25 September 2020

Manager
R&D Tax Incentive: Draft Refreshed Guide
Department of Industry, Science and Technology
GPO 2013
Canberra, ACT, 2601

Submitted via Department of Industry, Science and Technology Consultation Hub

Dear Sir/Madam,

R&D Tax Incentive: draft refreshed Guide to Interpretation

The Australian Investment Council welcomes the opportunity to contribute to the Department of Industry, Science and Technology's consultation process on the *R&D Tax Incentive draft refreshed Guide to Interpretation.*

At this critical juncture in our national response to the COVID-19 pandemic, it is vitally important for our economic recovery, and Australian jobs, that businesses are able to effectively and confidently invest in new ideas and new processes. The government's Research and Development Tax Incentive **(RDTI)** framework is one avenue where government can assist businesses invest in our nation's future and to create new Australian jobs.

A strong, robust and consistent Research and Development 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 a vitally important ingredient in enabling billions of dollars of investment capital to flow into Australian start-up and early stage businesses. These are the businesses that are vital for Australia's future growth through employment and economic contribution.

The Australian Investment Council is supportive of comprehensive clear and predictable guidance on the RDTI framework that clearly outlines circumstances where Australian entrepreneurs can confidently access the incentive to progress the development of their businesses and innovation ideation.

However, in our view some aspects of the current draft guidance are unclear in respect of:

1. Which activities are eligible for the RDTI;
2. Which activities are excluded;
3. How to assess eligibility for the incentive; and,
4. How to make an RDTI claim.

The potential impact of the guidance in its current form could be to disincentivise, rather than encourage, early stage and fast-growth businesses that genuinely fit the requirements for an RDTI claim from applying.

The private capital industry's key recommendations on the draft guidance are set out below. The Council encourages the Department to carefully consider the recommendations in respect of the long-term outcomes for the nation.

We look forward to participating in future discussions about the RDTI refreshed guidance. If you have any questions about the recommendations or any specific points outlined in this submission, please do not hesitate to contact me or Brendon Harper, the Australian Investment Council's Head of Policy and Research, on 02 8243 7000.

Yours sincerely

Yasser El-Ansary

Chief Executive

Level 12, Aurora Place
88 Phillip Street
Sydney NSW 2000
+61 2 8243 7000
mail@aic.co
aic.co

Overview

The Australian Investment Council is the voice of private capital in Australia. Private capital investment has played a central role in the 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 equity, venture capital and private credit funds, alongside institutional investors such as superannuation and sovereign wealth funds, as well as leading financial, legal and operational advisers.

Private capital fund managers invest billions of dollars into Australian companies every year. Funds under management of Australian-based private capital funds exceeded $33 billion in 2019, testament to the growth in available capital to support investment into businesses across every industry sector of the economy. Private capital investment offers smart, patient capital to privately backed companies along with expert guidance and strategic support.

More and more businesses are choosing to raise capital from private investors, rather than through public markets, because of the benefits of partnering with venture, private equity and private credit firms. Private capital investors can help unlock the growth and expansion opportunities of businesses through active asset management in a way that public markets simply cannot. This is evidenced by the fact that private capital-backed Australian businesses generate 1 in 9 new Australian jobs and contribute 2.6 per cent of Australia's GDP.[1]

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).[2] This investment generates economic benefits for the investing firms and their customers in the form of new/improved products and lower prices. Efficient access to R&D is a vitally important ingredient in enabling billions of dollars of investment capital to flow into Australian start-up and early stage businesses. These are the businesses that are vital for Australia's future growth through employment and economic contribution.

Tomorrow's new successful Australian companies are today's start-ups and early stage businesses. These companies are often innovative, nimble and forward looking. Some of today's largest companies have grown through private capital support. These include local success stories, such as Afterpay, Airwallex, Atlassian, Canva and Vaxxas, along with international successes, such as Alibaba, Apple, Facebook, Google, Netflix, Spotify and Twitter.

