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Committee Secretary
Senate Economics Legislation Committee, SG.64
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**<u>Inquiry into Tax Laws Amendment (Research and Development) Bill 2013</u>**

Michael Johnson Associates (MJA) welcomes the opportunity to comment on the proposed amendments to the R&D Tax Incentive (the Incentive).

MJA has assisted Australian companies in the preparation of R&D tax claims since 1985. Our client list ranges from start-up companies through to ASX Top 100 listed companies. Our Managing Partner, Kris Gale, is a founding member of the Federal Government's R&D Tax Incentive National Reference Group. We do not currently represent any taxpayers directly affected by the proposed measures.

MJA is opposed to the changes contained in the proposed amendments which seek to prevent company groups with over $20 billion assessable income from accessing the Incentive. This opposition stems primarily from the negative impacts that we believe the proposed amendments will have on the Australian innovation system. It also is based on the marked lack of consultation and detail provided around the changes. We are also further concerned about the context in which these changes have been proposed.

**Context in which the amendments are being proposed**

The proposed amendments are based on a key component of the previous Federal Government's "Targeting Access" 2013 Bill which also sought to remove access to the Incentive to company groups with an annual assessable income of $20 billion.

In a previous submission to the Treasury, we set out the context in which the 2013 Bill was introduced and that context is equally relevant to the current Bill:

- The Incentive was the result of the 2008 Cutler Review of the Australian Innovation System which went on to underpin the Federal Government's innovation policy announcements in May 2009.
- Cutler clearly identified and articulated the need to encourage more businesses to do more R&D and thereby help create a better future for Australia as a vital plank of the

Government's policy on innovation, science, research and technology. This included all Australian company groups.
- In 2012, the Business Tax Working Group (BTWG) visited the issue of excluding company groups from the Incentive based on size of turnover and did not recommend any such change be made.
- The first claims for the Incentive are only now just being bedded down administratively and the impact of the changes made in comparison to the previous R&D Tax Concession (the Concession) has yet to be assessed. We note that the R&D Tax Incentive Advisory Committee of the Innovation Australia Board (the Board) has not yet conducted its first review of the changes.
- To seek to change the Incentive again will create more uncertainty amongst the entire innovation community, well beyond those companies directly affected.
- There is insufficient data to determine the impacts of the new Incentive as it currently stands, let alone any proposed changes to it.
- Evidence from the introduction of the R&D Tax Concession (the Concession), the cutting of the R&D benefit in 1996, its reinvigoration in 2001 and various studies done by or for AusIndustry and the Productivity Commission on the effectiveness of the former Concession shows that, ultimately, a reduction in the incentive for businesses to do R&D will reduce R&D done in Australia and this may reduce economic growth and future tax revenue.
- The Bill is not the result of any consultation and stands in marked contrast to the consultative processes associated with Cutler and the BTWG. Yet the Explanatory Memorandum (EM) contends that there is a policy basis for making the changes beyond a simple revenue saving measure. The EM provides no evidence for the policy assertions contained therein.

Additional concerns apply to the current Bill in comparison to its Targeting Access predecessor:

- By way of contrast to the Targeting Access Bill, there is no reallocation of any the funds saved to other innovation initiatives. The previous Government's Innovation and Industry Statement, "A Plan for Australian Jobs", was to be funded in large part by the cuts to the Incentive.
- The Senate Committee is not due to report on the proposed measures until March 2014 which sees the commencement date of 1 July 2013 as being highly retrospective.
- The Government's announcement of the measure starkly contradicts a number of statements made by the Coalition when it was in opposition and is inconsistent with its stated policy position in the run up to the last Federal Election.

**Recommended course of action**

The context detailed above leads us to conclude that to proceed with the proposed measures would be tremendously damaging to the fabric of the Incentive. Comparative program certainty is a foundation stone upon which taxpayers make successful use of the Incentive as a funding mechanism for their innovation plans. This measure runs counter to this and has been viewed by many (including the Coalition prior to coming to power) as highly destabilising.

Since the release of the previous Government's Industry and Innovation Statement on 17 February, 2013, the companies with the largest revenue footprint in Australia (as opposed to globally), most of whom are recognised as key players in our innovation ecosystem, have had no guarantee as to the future availability of the Incentive. The previous Bill did not pass in an environment in which the Coalition opposed it. The current Bill then appeared towards the end of 2013 reversing that opposition, culminating in the current Senate review. And to date, the impacts of the measures have not been subjected to any public analysis or review at all, nor has there been any opportunity for meaningful dialogue with the private sector. At least this has been the case until now.

Under these circumstances, the potentially-affected companies have been obligated to continue tracking the Incentive in their businesses as it would not be possible to safely assume they will no longer qualify.

