Chapter 3

Technical issues and committee view

3.1 Several submissions commented on the suitability of the term 'aggregated assessable income' used in the bill. Various objections to the use of the term were put forward, including that the term may potentially result in anomalous outcomes for companies in certain sectors. These issues are examined in this chapter. The committee's overall conclusions and recommendations regarding the bill are then detailed at the end of the chapter.

Threshold based on 'aggregated assessable income'

3.2 As noted in chapter 1, the R&D incentive consists of two components: a 45 per cent refundable tax offset and a non-refundable 40 per cent tax offset. Whether the refundable or non-refundable tax offset is available to a particular R&D entity currently depends on that entity's 'aggregated turnover'[1]—if it is less than $20 million the R&D entity may use the 45 per cent refundable tax offset, otherwise the 40 per cent offset is available. The bill proposes to refine this further by stipulating that the 40 per cent offset is not available to R&D entities with an 'aggregated assessable income' for the income year of $20 billion or above.

3.3 'Assessable income' is a core concept in the ITAA 1997. It consists of income according to ordinary concepts (ordinary income) and income included as a result of income tax legislation (statutory income), excluding any ordinary or statutory income made exempt by legislation.[2] For the purposes of the R&D tax incentive, the bill proposes to define 'aggregated assessable income' as the sum of:

- an R&D entity's assessable income for the income year; and
- the assessable income for the income year of any entity that, at any time during the income year, is connected with the R&D entity, is an affiliate of the R&D entity, and of which the R&D entity is an affiliate.[3]

3.4 The rationale for basing the threshold on aggregated assessable income is outlined in the explanatory memorandum as being to ensure that the threshold 'cannot be easily circumvented by diverting income to an associated entity or directing another entity to conduct certain activities'.[4]

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1 This term is defined in section 328-115 of the ITAA 1997.

2 *Income Tax Assessment Act 1997*, ss. 6-5, 6-10 and 6-15.

3 See schedule 1, item 1, proposed new subsection 355-103(2). The assessable income of an entity that is only connected with the R&D entity because both of them are controlled by the same Australian government agency is excluded.

4 Explanatory Memorandum, paragraph 1.14.

3.5 Submissions advised that the use of this concept to identify large companies appeared to be a departure from the original policy announcement which referred to turnover.[5] A number of specific issues were raised which are discussed below.

Complexity and number of companies covered

3.6 Stakeholders questioned the use of aggregated assessable income from the standpoint that the concept is overly complex and technical (that is, the term does not correspond with the ordinary understanding of what $20 billion of turnover is). KPMG argued that basing the exclusion on this term 'may inadvertently capture even more taxpayers than initially announced and produce some unusual and possibly unintended consequences'. It provided the following overall explanation:

> Assessable income is a complex term which encompasses both common law and statutory income. This already hints at its complexity and the difficulties its use will impose on companies trying to determine 'aggregated assessable income' for themselves and other entities with whom they are connected.[6]

3.7 KPMG added:

- as the definition does not exclude income derived between related entities, a $20 billion threshold based on aggregated assessable income will be reached more quickly than a threshold set an aggregated turnover of $20 billion;
- businesses will be required to understand and apply 'yet another…subtly different definition'; and
- including both the assessable income of affiliates of the R&D entity, and of which the R&D entity is an affiliate is, in KPMG's view, 'inconsistent with the aggregated turnover definition and in practice, will have little further application'.[7]

3.8 Deloitte similarly expounded on the complexity associated with the definition and questioned the approach of including statutory income:

> As soon as you start to introduce multiple tests the compliance costs increase and confusion reigns. But also this concept of aggregated assessable income includes both income according to ordinary concepts but also statutory income. There is a lot in statutory income which is unusual by

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5 Michael Johnson Associates, *Submission 3*, p. [7]. The Gillard government's policy announcement stated: 'Very large companies with annual Australian turnover of $20 billion or more will no longer be able to claim R&D expenditure under the non-refundable 40 per cent R&D tax offset'. See Australian Government, *A Plan for Australian Jobs: The Australian Government's Industry and Innovation Statement*, February 2013, p. 13.

