The Senate

Economics Legislation Committee

Tax Laws Amendment (Research and Development) Bill 2013 [Provisions]

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Senate Economics Legislation Committee

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Abbreviations

CRC	cooperative research centres
GDP	gross domestic product
Industry Research and Development Act	*Industry Research and Development Act 1986*
ITAA 1997	*Income Tax Assessment Act 1997*
OECD	Organisation for Economic Co-operation and Development
PJCHR	Parliamentary Joint Committee on Human Rights
R&D	research & development
RCOP	replacement cost of sales operating profit
Scrutiny of Bills Committee	Senate Standing Committee for the Scrutiny of Bills
SMEs	small to medium enterprises
UNSW	University of New South Wales
US	United States of America

Chapter 1

Introduction

1.1 On 5 December 2013, the Senate referred the provisions of the Tax Laws Amendment (Research and Development) Bill 2013 to the Senate Economics Legislation Committee for inquiry and report by 17 March 2014.[1] The bill proposes to limit access to the research and development (R&D) tax incentive to companies with an aggregated assessable income of less than $20 billion.

Conduct of the inquiry

1.2 The committee advertised the inquiry on its website and wrote to relevant stakeholders and other interested parties inviting submissions. The committee received 20 submissions, which are listed in Appendix 1.

1.3 The committee held a public hearing in Canberra on 21 February 2014. The names of the witnesses that gave evidence are at Appendix 2.

1.4 The committee thanks all of the individuals and organisations that contributed to this inquiry.

Structure of this report

1.5 This report is comprised of three chapters:

- The remaining sections of chapter 1 provide an overview of the bill and detail about the consideration of the bill by other parliamentary committees.
- Chapter 2 discusses and analyses the overall policy behind the bill and assumptions that have been made. Amendments to the R&D tax incentive that stakeholders suggested should be considered as an alternative to the bill are also outlined.
- Chapter 3 outlines the technical issues raised in evidence regarding the concept of 'aggregated assessable income'. The committee's assessment of this evidence and its overall conclusions and recommendations about the bill can be found at the end of that chapter.

Overview and background

1.6 This section provides an overview of the R&D tax incentive framework as it currently operates. The changes proposed by the bill and the origin of these proposed changes are then outlined.

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1 *Journals of the Senate*, no. 7 of 2013–14 (5 December 2013), pp. 244–46.

R&D tax incentive

1.7 Tax incentives to promote R&D have been in place in Australia since 1986.[2] The current R&D tax incentive was introduced in 2011 and applies to income years commencing on or after 1 July 2011.[3] The incentive is contained in division 355 of the *Income Tax Assessment Act 1997* (ITAA 1997) and consists of two components:

- for eligible entities with an aggregated turnover of less than $20 million (provided that they are not controlled by tax exempt entities) a 45 per cent refundable R&D tax offset is available; and
- for all other eligible entities, a non-refundable 40 per cent R&D tax offset is available.[4]

1.8 To be eligible for the R&D incentive, an entity needs to:

- be registered for R&D activities[5] under Part III of the *Industry Research and Development Act 1986*;
- have one or more notional deductions for an income year, the main categories of which are:
    - R&D expenditure—expenditure on registered R&D activities subject to certain conditions, including that the activity is conducted for the R&D entity solely within Australia or an external territory; and

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2 Terry Cutler, Cutler and Company, and Department of Innovation, Industry, Science and Research, *Venturous Australia: Building strength in innovation*, August 2008, www.innovation.gov.au (accessed 22 January 2014), pp. 101–02; and Ms Maryann Quagliata, General Manager, Innovation Policy Branch, Department of Industry, *Proof Committee Hansard*, 21 February 2014, p. 21.

3 The current arrangements were introduced by the *Tax Laws Amendment (Research and Development) Act 2011* and the *Income Tax Rates Amendment (Research and Development) Act 2011*. For more information about this legislation, refer to the relevant report of this committee: Senate Economics Legislation Committee, *Tax Laws Amendment (Research and Development) Bill 2010 [Provisions] and Income Tax Rates Amendment (Research and Development) Bill 2010 [Provisions]*, 15 June 2010.

4 *Income Tax Assessment Act 1997*, ss. 67-30 and 355-100. Under the priority rules for tax offsets in the ITAA 1997, a refundable R&D tax offset is applied after all other tax offsets (except the tax offset arising from the payment of franking deficit tax) and if there is an excess the R&D entity is entitled to a refund. A non-refundable R&D tax offset is applied before refundable tax offsets but after all other tax offsets. If an amount of the offset remains, the R&D entity may carry it forward to a later year subject to the tax offset carry forward rules. See *Income Tax Assessment Act 1997*, divisions 63, 65 and 67.

5 'R&D activities' are defined in the ITAA 1997 to consist of 'core R&D activities' or 'supporting R&D activities'. Essentially, a core R&D activity is an experiment conducted using the scientific method conducted for the purpose of generating new knowledge. Supporting R&D activities are 'activities directly related to core R&D activities'. The definitions of core R&D activities and supporting R&D activities both include examples of activities that do not fall within the respective definition. See *Income Tax Assessment Act 1997*, ss. 355-20, 355-25 and 355-30.

- a decline in the value of tangible depreciating assets used for R&D activities, subject to certain conditions;[6] and

- have a total amount of notional R&D deductions that is at least $20,000.[7]

Changes proposed by the bill

1.9 The bill proposes to amend the ITAA 1997 to restrict the R&D tax incentive to companies with an aggregated assessable income of less than $20 billion for an income year. The bill also proposes a consequential amendment to the Industry Research and Development Act to address an adverse outcome that may arise if, because the $20 billion threshold made it ineligible, a company did not register its Australian core R&D activities conducted in earlier tax years.[8] The measures contained in the bill will apply to income years starting on or after 1 July 2013.

