



Complementary Medicines Australia

Title Review of the R&D Tax Incentive

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Mr Aiden Essery
Economic Policy Adviser
Complementary Medicines Australia

Published by: Complementary Medicines Australia
PO Box 450
Mawson, ACT 2606
Australia
Telephone: 02 6260 4022
Facsimile: 02 6260 4122
E-mail: aiden.essery@cmaustralia.org.au
Website: www.cmaustralia.org.au

Complementary Medicines Australia (CMA) welcomes the opportunity to respond to the Review of the R&D Tax Incentive released 4 April 2016.

CMA is the peak industry body for the complementary medicines (CM) industry, representing members throughout the value chain: manufacturers, raw material suppliers, distributors, retailers, practitioners and consultants. The Australian complementary medicines industry generates \$3.5 billion of revenue annually, which is expected to grow to \$4.6 billion in 2017-2018. CMA promotes appropriate industry regulation and advancement to ensure consumers have access to complementary medicines of the highest quality.

Regulated in Australia as medicines under the *Therapeutic Goods Act 1989*, complementary medicines include vitamins, mineral and nutritional supplements, homeopathic, aromatherapy products and herbal medicines (unless specifically exempt). The term 'complementary medicines' also comprises traditional medicines, including traditional Chinese medicines, Ayurvedic, Australian Indigenous and Western herbal medicines.

Research is the lifeblood of our industry. Through the discovery of new ingredients, delivery methods, and treatments for ailments, the CM industry develops products that empower individuals to manage their health and that have the potential to assist in the reduction of the ever-increasing healthcare costs associated with chronic disease. Furthermore, strong competition within the industry leads to consumers continually expecting more efficacious, safe and novel products.

Recommendations

Recommendation 1. Retain the current definition of eligible activities and expenses under the law, but develop new guidance, including plain English summaries, case studies and public rulings, to give greater clarity to the scope of eligible activities and expenses (Section 4.1, p. 30).

The review found that the OECD Frascati Manual for identifying R&D activities remains the international gold standard. It is understood that the OECD is adequately resourced and holds sufficient expertise to amend the manual in line with changes in the global business environment.

CMA agrees with the review that the current level of compliance burden facing firms leads to lower levels of research than would otherwise occur (is optimal). The inherent uncertainty of output from research activities lowers its attractiveness as an investment relative to alternative investments. It is therefore essential for the fixed cost or compliance component of research to be as low as possible to attract risk-averse firms into research activities. The provision of guidance material for business managers to assess their tax

eligibility would reduce the need for the consulting services which are currently driving the high compliance costs.

Although the literature shows that the spill-overs and additionality are greatest when there is a strong novelty requirement, CMA believes that removing supporting R&D significantly alters the incentive structure of research-facing firms. R&D aimed at translating new technologies into the Australian market, whether it to be account for cultural, environmental, legal or political factors, would not meet the strict novelty requirement and therefore not be incentivised under the program. As there is an element of technical risk this activity is currently covered under the 2011 legislation. Although this research is not contributing to the global stock of knowledge, the timely diffusion of new technology into the Australian market will drive productivity, competitiveness and flexibility of Australian industries.

Recommendation 2. Introduce a collaboration premium of up to 20 percent for the non-refundable tax offset to provide additional support for the collaborative element of R&D expenditures undertaken with publicly-funded research organisations. The premium would also apply to the cost of employing new STEM PhD or equivalent graduates in their first three years of employment. If an R&D intensity threshold is introduced (see Recommendation 4), companies falling below the threshold should still be able to access both elements of the collaboration premium (Section 4.2, p. 35).

Australia has world class academic and research bodies, and holds the potential to be an international leader in complementary medicines research and translation into both commercial and health policy outcomes. Our country is extremely fortunate to be home to two world leading research institutions for complementary medicines: the National Institute of Complementary Medicines and The Australian Research Centre in Complementary and Integrative Medicine, both five star accredited research centres.

The collaboration premium would further incentivise brand sponsors (such as Blackmores, Swisse and Sanofi), manufacturers and raw material suppliers to invest in R&D, further improving Australia's research sector, public health, as well as economic performance. Although a strong level of collaboration between these PFROs and firms exists, CMA believes that this collaboration premium will lead to higher levels of R&D spending than otherwise would have occurred, as well as providing certainty to investors and managers.

