AFANDIN

R&D Tax Incentive Review
Submission by Afandin Pty Ltd

1. Executive Summary

The R&D Tax Incentive is the single most important Government incentive encouraging innovation in Australia. In particular, the cash rebate available to small companies provides an incentive for innovation and investment in product development that sets Australia apart from most other countries in the world. The ability for small companies with low or no revenues to receive a cash rebate for their R&D expenditure is a critical factor in the nurturing of local technology companies. It has also encouraged numerous overseas development-stage companies to establish operations in Australia.

Policy stability is essential for companies, large or small, to make long-term R&D decisions and for investors to be prepared to support these decisions. Any change to the R&D Tax Incentive undermines confidence in the scheme and will have negative consequences. Previous "tinkering" to the scheme, most recently the reduction in the cash rebate from 45% to 43.5%, has already created a level of uncertainty about ongoing Government support of the incentive. Any further changes will exacerbate this uncertainty. R&D and new product development are long-term commitments – they require long-term, consistent policy settings. The Afandin base position is, therefore, that there should be **no change** to the R&D Tax Incentive scheme.

The review panel has recommended a number of "improvements" to the scheme. While accepting that the scheme is not perfect, it is important that the consequences of any "improvements" are fully understood before deciding to implement them.

Afandin agrees, in principle, with many of the recommended operational improvements. However, Afandin disagrees in the strongest possible terms with a cap on the annual refund payable under the R&D Tax Incentive (Recommendation 3). This recommendation is inherently biased against life science companies and implementation of the recommendation would (i) create a disincentive for life science companies to invest in the later stages of product development, (ii) force premature out-licensing or company acquisition, and (iii) reduce the capacity to invest in a pipeline of products.

The medical technology and pharmaceuticals (MTP) sector is one of the Government's five growth industries. Small life science companies need the opportunity to develop and mature to underpin a vibrant MTP sector. Implementation of Recommendation 3 would place a major block to the development and maturation of small life science companies and, therefore, would be detrimental to the MTP sector. The R&D Tax Incentive should reinforce Government policy, not act against it. Therefore, the Government should not accept Recommendation 3.

In summary, Afandin's position is that:

1. **Policy stability is critical to nurturing innovation in Australia**, particularly in the high cost, high risk, long development timeframe, life sciences industry.
2. Apart from meaningful improvements to the administration of the scheme, the R&D Tax Incentive should not change.
3. **In particular, Recommendation 3, proposing a cap on the annual cash refund for the reimbursable component of the scheme, should be rejected**.

2. Detailed Submission

2.1 Background and overview

Afandin congratulates the review committee on its thoughtful review of the R&D Tax Incentive scheme and welcomes the opportunity to comment on the committee's recommendations.

Afandin is a consulting company that advises life sciences companies and research institutions. Its client base is mostly small Australian companies but it has provided services to large and small companies in Australia, US, EU and Japan. Afandin's principals hold executive and board positions in a number of small companies, many of which are beneficiaries of the R&D Tax Incentive. They are therefore well placed to comment on the importance of the R&D Tax Incentive for small life science companies and the potential consequences of changes to the scheme.

Of particular concern to Afandin is any potential change to the scheme that will affect the cash rebate payable to small, pre-revenue companies. Already the Government has reduced the rate of the cash rebate from 45% to 43.5%. While this is a small change (which, notably, provides a minimal reduction in the expense of operating the scheme), it has created ongoing uncertainty for companies and their investors about the Government's commitment to the scheme. Any further changes should be strongly resisted.

2.2 Comments on specific 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.*

Afandin comment – we support this recommendation as a sensible operational improvement.

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 is introduced (see Recommendation 4), companies falling below the threshold should still be able to access both elements of the collaboration premium.*

Afandin comment – we agree in principle with this recommendation, with the caveat that the premium for collaboration should not come at the expense of support for "non-collaborative" R&D under the scheme. Collaboration requires time, effort and expense, so it is reasonable to provide an inducement to encourage it. However, there should be no penalty for not collaborating. Since this recommendation relates to the non-refundable part of the R&D tax incentive, it is primarily directed towards larger, revenue-generating companies. Such companies are much better placed to collaborate with publicly-funded research organisations and to employ meaningful numbers of STEM graduates than small, pre-revenue companies that have limited resources and need to stay very focused.