1.10 In his second reading speech on the bill, the Parliamentary Secretary to the Treasurer provided the following summary of the reasons underpinning the proposed amendments:

> The measure targets access to the research and development (R&D) tax incentive to the small and medium sized entities that are more responsive to increasing their R&D spending as a result of government incentives. In other words, it reduces waste by ensuring that government incentives for R&D are applied in a more effective way.[9]

1.11 The proposed changes were first planned by the previous government, which announced the measures in February 2013 as part of its *A Plan for Australian Jobs* package.[10] The proposed R&D tax changes were included in the 2013–14 Budget[11]

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6 The remaining categories of notional deductions are: a balancing adjustment for R&D assets; earlier year association R&D expenditure; a decline in value of R&D partnership assets; balancing adjustment for R&D partnership assets; and cooperative research centre (CRC) contributions. *Income Tax Assessment Act 1997*, s. 355-100.

7 However, expenditure incurred in relation to R&D activities performed by a research service provider and contributions to a CRC are not subject to the $20,000 minimum expenditure threshold. *Income Tax Assessment Act 1997*, s. 355-100(2).

8 The explanatory memorandum notes that an R&D entity may not register its Australian core R&D activities with Innovation Australia because it considers it will be ineligible to claim the incentive. However, if the entity conducts overseas R&D activities that may be eligible for the R&D incentive in the future, these activities need to be sufficiently related to at least one Australian core R&D activity that is registered. According to the explanatory memorandum, the consequential amendments focus on 'whether the Australian core activities would be reasonably likely to have been registered if the $20 billion aggregated assessable income test were disregarded'. See Explanatory Memorandum, paragraphs 1.19–1.23.

9 The Hon Steven Ciobo MP, *House of Representatives Hansard*, 14 November 2013, p. 291.

10 The Hon Wayne Swan MP and the Hon Greg Combet AM MP, 'Targeting small and medium sizes enterprises for R&D Tax support', *Media Release*, 17 February 2013.

11 Australian Government, *2013–14 Budget: Budget Paper No. 2*, May 2013, p. 21.

and a bill intended to give effect to the changes was introduced in June 2013.[12] However, that bill lapsed when the 43rd Parliament was prorogued.

Consideration of the bill by other committees

Senate Scrutiny of Bills Committee

1.12 The Senate Standing Committee for the Scrutiny of Bills assesses legislative proposals against a set of accountability standards that focus on the effect of proposed legislation on individual rights, liberties and obligations, and on parliamentary propriety. The Scrutiny of Bills Committee considered the bill in its eighth *Alert Digest* of 2013—it focused on the retrospective application of the proposed amendments. The issue of retrospectivity, including the Scrutiny of Bills Committee's assessment, is examined further in chapter 2.

Parliamentary Joint Committee on Human Rights

1.13 One of the functions of the Parliamentary Joint Committee on Human Rights (PJCHR) is to examine bills for compatibility with human rights, and to report to both Houses of the Parliament on that issue.[13] The PJCHR considers that the bill 'does not appear to give rise to human rights concerns'.[14]

12 The proposed measures were contained in schedule 1 to the Tax Laws Amendment (2013 Measures No. 4) Bill 2013.

13 *Human Rights (Parliamentary Scrutiny) Act 2011*, s. 7(a).

14 Parliamentary Joint Committee on Human Rights, *Examination of legislation in accordance with the Human Rights (Parliamentary Scrutiny) Act 2011: First Report of 44th Parliament*, December 2013, p. 82.

Chapter 2

Views on the policy underpinning the bill

2.1 This chapter outlines the evidence that the committee received regarding the overall policy intent behind the bill.

2.2 Swanson Reid, an R&D tax incentive advisory firm, advised that it supports the proposed amendments. Swanson Reid argued that the R&D tax incentive is over budget and that savings from the measure could allow resources to be reallocated within the Department of Industry portfolio.[1] However, submissions received by the committee from other professional services firms, corporations and industry bodies did not support the proposed policy change. For example, KPMG stated that it was 'disappointed' that the government had decided to proceed with the previous government's proposal.[2] Telstra wrote that it 'is regrettable that this taxation change appears to have been taken as a savings measure in isolation of any broader policy package to promote innovation, including R&D activities'.[3] Some of the submissions which questioned the merits of the policy, however, acknowledged the government's difficult budgetary circumstances.[4]

2.3 From the submissions that did not support the bill, the committee has identified several common arguments and areas of concern. These matters were examined further during the committee's public hearing. This evidence is discussed in the following paragraphs. Some submissions also outlined alternative options for amending the R&D tax incentive; these alternative policies are outlined at the end of the chapter.

Would the changes 'better target' access to the incentive?

2.4 The explanatory memorandum states that the bill 'better targets the R&D tax incentive to businesses that are more likely to increase their R&D spending in response to government incentives, delivering a greater return for taxpayers'.[5] It adds

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1 Swanson Reid, *Submission 7*, pp. 1, 3–4. Swanson Reid suggested that resources could be redeployed to the customer service area of AusIndustry.

2 KPMG, *Submission 1*, p. 1.

3 Telstra, *Submission 14*, p. 2.

4 For example, see Medicines Australia, *Submission 2*, p. 1; and University of New South Wales, *Submission 17*, p. 2. The December 2013 *Mid-Year Economic and Fiscal Outlook* provided the following assessment of the government's fiscal position: 'Budget deficits totalling $123 billion are now expected across the forward estimates, with a $47 billion deficit expected in 2013-14—3.0 per cent of Gross Domestic Product (GDP). Without policy change and taking no remedial action, budget deficits would be projected in each and every year to 2023-24'. Australian Government, *Mid-Year Economic and Fiscal Outlook 2013–14*, December 2013, p. 1.