6 KPMG, *Submission 1*, p. 6.

7 KPMG explained that '[a]ggregated turnover already encompasses any entity which on its own, its affiliates or together with its affiliates controls at least 40% of the R&D entity (whether directly or through interposed parties)'. KPMG, *Submission 1*, p. 8.

> its very nature. It is there because of the legislature deeming to tax certain classes of activities in a particular way. It includes, for example, capital gains which, depending on the particular transaction, an organisation may breach the $20 billion threshold notwithstanding its ordinary turnover would not include that sort of figure.[8]

3.9 In support of Deloitte's argument, Ernst & Young provided an example of a capital gains event that it considered counts towards the threshold and would result in an undesirable outcome:

> …if I am a business and there are two parts of my business and I sell that part of the business, the shares in that part of the business, that potentially triggers capital gains and therefore additional income for me. That can in a sense artificially inflate that. That is not the ordinary income.[9]

3.10 Deloitte also advised that gaining access to information about related party transactions with affiliates and entities controlled through affiliates can often be 'problematic'.[10]

Implications for companies approaching the $20 billion threshold

3.11 KPMG and Michael Johnson Associates suggested that the proposed amendments could create uncertainty for companies that could not confidently determine in advance whether their aggregated assessable income would be above or below the $20 billion threshold. As aggregated assessable income can only be determined after the end of an income year and, according to KPMG, is a figure that would be difficult to determine, these companies could not know if they were eligible for the incentive until after the decision to undertake (or not undertake) R&D activities had been made.[11] On this issue, Michael Johnson Associates provided the following reasoning and outline of the possible consequences:

> The use of the concepts of assessable income and grouping will make the potential application of the threshold highly unpredictable for company groups in the vicinity of the $20 billion figure.
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> The Incentive is designed to impact the type and level of investment decisions at the time they are made. The fact that the Incentive may subsequently not be available because a combination of circumstances sees a company group exceeding the $20 billion threshold where it is not certain that this will be the case will deter these groups from making R&D decisions on anything other than the conservative assumption that the Incentive will not apply.

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8 Mr Serg Duchini, National Leader, R&D and Government Incentives, Deloitte, *Proof Committee Hansard*, 21 February 2014, p. 5.

9 Mr Ezra Hefter, Partner, Ernst & Young, *Proof Committee Hansard*, 21 February 2014, p. 5.

10 Mr Serg Duchini, Deloitte, *Proof Committee Hansard*, 21 February 2014, p. 5.

11 KPMG, *Submission 1*, p. 8.

> This introduces more uncertainty into the system and will be an additional dampener on levels of R&D investment.[12]

3.12 BDO Australia noted that other provisions in the ITAA 1997 use a prior year test, such as the taxation of financial arrangements provisions in Division 230.[13]

Do the proposed amendments disadvantage Australian companies?

3.13 Several submissions argued that the use of aggregated assessable income discriminates against Australian companies because all income derived by Australian companies, whether in Australia or overseas, will be captured by the definition. For foreign companies, however, assessable income is only income derived in Australia.[14] The Australian Academy of Technological Sciences and Engineering believes that it 'is difficult to understand how the Parliament could agree to such a discriminatory approach'.[15] Michael Johnson Associates also questioned this aspect of the bill, suggesting that 'modest transnational performers in terms of Australian revenue remain in the program whilst stellar local performers are closed out'.[16]

3.14 This issue was discussed at the committee's public hearing. Deloitte explained how it expects multinational companies to respond:

> From a multinational perspective, depending on where they derive their assessable income, they may have income well in excess of $20 billion but they do not derive it here, and they would have an advantage compared with an Australian company that derives most of its assessable income in country, and they may be accessing and being supported whilst an Australian company is not. That might, however, have the positive impact of actually making Australia a little bit more attractive than a multinational to conduct R&D in country, but I still think it is discriminatory.[17]

3.15 Officials from the Department of Industry and Treasury confirmed that the policy intent behind the definition was a desire to continue to provide an incentive for foreign companies to undertake R&D in Australia. It is assumed that Australian companies affected by the proposed amendments will continue to undertake their

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12 Michael Johnson Associates, *Submission 3*, p. [7].

