AUSTRALIAN INVESTMENT COUNCIL

15 September 2021

Consultation Manager
Board of Taxation Secretariat
The Treasury
Langton Crescent
Parkes, ACT, 2600

Via Email: RandD@taxboard.gov.au

Dear Sir/Madam,

R&DTI – Review of the dual-agency administration model

As the industry association for private capital in Australia, the Australian Investment Council is pleased to present its submission to the Board of Taxation (**BoT**) on the *R&DTI – Review of the dual-agency administration model* following the Federal Budget announcement on 11 May 2021 and release of the Consultation Paper in June 2021.

Private capital investment has played a central role in the innovation, growth and expansion of thousands of businesses and represents a multi-billion-dollar contribution to the Australian economy. Our members are the standard-bearers of professional investment and include private growth (**PG**), venture capital (**VC**) and private credit (**PC**) funds, alongside institutional investors such as superannuation funds, sovereign wealth funds and family offices as well as leading financial, legal and operational advisers. Our members include both Australian domestic and offshore-based firms who in turn invest capital on behalf of millions of Australian families and attract capital from passive overseas investors.

The Research and Development Tax Incentive (**RDTI**) plays a pivotal role in supporting Australia's innovation ecosystem and consequently, its contribution to productivity, jobs and economic growth. A strong, robust and consistent RDTI scheme is important for maintaining the confidence of Australian businesses and entrepreneurs to invest in the future of our nation. Efficient access to Research and Development (**R&D**) is also vitally important for enabling billions of dollars of investment capital to flow into Australian start-up and early stage businesses. These are the businesses that are the foundation for Australia's future growth through employment and economic contribution.

R&D is primarily invested in industries with a start-up and early stage presence with service-focused industries making the most RDTI claims dominated by scientific research services claiming the largest share of $480 million in the 2018/19 year according to data modelling undertaken by EY and commissioned by the Council.[1]

We set out below our submission for consideration by the BoT and look forward to participating in any future discussion on this review.

If you have any questions about specific points made in our submission, please do not hesitate to contact me or our policy team on policy@aic.co.

Yours sincerely

Yasser El-Ansary
Chief Executive

[1] An overview of the impact of the ESVCLP and VCLP investments, EY, September 2021

Overview

The Australian Investment Council is the industry body for private capital investors in Australia, which includes the growth capital and venture capital firms that back innovative businesses across every sector of the economy.

The private capital industry has been a consistent and significant contributor to economic activity and job creation through the investment of capital to support the growth and expansion of thousands of Australian businesses every year. Australia's private capital industry represents 2.6 per cent of Australia's annual GDP output, and private capital-backed businesses create 1 in 9 new Australian jobs according to independent analysis by Deloitte Access Economics commissioned by the Council. [2]

The Council is supportive of policy initiatives and reforms that help ensure our economy is competitive, innovative and able to support Australia now and into the future. In particular, the Council encourages initiatives that help expand entrepreneurship, increase productivity and support investment, and those that drive the development of skills and talent, productive capacity and innovation through technology.

Australian business investment in innovation is estimated at $32-36 billion annually, or 1.9 per cent of GDP in 2016-17, of which about half is R&D ($16.7 billion in 2015-16, and $17.4 billion in 2017-18).[3] This investment generates economic benefits for the investing firms and their customers in the form of new/improved products and lower prices. It is also recognised by the OECD that businesses who invest in research are generally more productive, with turnover growth for high R&D intensity firms between 5.9 to 7.3 times higher than for low R&D intensity firms.[4]

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Data modelling by EY commissioned by the Council for the purposes of the current *Venture Capital Tax Concessions* review, shows a strong correlation between R&D investment and investments made through Early Stage Venture Capital Limited Partnerships (**ESVCLPs**) and Venture Capital Limited Partnerships (**VCLPs**).