5 Explanatory Memorandum, p. 3.

that there 'is broad support internationally for the view that R&D spending of small firms is more responsive than that of large firms to government incentives'.[6]

2.5 KPMG and Michael Johnson Associates, a consultancy firm specialising in R&D and other government innovation incentives, questioned these statements. They noted that the explanatory memorandum does not provide evidence in support of the contention that smaller firms are more responsive to R&D tax incentives. According to Michael Johnson Associates:

> A number of arguments can be put in counter to the assertions that small companies are more innovative than large companies and that they are more responsive to R&D incentives. These include the advantages afforded large companies through scale, deep access to supply chains and connections to research communities. The competitive environment regarding innovation outputs is one where large companies are the preferred medium to establish and compete in international markets of global dimension.[7]

2.6 KPMG countered the explanatory memorandum's claim by citing a paper written by Sir James Dyson CBE, founder of Dyson Limited.[8] Deloitte provided a specific example of where an R&D tax incentive has led to a large company undertaking additional activities in that jurisdiction:

> …the UK government, despite its ongoing recession, has recently made strong efforts to increase its lack of representation on the Top 100 Global Innovators list…by introducing its self-styled Patent Box legislation which cuts the tax rate for income derived from patented technologies to 10%. This has also been supported by a general cut in the UK corporate tax rate to 20% and other local initiatives to demonstrate its patent box incentives to internationally mobile companies … Subsequently GlaxoSmithKline recently invested £500m into its UK manufacturing operations based on the introduction of the UK patent box legislation. Recent UK filing records in late 2013 also reflect a move of many Australian technology companies (including Atlassian) to reincorporate in the UK; an early and significant indication that the Patent Box model and generous R&D tax breaks are indeed being successful in attracting its targeted internationally mobile capital to take advantage of the 10% patent box tax rate.[9]

2.7 The University of New South Wales (UNSW) also pointed to a Department of Industry report on innovation that stated:

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6 Explanatory Memorandum, paragraph 1.6.

7 Michael Johnson Associates, *Submission 3*, p. [5].

8 James Dyson, *Ingenious Britain: Making the UK the leading high tech exporter in Europe*, March 2010, cited in KPMG, *Submission 1*, p. 5. According to KPMG, Sir Dyson concluded that 'large companies undertaking R&D are likely to engage with academia and smaller companies to collaboratively undertake R&D and generally foster innovation in those around them'.

9 Deloitte, *Submission 12*, p. 4.

> [Small and medium enterprises] are lean innovators, accounting for a very small share of total investment in innovation, and are much less likely to generate new-to-world innovations. By contrast, large Australian businesses made up the majority or total investment in innovation, are much more likely to collaborate with the research sectors and generate new-to-the-world innovations.[10]

2.8 The explanatory memorandum does not provide sources to support its contention that the R&D spending of small firms is more responsive to government incentives than that of large firms. The initial policy announcement by the previous government, however, did refer to some research to support this position: a study of Norway's R&D tax incentive and a transcript of evidence given by the Organisation for Economic Co-operation and Development (OECD) to the US Senate Committee on Finance.[11] A Department of Industry official also referred to these papers at the committee's hearing.[12]

2.9 The OECD testimony considered that the aim of government incentives to encourage business investment in R&D is often to correct or alleviate the following two market failures:

- 'difficulties by firms to fully appropriate the returns to their investment';[13] and
- 'difficulties in finding external finance, in particular for small start-up firms'.[14]

2.10 The OECD considered that the available evidence—studies in Québec, the Netherlands and Norway—suggest that smaller firms appear to be more responsive to

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10 Department of Industry, *Australian Innovation System Report 2013*, p. 9; cited in University of New South Wales, *Submission 17*, p. 2.

11 Adne Cappelen et al, 'Evaluation of the Norwegian R&D Tax credit Scheme', *The Journal of Technology, Management and Innovation*, 5:3 (2010); and Dr Dirk Pilat, Head, Structural Policy Division, Directorate for Science, Technology and Industry, OECD, *Testimony to the US Senate Committee on Finance Hearing on Tax Reform Options: Incentives for Innovation*, 20 September 2011. See Australian Government, *A Plan for Australian Jobs: The Australian Government's Industry and Innovation Statement*, February 2013, p. 13 (n. 46).

12 Ms Maryann Quagliata, General Manager, Innovation Policy Branch, Department of Industry, *Proof Committee Hansard*, 21 February 2014, p. 19.

13 The OECD argued that '[r]eturns on investments in R&D are difficult to appropriate by firms as some of the resulting knowledge will leak out or "spill over" to other firms, to the benefit of society. This leads firms to 'underinvest' in innovation. Policy instruments such as intellectual property rights, grants, and R&D tax incentives can help address this problem'. Dr Dirk Pilat, Head, Structural Policy Division, Directorate for Science, Technology and Industry, OECD, *Testimony to the US Senate Committee on Finance Hearing on Tax Reform Options: Incentives for Innovation*, 20 September 2011, www.finance.senate.gov/hearings/hearing/?id=ef6a4c10-5056-a032-5212-fbf59e314035 (accessed 17 February 2014), p. 1.

14 Dr Dirk Pilat, OECD, *Testimony to the US Senate Committee on Finance Hearing on Tax Reform Options: Incentives for Innovation*, p. 1.

R&D tax incentives.[15] Additionally, at Senate Estimates in June 2013, the executive director of Treasury's Revenue Group noted that during the Business Tax Working Group process in 2012:

> …there were certainly a lot of anecdotes to the effect that for a range of very large firms the increased deduction did not drive a lot of activity.[16]

2.11 Mr Ezra Hefter, a partner at Ernst & Young, acknowledged that there 'is some truth' to the assertion that the R&D spending of small firms is more responsive to tax incentives than the spending of large firms. Even so, he added that large firms are still affected by the R&D tax incentive. Mr Hefter noted that differences between small and large firms are already reflected in the R&D tax incentive through the differential feature of the incentive that enables small firms to access a 45 per cent refundable tax offset while other firms are restricted to a 40 per cent non-refundable offset.[17]

Impact on economic activity in Australia

2.12 Related to the above discussion, submissions also questioned the impact that the proposed amendments may have on Australia's ability to attract or retain R&D investment in the global economy. They suggested that any loss of R&D could negatively impact economic growth, employment and tax revenue, and a point repeated in submissions was that the proposed amendments would encourage large companies to shift R&D activities to other countries with more favourable and more stable R&D tax arrangements. KPMG in particular clearly expressed how the two lines of argument are connected:

> Whether or not the R&D incentive encourages large companies to undertake R&D, it certainly encourages them to undertake the R&D activities in Australia (either directly or through contracted R&D with small and medium enterprises). Such activities create jobs in Australia and result in employment income, profits and transactions which are taxable in Australia.[18]

2.13 Ernst & Young argued that large multinational corporations have the greatest flexibility to choose where to undertake their R&D activities and that the attractiveness of tax incentives is one factor taken into consideration.[19] The Corporate

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15 Dr Dirk Pilat, OECD, *Testimony to the US Senate Committee on Finance Hearing on Tax Reform Options: Incentives for Innovation*, p. 7.

