# TREASURY LAWS AMENDMENT (MAKING SURE MULTINATIONALS PAY THEIR FAIR SHARE OF TAX IN AUSTRALIA AND OTHER MEASURES) BILL 2018

## Response to the Inquiry by the Senate Economics Legislation Committee

November 2018

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**Our mission:** To use our unique convening power to position health and medical research as a significant driver of a healthy population and contributor to a healthy economy.

**Our role:**

**Engage**
Australia in a conversation about the health benefits and economic value of its investment in health and medical research.

**Connect**
researchers, funders and consumers to increase investment in health and medical research from all sources.

**Influence**
government policies that support effective health and medical research and its routine translation into evidence-based practices and better health outcomes.

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| **$4 million cap on the refundable R&DTI** | The Government has not provided an assessment of the impact of this measure.<br><br>**In the absence of information about the effects of the reduction in the rate of the R&DTI offset, and therefore not being able to evaluate the effect of this measure, the Senate should reject the proposal to cap the refundable R&DTI.** |
| **Clinical Trial Exemption** | Clinical trials is an area where annual R&D expenditure by a small research intensive company can be in the many millions of dollars.<br><br>**The Senate should support the exemption of clinical trials from any cap on the refundable R&D TI and the inclusion of the definition of 'clinical trial'.** |
| **Intensity Measure** | By linking the R&D TI to the value of R&D as a percentage of total expenditure, the proposed Intensity Measure not only provides an incentive to increase R&D, but to reduce other expenditure, including moving other expenditure, such as manufacturing, to other countries.<br><br>**The intensity measure proposed in the Bill should not be supported by the Senate, as it could have the unintended consequence of discouraging non R&D business investment in Australia.** |
| **Supporting collaboration** | Increasing the engagement of PFROs with the private sector has been a key feature of Government policy, reflected in the National Innovation and Science Agenda, and in specific measures such as the change to the calculation of funding for universities' indirect research costs.<br><br>**Amendments to the R&DTI Scheme to encourage collaboration between business and PFROs, and indeed, between large and small businesses, are worthy of further consideration by the Committee, particularly in the context of the recent reduction in private sector R&D expenditure.** |

# TREASURY LAWS AMENDMENT (MAKING SURE MULTINATIONALS PAY THEIR FAIR SHARE OF TAX IN AUSTRALIA AND OTHER MEASURES) BILL 2018

## RESPONSE TO THE INQUIRY BY THE SENATE ECONOMICS LEGISLATION COMMITTEE

## Introduction

Research Australia welcomes the opportunity to make this submission in respect of Schedule 1 of the Treasury Laws Amendment (Making Sure Multinationals Pay Their Fair Share of Tax in Australia and other measures) Bill 2018 (the Bill), which seeks to amend the Research and Development Tax Incentive (R&DTI) Scheme.

Research Australia is supportive of the R&DTI in its current form and opposes several of the proposed amendments.

A stated objective of the current Bill is to reduce the total level of government expenditure through the R&DTI Scheme. Such a reduction was first announced in the 2014-15 Budget with tax offsets available under the research and development tax incentive for the first $100 million of eligible expenditure reduced by 1.5 percentage points.

This measure was followed by the *2016 Review of the R&D Tax Incentive*, which is the genesis for the proposals contained in the current Bill.[1] The initial Budget announcement and the Review occurred against the backdrop of expenditure on the R&DTI which was increasing at a rate that exceeded successive budget forecasts.

The *2016 Review of the R&D Tax Incentive* relied on estimates that the total cost of the R&D Tax Incentive in 2017/18 would be $3.485 billion.[2] The latest figures published by the Department of Industry, Innovation and Science estimate the actual cost in 2017/18 at $2.832 billion, some $600 million lower than the forecast in the Review's report, and $100 million lower than its estimate for 2015-16.