CMA also welcomes the premium being applied to STEM PhD graduates. Firstly, we believe that there is scope for firms in the industry to internalise some development or research activities. Literature shows that this capability produces positive spill-over effects on a micro scale onto other internal departments as well as across industries¹. This recommendation

¹ Nelson, R.R. ed., 1993. *National innovation systems: a comparative analysis*. Oxford university press.

would synergise well with model 3 proposed by NHMRC grant program review, the Chief Investigator model, which is embraced by CMA. The review found that post-docs, when given adequate flexibility and freedom to pursue their primary interest, produce innovative, inspired research. The collaboration premium would also incentivise more students to continue their studies to the PHD level through the provision of greater certainty. This approach should not only produce a greater number of doctorate level researchers in the private sector but will also strengthen ties between academia and the private sector, as the graduate's personal relationship with the faculty, academics and fellow PhD students are still fresh.

Recommendation 3. Introduce a cap in the order of \$2 million on the annual cash refund payable under the R&D Tax Incentive, with remaining offsets to be treated as a non-refundable tax offset carried forward for use against future taxable income (Section 4.3, p. 37).

The fiscal sustainability of the R&D tax program is an important factor underpinning the long term success of Australia's innovation and science agenda. We agree with recommendation 3 that companies receiving greater than \$2 million annual refund are not likely to be facing liquidity constraints. These firms inherently have a long-term strategic vision and would not be seriously adversely affected with the timing of the rebate. With greater certainty surrounding the expected payoffs of research activities, investors and managers will gradually allocate more resources into R&D, reflecting the lower risk profile. Furthermore, increasing the total balance of non-refundable offsets increases the switching costs facing Australian firms thinking about relocating their research function overseas.

Recommendation 4. Introduce an intensity threshold in the order of 1 to 2 percent for recipients of the non-refundable component of the R&D Tax Incentive, such that only R&D expenditure in excess of the threshold attracts a benefit (Section 4.4, p. 39).

CMA, while recognising the superior spill-over effects of larger R&D projects, is concerned about the incentive structure created by recommendation 4 and therefore the equilibrium allocation of funding between private and public researchers. More research is needed in this area to assess the net effect of this threshold on additionality within the system. As the review states, firms close to upper bound may very well increase their net R&D expenditure to remain eligible; however, questions remain unanswered about the behaviour of firms or industries whose R&D expenditure is well below this arbitrary threshold. CMA is concerned that it may be economically advantageous for these firms to outsource their research function through funding partnerships with PFROs. Experienced researchers would move to the public sector where their services attract a 20% collaboration premium. This redistribution ultimately exacerbates the problems faced by Australia of insufficiently translating blue-sky research into valuable intellectual property. The worst case scenario, however, would be risk-adverse firms ceasing all R&D activities and allocating this capital

into lower risk investments. The net effect of this measure could very well be a more costly program, with lower levels of private sector research and as a result, translation.

Recommendation 5. If an R&D intensity threshold is introduced, increase the expenditure threshold to \$200 million so that large R&D-intensive companies retain an incentive to increase R&D in Australia (Section 4.4, p. 41).

CMA welcomes the recommendation to increase the expenditure threshold to \$200 million; however, we believe that this should not be conditional on the introduction of an intensity threshold. In an increasingly globalised world, countries should avoid arbitrary rules that could dissuade large R&D firms investing in the domestic facilities, researchers, and product applications. As mentioned in the review, there are increasingly returns to scale in spillovers resulting from larger R&D projects.

Recommendation 6. That the Government investigate options for improving the administration of the R&D Tax Incentive (e.g. adopting a single application process; developing a single programme database; reviewing the two-agency delivery model; and streamlining compliance review and findings processes) and additional resourcing that may be required to implement such enhancements. To improve transparency, the Government should also publish the names of companies claiming the R&D Tax Incentive and the amounts of R&D expenditure claimed (Sections 5.1-5.5, p. 45).

CMA embraces the recommendation to increase transparency and clarity to the R&D tax incentive program through the introduction of an online database. The publishing of these details will signal to customers, investors and competitors the firms with a strong culture of innovation. Business literature has found that the level of R&D spending is a strong predictor of long-term profitability² and therefore the publishing of this information should lead to a more efficient allocation of capital. Furthermore, the database should dissuade managers from inefficiently using the program to lower their tax threshold or manage liquidity.

CMA agrees that more research is required to better predict the net effect of a single-agency model. There is a clear separation between the roles of assessing the eligibility of a particular activity currently done by the AusIndustry, and assessing the integrity of R&D tax return schedule, done by the ATO. Abolishing the registration would increase the level of compliance risk facing firms lodging their tax return. This would further increase the demand for specialist consultation, and tax services currently estimated at 50% of total compliance costs, further reducing the net benefit from engaging in R&D activities.

² Jiménez-Jiménez, D. and Sanz-Valle, R., 2011. Innovation, organizational learning, and performance. *Journal of business research*, 64(4), pp.408-417.

Thank you for the opportunity to submit our feedback; we would be pleased to discuss any points of this submission further as required.