16 Mr Rob Heferen, Executive Director, Revenue Group, The Treasury, *Committee Hansard*, Estimates, 5 June 2013, p. 97.

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

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

19 Ernst & Young added that corporations 'in global trade exposed sectors such as pharmaceuticals, oil and gas, [information technology], manufacturing and finance' especially have flexibility in choosing where to undertake R&D activities. Ernst & Young, *Submission 5*, p. 6. See also KPMG, *Submission 1*, p. 3.

Tax Association noted that when a large corporation engages an external party to undertake R&D activities of its behalf:

> …the terms of engagement often include an express requirement that the R&D activities (or at least the majority of the activities) be conducted in Australia. Under the proposed changes, there is no incentive for the affected companies to conduct R&D activities in Australia.[20]

2.14 BDO Australia observed that any move by companies affected by the proposed amendments to conduct more R&D activities in other countries could result in: the loss of Australian jobs and tax revenue associated with those jobs; limited benefits and royalty streams to Australia associated with any intellectual property developed as a result of the R&D activities; and a loss of expertise.[21] Deloitte expects an initial 'severe' impact on the large corporate groups directly impacted by the proposed amendments followed by consequential effects on entities in the supply chain, such as smaller 'speciality firms with niche capability'.[22]

2.15 Submissions also considered the proposed changes in a global context. KPMG claimed that, to the best of its knowledge, Australia 'will be the first country in the world to exclude such a specific and targeted subset of large companies from claiming an R&D tax incentive'.[23] To bolster an argument that Australia's R&D tax policy is moving in a different direction to those of other countries, submissions advised that:

- the United Kingdom has expanded its R&D assistance regime despite difficult economic circumstances;[24]
- Singapore recently introduced an R&D regime with a 400 per cent tax incentive and has since increased the level of benefit available to all companies;[25]
- the French Minister for Innovation directly responded to the announcement of the R&D changes made by the previous government and 'invited large companies to undertake their R&D in France instead of Australia';[26] and

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20 Corporate Tax Association, *Submission 10*, p. 1. Telstra's submission noted that the R&D Tax Incentive 'has been one of the reasons behind Telstra's commitment to undertake the majority of our R&D work onshore, and where we partner with our vendors to undertake R&D on our behalf mandated this requirement with them'. Telstra, *Submission 14*, p. 5.

21 BDO Australia, *Submission 16*, p. 4.

22 Mr Serg Duchini, National Leader, R&D and Government Incentives, Deloitte, *Proof Committee Hansard*, 21 February 2014, p. 10.

23 KPMG, *Submission 1*, p. 3.

24 Specifically, according to KPMG, the United Kingdom has 'increased support for small companies; extended the program to large companies; enabled all companies to report R&D assistance as an 'above the line' benefit; and provided refundable benefits to both large and small companies'. KPMG, *Submission 1*, p. 3.

25 KPMG, *Submission 1*, p. 4; Ernst & Young, *Submission 5*, p. 6; Telstra, *Submission 7*, p. 3.

- Japan, as of 2013, has a 40 per cent tax credit for R&D activities.[27]

2.16 Ernst & Young summed up its concern about Australia's apparent divergence in R&D tax policy, particularly compared to countries in Asia, as follows:

> In short, as the Government prepares Australia and Australians to thrive in the "Asian Century", it appears counter-productive to be pulling back on incentivising R&D activities for our largest companies, just when the Asian region appears to be heading in the opposite direction when it comes to R&D tax policy.[28]

2.17 However, a Department of Industry official noted that there are factors other than the R&D tax incentive which influence decisions about where R&D is conducted, such as the existing R&D contacts and relationships in Australia that the large corporations have:

> Our expectation based on that is that large firms will continue to conduct R&D in Australia, as they always have, using the smaller research agencies, as they have; that they value the R&D contacts and relationships that they have in Australia; and that there are factors other than the R&D tax incentive which determine where they conduct their R&D research.[29]

2.18 The OECD's testimony to the US Senate Committee on Finance also suggested that government incentives were a secondary consideration for large multinational companies when determining where to locate their R&D activities:

> In recent years, several governments have also started to use innovation policies to attract R&D activities of multinational corporations. The reason is that in a context of growing internationalization of R&D activities, government support might make a country a relatively more attractive location for R&D investments than its competitors. However, the available evidence suggests that government support is often only of minor importance for the decisions of multinationals to locate their R&D facilities in a particular country; other factors such as access to markets and to a country's knowledge base, or the availability of researchers tend to be more important.[30]

2.19 Deloitte also acknowledged that if the R&D activities of companies targeted by the bill were reconsidered because of internal competition for funding within the

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26 David Ramli, 'France offers stable R&D incentives', *Australian Financial Review*, 12 March 2013, p. 24; cited in KPMG, *Submission 1*, p. 5.