**Research Australia submits that with expenditure on the R&DTI Scheme failing to meet the earlier projections which precipitated concerns about the escalating cost of the scheme, much of the rationale for the amendments contained in the Bill is no longer valid.**

The reduction in expenditure on the R&DTI Scheme has been accompanied by a reduction in Business Expenditure on R&D (BERD) from 1.19% of GDP in 2013-14 to 1.01% of GDP in 2015-16 (the latest period for which figures are available)[3]. This reduction is largely unexplained and unexpected, and occurs at a time when other developed countries already have BERD that is significantly higher than Australia's. The USA and Germany have BERD of 2% of GDP; in Japan it is at 2.6%, and 3% in Korea.[4]

Research Australia is concerned that the proposed reductions in the R&DTI are being undertaken without assessing the impact the R&DTI has had on R&D activity in Australia since its inception in 2011. Nor has there been an assessment of the impact of the subsequent reductions in the R&DTI offset rate.

The real measure of effectiveness of the R&DTI is the degree to which it has caused additional R&D in Australia that results in additional economic benefits. This will always be difficult to determine as there are many factors that affect the level of R&D undertaken in any country at any time, of which the R&DTI is only one. In addition, the R&DTI has only been operating since 2011 and R&D is typically a long and time consuming process. It can take many years for products to make it to market and generate revenue; consequently, the R&DTI has not yet been operating for a sufficient period to determine its economic impact.

While Innovation and Science Australia's 2017 Report supported a reduction in expenditure on the R&DTI in the context of increased government expenditure on other measures to support innovation and a commitment to a funding 'floor' of its medium-term average of 0.63 per cent of gross domestic product (a modest proposal), no such commitment has been made by Government.[5] In an environment in which private sector R&D is declining, this lack of a commitment to private sector R&D is a significant concern.

[1] Mr Bill Ferris AC, Chair, Innovation Australia, Dr Alan Finkel AO, Chief Scientist, Mr John Fraser, Secretary to the Treasury; *Review of the R&D Tax Incentive* 4 April 2016
[2] Ibid, p.24
[3] Australian Bureau of Statistics, Catalogue No. 8104.0 - Research and Experimental Development, Businesses, Australia, 2015-16
[4] Innovation and Science Australia 2017, *Australia 2030: prosperity through innovation*, Australian Government, Canberra. Figure 7
[5] Ibid, Recommendation 6

Finally, Research Australia is aware that this current Bill is the latest in a succession of Bills seeking to amend the R&D TI, as we are sure, are the members of the Senate Economics Legislation Committee. This submission reiterates many of the arguments put by Research Australia to the Senate Economics Legislation Committee's Inquiry into the Tax and Superannuation Laws Amendment (2014 Measures no. 5) Bill 2014 and its Inquiry into the Budget Savings (Omnibus) Bill 2016.

# Amendments to the Refundable Component of the R&D Tax Incentive

## Proposed reduction in the rate

When the R&DTI Scheme was introduced in 2011, the rate at which the refundable component of the R&DTI offset was paid was 45%. Effectively this meant that for every $100 spent on eligible R&D activity, the company was entitled to a refund of $45. This refund was paid regardless of whether the company had paid any or even no tax in the relevant year.

While the R&DTI is described as a tax measure and as a tax offset, this hides the reality that many of the recipient companies pay little or no tax and yet still receive the full value of the R&DTI.

Part of the argument advanced for the reduction in the refundable R&DTI is that small companies benefit from the reduction in the company tax rates. On face value it appears that the reduction in the rate of the R&DTI offset would be revenue neutral for the companies involved; i.e. the benefit of the R&DTI will be reduced but this loss will be made up by a corresponding reduction in tax paid.

However, this reasoning is fundamentally flawed; it assumes that the companies receiving the refundable R&DTI are paying sufficient income tax to receive the benefit of the reduction in the tax rate. This is clearly not the case for the small research-intensive companies in the startup phase that are undertaking R&D activity to commercialise their prototype product; many of these companies are paying little or no income tax because they are operating at a loss for many years while they are in the process of developing products for market.