***Recommendation 3**. Introduce a cap in the order of $2million 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.*

Afandin comment – we strongly disagree with this recommendation. It would effectively limit the annual R&D expenditure against which a cash rebate could be claimed to ~$4.6million. For non-life science companies such a limit may well not be an issue. However, for life science companies that need to invest millions to tens of millions of dollars in individual clinical trials for their products, it would create a major disincentive (if not roadblock) for them to continue to invest in the later stages of product development. For early stage companies, the non-refundable tax offset is meaningless and would provide no compensation for a cap in the cash rebate.

The impact of implementing this recommendation would likely include the following:

- Reduced ability of small life science companies to invest in mid- or late-stage clinical trials, which represent the greatest "value creation" step in pharmaceutical product development.
- Increased pressure for companies to execute early stage licensing deals or company acquisitions, resulting in loss of value (and companies) to overseas interests.
- Reduced ability of companies to build a pipeline of multiple clinical-stage assets and therefore manage risk via a portfolio approach to product development.
- Reduced contracting by Australian companies to service providers (contract research organisations, contract manufacturers, hospitals, academic institutions, etc.) for clinical trial activities.
- Reduced prospects for the emergence of mid-tier life science companies to underpin a vibrant MTP sector, instead perpetuating the problem of undercapitalised, single product companies.
- Reduced incentive for investors to invest in life science companies.

Apart from the significant negative impact on local life science companies, a cap on the cash rebate would likely lead to an exit of overseas development-stage life sciences companies from Australia. To Afandin's knowledge, at least 20 such overseas companies have set up operations in Australia, driven heavily by the cash rebate for R&D activities undertaken in Australia. While this is not the primary purpose of the R&D Tax Incentive, the benefits of this influx of overseas companies into Australia are multifold and include:

- New and ongoing revenues for local CROs, manufacturers, clinical sites, accounting firms, legal firms, etc.
- Australian researchers and service providers gaining experience and expertise, and improving their international networks.
- Access by Australian patients to new and innovative therapies that otherwise would not become available for many years.
- Potential for future R&D and clinical development based on positive results and experience.
- Spin-off revenues to airlines, hotels, restaurants, etc. associated with business visits to Australia by company representatives.
- Employment opportunities for local STEM graduates as overseas companies expand their operations.
- Increased visibility of Australian researchers, clinical sites and research institutions.
- Increased critical mass for the local biotechnology industry.

If a cap is placed on the cash rebate, overseas companies will likely reconsider their commitment to Australian operations and these benefits to the local sector will be lost.

The cash rebate component of the R&D Tax Incentive is central to the emergence of a viable pharmaceutical sector in Australia, based on both home grown opportunities and those relocated from overseas. The MTP sector is one of the Government's five growth industries. A cap on the cash rebate will detract significantly from the MTP sector, thus undermining Government policy. It will also negatively impact on the Government's initiatives under the National Innovation and Science Agenda (NISA) to encourage new investment into the MTP sector.

This recommendation should be rejected by the Government.

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.*

Afandin comment – we agree in principle with this recommendation, subject to minimum impact on "red tape" associated with documenting "additionality". Since the recommendation relates to the non-refundable part of the R&D tax incentive, it is primarily directed towards larger, revenue-generating companies. The small, life sciences companies with which we work are already "R&D-intensive" – R&D is generally the prime, if not the sole, focus of the company.

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.*

Afandin comment – we agree with this recommendation.

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.*

Afandin comment – we agree in principle with this recommendation, subject to "improvements" being true enhancements in administration of the scheme and "additional resourcing" not coming at the expense of funding available via the scheme.

2.3 Summary

Afandin agrees, in principle, with many of the recommended operational improvements. However, Afandin disagrees in the strongest possible terms with a cap on the annual cash refund payable under the R&D Tax Incentive (Recommendation 3) on the basis that the recommendation is inherently biased against life science companies and implementation of the recommendation would have very negative consequences for the sector.

The MTP sector is one of the Government's five growth industries. Small life science companies need the opportunity to develop and mature to underpin a vibrant MTP sector. Implementation of recommendation 3 would place a major block to the development and maturation of small life science companies and, therefore, would be detrimental to the MTP sector. The R&D Tax Incentive should reinforce Government Policy, not act against it. Therefore, the Government should not accept Recommendation 3.

In summary, Afandin's position is that:

1. **Policy stability is critical to nurturing innovation in Australia**, particularly in the high cost, high risk, long development timeframe, life sciences industry.
2. Apart from meaningful improvements to the administration of the scheme, the R&D Tax Incentive should not change.
3. **In particular, Recommendation 3 proposing a cap on the annual cash refund for the reimbursable component of the scheme should be rejected.**

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