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2 November 2018

Senator Jane Hume
Chair
Senate Standing Committee on Economics Legislation Committee
Parliament House
CANBERRA ACT 2600

Dear Senator,

Inquiry into the Treasury Laws Amendment (Making Sure Multinationals Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018 [Provisions] – Chemistry Australia Submission

1. Chemistry Australia welcomes the opportunity to provide this submission on the R&D tax incentive aspects of the Committee's inquiry into the *Treasury Laws Amendment (Making Sure Multinationals Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018* (the Bill).
2. Chemistry Australia (formerly the Plastics and Chemical Industry Association) is the peak national body representing the chemistry industry. Chemistry Australia members include chemicals manufacturers, importers and distributors, logistics and supply chain partners, raw material suppliers, plastics fabricators and compounders, recyclers, service providers to the sector and the chemistry and chemical engineering schools of leading Australian universities.
3. The chemistry industry is one of the largest manufacturing sectors in Australia. Our industry employs more than 60,000 people, with every job creating five more in related supply chains. The industry contributes \$11.6 billion to gross domestic product, and supplies inputs to 109 of Australia's 111 industries.
4. Chemistry Australia and its members have a long history of collaboration with the CSIRO, Australian universities and the research community. To illustrate, the inaugural intake under the Chemicals and Plastics Manufacturing Innovation Network (CAPMIN) program co-ordinated by Chemistry Australia and Monash University has placed 17 Ph.D. candidates within chemical manufacturing businesses across Australia, providing an opportunity for those candidates to complete their studies undertaking R&D that delivers innovation in a commercial environment. A second round of 16 Ph.D. candidate placements under the CAPMIN program is about to commence.
5. The Australian chemistry sector is a significant investor in Australian R&D, spending \$760 million in 2015/16. Just over 60% of this spend was by companies with more than 200 employees.

6. Chemistry related R&D addresses many of the challenges currently confronting modern society. Innovative chemistry plays an active and essential role in: mitigating the impacts of climate change; improving agricultural productivity while supporting more sustainable farming practices; and improving energy efficiency and reducing the emissions associated with vehicles, trains, ships and aircraft (i.e. light-weight composites) as well as dwellings and buildings. Chemistry delivers the battery technologies necessary for electric/hybrid vehicles and for the increased deployment of renewable energy infrastructure. Chemistry related R&D is also focused on the development of alternative fuels, including the development and deployment of hydrogen as an alternative to fossil fuels which offer reduced emissions, enhanced fuel security and greater self-dependence. Chemistry innovation supports mining and minerals production, delivering the solutions needed to extract and refine minerals, including rare-earths. Innovations in materials science have delivered the technological advances that underpin many of the products and devices that have improved productivity and become part of our everyday lives.
7. The global market for the capital available for chemistry related R&D investment is highly competitive. If Australia wants to attract capital and play a part in global chemistry innovation, it must provide a framework that both supports and rewards R&D investment. A globally competitive tax system, including a competitive R&D tax incentive, are important elements of this framework.
8. Feedback from Chemistry Australia members - be they Australian headquartered multinational enterprises or Australian subsidiaries of overseas businesses - indicates that the Bill will result in a reduction in R&D activity undertaken in Australia. Indeed, Chemistry Australia members have suggested that the announced changes are already factoring into decisions about where they locate R&D activities. Australian based R&D activities will be reduced and shifted to locations that offer a better return on R&D investment.
9. Chemistry Australia members cite the following concerns:
 - a. the Bill will essentially halve the value of the R&D tax incentive for most recipients;
 - b. the Bill will increase the complexity and compliance costs associated with accessing the tax incentive, further eroding its value; and
 - c. continued tinkering with the R&D tax incentive in recent years has increased the risk and uncertainty of committing to R&D investment in Australia.
10. With regard to the specific elements of the Bill, Chemistry Australia opposes the introduction of R&D expenditure intensity thresholds for the reasons explained below. However, if R&D expenditure thresholds are to be introduced, Chemistry Australia believes that provisions that establish a premium rate of tax incentive for expenditure related to collaboration with a publicly funded research organisation should be incorporated into the Bill in accordance with the recommendations of the *Review of the R&D Tax Incentive*.
11. The introduction of the intensity thresholds contained in the Bill is likely to significantly disadvantage the chemistry sector which is typified by businesses that require large capital investment, have large input and running costs and which operate on very tight margins.