This fact is recognised in the design of the R&DTI Scheme, and is the reason why the refundable component is refundable i.e. it is **expected** that the value of the R&DTI may exceed the value of the tax payable. In this circumstance, the reduction in the rate of the R&DTI offset is not 'revenue neutral', and results in a direct reduction in the support provided to small innovative companies in their early stages when they need it most.

Research Australia opposed the 1.5% reduction in the rate of the refundable R&D Tax component in 2016 when the Committee conducted its Inquiry into the Budget Savings (Omnibus) Bill 2016, and we oppose the further 1.5% reduction now, for the same reasons.

**Research Australia submits that the proposal to reduce the rate of the refundable R&DTI offset by 1.5% be rejected by the Senate, and the Bill should be amended to reinstate the rate of the refundable R&D Tax Incentive at 45%.**

The consequence of the Bill will be to reduce the level of Government support for the R&D undertaken by thousands of small research-intensive companies, regardless of reductions in the corporate tax rate. This has a direct impact on the capacity of these companies to undertake research and development, including their ability to employ the staff they need. And it is occurring against the backdrop of a recent fall in private sector investment in R&D when the Government's ambition for future Australian prosperity relies on an 'Innovation Nation'.

## The $4 million cap

The current Bill proposes an annual cap of $4 million on the refundable R&DTI.

It is difficult to gauge the direct impact of this measure on companies as there is no publicly available information about how many claims for the refundable R&DTI exceed this claim, or the size, industry sector or financial position of such claimants. Beyond overall estimates of the cost of the refundable and non-refundable components of the R&DTI, the Government has not provided information about which industry sectors are benefiting from the R&DTI or any statistics about the size of claims that are made. Similarly, while the Explanatory Memorandum has estimates of the aggregate savings to be made from the measures contained in this Bill, there is no information about the estimated savings from each individual measure.

In the absence of this information, and with the exception of companies conducting clinical trials (see the next section) it is difficult to know how many companies would be affected by a $4 million cap on the refundable R&DTI.

Research Australia submits the Committee should ask the Government to provide statistical information about the number, size and value of claims made for the refundable R&DTI. In particular the Committee should seek information about the companies claiming the refundable R&DTI where the R&DTI exceeds the tax they pay, and which will not therefore benefit from claiming a tax deduction for expenditure in excess of $4 million. This information will assist the Committee to assess the likely impact of this measure and of the other measures contained in this Bill.

**In the absence of information about the effects of the reduction in the rate of the R&DTI offset, and therefore not being able to evaluate the effect of this measure, Research Australia submits that the Senate should reject this amendment to the R&D Tax Incentive.**

## Exemption of Clinical Trials from the $4 million cap

Successive Australian governments have identified the economic and other benefits that derive from encouraging the conduct of both commercial and non-commercial clinical trials in Australia and has provided a range of different policies and programs in support.

This in turn, has helped to increase the number and value for clinical trials conducted in Australia, generating export income and supporting local drug and medical device development. As a vital but expensive R&D activity, the clinical trial exemption from the cap is essential to ensuring that this concerted, cross portfolio effort has not been in vain.

Research Australia and the health and medical research sector more broadly have been arguing against a cap on the refundable R&DTI offset for the last two years. In particular, we have been concerned about the impact of the cap on clinical trials as this is one area where annual R&D expenditure by a small research-intensive company can be in the many millions of dollars. We welcome the exemption of clinical trials from the proposed cap and are supportive of the definition of clinical trial contained in the Bill.

Research Australia is focused on health and medical research (HMR) and its commercialisation. Relative to many other sectors, the commercialisation of health and medical research into new drugs, therapies diagnostics and devices is highly research intensive. This R&D activity is characterised by:

- relatively longer timeframes, because the scientific and regulatory hurdles to market are greater and take longer to overcome; and
- relatively higher expenditure on R&D, particularly in later stages with activities like clinical trials.

While a typical firm spending in excess of $9.2 million per year on R&D (roughly equivalent to the expenditure required to reach the proposed cap of $4 million) might be expected to be relatively large and have significant assets and revenues, this is much less likely to be the case when it comes to the commercialisation of HMR. This is often undertaken by an early stage SME where the company's only asset is likely to be the intellectual property it is seeking to develop; its sole activity is R&D; and it has no revenue.