The modelling shows that R&D is primarily spent in industries with a strong start-up and early stage presence with the top three investment industries through ESVCLPs and VCLPs being Professional, Scientific and Technical Services (31%), Health Care (20%) and Manufacturing – Machinery, Food and Chemical (18%). The data also shows that start-ups invest more in R&D per employee than more established businesses. (see **Figure 1**)

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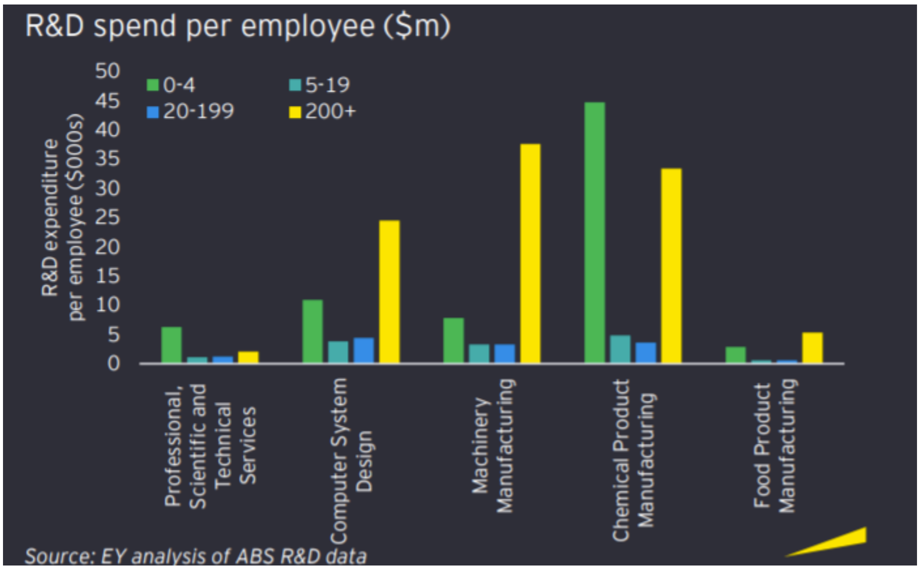
[2] EY ibid

[3] AlphaBeta, (January 2020) Australian Business Investment in Innovation,

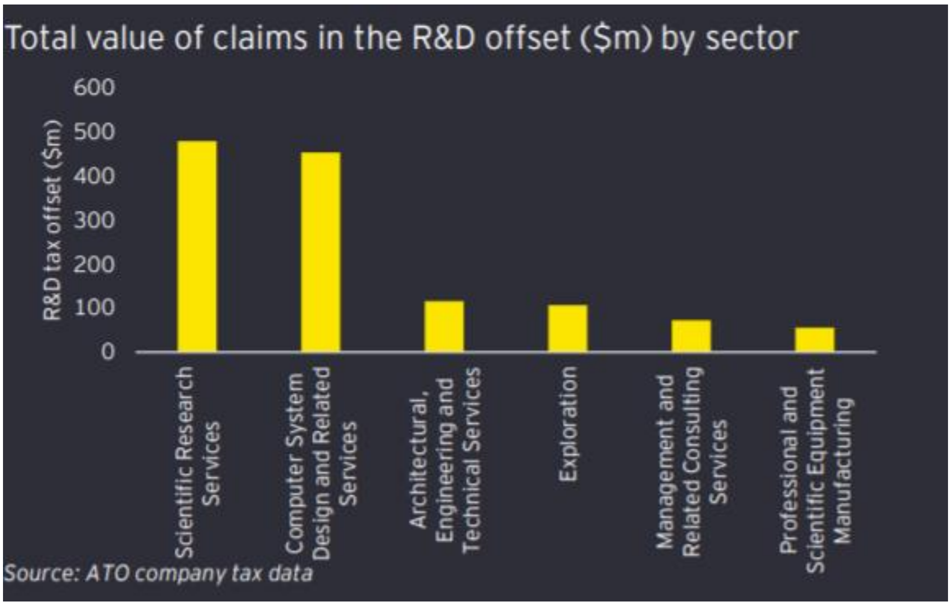
[4] Department of Industry, Science, Energy and Resources, *Australian Innovation System Report*, 2017.

Figure 1. R&D spend per employee ($m)



Tax data for the RDTI also supports the analysis that start-up and early stage industries invested heavily in R&D in 2018/2019. The EY modelling found service focused industries have been claiming the most RDTI, with scientific research services the largest with $480 million spent on R&D. Exploration and professional and scientific equipment manufacturing were the only non-service industries in the top six, aligning with manufacturing being the third largest VC investment industry through the ESVCLP and VCLP programs. Computer system services had the most businesses claiming the RDTI with 1,820 businesses making a claim. (see **Figure 2**)