The COVID-19 pandemic has hit early stage and high-growth companies particularly hard. This includes companies who were on a growth trajectory and were relying on quickly building momentum to become financially sustainable. COVID-19 restrictions have inhibited many of these companies' ability to develop products (including not being able to conduct clinical trials) and to take products to market. These challenges have been coupled with not being able to utilise some of the government's key assistance programs, such as JobKeeper.

The road ahead for this sector remains challenging. The path out of COVID-19 is unclear and, importantly, recent history has demonstrated that investment in innovation and R&D typically falls after a major economic crisis.[3] Already there is evidence of capital markets becoming risk averse and investment into alternative assets waning. Without government support, Australia risks losing a generation of new companies, and the economic and employment benefits that come with the scaling-up of these new businesses.

The RDTI framework is a critical element of the innovation and tax system which ensures that valuable R&D expenditure is carried out by Australian companies, and that offshore companies that undertake R&D in Australia (such as clinical trials) continue to do so. However, uncertainty regarding the guidance (and eligibility for the program generally) has added additional pressure to start-up and fast-growth companies in the already challenging current

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[1] Deloitte Access Economics (April 2018) *Private Equity: Growth and innovation*

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

[3] Archibugi, D., Filippetti, A., and Frenz, M, (2012) *Economic crisis and innovation: is destruction prevailing over accumulation?*, Centre for Innovation Management Research, April and OECD (2012) *Science, Technology and Industry Outlook 2012, Chapter 1: Innovation in the crisis and beyond*

environment. At a time of economic transition, it is vital that this uncertainty does not negatively impact the development of R&D initiatives that can contribute to employment and economic growth.

A number of recommendations relating to specific aspects of the consultation are set-out in the submission below. These recommendations are largely aimed at reducing uncertainties for the target users of the guidance.

1. Structure and purpose of the Guide

The *R&D Tax Incentive draft refreshed Guide to Interpretation* (**the Guide**) is a good step in the right direction to assist stakeholders in understanding how the RDTI framework works. While the content in the Guide is easier to read than previous iterations, there are a number of items that require clarification and further explanation.

In its current form, the Guide appears to be directed to advisers and practitioners rather than to companies and individuals seeking to claim the incentive. For example, Questions 1 to 4 all link back to the Tax Act which is useful for advisers as a reference point. However, companies and entrepreneurs seeking to assess their eligibility for the scheme would benefit from worked examples that illustrate when an application is eligible for the incentive.

To this extent and for clarity and completeness, the Guide should include information on the benefits of the RDTI and how to make a claim so companies and entrepreneurs can holistically assess their eligibility for the incentive and whether or not they need the assistance of a professional adviser.

While the material in the Guide is substantial, there is scope to simplify the language and content so it is more of a "how to" format that is relevant to claimants. The guide should focus on the core areas of:

1. Which R&D activities are eligible
2. Which R&D activities are excluded
3. How to assess the eligibility of R&D activities
4. How to prepare an RDTI claim.

These points would need to be supported with illustrative examples and also any relevant legal cases that have tested the content.

Further, the self-assessment tool on page 9 could also be simplified so it is easier to follow for the intended audience.

Recommendation 1: *Target the guidance at company and entrepreneur claimants*
The Council recommends the Guide is simplified in terms of language and content to provide holistic "how to" guidance for claimants on the process for making an RDTI claim from eligible and excluded activities to preparing a claim.

Recommendation 2: *Reconfigure the structure of the Guide to provide more clarity for users*
The Council recommends the Guide is restructured so claimants can follow a sequential progression for making a claim. This includes: 1) which R&D activities are eligible; 2) which R&D activities are excluded; 3) how to assess the eligibility of R&D activities; and, 4) how to prepare an RDTI claim.

2. Further guidance to assist businesses in assessing eligibility

Under the current R&D regime, there are numerous examples of inconsistencies where applicants have received refunds for their R&D expenditure which were later rejected by the Australian Taxation Office. 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. Additionally, these unexpected rulings have created uncertainty in the business community which has led to some businesses and entrepreneurs being reluctant to lodge RDTI claims. As a result, investment into R&D activities, and the associated job creation, has been reduced.