12. More generally, the intensity thresholds introduced by the Bill will have the following consequences:

- a. **Manufacturers disadvantaged:** The inclusion of the cost-of-goods-sold in the total expenditure element of the R&D intensity calculation disadvantages manufacturers and distributors vis-a-vis enterprises that generate their income from large capital assets or from services. The cost-of-goods-sold should be excluded from the R&D intensity threshold calculation to better reflect a business' capacity to invest in R&D activities.

Illustration

Manufacturer A has a profit of \$25 M on a turnover of \$450 M. Of its total expenditure of \$425 M, the cost-of-goods-sold is \$400 M. To achieve an R&D expenditure intensity greater than 2%, Manufacturer A would need to spend more than \$8.5 M on R&D activities – that is, more than 34% of its total profits or 34% of its general expenses or 17% of its gross margin.

The cost-of-goods-sold do not reflect Manufacturer A's capacity to invest in R&D activities. Manufacturer A has \$50 M available to operate its business and invest in R&D activities.

For Manufacturer A to be in a position that might enable it to achieve an R&D expenditure intensity of 10%, an R&D expense margin of approximately 10.5% (\$42.5 M) would need to be added to the cost-of-goods-sold across-the-board to the products it sells. Manufacturers operating in globally competitive markets rarely have the capacity or opportunity to impose such margins on their customers.

- b. **Increased uncertainty:** Expenditure, and therefore, the level of R&D intensity and the value of the R&D tax incentive can only be determined when the tax return is prepared and lodged, many months after the end of a financial year. Unexpected expenditure during a financial year may reduce the level of intensity and result in the loss of tax incentive. This creates a level of uncertainty around the value of the tax incentive, making R&D expenditure in Australia less attractive. Ironically, the level of uncertainty is likely to be greatest for the higher-tier intensity thresholds. So, instead of attracting additional R&D expenditure, the introduction of intensity thresholds may ultimately discourage R&D expenditure in Australia. Businesses will prefer to invest their limited R&D capital in locations that provide certainty.
- c. **Timing of R&D activities:** The intensity thresholds may also impact the regularity and scheduling of R&D activities to the detriment of Australia's R&D capability. Businesses will be incentivised to defer R&D expenditure to achieve a greater level of intensity in subsequent years. For example, a business with an average annual R&D expenditure intensity of 2 % that defers its R&D activities and expenditure for 2-years would receive the 4%, 6.5% and 9% R&D tax incentive on the same amount of total R&D expenditure by conducting it in a single financial year instead of spacing it over 3 financial-years.

- d. **Certain business structures disadvantaged:** Australian entities that run overseas businesses or operations as a branch of the Australian entity are also disadvantaged by the inclusion of expenditure relating to overseas branches or operations in the total expenditure element of the R&D intensity calculation. Expenditure related to any business run as an overseas branch of the Australian entity should be excluded from the R&D intensity threshold calculation.
 - e. **Increased complexity:** The proposed intensity calculation method combines tax and accounting concepts that will be challenging for companies to apply and the ATO to regulate. This will likely result in additional compliance challenges and increased costs for companies. It is also possible that 'expenditure' will be held to include capital expenditure, which is a normal concept for accounting and a subset of total expenditure, further distorting the ratio calculations.
 - f. **Impact of higher energy costs:** The rapid increase in energy costs are likely to increase a business' total expenditure and therefore reduce the levels of R&D expenditure intensity. Businesses already struggling with high energy costs may now be additionally penalised by the loss of R&D tax incentive.
13. The changes to feedstock and clawback provisions contained in the Bill merely serve to add further layers of significant complexity in terms of compliance which, of themselves, add no tax benefit.
14. Finally, the changes to the R&D tax incentive run counter to the aims of encouraging R&D activities in Australia, they reduce the value of the tax incentive, increase uncertainty and compliance costs for business and do little to attract, retain and provide increased opportunities for STEM professionals.
15. If you would like to discuss aspects of this submission, please don't hesitate to contact me on [REDACTED] or by email at [REDACTED]

Yours faithfully

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Bernard Lee
Director – Policy and Regulation
Chemistry Australia