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Submission - Treasury Laws Amendment (Research and Development Tax Incentive) Bill 2019

Senate Standing Committees on Economics
PO Box 6100
Parliament House
Canberra ACT 2600
Submitted by upload to inquiry website

6 March 2020

Dear Sir/Madam

StartupAUS submission: Treasury Laws Amendment (Research and Development Tax Incentive) Bill 2019

StartupAUS welcomes the opportunity to contribute to the consultation process on the current review of the proposed amendments to the Research and Development ('R&D') Tax Incentive program.

Summary of key submission elements:

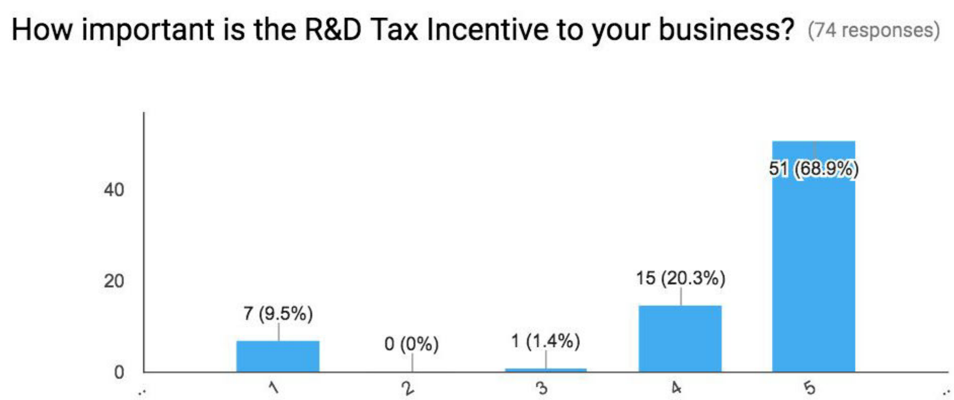
1. The **R&D Tax Incentive (RDTI) plays a vital role** in supporting the growth of a high value emerging tech sector for Australia.
2. **Young, high-growth tech firms** in particular rely on the scheme and overwhelmingly use it to employ more staff and conduct more R&D.
3. Thanks to shifts in interpretation, the RDTI is currently **failing to adequately support software development activities**
4. Any amendments to the scheme (such as those proposed by this Bill) should address this shift away from support for software development activities by **adding clarifying language** to the scheme reinforcing the eligibility of software development activities.
5. **The cap for refundable RDTI claimants** proposed in the Bill would not materially prejudice the majority of startup claimants, so long as support for software development is reinforced.
6. **Intensity measures** proposed in the Bill would not materially prejudice the majority of startup claimants, so long as support for software development is reinforced.

The R&D Tax Incentive is vital to startups, and it's working

Startups rely on the R&D Tax Incentive

Research conducted by StartupAUS indicates unambiguously that the RDTI is a critical part of the success of startups in Australia. In a survey of 74 startups conducted by StartupAUS, 89% of national respondents reported that the RDTI was either critical (68.9%) or very important (20.3%) to their business. StartupAUS has conducted extensive in-person Australia-wide consultation on this topic, with similar results.

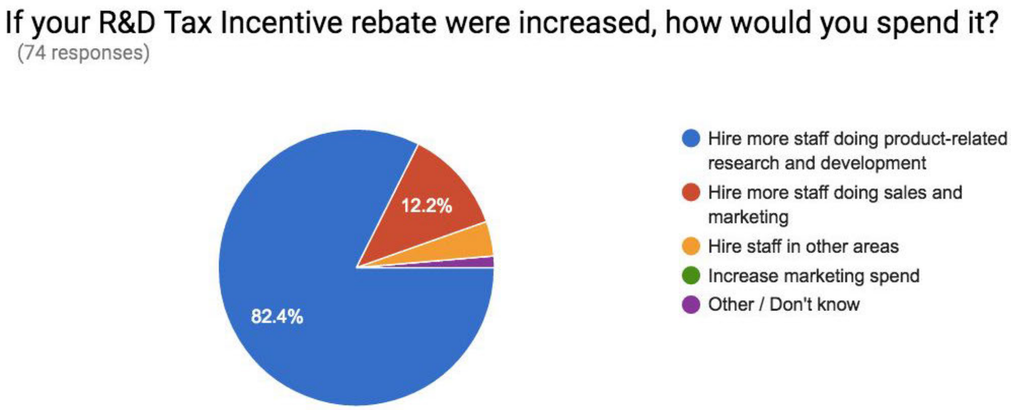
> "In the period before scale up, it was critical for us. It leveraged our development spend, enabled us to cash out our tax losses. At one point it made the difference between continuing and shutting the business. We are now successfully scaling up."
> Jeff Ryall, Managing Director of RelianSys.



Startups use the R&D Tax Incentive to do more R&D, and employ more people

The principle purpose of the RDTI is to encourage additional R&D. The RDTI allows such companies to grow, and growth in this market segment necessarily entails substantial product development and additional employment. The Office of the Chief Economist noted in *The employment dynamics of Australian entrepreneurship* that high-growth startups account for 77% of new jobs created by SMEs between 2006 and 2011. SMEs, in turn, accounted for the vast majority of new jobs in the economy.