27 Ernst & Young, *Submission 5*, p. 6.

28 Ernst & Young, *Submission 5*, pp. 6–7.

29 Ms Maryann Quagliata, Department of Industry, *Proof Committee Hansard*, 21 February 2014, p. 18.

30 Dr Dirk Pilat, OECD, *Testimony to the US Senate Committee on Finance Hearing on Tax Reform Options: Incentives for Innovation*, p. 1.

company and the tax incentive no longer being available, it would likely only affect more marginal projects:

> There is bidding for internal projects and some projects are cut. Some projects on the margin only get over because of the incentive. If you took a step back and looked at what we are trying to do from an economic perspective, a 10c in the dollar subsidy will only impact the marginal project.[31]

Impact on SMEs and collaborative R&D projects

2.20 Michael Johnson Associates questioned the impact that the changes would have on R&D collaborations large companies may undertake with other entities, such as small to medium enterprises (SMEs), co-operative research centres (CRCs) and universities. It added that collaborative R&D projects could be negatively affected if companies above the $20 billion threshold were no longer attracted to a project because they could not access the R&D tax incentive, a possible consequence being that the project is ultimately carried out with a partner 'less suited for the work on a range of key criteria such as market access, technical qualification and relevant research facilities'.[32]

2.21 Ernst & Young similarly considered that the proposed amendment could negatively impact 'innovation ecosystems'. Mr Ezra Hefter, a partner at Ernst & Young, explained:

> There is a high degree of interdependence between researchers from very large companies through to small companies through to universities. I think it is fairly well understood that the large companies have the ability to fund research that looks to the future, that steps out. They have deeper pockets and a greater ability to do that, whereas smaller companies often do not. And I think there is a real risk there for collaboration between large and small companies but also for universities and CRCs.[33]

2.22 UNSW advised that companies affected by the proposed amendments support about 30 per cent of UNSW's research effort, with $6 million contributed by these companies per annum (on average over the past seven years).[34]

2.23 When asked about the likely impact of the proposed amendments on other entities that support R&D, Department of Industry officials reiterated the view—supported by international research—that large companies will continue to undertake R&D in Australia. A Treasury officer observed that 'it is difficult to draw a conclusion':

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

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

33 Mr Ezra Hefter, Partner, Ernst & Young, *Proof Committee Hansard*, 21 February 2014, p. 3.

34 University of New South Wales, *Submission 17*, p. 1.

> The structure of the concession is that it is relatively more generous at smaller levels, so the question is how often the R&D activity is structured. Sometimes I think that when we talk about R&D activity it is quite a broad term. Some of it, as people probably imagine, is in a lab somewhere and fairly mobile. But it is important to point out that a lot of R&D activity is also carried out in the production process. So you can think about some elements of R&D activity that are fairly mobile and can be carried out in a range of different ways, and you can think about some elements of R&D activity as forming parts, essentially, of the production process, so then the decision is linked to the actual production of a product.[35]

Frequent changes create uncertainty

2.24 Submissions also stressed the need for stability and certainty in the R&D tax incentive. The primary basis of this concern is that the current R&D tax incentive was only introduced in 2011 (applied to the 2011–12 tax year onwards); however, an additional consideration is that the R&D tax incentive is scheduled to be reviewed in 2014 and may be reviewed again as part of the taxation white paper.[36] Ernst & Young pointed to a 2013 report by the OECD that stated:

> OECD analysis…suggests that in countries that have experienced a large number of R&D tax policy reversal, the impact of R&D tax credits on private R&D expenditure is greatly diminished. It is therefore important that governments do not repeatedly tinker with such policies to minimise policy uncertainty for firms.[37]

2.25 Medicines Australia similarly expressed concern that changing what it considers are 'globally competitive' R&D tax incentives could harm Australia's reputation 'as a stable and predictable business environment' and impact future R&D activities. Medicines Australia recommended that the current arrangements operate unchanged at least until the entire system is reviewed, although it did inform the committee that it understood the rationale for the proposed amendments in the context of the government's budgetary position.[38]

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35 Mr Hector Thompson, General Manager, Small Business Tax Division, The Treasury, *Proof Committee Hansard*, 21 February 2014, p. 18.

36 The explanatory memorandum confirms that the government will undertake a review of the R&D tax incentive in 2014. See Explanatory Memorandum, paragraph 1.7.

37 OECD Directorate for Science, Technology and Industry, 'Maximising the benefits of R&D tax incentives for innovation', October 2013, p. [5], cited in Ernst & Young, *Submission 5*, p. 3.

38 Medicines Australia, *Submission 2*, p. 1. Medicines Australia noted that its members would not be affected by the bill.

Revenue implications

2.26 Treasury estimates that the proposed amendments will increase revenue by $1.05 billion over the forward estimates period.[39] This figure is based on modelling of the direct revenue impact associated with the measure, not any flow-on effects.[40]

2.27 KPMG asserted that this estimate is 'flawed'; it argued that the proposed changes will provide 'at best a small increase in consolidated revenue now at the price of longer term growth in Australia in future' given the medium to long-term timescale of R&D investment decisions.[41] Other stakeholders found it difficult to comment on the reliability of this projection as they did not have access to Treasury's modelling.[42]

Retrospective application

2.28 The amendments are intended to commence on Royal Assent and apply to income years commencing on or after 1 July 2013.[43] As noted in chapter 1, the measure was first announced by the previous government on 17 February 2013. The explanatory memorandum notes that the commencement date is intended to be before the date of enactment. Nevertheless, it states that the measure 'would not catch taxpayers unawares because the measure was previously introduced in a bill that lapsed when the Parliament was prorogued for the 2013 federal election'.[44] However, the explanatory memorandum does warn that if 'there were a significant delay in [the bill] receiving the Royal Assent, it is possible that the measure could apply to an income year that has finished'.[45]

2.29 Several submissions disagreed with the explanatory memorandum's assessment about taxpayers' awareness of the proposed amendments.[46] Although they acknowledged that the proposal had been in the public domain since it was announced by the previous government, they argued that taxpayers could not be certain that the measures would proceed as a result of the federal election and the change of government. That the bill was being reviewed by this committee with a reporting date

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39 Mr Matthew Maloney, Manager, Costings and Quantitative Analysis Unit, The Treasury, *Proof Committee Hansard*, 21 February 2014, p. 17.

