incentive (as outlined in draft legislation released on 29 June 2018) will have a positive or negative impact on the Australian Innovation ecosystem.

When details of the proposed changes to the R&D program were released in the 2018 Federal Budget, the Treasurer indicated the changes were required to restore the integrity of the program and to reward those companies that invest heavily in R&D activities. In seeking to achieve these objectives, the Budget identified the introduction of a '4 tiered' benefit program based on an R&D entity's 'R&D Intensity'. R&D Intensity is calculated by establishing R&D expenditure as a proportion of total expenditure. The '4 tiered' benefits were set out as follows: -

R&D Tax Incentive Rate	Level of intensity (eligible R&D expenditure as a percentage of total expenditure)
4%	0% - 2%
6.5%	>2% - 5%
9%	>5% - 10%
12.5%	>10%

When the details of the new program were published in the draft legislation, it became evident that the 4-tiered program was an incremental benefit, rather than an aggregate benefit. What this means is that if a company has an R&D intensity of 4%, and spends $100,000 on R&D, all expenditure up to 2% intensity attracts a rate of 4% tax benefit and the amount over 2% up to 4% intensity attracts a benefit of 6.5%. That is, the total $100,000 in R&D spend does not attract a 6.5% tax benefit for the total $100,000 (i.e the company would not receive an R&D benefit of $6,500). Instead, the first 0-2% intensity (i.e. $50,000) would attract a 4% benefit (i.e. $2,000) and R&D spent above the 2% intensity threshold (i.e. $50,000) would attract a tax benefit of $3,250, with an overall total benefit of $5,250).

The cascading return of the proposed 4-tiered benefit, combined with the manner in which the R&D intensity is calculated (R&D spend as a proportion of total expenditure), results in companies being unable to predict their level of R&D intensity **prior to start of a financial year** (due to potential factors influencing total expenditure). It also results in the benefit associated with increasing R&D spend in order to access the next bracket within the 4-tiered benefit structure being negligible.

The inability to predict the level of benefit able to be accessed as a result of R&D activities is often cited as a flaw in any R&D Tax Incentive program. However, the success of R&D Tax Incentive schemes that are based on incremental benefits have also been challenged, including within a review of R&D expenditure commissioned by the Department of Industry, Tourism & Resources in March 2007. In that review, the following observations were made: -

- The study identified that 75% of Australian firms examined have moderate to highly variable patterns of R&D Expenditure.

- If most firms cannot easily predict their R&D expenditures, then they are unable to benefit from a scheme based on incremental increases in R&D.

- In particular, proposals to use an **incremental scheme based on R&D intensity would not work**, as only 8% of firms have stable intensity. It follows that most firms with year on year variability in R&D intensity would not be able to access the incremental 175% scheme (compared to the initial 125% benefit).

- Firms that are able to predict future R&D expenditure and factor it into their R&D decision making processes are likely to increase their expenditure on R&D and, as such, benefit from the incremental scheme. [5]

What this study suggests is, if a company cannot predict its level of R&D intensity (due to an inability to accurately predict its R&D spend or total expenditure) it is unlikely to increase its R&D expenditure to access the next level of incremental benefit.

This observation is consistent with the findings within the previously noted OECD guidelines, which noted that R&D programs that lacked predictability are more likely to reduce the incentive for a business to increase its R&D spend, due to the inability to predict the outcome and profitability of their investment in innovation. Given this factor alone, it would appear the lack of predictability and uncertainty associated with many of the concepts within the proposed revisions to the current R&D program will not lead to an increase in R&D expenditure and, as such, we should not expect an increase in the level of local patent filings (which is proxy for local innovation).

In introducing the proposed R&D Tax Incentive, the Federal Government identified that the top benefit of 12.5% for R&D intensity of over 10% was a significant inducement for companies to increase their R&D spend, in order to access such a high rate of R&D benefit.

We have conducted an analysis of data associated with the ASX200 Top 20 most innovative companies, in order to determine which of these innovative companies would actually be capable of accessing the 12.5% R&D Tax benefit under the proposed new R&D program, taking into account that any expenditure over $150 million is treated as ineligible.

The results of this analysis are shown in the Table on the following page.