13 BDO Australia, *Submission 16*, p. 5.

14 The ITAA 1997 specifies that for Australian residents, assessable income is derived from all sources, whether in Australia or overseas. For foreign residents, assessable income is only income derived in Australia and otherwise specified by legislation. See *Income Tax Assessment Act 1997*, ss. 6-5 and 6-10.

15 Australian Academy of Technological Sciences and Engineering, *Submission 8*, p. 4.

16 Michael Johnson Associates, *Submission 3*, pp. [5]–[6].

17 Mr Serg Duchini, Deloitte, *Proof Committee Hansard*, 21 February 2014, p. 3.

R&D in Australia regardless.[18] A Department of Industry official added that the aggregated assessable income test would result in 'ease of administration', as foreign companies are already required to determine their assessable income in Australia for their tax returns.[19]

Potential anomalous impacts on particular sectors

3.16 Submissions advised that the proposed definition of aggregated assessable income could have particular consequences for life insurance companies and petroleum retailers.

Life insurance companies

3.17 Life insurance companies are subject to special rules for determining their taxable income due to the nature of their business. These rules are contained in division 320 of the ITAA 1997, which aims to ensure that the taxation of life insurance companies occurs 'in a broadly comparable way to other entities that derive similar kinds of income'.[20] Under these rules, the total amount of the life insurance premiums paid to the company in the income year is included in the company's assessable income.[21] When determining taxable income, however, the inclusion of these premiums is offset by deductions for investment capital.[22] KPMG argued that the actual turnover of life insurance companies 'is in reality limited to the fees received by the company'.[23] The mechanism in division 320 reflects this understanding by providing that life insurance companies are not taxed on premiums that do not constitute their economic income.

3.18 This net outcome does not appear to be reflected in the bill as deductions are not considered. Accordingly, KPMG argued that life insurance companies could reach the $20 billion aggregated assessable income threshold and be excluded from claiming the R&D tax incentive while having an actual turnover that was much lower.[24]

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18 Ms Maryann Quagliata, General Manager, Innovation Policy Branch, Department of Industry; Mr Hector Thompson, General Manager, Small Business Tax Division, The Treasury, *Proof Committee Hansard*, 21 February 2014, p. 21.

19 Ms Maryann Quagliata, Department of Industry, *Proof Committee Hansard*, 21 February 2014, p. 21.

20 *Income Tax Assessment Act 1997*, s. 320-1.

21 *Income Tax Assessment Act 1997*, s. 320-15(1)(a).

22 *Income Tax Assessment Act 1997*, subdivision 320-C.

23 KPMG, *Submission 1*, p. 7.

24 KPMG, *Submission 1*, p. 7.

Downstream petroleum industry

3.19 It was argued that petroleum retailers could be disadvantaged by the proposed definition because of the high turnover, low margin nature of that industry and the items that petroleum retailers include in their assessable income.

3.20 Caltex advised that it is likely to surpass the $20 billion aggregated assessable income threshold, and thus would no longer be eligible to claim the R&D tax incentive in future if the bill were passed.[25] However, Caltex argued that the ability to afford R&D is measured by profitability, and that profitability and assessable income 'are not always well correlated'.[26] To demonstrate this, Caltex advised that in 2012 it had an after tax profit of $57 million on a historic cost basis, or $458 million on a replacement cost of sales basis. Caltex argued that its profitability, and the profitability of the oil industry generally, is relatively low compared to turnover and the turnover of other very large companies that would be affected by the proposed changes.[27] Caltex provided a table of the top companies by revenue and net profit after tax to support this reasoning. An abridged version of this table is at Table 3.1.

