Hon Alannah MacTiernan MLC
Minister for Regional Development; Agriculture and Food;
Minister Assisting the Minister for State Development; Jobs and Trade

Our ref: 64-09650

Senator Jane Hume
Chair - Senate Standing Committees on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

Dear Ms Hume

SENATE ECONOMICS LEGISLATION INQUIRY ON THE TREASURY LAWS AMENDMENT BILL 2018 – CHANGES TO R&D TAX INCENTIVES

Please find attached the Western Australian Government Submission to Senate Inquiry into Treasury Laws Amendment (Making Sure Multinationals Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018.

Our government has a strong policy focus on economic diversification and jobs creation. To this end the State is exploring and supporting the development of a range of highly prospective new industries. We believe the retrospective changes to the Research and Development Tax Incentive for small companies will undermine a number of significant merging companies.

I understand that the Senate Economics Legislation Committee will be holding a hearing into the Bill in Canberra on 16 November 2018 and we would ask our submission be considered.

We also encourage your Committee to hold its hearing in WA to gain insights into the issues affecting these affected industries in the State.

Yours sincerely

[redacted]

HON ALANNAH MACTIERNAN MLC
MINISTER FOR REGIONAL DEVELOPMENT; AGRICULTURE AND FOOD;
MINISTER ASSISTING THE MINISTER FOR STATE DEVELOPMENT, JOBS AND TRADE

CC: Deputy Chair. Senator Chris Ketter

Level 11, Dumas House, 2 Havelock Street, West Perth, Western Australia 6005
Telephone: +61 8 6552 6200 Facsimile: +61 8 6552 6201 Email: Minister.MacTiernan@dpc.wa.gov.au

Western Australian Government Submission to Senate Inquiry into Treasury Laws Amendment (Making Sure Multinationals Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018

Executive Summary

The Western Australian State government has a strong policy focus on economic diversification, productivity enhancement and jobs creation to ensure greater economic sustainability and resilience. We have seen in recent years the problem that is created by too heavy a reliance on bulk commodities. To this end the State is exploring and supporting the development of a range of highly prospective new industries including energy materials processing, renewable hydrogen, renewable energy, advanced manufacturing, supply chain optimisation and digital technologies. R&D is a key component in driving these industries forward.

The proposed changes to the Research and Development Tax Incentive (RDTI) are expected to have a significant negative impact on these emerging Western Australian companies undertaking Research and Development (R&D). These R&D intensive businesses are heavily reliant on the tax incentives for their operational cash flow at the earlier stage of their development and are expected to experience a significant negative financial and operational impact as a result of these changes.

These are companies that have raised significant investment funding and are spending a lot of money to build new businesses through R&D. It is expected that these are the types of companies the Federal Government would wish to encourage to establish in Australia.

Industry feedback received indicates that the cap will have a detrimental affect on Western Australian innovation and industry productivity, as companies would have raised investment funding to conduct eligible R&D on the basis of their future cash-flow projections, which includes R&D refunds.

It is expected that the proposed changes will discourage investors into Australian R&D as this will require them to put more money in and they will consider other (less R&D intensive) investment options in the future.

Companies affected by the cap would have to either reduce their R&D spend, find new sources of funding to fill the cash gap that this amendment will create or shift their R&D overseas. It is likely that these companies would begin global reviews of where the R&D exceeding the cap can be either carried out cheaper, or conducted with support in other countries.

Whilst it is acknowledged that issues surrounding RDTI can be complex, there is a need to incentivise the building of Australian business capacity. A direct result of the proposed changes to the R&D legislation is that much of this R&D could be lost to Australia, as these companies move offshore to take advantage of better incentives and support offered overseas.

It should also be noted that in the current global economy significant support is required to just maintain the status quo level of R&D in Australia due to international competition. Companies should be encouraged and supported to undertake any R&D in Australia as it enhances economic productivity.

The Western Australian State Government has made several written representations to the Federal Government regarding the potential negative impacts of the proposed changes to the legislation on R&D intensive businesses in Western Australia. To date no response has been received from the Federal Government.

In light of the proposed changes the Western Australian State Government makes the following recommendations to ensure that companies undertaking critical R&D to drive our global competitiveness and sustainability are not unduly disadvantaged.

Recommendation 1

- That the Federal Government reconsider the retrospective application of the Treasury Laws Amendment (Making Sure Multinationals Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018 with caps proposed to apply from the beginning of the 2018-19 financial year. In order to mitigate the unexpected financial risk it would be highly beneficial if existing projects, where the current R&D arrangements have been used to finance the project, be exempt in the 2018-19 financial year. This would allow projects to be completed according to their planned financing structure. This option would support advanced existing projects but not future projects. This amendment would acknowledge the risk posed to advanced projects which have made investments and proceeded in reliance on the established RDTI.