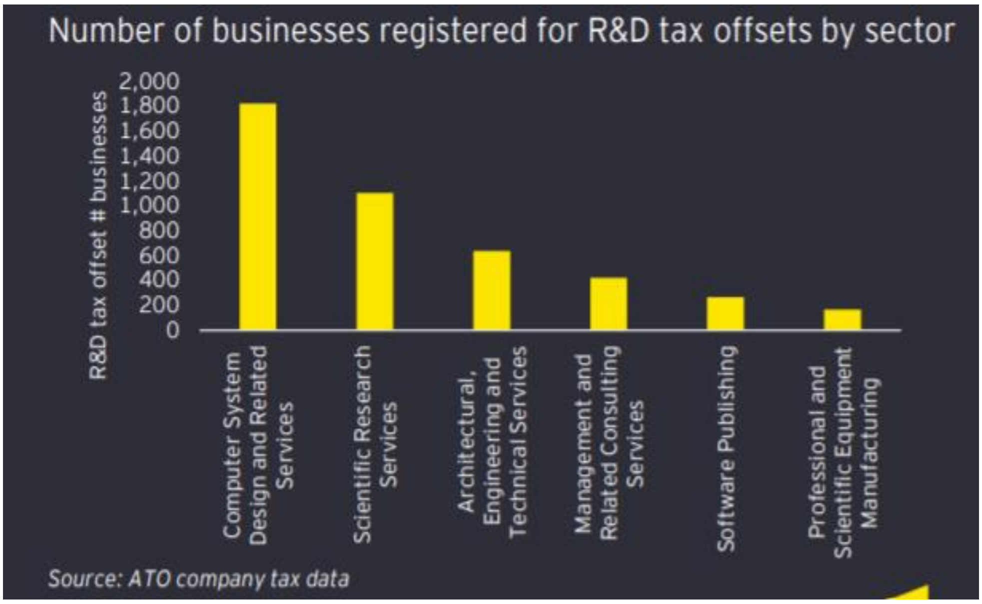
Figure 2: Total Value of Claims in the R&D offset ($m) by sector (through ESVCLP and VCLP programs)



With a significant proportion of R&D claims from start-up and early stage businesses, the importance of having a RDTI program that can provide self-assessment support, is easy to access and understand, becomes more profound as these start-up and early stage businesses often have limited cash flows and resources to access professional advice.

If the stated objective is also "to encourage industry to conduct R&D activities that may otherwise not be conducted", the EY data modelling points to the program achieving this objective with the RDTI supporting innovation in industries aligned to Australia's transition to a knowledge-based economy. (**Figure 3**)

Figure 3: Number of businesses registered for R&D tax offsets by sector



1. Despite positive tailwinds, participation in the program is declining

This current review follows a review of the RDTI program in 2016 as part of the National Innovation and Science Agenda (**NISA**) alongside a recommendation to review the two-agency delivery model and streamlining compliance review and findings processes. The Council notes that the Australian Taxation Office (**ATO**) and Industry Innovation and Science Australia (**IISA**) updated their joint strategy to ensure a more coordinated approach to administration and prioritisation across both agencies. A new customer portal was launched in July 2021 with the objective to improve the application process. While the new portal is in the early days of implementation, there remains work to be done.

While, as outlined above, the RDTI is supporting the innovation sector in industries central to Australia's knowledge-based future, participation in the program has declined from approximately 15,000 at the program's peak when the NISA changes were announced in 2016 to 11,485 claims in 2019/20. While there may be several factors involved, the Council's members have indicated that a reduction in the annualised claim limits and uncertainties surrounding potential changes to the R&D legislation which were eventually abandoned in the October 2020 Federal Budget may have led to a loss of confidence in the program. Furthermore, there have been numerous examples of inconsistencies where applications that were initially processed were later rejected by the ATO. This *about-turn* on eligibility has had a material effect on many early stage businesses, who have relied on their access to RDTI refundable offsets in order to fund ongoing cashflow investment into R&D activities. In addition, these decisions on eligibility in audits by IISA and the ATO have often not been sustained when tested through the courts.

Recommendation 1: ATO, IISA and the Department of Industry, Science, Energy and Resources (DISER) work in consultation with industry stakeholders to map out agreed goals for the administration and interpretation of RDTI claims to ensure an approach that is consistent with their intent.

2. Inconsistency in RDTI administration and claims

Our members have also raised concerns on the outcome of the *Auctus Resources Case* [5] which suggests that the Commissioner of Taxation can form their own view on the eligibility of a taxpayer's R&D activities where there is no finding by the IISA Board.