This is why the exemption for clinical trials from any cap on expenditure is so important if a cap is implemented. Without the exemption, the cap would lead to fewer and/or delayed clinical trials and longer timeframes to get to market. In the competitive global market for medical devices and medicines, the first to market advantage can be critical to commercial success.

**Research Australia submits that the Senate should support the exemption of clinical trials from any cap on the refundable R&D TI and the inclusion of the definition of 'clinical trial'.**

Research Australia acknowledges that clinical trials are also undertaken by large established companies that are not eligible for the refundable R&DTI and that the non-refundable R&DTI plays an important role in bringing international clinical trials to Australia.

Raising the expenditure limit for the refundable R&D TI to $150 million should ensure that Australia remains an attractive destination for international clinical trials.

This not only generates valuable export earnings and increases Australian clinical trial capacity but provides Australians who participate in clinical trials with early access to the latest therapies.

# Amendments to the Non-Refundable Component of the R&D Tax Incentive

## Intensity Threshold

Research Australia notes that the objective of the intensity measure, as initially proposed by the *2016 Review of the R&D Tax Incentive*, is to reward additional R&D by large companies. In proposing that the R&DTI only be available for R&D in excess of a fixed percentage of total expenditure (not the proposal contained in his Bill), the Panel acknowledged 'There are limits in the ability to target additional R&D in a volume-based scheme'.[6]

Some of the difficulties with using the R&D TI to target additional R&D are highlighted by the proposed measure in this Bill. CSL is a Research Australia member and an Australian multi-national biotechnology manufacturer. CSL has made its own submission to the Inquiry which clearly articulates the perverse effect that the formula in the legislation, used in conjunction with the sliding scale of benefits, could have.

> *Companies which invest significantly in R&D but are also large Australian manufacturers and employers will have a lower 'intensity' compared to a company which only conducts R&D in Australia and manufactures offshore or, is engaged in an industry which does not have high raw material and production costs (for example digital and online).*
>
> *A good example is the comparison between CSL and any of the multinational auto-manufacturers which have now shut down their Australian manufacturing but retained a level of R&D in Australia. Under the above formula, that business model will have a higher 'R&D intensity' and that company will receive a much greater tax concession than a manufacturer/employer like CSL.*
>
> *We do not believe this is the Government's intention, but it will be an unintended outcome of this formula which values the same dollar value of R&D expenditure differently but, we would argue, not appropriately. To this point, CSL notes that the concept of an intensity measure in this legislation varies considerably from the original review recommendation which was to use intensity as an integrity measure establishing a minimum level not as a sliding scale for determining reward.*

By linking the R&DTI to the value of R&D as a percentage of total expenditure, the proposed measure not only provides an incentive to increase R&D, but an incentive to reduce other expenditure. One obvious way to do this is to retain R&D in Australia but move other expenditure, such as manufacturing, to other countries. It also acts as a disincentive to companies undertaking R&D in Australia to increase manufacturing in Australia, and to bring manufacturing on shore. (Research Australia is not suggesting that CSL would do so.)

In an increasingly global economy, decisions by large corporations, and multinational corporations in particular, about where to undertake activities such as R&D, manufacturing and distribution are based on a range of factors, and many countries offer a range of incentives to win their business. In this context, it is a mistake to view R&D activity (and expenditure) in isolation from other business activity.

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[6] Mr Bill Ferris AC, Chair, Innovation Australia, Dr Alan Finkel AO, Chief Scientist, Mr John Fraser, Secretary to the Treasury; *Review of the R&D Tax Incentive* 4 April 2016, page 4

While the R&DTI will never be the only consideration in where a company undertakes its activities, it can be an important one, and anything that could act as a disincentive to further investment in non R&D activity in Australia should be avoided, unless there is good reason.