[5] High variation in R&D expenditure by Australian Firms, Department of Industry, Tourist, and Resources, 2007, page 3

#	Company	Aggregate expenditure ($)*	R&D expenditure required to *reach* the 12.5c benefit under the proposed 4 tier structure ($)
1	Seek	781,400,000	78,140,001
2	REA Group	477,011,000	47,701,101
3	CSL	1,827,100,000	182,710,001
4	Dominos Pizza Enterprises	1,922,000,000	192,200,001
5	Xero	297,918,000	29,791,801
6	QANTAS	14,687,000,000	1,468,700,001
7	Carsales.com	195,617,000	19,561,701
8	MYOB Group	328,648,000	32,864,801
9	Cochlear	584,331,000	58,433,101
10	Telstra	17,558,000,000	1,755,800,001
11	Ramsey Health Group	7,837,368,000	783,736,801
12	ANZ	9,448,000,000	944,800,001
13	Coca Cola Amatil	1,242,200,000	124,220,001
14	Commonwealth Bank	11,082,000,000	1,108,200,001
15	Charter Hall Group	142,670,000	14,267,001
16	AGL Energy	11,131,000,000	1,113,100,001
17	Webjet	98,009,000	9,800,901
18	Brambles	4,416,100,000	441,610,001
19	Flight Centre	438,949,000	43,894,901
20	GUD Holdings	114,910,000	11,491,001

*'total expenditure' has been calculated as per the data available from the latest set of annual accounts.

From the above information, out of the top 20 most innovative companies in the ASX200, 9 out of the 20 **would never be able to access the proposed top R&D Tax benefit of 12.5%** due to the fact that they would need to have R&D expenditure of above $150 million to achieve an intensity level of above 10%.

Another failure point in the proposed R&D Tax Incentive is the fact that it appears to provide preferential benefits to overseas based multinationals conducting R&D in Australia via a subsidiary, compared to R&D conducted by Australian based multinationals conducting R&D in Australia. There also appears to be preferential treatment provided to entities within an unconsolidated group, verses R&D conducted within a consolidated group.

Given how the proposed R&D legislation will deliver an R&D benefit to overseas multinationals that are not available to locally headquartered multinationals, it is difficult to reconcile why, on the one hand, the Federal Government is implementing a suite of legislation to ensure multinationals are paying their 'fair share' of tax in Australia (via stringent transfer pricing and related integrity provisions), but at the same time, it is preferentially providing multinationals with a higher R&D Tax benefit that is simply not available to Australian based multinationals conducting R&D in Australia in the same set of circumstances.

The reason for this inequity (and why the proposed changes to the current R&D Tax program will preferentially benefit overseas based multinational groups conducting R&D in Australia, compared to Australian based multinationals) comes down to how the new legislation requires a company to calculate its 'R&D intensity'. e limited detail was provided in the initial Budget papers as to how a company's 'R&D intensity' percentage would be calculated, the recently released draft legislation provides this detail, detail that creates further confusion and uncertainty regarding the application of the new program. For example, in the draft legislation, a company's 'R&D intensity' will be assessed by comparing the 'R&D entity's' (a defined term in the legislation) eligible R&D expenditure over the R&D entity's total expenditure (according to accounting principles). Whilst this seems a straightforward concept, this methodology *will significantly disadvantage Australian multinational companies conducting R&D in Australia.*

5 Financial advantage provided to overseas based multinationals

In understanding the inequity within the proposed R&D legislation, consider a scenario whereby a German multinational has $4billion in global expenditure and has an Australian subsidiary engaged in R&D activities. The local Australian subsidiary (i.e. the 'R&D entity' which is the entity that lodges its R&D application with AusIndustry) has a turnover of $50 million, total expenditure of $40million and spends $3million on R&D activities. In calculating this company's R&D intensity percentage, the proposed legislation requires only the expenditure of the Australian based entity to form the denominator in the calculation (i.e. is not required to include the nearly $4 billion of expenditure incurred worldwide by the rest of the German multinational Group). This is because the 'R&D entity' only encompasses the Australian based subsidiary. In this example, the Australian subsidiary of the German multinational will have an R&D intensity level of 7.5% (despite having global expenditure of $4 billion), which will provide it with an R&D Tax benefit of $200,000.