Recommendation 2

- That the Federal Government apply the same annual cap exemption for the energy and battery materials industry as has been proposed to apply to clinical trials. This would send a positive signal to potential investors in this emerging strategic industry and support its development for the long term benefit of Australia.

Recommendation 3

- That the Federal Treasury considers splitting the proposed changes to the RDTI from the broader Treasury Laws Amendment (Making Sure Multinationals Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018 for separate consideration; and
- undertakes a more comprehensive review of the economic impacts of the proposed changes to determine the true long-term cost that the proposed changes will have on Western Australia businesses.

Recommendation 4

- That the Senate Economics Legislation Committee consider holding one of its hearings in WA to gain local Western Australian insights into the issues affecting the State's new and existing industries.

1. Background

The Commonwealth Government's Research and Development (R&D) Tax Incentive RDTI) has been in place since 1 July 2011. The RDTI is accessible by all sectors and encourages companies to engage in R&D benefiting Australia, by providing a tax offset for eligible R&D activities.

The object of the RDTI is to support industry to conduct R&D activities that might otherwise not be conducted. It has two core components:

- a 43.5 per cent refundable tax offset for eligible entities with an aggregated turnover of less than $20 million per annum, provided they are not controlled by income tax exempt entities; and
- a 38.5 per cent non-refundable tax offset for all other eligible entities (entities may be able to carry forward unused offset amounts to future income years).

A review of the RDTI (the Review) was commissioned in December 2015 and concluded in April 2016. The Review report was released for public consultation in September 2016 and interested parties were invited to comment on the report and the proposed recommendations.

The Review panel found that the RDTI could be better targeted, making a number of recommendations to improve the effectiveness and integrity of the program, including introducing a cap in the order of $2 million on the annual cash refund payable under the RDTI.

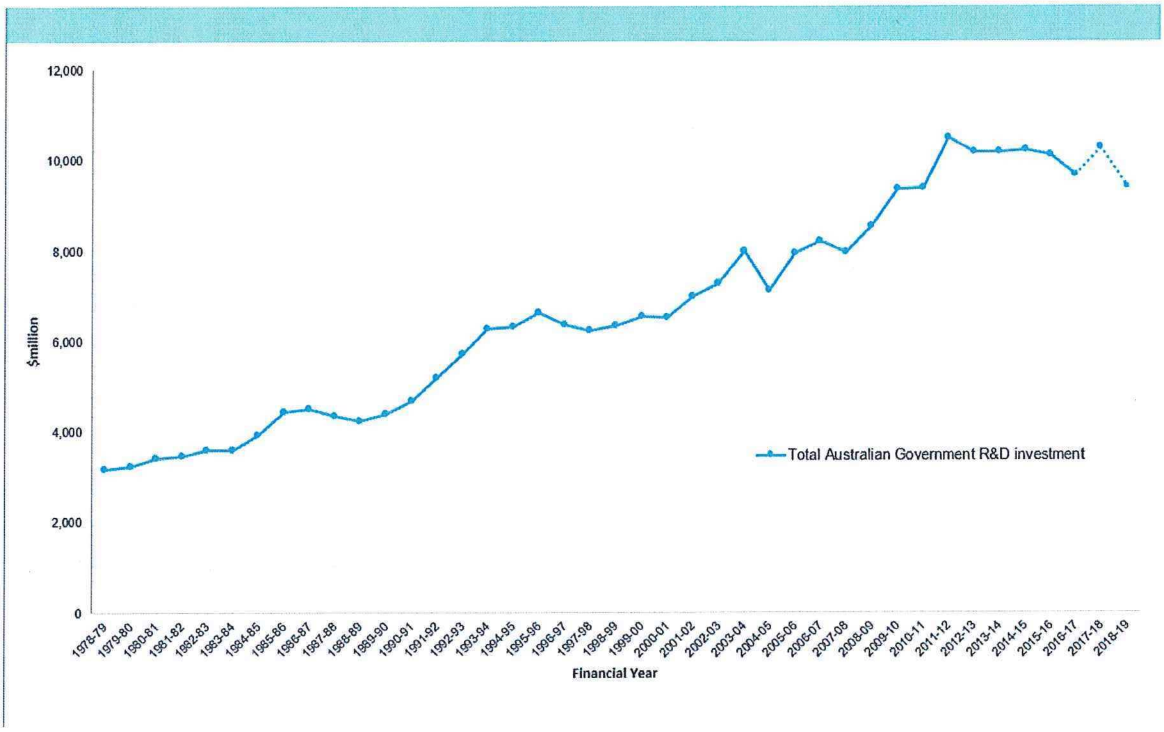
In its 2018-19 Budget, the Commonwealth Government announced a number of amendments to the RDTI in response to the Review's recommendations, with the changes to apply from 1 July 2018. Among the changes were, that for companies with aggregated annual turnover below $20 million:

- Cash refunds from the refundable R&D tax offset be capped at $4 million a year.
- R&D tax offsets that cannot be refunded will be carried forward as non-refundable tax offsets to future income years.
- Refundable R&D tax offsets from R&D expenditure on clinical trials will not count towards the cap.