**Research Australia submits that the intensity measure proposed in the Bill should not be supported by the Senate, as it could have the unintended consequence of discouraging non R&D business investment in Australia.**

# Other measures

Research Australia notes that one of the recommendations of the 2016 Review of the R&D tax Incentive that has not been adopted was a proposal for a Collaboration Premium.

> ***Recommendation 2***- *Introduce a collaboration premium of up to 20 percent for the non-refundable tax offset to provide additional support for the collaborative element of R&D expenditures undertaken with publicly-funded research organisations. The premium would also apply to the cost of employing new STEM PhD or equivalent graduates in their first three years of employment.*[7] *If an R&D intensity threshold is introduced (see Recommendation 4), companies falling below the threshold should still be able to access both elements of the collaboration premium (Section 4.2, p. 35).*

The Report provided the following rationale for such an incentive.[8]

> *Collaborative R&D, especially between companies and publicly-funded research organisations (PFROs)*[9]*, is considered to be more likely to produce spillovers, so adjusting the programme to encourage collaborative R&D could increase the programme's effectiveness. Supporting this claim, the Review of Research Policy and Funding Arrangements reports that collaboration with research institutions has a highly positive impact on business. The report cites evidence that collaborative innovation more than triples the likelihood of business productivity growth.*[10]

Research Australia notes that increasing the engagement of PFROs with the private sector has been a key feature of Australian Government policy, reflected in the National Innovation and Science Agenda, and in specific measures such as the change to the calculation of funding for universities' indirect research costs.

Much of the Government's focus in this area has been on increasing engagement with SMEs, whereas the above recommendation is focused on the larger companies that are eligible for the non-refundable R&D TI offset. The Government has not formally provided a response to this recommendation from the Review, but it seems likely that it was not adopted because it would increase rather than decrease R&D expenditure.

**Research Australia submits that measures to encourage collaboration between business and PFROs, and indeed, between large and small businesses, are worthy of further consideration by the Committee, particularly in the context of the recent reduction in private sector R&D expenditure.**

[7] Op Cit, *Review of the R&D Tax Incentive* 4 April 2016, page 3
[8] Op Cit, *Review of the R&D Tax Incentive* 4 April 2016, page 30
[9] PFROs include universities, medical research institutes and public research agencies.
[10] Department of Education, (2015), *Review of Research Policy Funding Arrangements*.

# Conclusion

Private sector R&D is critical to Australia's future prosperity as a nation. The R&D Tax Incentive is still a relatively new scheme introduced to better target and streamline Australian Government support for private sector R&D. It has already been subjected to several changes, the effects of which have not been evaluated.

The proposed reduction in the R&DTI Scheme occurs at a time when Australia needs to boost rather than wind back its support for R&D.

> '*Looking towards 2030, innovation will be integral to the expansion of Australia's economy, keeping its workforce strong, and addressing societal challenges. Australia will need to be competitive in a global innovation race by scaling up more high-growth industries and companies; commercialising more high-value products and services; fostering great talent; and daring to tackle global challenges.*
>
> *Yet just at the time when Australia needs to accelerate its innovation performance, we are falling behind our global peers, particularly in student performance in science and mathematics, and in business investment in research and development. This is more than a canary chirp in our economic mineshaft: it is a clarion call for national action.'*[11]

Research Australia supports these views expressed by Bill Ferris AC, Chair of Innovation and Science Australia. Research Australia is of the view that in the current climate of falling private sector R&D the measures in this Bill to restrict expenditure on the R&DTI Scheme is ill-advised and lacks longer term risk-benefit weighting.

It is at odds with the need to accelerate Australia's innovation performance, and we urge the Committee to consider the opportunities to use the R&D Tax Incentive to increase private sector R&D rather then focusing on constraining the scheme, when the most recent evidence is that the feared 'blow out' in expenditure on the scheme has not materialised.

Research Australia is pleased to have had the opportunity to make this submission and is willing to contribute further information and use its convening power in the health and medical research and innovation sectors to respond to any further questions the Committee may have.

[11] Innovation and Science Australia 2017, *Australia 2030: prosperity through innovation*, Australian Government, Canberra. p.iii

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