German Multinational R&D Tax Benefit Calculation		
Percentage	**R&D Tax Benefit Rate**	**R&D Tax Benefit Amount**
0% - 2%	$ 800,000 @ 4%	$ 32,000
> 2% - 5%	$1,200,000 @ 6.5%	$ 78,000
> 5% - 10%	$1,000,000 @ 9%	$ 90,000
	Total Tax Benefit	**$200,000**

Now consider the same scenario, but with an Australian multinational with an Australian subsidiary engaged in R&D activities – with the same turnover, same expenditure, same level of R&D spend as in the previous example and the same global expenditure for the Australian multinational Group of $4 billion.

In this scenario, it would be reasonable to expect that the Australian subsidiary of an Australian based multinational would receive the same R&D benefit (i.e. $200,000) as previously calculated for the subsidiary of the German multinational conducting R&D in Australia.

However, due to the fact that the head entity of the Australian multinational tax consolidated group would be deemed to be the 'R&D entity' in any R&D claim (i.e. the entity that lodges its R&D application with AusIndustry), the proposed new legislation requires the 'R&D entity' to include all expenditure to be taken into account when calculating its R&D intensity which, in the case of the Australian subsidiary of an Australian based multinational, would include global expenditure of $4 billion. This inconsistency is due to the operation of Section 355-115 of the Income Tax Assessment Act 1997 ('ITAA 1997'), which defines an R&D entity's expenditure as: -

> **355 – 115 – Working out an R&D entity's expenditure**
>
> (1) An R&D entity's expenditure for an income year is the sum of the amounts covered by subsection (2)
>
> (2) The following amounts are covered by this subsection: -
>
> (a) the expenditure incurred by the R&D entity for the income year worked at in accordance with the accountancy principle;
>
> (b) any amount the R&D entity can deduct for the income year as mentioned in sub paragraph 355-100(1) to the extent the amount is not covered by paragraph (a).

This definition and its impact on calculating a company's R&D intensity has generated a significant level of uncertainty in how to apply the proposed new R&D legislation, specifically around how broadly the net is cast when it comes to calculating total expenditure for the R&D entity. However, given section 355-35 of the ITAA 1997, defines an 'R&D entity' to include, "a body corporate incorporated under Australian law.", it is reasonable to interpret that a body corporate incorporated under Australian law (that lodges an R&D claim under the proposed new provisions) will need to include total global expenditure in calculating its R&D intensity percentage.

If we interpret the proposed legislation to include the global expenditure of the Australian multinational (given the head entity of this Australian based group would be considered the 'R&D entity') and we assume the same figures from the previous example (i.e. global expenditure of $4 billion), the R&D intensity for the Australian subsidiary of the Australian based multinational would be 0.00075% (i.e. $3 million in R&D expenditure over $4 billion of the R&D entity's expenditure).

In this example, as the R&D entity's R&D intensity falls between 0% - 2%, the Australian subsidiary of an Australian based multinational would only have access to a total R&D benefit of $120,000 under the proposed new R&D tax legislation. This is despite undertaking the same level of R&D activities in Australia and despite investing the same level of R&D expenditure in Australia as the Australian subsidiary of a German multinational. Given the Australian subsidiary of the Australian based multinational has an R&D intensity level of 0.00075%, the disparity in R&D benefit is demonstrated in the table below.

Australian Multinational R&D Tax Benefit Calculation		
Percentage	**R&D Tax Benefit Rate**	**R&D Tax Benefit Amount**
4% uplift (0-2% intensity)	$ 3,000,000 @ 4%	$ 120,000
6.5% uplift (>2-5% intensity)	$ -	$ -
9% uplift (>5-10% intensity)	$ -	$ -
12.5% uplift (>10% intensity)	$ -	$ -
Total Tax Benefit		**$ 120,000**

This appears to be an unacceptably unfair outcome that provides multinationals based in other countries with a higher benefit than is available to the Australian multinationals investing the same level of expenditure on R&D in Australia. In effect, the proposed legislation will penalise Australian based multinationals conducting R&D in Australia, including some of our most innovative and iconic companies such as CSL, Ramsey Health Group, Brambles, and Bradken.

6 Inequity of R&D benefits between consolidated and unconsolidated groups

The inequity in the proposed legislation (i.e. Australian and overseas based multinationals) also extends to consolidated tax groups, when compared to non-consolidated tax groups. Under the proposed new legislation, if R&D is conducted by a company within a tax consolidated group, given that the head entity is deemed to be the 'R&D entity', the R&D intensity (and therefore its available R&D Tax benefit) of that R&D entity will be reduced, compared to R&D conducted in an unconsolidated group.