The omnibus Treasury Laws Amendment (Making Sure Multinationals Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018 (the Bill), which includes the proposed changes to the RDTI had a second reading in the House of Representatives on 20 September 2018.

Subsequently a Senate Standing Committees on Economics Inquiry into the Bill was announced and is scheduled to report on 3 December 2018.

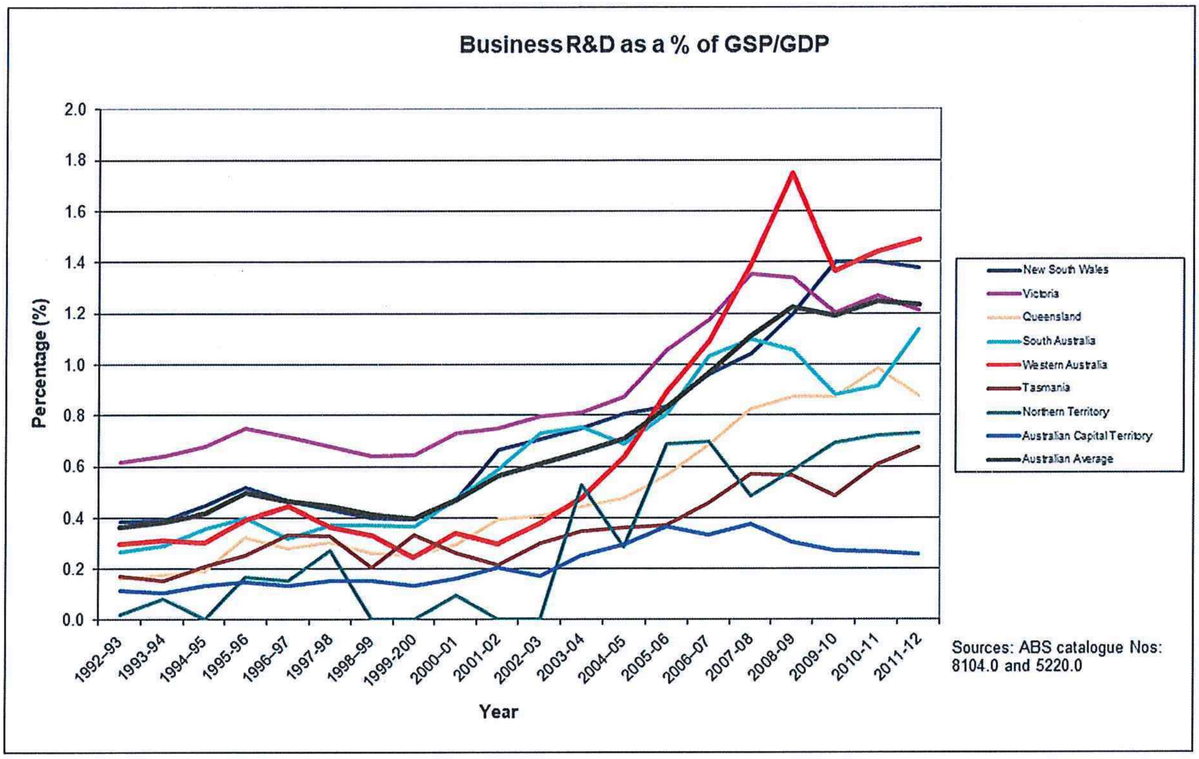
In an article published by Science and Technology Australia on 18 October 2018 concerns were raised about the continued fall of overall investment in R&D in Australia. The article cites that while recent measures by the government have stabilised funding for the nation's major research grants and institutions, investment through the RDTI, and from business in general, continues to fall.



2. Research and Development in Western Australia

The Western Australian State government has a strong policy focus on economic diversification, productivity enhancement and jobs creation to ensure greater economic sustainability and resilience. We have seen in recent years the problem that is created by too heavy a reliance on bulk commodities. To this end the State is exploring and supporting the development of a range of highly prospective new industries including energy materials processing, renewable hydrogen, renewable energy, advanced manufacturing, supply chain optimisation and digital technologies. R&D is a key component in driving these industries forward.

Western Australian based business operations were the third largest investor in R&D in the latest available ABS statistics from 2015-16, with NSW and Victoria being the largest investors. Business in Western Australia spent $2,082 million out of the Australian total of $16,659 million. This is substantially below the peak investment of $3,638 million in WA business R&D in 2008-09.



Tax concession changes relate to business R&D the relevant data source is the ABS data on business expenditure on R&D (BERD). The latest results were published in September 2017 for the financial year 2015-2016.