The current review provides the ideal opportunity to end this prolonged uncertainty. If the Bill passes, Australia will be the only jurisdiction that excludes participation in its flagship innovation program by dint of size alone. The fact that it is an exclusion based on local, rather than global, activity compounds the problem and heightens the risk to Australia's innovation culture.

When the Incentive commenced in July 2011, a comprehensive review of program performance after two years of operation was built into the delivery schedule. Further, the Coalition's 2013 policy document, "The Coalition's Policy to Boost the Competitiveness of Australian Manufacturing" undertook to review the Incentive as one of the inputs to the proposed Taxation White Paper. The 2014 review has been confirmed in the Explanatory Memorandum to the current Bill (para. 1.7). We recommend that this is the course of action that should be followed without enacting the current measure in the interim.

**Why we need the R&D Tax Incentive**

The need for the Incentive is shown in the history of its predecessor, the Concession. Prior to the introduction of the Concession in 1985, Australian Business Expenditure on R&D (BERD) was only 0.39% of GDP. The success of the program in encouraging BERD that might not otherwise have occurred is shown in the growth of BERD to 1.35% of GDP by 2008. Further proof that businesses need encouragement to invest enough in R&D was shown in 1996 when the rate of encouragement was halved and eligibility tightened. BERD fell significantly and did not fully recover until corrective action was taken in 2001. A number of studies were undertaken by AusIndustry and the Productivity Commission up to 2007. All these studies identified that the Concession helped contribute more to taxation revenue than it ever cost.

Despite this clear evidence, some still stay that the Incentive does not encourage businesses to invest more in R&D because much of that R&D would have occurred anyway and that this is particularly the case with larger companies. The changes since 1985 and in 1996 show this claim to be unjustified. Further, such comments reflect a misunderstanding of the additionality argument. MJA has repeatedly submitted to a number of Government enquiries that additionality is primarily about the increased amounts of R&D that companies perform on R&D projects that they had already decided to undertake; it is far less about enabling the R&D projects that companies had previously rejected as being marginal on internal risk/return criteria. By reducing project costs, the Incentive enables more R&D to occur in approved projects while also bringing in some R&D that would otherwise have not occurred.

**The policy issues contained in the draft legislation and the EM**
A number of the concerns with the Bill carry over from the previous draft Targeting Access legislation.

The title of the new EM again uses the words “targeting access”. Paragraph 1.1 of the EM goes on to assert that the amendment “better targets” the Incentive to businesses more likely to increase their R&D spending in response to government incentives resulting in a greater return on taxpayer funds.

MJA has two major points of disagreement with the above contentions:

1. Not one dollar saved by the amendments is reallocated under the Incentive to support R&D conducted by company groups with assessable incomes below $20 billion. The support going to those companies is determined by what they spend and is in no way affected by the removal of the large company groups from the system. As acknowledged elsewhere in the EM, this is a savings measure and to brand it as better targeting of the Incentive is misleading.
2. The EM provides no evidence to support its contention that companies with assessable income below $20 billion are more responsive to government incentives than large ones. At Paragraph 1.6, there is mention of the broad international support for the view that small firms are more responsive than large firms to government R&D incentives but not one piece of authority is offered to make out this argument. In the same paragraph, the assertion is repeated that the changes better target “small to medium enterprises,” which thereby infers that such enterprises have an assessable income of less than $20 billion. It is an absurdity to characterise companies with a turnover of less than $20 billion as small to medium enterprises and highlights how flimsy the policy positions are in the EM.

Looking at some of the policy concerns in greater detail:

<u>Lack of modelling of impacts of proposed changes</u>
The proposed amendments set a dangerous precedent for a process by which changes can be made to Australia’s largest innovation support program. In this instance, there is a complete lack of financial modelling and data to justify the changes and to outline the expected impacts on R&D spend and the various tax revenue dimensions.

Exploring this issue a little further, the Incentive offers company groups with assessable income greater than $20 billion an after-tax benefit of 10 cents in the dollar. This is roughly comparable with what was most recently available under the Concession (a hybrid of 7.5 cents and 22.5 cents) but well below what was first provided when the Concession began in 1985 (24.5 cents in the dollar).

As highlighted earlier, no data is yet available as to what the impact of the Incentive regime has had on R&D behaviour in any Australian company and the EM offers no evidence that larger organisations were historically less responsive under the Concession. In addition, there is no modelling provided in terms of the savings expected from the amendments or of the lost taxation revenue associated with any R&D that might not occur. No indication is given of the type or number of company groups likely to be affected. Further, the EM fails to specify what uses the saved funds will be put to.