Startups overwhelmingly tell us that they spend RDTI receipts on hiring additional staff (98.7%) across the business. Of these, 82% said they would hire additional staff specifically to conduct further R&D.



These numbers highlight the potent effect that the RDTI has in achieving its aims when directed towards young, high growth, software businesses.

> "Every dollar we receive from the R&D tax incentive is spent on furthering our research into ground breaking medical devices."
> Trevor Townsend, OMX Solutions

<u>When working effectively, the R&D Tax Incentive keeps startups based in Australia (and employing Australians) for longer</u>

Maturing startups consistently report that the R&D tax incentive is a major reason to continue to be headquartered in Australia. Startups that have expanded into other jurisdictions regularly retain much or all of their R&D capability in Australia to take advantage of the scheme.

These factors mean the refundable portion of the R&D Tax Incentive is directly responsible for jobs growth and retention in Australia, and increases the likelihood that globally successful startups will remain Australia-based for longer periods or permanently. The R&D Tax Incentive directly helps keep key R&D jobs in Australia.

> "We are in a rapid expansion phase and planning to employ dozens of new people. The R&D Tax Incentive is the single most important factor in deciding whether to employ new roles in Australia or overseas."
> Chris Clark, CEO of fusesport

Despite this, support for software R&D is diminishing

Software claims now make up a significant proportion of the RDTI, but tech startups now view the program as in crisis. The amendments proposed in the Bill, designed to target the scheme more effectively towards high-intensity firms contributing to R&D additionality, only make sense if support for software is bolstered.

Since February 2017, shifts in interpretation of eligible R&D activities under the program have cut out an increasing number of software claims. This is undermining a bedrock platform of government support for the emerging technology sector. Retroactive enforcement measures (clawbacks) have meant a growing number of companies are facing serious financial challenges as a result, breeding uncertainty about the future of the program for startups and established software firms.

This problem has developed in part because the model used in the RDTI assessment process is not well adapted to the process of software development. This has led to a situation where, despite support for software R&D being one of the main reasons for amending the scheme in 2011, it is becoming increasingly difficult for companies to claim for software development activities.

Solution

- Amend the proposed Bill to include clear language that clarifies support for claims based on software development.
- Freeze retroactive compliance measures relating to small software companies until language identified above has been introduced.

Detail

The process for identifying eligible R&D activities under the RDTI involved a strong emphasis on the generation of 'new knowledge'. While the legislation specifically identifies '*developing new or improved products or services*' as one stream of the definition of 'new knowledge', this has been largely overlooked in recent years in favour of a more research-led definition of novelty. This has cut out claims by companies doing innovative product-related software development work.

Clearer language in the operative section of the legislation would help resolve this problem. The language should: specifically identify software development as an eligible R&D activity; and reinforce that 'new knowledge' includes developing new or improved software applications.

In the meantime, there is an urgent need for a freeze on audits for small software companies. A moratorium on new audits would help vulnerable companies manage the increased risks around the RDTI more effectively. Specifically, the moratorium should:

- Be applied to all software claimants with turnover less than $20m
- Prevent new audits and halt existing audits as long as:
    - the claim in question is similar in scope to claims submitted in previous years (i.e. similar technology area);
    - the claim is not more than 50% larger than the previous year; and
    - there is evidence the claim was made in good faith, such as reliance on expert RDTI advice.

If combined with adequate support for software claims, amendments proposed in the Bill are appropriate

Cap on refundable claims

As part of a submission to the Ferris, Finkel, Fraser RDTI review in October 2016, StartupAUS made a submission on capping refundable claims. As a result, the proposal for a $2m cap on such claims was subsequently amended to the proposal now contained in the Bill. If software development is appropriately supported under the RDTI, our assessment is that the cap proposed in the Bill would not be materially prejudicial to the interests of the majority of startups.

Nevertheless, there are circumstances in which legitimate (and ultimately very successful) high-growth tech businesses might develop a product intensively over a substantial period before seeking to monetise. In such circumstances a business might have high R&D expenditure (backed by venture capital) with little or no revenue, thus creating a scenario where a claim exceeding the cap could be made by a company in the refundable part of the program. Social media platforms present a prominent example of a business model where very substantial R&D spending is done before any revenue can be expected. A cap on the refundable element of the R&D Tax Incentive could limit Australia's ability to support the growth of such companies.

Intensity threshold

Our submission is that, if Bill is amended to insert new language to reinforce the eligibility of software development claims, the proposed R&D intensity tests would not be materially prejudicial to the interests of the majority of startup claimants. In our view, increasing the scheme's focus on firms with high R&D intensity is a step towards boosting additionality. Innovative high-growth software firms typically spend a large proportion of overall expenditure on developing new products or improving existing ones. If the eligibility of those activities is recognised in the scheme, these firms are exactly the kinds of companies these amendments to the RDTI are seeking to target.

Please do not hesitate to contact me if you have any questions.

Yours faithfully

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Alex McCauley
CEO, StartupAUS