> *The Commissioner is not bound by the taxpayer's self-assessed view that their activities are "R&D activities". If it were otherwise, the taxpayer's opinion about their activities constituting R&D activities would, in the absence of a finding by the Board, be determinative of this aspect of the taxpayer's eligibility to the tax offset refund.*

Again, this points to the importance of ensuring administration of the RDTI program and the rules for eligible entities and costs are aligned and implemented in accordance with the intent of the legislative requirements and the spirit of the program to foster innovation and encourage investment into the domestic economy. This current incongruity is generating inconsistencies in how the program is delivered under the dual model and is, in some circumstances, causing negative impacts on innovative companies, even to the point of them ceasing to exist.

Recommendation 2: The Council anticipates that as an outcome of this review, the BoT will make recommendations on how the administration and delivery of the RDTI program could be improved in order to achieve its full market potential.

Recommendation 3: Align administration of the RDTI program and the rules for eligible entities and costs to ensure they are implemented consistently to provide applicants with certainty around both the application and eligibility experience.

3. More engagement with industry stakeholders

While there have been a number of meetings of the R&D Roundtable, this forum provides a sound platform to genuinely engage with industry stakeholders to determine where there are challenges and opportunities and to continuously improve the RDTI into a "gold standard" program that supports innovation and the development of Australia's emerging and scale-up companies. Currently, the structure of the Roundtable, alternating between the two administrator's needs, does not provide the opportunity to form shared objectives or to adequately review the progress of the program.

The R&D Roundtable could provide the optimum forum for industry and the dual administrators of the RDTI program to consult on developments that would improve the effectiveness and success of the program.

Recommendation 4: Review the purpose of the R&D Roundtable and reset its focus to facilitate industry consultation and input on the RDTI program with the aim of improving the contribution of R&D to Australia's innovation ecosystem and businesses of the future.

[5] *Commissioner of Taxation v Auctus Resources Pty Ltd [2021]*

4. New registration portal

The Council supports efficiencies and improvements that enhance productivity and lead to a better user experience. To this extent, the new application portal launched by IISA in July has been viewed as a positive step towards being more "user friendly" and making it easier for "applicants" to provide required information. As raised earlier in this submission, with many applicants being from start-ups and early stage companies who are often cash constrained, ensuring the portal is "user friendly" and is "intuitive" in nature is a positive step in the application process. Applicants appreciate feedback and guidance from IISA where there are deficiencies in the information provided in their applications. We understand the new portal is continuing to be refined and encourage IISA to consider these refinements in the context of ensuring that the information required from the applicants does not lead to additional compliance costs.

Recommendation 5: Refine the new registration portal to ensure it provides a clear path for applicants to register their projects and does not lead to additional compliance costs. Implement these changes when the next release of the customer portal is implemented in November 2021.

5. Confusion around guidance on ANZSIC codes

There appears to be confusion regarding the use of ANZSIC codes in the application process that is leading to automated messages that activities are **"highly unlikely"** to be ineligible for the RDTI. This occurs when the applicant selects an ANZSIC code in the registration process where the code has published guidance. Given that guidance exists for most R&D activities from medical technology to biotechnology, manufacturing, IT, mining and minerals processing and agriculture, most claimants will receive this message. As the portal is a self-assessment process, this may have significant unintended consequences of discouraging participation in the RDTI program. This needs to be resolved to provide clarity to the users of the portal and also to provide relevant guidance where possible without any negative consequences for the applicants.

Recommendation 6: We encourage resolution of the current connection between ANZSIC codes and the "highly unlikely" message when the next release of the customer portal is issued in November 2021.

6. More clarity needed around audit activity and tax rulings

The Council understands that ATO audit activity in relation to the programs has focused on expenditure direct nexus audits and whether or not activities link to the registered activities. There is some uncertainty from claimants around the rationale for the methodologies being applied to these audits. This uncertainty has been exacerbated by unusual circumstances generated by the COVID pandemic which led to the JobKeeper payments. The draft determination on the eligibility of R&D salaries connected to JobKeeper Payments –*Draft Tax Determination TD2020/D1 Income tax: notional deductions for research and development activities* – was announced on 27 July 2020 and has not yet been finalised. This is now impacting two years of RDTI claims.

We understand from our members that a further complication is that the *Draft Tax Ruling TR 2021/D3 Income tax: research and development tax offsets* (the "at risk rule") announced on 25 June 2021, must first be finalised before a determination can be made on the eligibility of R&D salaries connected to JobKeeper payments.

Recommendation 7: Provide certainty and clarity to R&D claimants by finalising *Draft Tax Ruling TR 2021/D3 and Draft Tax Determination TD2020/D1* as priorities as well as details on the rationale relating to the methodologies being applied to audits.