The largest Australian companies are a critical part of our innovation system

It can be argued that the Coalition supported the immediately above statement prior to the introduction of this Bill. Now these companies are seen as not requiring the support provided by the Incentive to address the market failures associated with R&D nor generate the externalities customarily associated with those performing R&D.

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.

To remove the Incentive from these organisations will not only reduce the R&D being performed directly by these groups, it will threaten the basis on which these organisations engage in collaborative R&D with smaller companies, Co-operative Research Centres (CRCs), universities and other research institutes. The predisposition of large organisations to be involved in joint ventures, partnerships and the like will be compromised by the absence of the Incentive and the interests of the relevant parties will be defined to some extent around the tax benefits available. For example, if the operator of a joint venture is effectively excluded from the Incentive, it is far less likely to assist other venturers in the meeting of their obligations required to successfully claim the Incentive.

The Cutler Review emphasised the need to fully integrate all the components of the Australian innovation system and an attractive R&D incentive was seen as playing a key role in this integration. The company groups likely to be excluded from the Incentive are often the customers of the smaller companies that the Government is seeking to assist. These smaller companies often supply research inputs to the R&D projects that the very large companies conduct. Demand for these inputs will fall in line with the falls in the R&D spends of their largest domestic customers.

The change in circumstances may well lead the excluded companies to source their R&D inputs and collaborations in overseas jurisdictions.

The Incentive is an issue of international competitiveness

Government incentives for R&D are offered in a multitude of overseas jurisdictions. None exclude large corporates in the manner proposed in the amendments.

A number of jurisdictions do have provisions to limit the maximum benefit of the available R&D tax benefits including, Japan, The Netherlands, Singapore and the United Kingdom. All utilise variations around an expenditure cap methodology. No jurisdiction denies access to its program by reasoning of the entity exceeding a general turnover limit.

A further distortion associated with the Bill is that the exclusion is calculated against Australian assessable income only meaning that modest transnational performers in terms of Australian revenue remain in the program whilst stellar local performers are closed out. It is hard to see any policy logic behind this notion.

Given that large corporates are highly mobile in the location of their R&D, it stands to reason that Australia will be put at a distinct competitive disadvantage by failing to offer any incentive to conduct R&D locally.
The recent trend, particularly in the Asian region, has been to increase the value of the offerings. Evidence can be put forward that the presence of an R&D tax incentive does impact on decisions regarding location of R&D and the associated knowledge-based workers to carry out the projects.

The timing of the removal of this support seems particularly ill-advised as Australia seeks to establish our points of difference in the 21st Century Asian economy.

**Additional concerns with this Bill**
As highlighted in the introduction, there are some additional concerns with the current Bill in comparison with the provisions put forward by the previous Government.

1. Full cut to innovation support
   There is no commitment to reallocate any of the saved expenditure to other forms of innovation support. The previous Bill did have include a commitment to partially fund the Industry and Innovation Statement. There is no such commitment attached to this Bill. Such a deep cut to systemic innovation support seems out of step with global trends.

2. Retrospectivity
   With the Senate Committee not due to report back until March 2014, this measure will be highly retrospective if it commences from 1 July 2013. The EM states in its 'General outline and financial impact' that the measure would not catch affected taxpayers unawares due to the introduction of the previous Targeting Access Bill. This ignores the trend in the Coalition's commentary since the 17 February 2013 press release through to the announcement of this Bill as outlined immediately below. As mentioned earlier, given the prevailing uncertainty around this initiative, no affected taxpayer has been able to safely ignore the Incentive at this stage and all would be maintaining full claiming practices including innovation planning, albeit in an environment of extreme uncertainty.

3. Policy contradiction
   The Coalition was a strident critic of the previous Targeting Access Bill. It characterised the change as "disappointing…at worst, confidence destroying" in a 19 February media release headed "Industry joins coalition on R&D revenue concerns". It raised concerns about the impact the cut would have on the sovereign risk of investing in Australia. The then-shadow Treasurer, Joe Hockey, referred to the "charade of consultation" from Labor surrounding the cut in an address to the CEDA Economic and Political Overview Conference on 28 February 2013.
   In its policy statements in the run up to the Federal Election, the Coalition described the measure as punitive, acknowledged that it was without global precedent and committed

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to use the scheduled 2014 review of the Incentive to revisit the issue comprehensively. We unreservedly support the notion that the new Government should stick to its election commitment, withdraw the Bill and conduct the 2014 review of the Incentive for the purpose of providing an input for the upcoming Taxation White Paper.

**Technical tax concerns with the draft legislation**

There are a number of concerns that we would like to reflect upon in terms of the technical tax impact of the draft legislation.