40 Mr Matthew Maloney, The Treasury, *Proof Committee Hansard*, 21 February 2014, p. 20.

41 KPMG, *Submission 1*, p. 1.

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

43 Clause 2 and schedule 1, item 3 of the bill.

44 Explanatory Memorandum, p. 3.

45 Explanatory Memorandum, paragraph 1.25.

46 See Michael Johnson Associates, *Submission 3*, p. [2]; Ernst & Young, *Submission 5*, p. 3; Deloitte, *Submission 12*, p. 7; and Minerals Council of Australia, *Submission 13*, p. [3].

of mid-March 2014 was another factor cited.[47] The Minerals Council of Australia articulated the nature of the concern as follows:

> Companies that undertook R&D spending in good faith on existing law prior to announcement will be unfairly impacted. Large multinationals that focus the majority of their R&D spend in Australia will be particularly affected. Such an outcome hardly fosters confidence in multinational companies to undertake their R&D in Australia.[48]

2.30 As noted in chapter 1, the Senate Standing Committee for the Scrutiny of Bills considered the retrospective application of the bill. That committee encountered the following difficulty:

> Senate Resolution No. 40 relates to the introduction of a bill to amend taxation law within 6 months after a government announcement of that proposal. However, the resolution does not contemplate the current circumstance in which a bill that lapsed upon Parliament being prorogued could be passed by a newly constituted parliament (whether within, or outside, the 6 month timeframe).[49]

2.31 Nevertheless, that committee accepted that a bill proposing to introduce the measure was first introduced in June 2013. As the Scrutiny of Bills Committee generally does not recommend particular action on a bill but instead raises issues for the Senate's consideration,[50] the 'question of whether the proposed approach is appropriate' was left to the consideration of the Senate.[51]

Committee comment

2.32 Generally, retrospective tax legislation is not desirable and any such legislation should ideally be limited to rare circumstances, such as to correct unintended consequences or to address integrity issues. However, the proposed amendments have been foreshadowed for some time—the previous government introduced a bill in June 2013 which, if passed, would have enacted them.

2.33 The committee appreciates the difficulties that the uncertainty associated with the passage of time and change of government may have caused for the small number of affected taxpayers and those that advise them. However, the committee is not

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47 Michael Johnson Associates, *Submission 3*, p. [2].

48 Mineral Council of Australia, *Submission 13*, p. [3].

49 Senate Standing Committee for the Scrutiny of Bills, *Alert Digest*, no. 8 of 2013 (4 December), p. 48.

50 Although, this is not always the case: for examples of bills the Scrutiny Committee has requested be amended, see Senate Standing Committee for the Scrutiny of Bills, *Final Report: Inquiry into the future role and direction of the Senate Scrutiny of Bills Committee*, May 2012, p. 21.

51 Senate Standing Committee for the Scrutiny of Bills, *Alert Digest*, no. 8 of 2013 (4 December), p. 49.

necessarily convinced that there is any significant detriment given the evidence received that suggests the R&D activities of these very large companies would have been undertaken regardless. Further, the proposed amendments could only reasonably pose uncertainty for decisions made between when the previous bill lapsed and the new bill was introduced.

Alternative approaches

2.34 The explanatory memorandum advises that the government will use an upcoming review of the R&D tax incentive, scheduled to take place in 2014, to review access to R&D support. The taxation white paper will also consider the effectiveness of existing innovation tax incentives.[52] Several submissions suggested that the proposed amendments contained in the bill should instead be considered as part of these processes.[53]

2.35 Submissions also put forward alternative proposals for consideration. Ernst & Young argued that, if the aim of the measures 'is to only provide an incentive where it is absolutely certain to sway the R&D investment decision', then a pre-approval system for large companies considering significant projects could be developed as part of AusIndustry's existing R&D advance ruling system:

> This would allow large companies to present their proposed R&D Tax activities and seek approval from government prior to expenditure being incurred, if approval is given. This would provide certainty for claimants and allow them to employ relevant staff/resources. If not approved then these companies can make an informed decision about whether it is worthwhile to proceed without an incentive or not proceed at all.[54]

2.36 Deloitte argued that if changes to the R&D tax incentive need to be made, one of the other options for changing the incentive outlined by the Business Tax Working Group in 2012 should be consulted on instead. These included:

- a reduction in the percentage rate of the R&D tax incentive from 40 per cent to 37.5 per cent; and
- imposing a cap per taxpayer on the amount of R&D expenditure eligible for the tax incentive.[55]

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52 Explanatory Memorandum, paragraph 1.7.

53 For example, see Michael Johnson Associates, *Submission 3*, p. [2].

54 Ernst & Young, *Submission 5*, pp. 8–9.

55 According to the Business Tax Working Group, companies could deduct expenditure beyond that cap under the normal deduction provisions of the tax law, an approach that 'targets the offset more towards smaller companies that are more likely to respond to R&D incentives'. Business Tax Working Group, *Discussion Paper*, 13 August 2012, www.treasury.gov.au (accessed 7 February 2014), p. 38. Deloitte gave an example $200 million per claimant group as an expenditure cap. Deloitte, *Submission 12*, p. 8.

Committee comment

2.37 The committee considers that the upcoming review of the R&D tax incentive and the taxation white paper will provide a useful opportunity for wide consultation to be undertaken on a range of issues relating to R&D and government incentives to encourage R&D. However, the future scheduled reviews do not mean that the R&D tax incentive cannot be amended in the meantime if necessary.