Table 3.1: Top 20 companies by revenue and net profit after tax

Rank	Company	Total revenue ($billion)	Net profit after tax ($billion)
1	BHP Billiton	72	15.2
2	Rio Tinto	60	5.7
3	Wesfarmers	58	2.1
4	Woolworths	56	1.8
5	National Australia Bank	49	4.1
6	Commonwealth Bank of Australia	47	7.1
7	Westpac Banking Corporation	42	6
8	ANZ Banking Corporation	40	5.7
9	Telstra	26	3.4
10	Xstrata Holdings	23	3.2
11	Caltex Australia	23	-0.7*
12	Shell Australia	22	-0.8
13	BP Australia	21	0.8
14	QBE Insurance Group	21	0.7

25 Caltex advised that it received $4.2 million in R&D tax incentives between 2009 and 2012: Caltex, *Submission 15*, p. 3.

26 Caltex, *Submission 15*, p. 5.

27 Caltex, *Submission 15*, pp. 1, 5.

15	Suncorp Group	16	0.7
16	Qantas	16	-0.2
17	NSW Health	16	0.09
18	Fonterra Co-op Group	15	0.5
19	Origin Energy	13	1
20	Metcash	12	0.09

Source: Caltex Australia, *Submission 15,* p. 8; originally sourced from BRW Top 1000 Companies in 2013.

* Caltex notes that the replacement cost of sales operating profit (RCOP) net profit after tax (pre-significant items) is $0.3 billion. Caltex advised that RCOP 'results remove the impact of fluctuations in the US$ price of crude and foreign exchange an cost of sales, which is separately identified as inventory gains/(losses) in the statutory accounts'.

3.21 Caltex provided a two-part explanation for petroleum companies having a high assessable income relative to profit. The first reason given is petroleum companies face a high cost of sales that fluctuates due to the exchange rate:

> The cost of goods, as we have shown on the schedule, has gone from about $12 billion in 2009 to almost $17 billion as at the end of December 2012. That is a significant sum that we have to expend. When we exclude all that, our profits are really down to about $1.7 billion as at the end of 2012.
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> * * *
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> A lot of our costs, a lot of our turnover, is influenced by the foreign exchange rates which have significantly varied over the last few years. We have gone from 80c for a US dollar to 96c. The average price of crude oil, which is also denominated in US dollars, which we buy in order to manufacture, has gone from US$64 to US$114 on average. When one considers that, it automatically has external factors which adversely impact an organisation such as Caltex which has to compete with all the other multinationals.[28]

3.22 The second explanation provided for petroleum companies having a high assessable income relative to profit is excise. Caltex stated that its ordinary income

28 Caltex noted that this instability can also make it difficult to predict its end of income year profitability: 'We have had occasions in the past where we may have had a very large turnover and could end up with almost a loss during the year, and some of our profits could be wiped very close towards the end of the year because of changes to crude prices, product prices and the US dollar exchange rate'. Mr George Chenouda, Manager, Tax, Caltex Australia, *Proof Committee Hansard*, 21 February 2014, p. 12.

includes cost recovery from customers of excise of over $5 billion, representing $0.38 for every litre of fuel sold in Australia.[29]

3.23 Overall, Caltex considered that both turnover and aggregated assessable income are a 'very poor metric for the size of a firm'.[30] It recommended that a second test be introduced based on taxable income:

> By all means leave the turnover or assessable income test in place, if that is the government's intention, but ensure that more profitable firms are captured by introducing a second test or threshold which relates to taxable income.[31]

3.24 Alternatively, Caltex suggested the definition be amended to exclude ordinary income derived from sales of retail fuel—an exclusion already contained in the ITAA 1997 to ensure that small petroleum retailers were not excluded from the definition of a small business used for Pay As You Go withholding tax.[32] However, Caltex advised that it preferred the addition of a threshold based on taxable income to an exclusion, given that future increases in oil prices may still push Caltex above the $20 billion threshold even if excise were excluded.[33]