This issue highlights the disconnect in communication to consumers between the registration process with AusIndustry and the process for making claims. Further guidance that holistically covers the registration and claims processes is required to provide consistency on which claims are, and are not eligible to provide clarity and certainty amongst claimants so they can confidently continue to develop their R&D activities. Areas where more guidance is required are set-out below.

Include more examples on eligible activities

The draft Guide contains a relatively comprehensive account of the R&D activities that are ineligible for a claim. Further detail is required on activities that can be claimed under the RDTI. Examples to assist companies identify activities that can be claimed would significantly benefit the users and provide a balance with the current material in the draft on exclusions.

A more balanced description of eligible vs ineligible activities would also support the government's intent that the system be utilised as a mechanism to assist genuine R&D investment and activities.

Indirect costs

Further clarification on what constitutes an eligible R&D activity and an eligible R&D expense would be beneficial. This should include examples of eligible expenditure in the worked examples to assist claimants with their eligibility assessment. It would also benefit the Australian Tax Office in assessing claims.

Information on the allocation of R&D spend to indirect costs is one area that is creating confusion amongst claimants. While the process is straight forward for allocating direct R&D spend it is not the case for indirect costs including items such as salaries, rent and other overheads.

Timing of activities

In certain circumstances such as clinical trials, more clarity is needed around the timing of activities. As an example, a life sciences company may be planning a clinical trial in 2 years which may or may not proceed. Guidance on how this scenario may or may not impact an application is needed.

Grants

As many claimants for the RDTI are start-up or early stage companies, they also receive grants from time to time. Guidance on how the RDTI applies to companies that are grant recipients would provide clarity and certainty for this cohort.

Overseas Expenditure

Some R&D is not possible in Australia due to the need to access certain facilities and expertise that are not available domestically. There is some confusion on how claims in these circumstances would be assessed. This is an area that the Council's members are seeking more guidance on.

Recommendation 3: *Include more examples of eligible activities*
The Council recommends more guidance is included in the Guide to provide clarity and consistency on eligible activities, and how the RDTI applies to indirect costs, activities such as clinical trials, grants and overseas expenditure.

More clarity needed on "experiments"

The narrow interpretation of "experiments" in the RDTI legislation has caused some confusion within industry. There is scope to provide further clarity on this area in the Guide. For example, pages 10 and 11 refer to the relevance of "existing knowledge" in the context of Core R&D Activities. However, there are instances of case law where if the knowledge is not "reasonably accessible" to the company and the only way to acquire this knowledge is through experimental activity. Therefore, the applicant should be eligible for the RDTI.

Eligibility for software

The eligibility for software development under the RDTI has been the subject of considerable debate. While the guidance document on this issue was published in 2019, further guidance is required. The Moreton Resources case, for example, tested the interpretation of the new use of technology for R&D. Guidance, including examples this interpretation would be beneficial for the industry.

Recommendation 4: *Further guidance and clarity on eligibility of experiments and software*
The Council recommends further guidance, including case studies and reference to case law be included in the guide to assist companies assess their eligibility for the RDTI

Ensure consistency with the Tax Act

A further example is the suggestion that all parts of an experiment from hypotheses to logical conclusions need to exist in a single R&D activity. The Council recommends this section is aligned with the definition of core R&D activities in the *Income Tax Assessment Act* which looks at activities in a plural sense. Users of the guide would also benefit from more working examples.

Recommendation 5: *Ensure the description of "experiment" is consistent with the Tax Act*
The Council recommends any reference to "experiment" in a single R&D activity is consistent with the definition in the *Income Tax Assessment Act* and that tangible examples are included in the Guide.

3. How the refreshed Guide will be used

In its current form, the Guide appears to be directed to advisers and practitioners rather than to companies and individuals seeking to claim the incentive. However, the Council's view is that the main user of the Guide will be companies and entrepreneurs seeking to assess their eligibility for the scheme.

To this extent and for clarity and completeness, the Guide should include information on the benefits of the RDTI and how to make a claim so companies and entrepreneurs can holistically assess their eligibility for the incentive and whether or not they need the assistance of a professional adviser. *See Recommendation 2.*