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.
>
> 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.
>
> * * *
>
> 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

Labor Senators' Minority Report

1.1 Tax incentives are recognised as one of the most effective tools available to government for stimulating and attracting investment in innovation. This investment, in turn, is critical to the development of dynamic and highly productive industries, able to compete at the top of the global value chain. As the Australian Industry Group notes:

> Innovation by business, including innovation associated with business engagement with research and development, is critical to the future success of the Australian economy. It is particularly important at the moment because we have a legacy of low productivity growth to address and because there is a need for new sources of growth to emerge to assist the economy rebalance as the boom in mining investment wanes.[1]

1.2 The point was recently echoed by Mr Glenn Stevens, Governor of the Reserve Bank of Australia, joining the growing consensus that 'a culture of innovation is the real key to the challenges of economic transition.[2]

1.3 This is not a matter that can simply be left to chance. The global competition for research talent and investment capital is intense—and with good reason. Every nation wants the jobs, skills and opportunities that go hand in hand with R&D investment.

1.4 Australia has every reason to enter this competition with confidence. As numerous submissions to the committee have affirmed, the excellence of our scientific institutions and the talents of our research workforce—when partnered with our stable investment climate and strong intellectual property framework—are an attractive proposition for global investors.

1.5 The fact remains, we cannot afford to be complacent about these advantages or fall behind in the race for new technologies. All sides of politics acknowledge the obligation of governments, state and federal, to showcase and nurture our strengths for the future. In this respect, the significance of our R&D tax environment cannot be emphasised too strongly.

1.6 Submission after submission points to the R&D Tax Incentive as an important, even decisive factor for companies looking to allocate their highly prized research dollars. Telstra, one of our largest R&D investors, notes:

> As a proud Australian company, and one with an increasing global footprint, the R&D Tax Incentive has been one of the reasons behind Telstra's commitment to undertake the majority of our R&D work onshore,

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1 Australian Industry Group, *Submission 18*, p. 1.

2 Mr Glenn Stevens, *House of Representatives Standing Committee on Economics Hansard*, 7 March 2014, p. 11.

> and where we partner with our vendors to undertake R&D on our behalf; we have mandated this requirement with them.[3]

1.7 At a time when companies like Telstra and the automotive manufacturers, another significant R&D investor group of companies, are offshoring jobs, it is now more critical than ever to ensure their R&D spend—and the jobs it creates—remain in Australia.

1.8 Given the importance of this measure, and the need for clear signals to prospective investors, any changes must be approached with great caution and underpinned by a compelling policy rationale. As Mr Serg Duchini of Deloitte submitted:

> It is clear that attracting innovation and its contribution to domestic prosperity depends on more than favourable tax policy decisions, but recent studies have confirmed that business expenditure on R&D is indeed strongly influenced by stable innovation policy.[4]

1.9 That is not to say that the policy framework should be static. On the contrary, it is important that the policy keep pace with the needs of modern business and the nature of modern research.

1.10 The Labor Government recognised this need with the pivotal reforms of 2011, which replaced the old concession with a credit, tightened the eligibility criteria to focus on genuine R&D, and lifted the level of support for both smaller and larger firms. The impact was immediate. In the first year alone, the number of firms registered grew by 15 per cent; and the total sums invested grew by 20 per cent. In the same year, the Labor Government committed to introducing R&D quarterly credits from 1 January 2014 as a further measure to boost R&D expenditure.

1.11 All of these measures were proposed and adopted with the benefit of widespread consultation across the innovation community, in and beyond Australia. In this way they affirmed—rather than called into question—our long-term commitment to this vital policy.

1.12 The Government now proposes to add a third tier to the eligibility requirements for the R&D Tax Incentive, with the result that very large companies with aggregate Australian assessable income of $20 billion or more would no longer be able to claim the R&D Tax Incentive.

1.13 It is true that this proposal stems from a measure put forward by the Labor Government in February 2013. That measure, however, must be understood in context. It was not an isolated savings measure, but the means of funding an ambitious package focussed on innovation policy, *A Plan for Australian Jobs*, centred on

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3 Telstra, *Submission 14*, pp. 4–5.

4 Mr Serg Duchini, Deloitte, *Proof Committee Hansard*, 21 February 2014, p. 4.

strategic industry-led Innovation Partnerships. These Partnerships would have the scale to attract major global investments in Australian firms and research institutions. They were, in other words, a new means to the same end: working with business to build jobs for Australians.

1.14 That rationale is gone. The Abbott Government has made no commitment to the job-building measures the previous Labor Government tied to the changes to the R&D Tax Incentive. Nor has it earmarked the savings from this measure for the vital task of lifting R&D investment. It is simply ripping support from innovators in business.

1.15 As Michael Johnson Associates notes:

> As acknowledged elsewhere in the Explanatory Memorandum, this is a savings measure and to brand it as better targeting of the Incentive is misleading.[5]

1.16 The submissions are almost unanimous in their opposition to this bald grab for any available 'savings'—savings that exact a heavy toll in jobs lost, capabilities impaired and talent sent offshore with no corresponding benefit introduced.

1.17 Three risks in particular are highlighted.

1.18 The first is the obvious risk of major R&D investments from very large companies heading offshore, with neither the R&D Tax Incentive nor the Innovation Partnerships to attract them. It cannot be put more clearly than in KPMG's submission:

> The estimated savings of $1.1 billion gained by the proposed changes are flawed and will provide the Government with at best a small increase in consolidated revenue now at the price of longer term growth in Australia in future.[6]

1.19 The argument has been put by the majority of the Committee that larger organisations are less receptive to tax incentives than smaller firms. The underlying assumption is that larger firms have the will and capacity to make these investments without the need for government prompting.

1.20 The evidence for this argument is far from clear.[7] What is certain is that these companies have the flexibility to direct their research investments to the jurisdiction they judge most attractive. Cost is clearly a relevant consideration, as is the

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5 Michael Johnson Associates, *Submission 3*, p. 4.

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

7 Australian Industry Group, *Submission 18*, p. 1; Michael Johnson Associates, *Submission 3*, p. 3.

commitment to innovation displayed by the national government. On both fronts, this Bill risks sending investment from 'the companies that spend the most'[8] offshore.