Committee view

3.25 The committee acknowledges that most submissions do not agree with the intent behind the bill. A proposed change to taxation arrangements inevitably triggers a vocal response from those that do not agree with the proposal, particularly the entities directly affected by it. The committee welcomes a robust debate about tax policy and seriously considered the views put forward. However, during this inquiry the committee has been mindful of the statutory object of the R&D tax incentive, which is to:

> encourage industry to conduct research and development activities that *might otherwise not be conducted* because of an uncertain return from the activities, in cases where the knowledge gained is likely to benefit the wider Australian economy.[34] (emphasis added)

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29 Caltex, *Submission 15*, p. 5; Mr George Chenouda, Caltex Australia, *Proof Committee Hansard*, 21 February 2014, p. 12. Mr Chenouda explained that Caltex considers excise to be part of its ordinary income 'for the simple reason that, it not being a tax, it forms part of the cost of goods. The amount is paid before we sell. As soon as the product leaves our bonded locations, we pay the tax…Therefore it becomes part of our goods, like part of our distribution costs and so forth'. *Proof Committee Hansard*, 21 February 2014, p, 13.

30 Mr Frank Topham, Head of Government Affairs, Caltex Australia, *Proof Committee Hansard*, 21 February 2014, p. 11.

31 Mr Frank Topham, Caltex Australia, *Proof Committee Hansard*, 21 February 2014, p. 11.

32 Caltex, *Submission 15*, p. 6.

33 Mr Frank Topham, Caltex Australia, *Proof Committee Hansard*, 21 February 2014, pp. 13–14.

34 *Income Tax Assessment Act 1997*, s. 355-5(1).

3.26 The committee has been provided with evidence that supports the contention that the R&D tax incentive could be better targeted. It is acknowledged that there is some research which reaches a different conclusion, although some of the counterarguments made and studies cited in submissions focused on the benefits R&D undertaken by large companies provide for the economy. This is not in question—how responsive these companies are to the R&D tax incentive and whether this represents the best use of taxpayer money are the key issues.

3.27 The committee is also mindful of the government's intention to implement a sustainable fiscal strategy and how the bill fits in with efforts to strengthen the budget position. Given the evidence received, it is prudent for changes to be considered that will better target the R&D tax incentive to companies that are more likely to increase their R&D spending in response to the incentive. This will ensure that the government revenue foregone as a result of the tax offsets that make up the incentive delivers the greatest possible return for taxpayers. Accordingly, the committee supports the bill.

3.28 There are elements of the bill that the committee considers require specific comment. The retrospective application of the proposed amendments is already discussed in chapter 2. The second matter is the concept of aggregated assessable income used in the bill. Although it is a technical taxation law term that is a more complex concept than turnover, the committee does not consider that its use will, generally, pose issues for the large, well-informed taxpayers affected by the proposed amendments. The committee also notes the evidence that asserts Australian companies will be disadvantaged by the proposed amendments compared to foreign companies. This is a difficult policy question although, on balance, the committee agrees with the approach taken on the basis it will maintain an incentive for foreign companies to undertake R&D in Australia and therefore maximise the amount of R&D undertaken in this country.

3.29 The evidence received regarding the practical application of the bill to companies in particular sectors, such as life insurance companies and petrol retailers, warrants further consideration. It may be appropriate to include certain exclusions to the definition of aggregated assessable, such as excluding the assessable income of an R&D entity to the extent it is attributable to life insurance company policyholders' interests, or to introduce a secondary test based on taxable income. These are matters the government should consider further before the bill proceeds, although this recommendation does not impact the committee's endorsement of the bill.

Recommendation 1

3.30 The committee recommends that the government further consider the definition of 'aggregated assessable income' of an R&D entity in the proposed new section 355-103 of the *Income Tax Assessment Act 1997* with a view to addressing, to the extent possible and with minimum fiscal impact, any potential anomalies that the use of the term may create for life insurance companies and petroleum retailers.

Recommendation 2

3.31 Subject to recommendation 1, the committee recommends that the bill be passed.

Senator David Bushby
Chair