The source of the inconsistent treatment and the reason for the reduced benefit available for R&D conducted within tax consolidated groups compared to unconsolidated groups is due to the requirement to include the expenditure of the **entire consolidated group** as the denominator in the calculation of R&D intensity, whereas an unconsolidated entity only has to take its own expenditure into account when calculating their R&D intensity.

As drafted, the proposed legislation provides unconsolidated entities with the potential to access a materially higher R&D tax benefit than the benefit available to entities within a tax consolidated group. This outcome therefore provides an incentive to structure a Group's tax affairs in a way that enables the R&D entity to sit outside the tax consolidated group where possible. This obviously creates an integrity issue, in a regime where the Treasurer indicated he was seeking to restore integrity to the program.

One of Treasurer Morrison's stated objectives for introducing a '4-tiered' R&D premium was to provide an increased benefit for those companies that invest more of their expenditure on R&D activities. From the examples provided (which primarily relate to companies with an aggregate turnover of more than $20 million), it is clear that the proposed legislation will never be able to deliver on this primary stated objective, due to the introduction of complex concepts that will disadvantage genuine R&D Innovators and encourage creative tax planning structuring to circumvent specific limitations associated with the legislation.

What the proposed new R&D program does, however, deliver is access to an increased R&D tax benefit by multinational groups conducting R&D within Australia, compared to Australian based multinationals conducting R&D in Australia.

The proposed new R&D legislation will also deliver increased R&D benefits to entities outside the consolidated tax regime, compared to entities within, in comparable circumstances.

7 Concluding comments

In summary, given all the information available on the impact of the proposed changes to the R&D Tax Incentive, it is our view, as experts within the intellectual property industry, that the changes will have a negative and adverse impact on the ability to drive innovation within the Australian economy. These comments are based on the fact that the proposed changes: -

- Increase the uncertainty associated with the program, uncertainty that has persisted for the past 20 years.
- Uncertainty in the R&D program reduces a company's appetite for investment, as it is difficult to predict the benefit able to be accessed and thus the profitability associated with their investment in innovation.
- The proposed changes have a number of provisions that promote inequity in access to the R&D Tax Incentive by certain categories of companies, further undermining the confidence and predictability in the program.
- The proposed changes introduce a number of complex terms (i.e. total expenditure) and features that not only create uncertainty and unpredictability, is likely to lead to innovative tax planning opportunities to circumvent these inequities.
- The proposed changes incorporate a 4% tax benefit, which is the lowest tax incentive in the OECD. Although the program also includes a top benefit of 12.5%, as demonstrated, very few companies will ever access this level of benefit.
- There is nothing within the proposed legislation that we believe will promote an increase in innovation within Australia or address the relatively stagnant local patent activity in Australia compared to our trading partners and other OECD countries.

As a number of analysts and industry commentators have observed, over the last few decades the proportion of total market value of companies comprising the S&P 500 has fundamentally transitioned - from over 80% *physical* assets to almost 90% *intangible* assets, with much of that intangible asset value directly related to IP of various types, including patents. This fundamental paradigm shift is broadly reflected in most developed economies.

In a globalising economy that is increasingly technology driven and knowledge-based, companies that are not innovating, and/or that are not effectively capturing the value of their innovations, are at serious risk of not only falling behind, but of falling out of the race altogether. As for companies, the same could be said for countries.

The present assessment of Australia in this context, based on current trends, is seriously concerning. Turning this around will require vision, insight and leadership, in both the political and commercial arenas. It will also require a stable policy framework, with predictable outcomes, designed to strongly incentivise and reward investments in research and technological innovation. From that perspective, we would strongly caution against both ad hoc changes to important policy foundations and further watering down of already diluted innovation incentives.

I trust that you will consider the issues raised in this paper in your deliberations on these significant proposed changes, given the potentially critical impact on the incentivisation of innovation within the Australian economy.

Please do not hesitate to contact me should you require further information in relation to this submission.

Yours sincerely,

(Stuart M Smith)

Chief Corporate Development Officer

Xenith IP Group