1.21 The second risk is the flow-on impact to small and medium enterprises, in addition to Australian research institutions (including universities and public agencies such as the CSIRO). The point was well made in evidence by Mr Duchini, who cited the SME technology company Gekko Systems as an example.[9] As a research partner, Gekko is naturally concerned that the changes will discourage our largest firms from building collaborative ventures with Australian businesses.

1.22 The University of New South Wales notes that 30 per cent of its research effort at is supported by business entities directly impacted by the proposed changes.[10] The Innovation Partnerships, along with the move to quarterly credits, might have alleviated these concerns. The Government's proposal does not.

1.23 The third risk is the 'perverse outcome', as KPMG notes, of a large foreign company receiving preferable tax treatment in Australia to an Australian company of equivalent size.[11] It is an unfortunate message to be sending to local industry at this time.

1.24 Labor is keenly aware of the challenges facing many Australian firms as a result of the unprecedented strength of the Australian dollar, the rapidity of technological change and the increased competition in both domestic and export markets. We are concerned by the crisis in the automotive sector with the coming loss of all three major vehicle producers. We are concerned by the mass lay-offs in the aluminium sector, aviation, and service industries, amongst other sectors. We are concerned that the Government has failed to lay down a coherent strategy for a shift from the resources boom to the jobs of the future—jobs in advanced manufacturing, creative industries and health technologies, to name a few.

1.25 This is not the time to be putting investments in future industries at risk.

1.26 Another concern to Labor members is the Government's decision to scrap the option of quarterly credits. Even if the ostensible rationale for the targeting of the R&D Tax Incentive to smaller firms is accepted, it is often smaller firms and innovative start-ups that have the most difficulty with cash flow and accessing capital. The flexibility of the quarterly credit is critical to the very firms and industries the Explanatory Memorandum claims the Governments wishes to support. This contradiction between stated aim and likely outcome is a mark of the incoherent and ill-considered approach by the Abbott Government to a vital national agenda.

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8 KPMG, *Submission 1*, p. 4.

9 Mr Serg Duchini, Deloitte, *Proof Committee Hansard*, 21 February 2014, p. 2.

10 University of New South Wales, *Submission 17*, p. 1.

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

1.27 The Government has attempted to downplay the significance of measures in the Bill, in stark contrast to the position it adopted prior to the election.

1.28 Then Coalition Industry spokesperson Ms Sophie Mirabella MP responded to Labor's proposed Jobs Package with the claim that the 'change to the R&D tax concession [sic] casts doubt on the stability of tax policy and raises more concern about the sovereign risk of investing in Australia'.[12]

1.29 In its subsequent Manufacturing Policy Statement, the Coalition pledged that: 'We will therefore use the opportunity of the scheduled 2014 changes to the R&D Tax Incentive programme to review access to R&D tax support for many businesses that have been barred from possible access under a series of retrograde cost savings made by Labor'.

1.30 From this, the business community could reasonably conclude that the Coalition Government would maintain, if not expand, the generosity of the R&D tax environment. These same businesses are now left with only the certainty of a further review, further changes and—as is foreshadowed in this current revenue grab—further cuts.

Conclusion

1.31 Labor recognises that investments in innovation are critical to the future prosperity of Australians. We were and are prepared to work with business and researchers to ensure the innovation budget is used wisely. We are not prepared to stand by as the Government plunders that budget for savings.

1.32 This is the time for innovation to be the frontline of economic policy and the signals from the Government must prove it.

1.33 The evidence tendered to the Committee overwhelmingly argues against the changes proposed by the Government. Labor accepts this evidence and the flaws it points to in the Government's approach.

1.34 In our view the Government has not provided a credible rationale for the proposed cuts to the R&D Tax Incentive, particularly given its opposition to the corresponding innovation measures they were designed the fund and its lack of any other plan to use these savings to support innovation.

12 Sophie Mirabella MP, 'Industry joins Coalition on R&D Revenue Concerns', *Media release*, 19 February 2013.

1.35 For these reasons Labor does not support the majority report and is opposed to the Tax Laws Amendment (Research and Development) Bill 2013.

Senator Mark Bishop
Deputy Chair

APPENDIX 1

Submissions received

Submission Number	Submitter
1	KPMG
2	Medicines Australia
3	Michael Johnson Associates
4	The Australasian Industrial Research Group
5	Ernst and Young
6	Australian Information Industry Association
7	Swanson Reed
8	Australian Academy of Technological Sciences and Engineering
9	CPA Australia
10	Corporate Tax Association
11	PricewaterhouseCoopers
12	Deloitte
13	Minerals Council of Australia
14	Telstra
15	Caltex Australia
16	BDO Australia
17	The University of New South Wales
18	Australian Industry Group
19	Confidential
20	Confidential

Additional information received

- Answer to a question on notice asked at a public hearing held in Canberra on 21 February 2014, received from Ernst&Young on 26 February 2014.

APPENDIX 2

Public Hearings and Witnesses

CANBERRA, 21 FEBRUARY 2014

ALLEN, Mr Malcolm, Assistant Commissioner, Public Groups and International, Australian Taxation Office

BOLTON, Mrs Kathrine, Tax Adviser, Caltex Australia

CHENOUDA, Mr George Henry, Manager, Tax, Caltex Australia

DUCHINI, Mr Serg, National Leader, R&D and Government Incentives, Deloitte

HEFTER, Mr Ezra, Partner, Ernst&Young

JONES, Mr Malcolm, Assistant Manager, Department of Industry

MALONEY, Mr Matthew, Manager, Costings and Quantitative Analysis Unit, Department of the Treasury

QUAGLIATA, Ms Maryann, Ms General Manager, Innovation Policy Branch, Department of Industry

ROBINSON, Mrs Deborah, Director, New Measures, Australian Taxation Office

ROESSGEN, Ms Jacqueline, Manager, Department of Industry

SALVESTRO, Ms Alisha, Government Affairs Adviser, Caltex Australia

THOMPSON, Mr Hector, General Manager, Small Business Tax Division, Department of the Treasury

TOPHAM, Mr Frank, Head of Government Affairs, Caltex Australia