<u>The exclusion test should be based on turnover, not assessable income</u>

MJA believes that the draft legislation contains a major departure from what was originally understood to be the basis of the cut-off being the '$20 billion **turnover** or more' principle.

We have seen advice from chartered accounting firm, EY that sets out the differences between turnover and assessable income. In short, its advice is that assessable income is a broader concept in Australian tax law including a number of elements excluded from the concept of turnover including statutory income, sales of retail fuel and amounts derived from dealings with connected entities and affiliates. EY has given MJA permission to support that position in this submission and to voice our support for the overall EY submission.

In addition, the original understanding was that the exclusion test was to be based on annual **Australian** turnover while the draft legislation clearly captures foreign income of both Australian residents and Permanent Establishments in Australia.

Should the legislation proceed in spite of the arguments we have set out earlier, we submit that the draft legislation be rewritten to give accurate voice to the original announcement of an Australian turnover-based test.

<u>The application of the exclusion is unpredictable for taxpayers close to the $20 billion threshold</u>

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

Further, the threshold institutionalises a bias to R&D projects being done in smaller organisations which might lead to a sub-optimal portfolio of projects from a national perspective. For example, an SME looking to do a collaborative project with a large venture partner is only able to pitch the favourable R&D tax treatment to those organisations below the $20 billion threshold which could see the project ultimately being 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.

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In addition, thought should be given to indexation of the threshold to preserve the current notion of $20 billion as being the appropriate determinant of exclusion.

**Conclusion**

MJA supports any process by which the Incentive can be shown to deliver improved outcomes for Australian taxpayers. We understand the need to address issues of fiscal responsibility as well as innovation policy. We pride ourselves on our participation and contribution to the various processes that ultimately resulted in the Incentive.

Our opinion is not swayed by our direct business interests. For example, we always argued vigorously against the Incremental component of the old Concession even though we continuously assisted our clients in accessing these benefits. We recently made a submission regarding the (now withdrawn) quarterly credits legislation that set out our deep misgivings about the system even though we believed it would have grown our business in the short term.

In this instance, we oppose the legislation on the basis that it utilises unsubstantiated policy assumptions. Perhaps more significantly, we oppose these changes because they have not been the subject of any analysis, scrutiny or debate. The extremely short timeframe for responses regarding these changes has meant that no real consultation has been possible. Given the alarming impacts we believe that the changes could occasion on the Australian innovation system, we cannot in good conscience support them.

We are not alone in taking this position. In a 26 February MJA Update, we detailed the broad church of commentators that opposed the Targeting Access Bill. They included the following:

• Business Council of Australia chief executive, Jennifer Westacott
• Minerals Council of Australia chief executive, Mitch Hooke
• Chairman of the Group of Eight universities, Fred Hilmer
• Universities Australia chief executive, Belinda Robinson
• Dean of the UTS Business School, Professor Roy Green
• Australian Financial Review commentator, Peter Roberts
• Head of the Cutler Review, Terry Cutler
• CSIRO chairman, Simon McKeon
• Shell Australia
• Leighton Holdings
• CPA head of business and investment policy, Paul Drum
• Australian Chamber of Commerce and Industry economics director, Greg Evans
• Australian Industry Group chief executive, Innes Willox
• Reserve Bank of Australia board member, Heather Ridout

To date, we have not seen any public support at all for the deep cut contained in the current Bill.

If the Bill passes, we will be the only jurisdiction that excludes participation in its flagship innovation program by dint of size alone. The fact that it is an exclusion based on local, rather than global, activity compounds the problem and heightens the risk to Australia's innovation culture.

Critically, it would also establish a precedent that the preferred means of controlling program cost is to exclude participation potentially leaving more members of the Australian innovation community out in the cold in the future. The debate about cost control has always centred on the levers of permanent difference (tax saving per dollar of R&D expenditure) and claimable amount at a company group level. These are the levers used by all current jurisdictions to determine the level of support. To start excluding taxpayers due to their size alone introduces an institutional bias that would see the Government assisting similar R&D projects in smaller companies to those of their larger brethren who are put at a distinct competitive disadvantage. This clear institutional bias has to play in to the decisions of these larger organisations as to where to locate their innovation spend globally and the amounts they allocate to those various locations going forward. This is a risk not worth taking.

By putting this measure, and the Incentive as a whole, into the proposed White Paper process, the best opportunity for balanced review of the program will be provided and program effectiveness can be further promoted whilst having suitable regard to the fiscal demands of the present day.

We greatly appreciate the opportunity to make this submission. Should you have any questions regarding the above, please contact me or Ian Ross-Gowan on

Yours sincerely

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