BERD in WA is dominated by mining (ABS includes oil and gas) comprising around $1 billion, or half of the WA total of $2 billion. In 2015-2016 BERD fell by $650 million or 24% from the previous year.

The table below provides details on the focus areas of WA based business R&D. Whilst the data below suggests that major operators in the resource activity is a key driver of R&D, it is also important to note that various operators across the local supply chain also invest in solutions that will drive productivity, cost reductions and safety improvements. Much of the R&D activity in heavy construction, professional services and machinery and equipment manufacturing will have a resource sector focus.

WA Sector Focus	$ million
Metal ore mining	354
Oil and gas extraction	337
Other mining	327
Other manufacturing	166
Professional, scientific and technical services (incl. engineering)	136
Other construction	105
Computer system design	86
Machinery and equipment manufacturing	76
Heavy and civil construction	61
Electricity, gas, water and waste services	48
Primary metal and metal products manufacturing	46
Basic chemical and chemical product manufacturing	44
Agriculture	20
Forestry and fishing	13
Other	*262*
TOTAL BUSINESS R&D in Western Australia	**2,082**

Source: ABS Cat 8104, Business Expenditure on R&D.

The Federal government report "Australia 2030 – Prosperity through Innovation", which was published in November 2017, highlights Australia's imperative to be proactive in the $1.6 trillion global innovation race to enhance our global competitiveness. The report states that innovation is essential to create more economic and social opportunities in light of easing investment in the resources sector and an ageing population profile. It also highlights the need for R&D, and in particular improved R&D effectiveness by increasing translation and commercialisation of research. The report states that a key role for government is accelerating R&D by providing incentives that increase commercialisation and stimulate jobs growth. The proposed changes to the RDTI appear to contradict this Federal Government plan.

3. Impacts on Western Australia

The Western Australian State Government recognises that the proposed changes to the RDTI are likely to negatively affect all companies undertaking R&D and seeking to claim RDTI. In particular, a number of R&D intensive businesses that are heavily reliant on the tax incentives for their operational cash flow, are expected to experience a significant negative financial and operational impact as a result of these changes.

These highly prospective companies are critical for diversifying the economy and can only survive through substantial investor funding to support product development expenses. The impacted companies span a range of sectors including renewable energy, manufacturing, supply chain optimisation and digital technologies, for which ongoing R&D is fundamental to ensure their sustainable growth and transformation.

These are companies that have raised significant investment funding and are spending a lot of money to build new businesses through R&D. It is expected that these are the types of companies the Federal Government would wish to encourage to establish in Australia.

Industry feedback received indicates that the cap will reduce Western Australian innovation and industry productivity, as companies would have raised investment funding to conduct eligible R&D on the basis of their future cash-flow projections, which includes R&D refunds.

It is expected that the proposed changes will discourage investors into Australian R&D as this will require them to put more money in and they will consider other (less R&D intensive) investment options in the future.

Companies impacted by the cap would have to either reduce their R&D spend, find new sources of funding to fill the cash gap that this amendment will create or shift their R&D overseas. It is likely that these companies would begin global reviews of where the R&D exceeding the cap can be either carried out cheaper, or conducted with support in other countries.

Whilst it is acknowledged that issues surrounding RDTI can be complex, there is a need to incentivise the building of Australian business capacity. A direct result of the proposed changes to the R&D legislation is that much of this R&D could be lost to Australia, as these companies move offshore to take advantage of better incentives and support offered overseas.

It should also be noted that the concept of encouraging additional R&D expenditure fails to take into consideration that in the current global economy significant support is required to just maintain the status quo level of R&D in Australia due to international competition. Companies should be encouraged and supported to undertake any R&D in Australia as it enhances economic productivity.

For all businesses under $20 million in turnover there will be a reduction in the R&D rate and thus less cash in their R&D rebates. This will cause a flow forward challenge that the companies will need to raise more investment capital or spend less on future R&D.

For all businesses over $20 million there is a new more complicated calculation and reduction to the R&D benefit they receive. In many circumstances the benefit will be so small that the effort to claim it will not be worth the result of the claim and thus they will stop claiming.

The State Government has received both direct and indirect feedback from industry in regards to the proposed changes. It is also understood that several WA businesses have been actively lobbying the Federal Government to reconsider these changes.

The Western Australian State Government has made several written representations to the Federal Government regarding the potential negative impacts of the proposed changes to the legislation on R&D intensive businesses in Western Australia.

To date no response has been received from the Federal Government.

3.1. Impact on high R&D intensive WA Small and Medium Enterprises (SMEs)

Western Australian SMEs operating with a turnover less than $20 million of expenditure are generally backed by industry investors. These highly prospective companies are critical for diversifying the economy.

In order to conduct significant R&D these companies can only survive through substantial investor funding to support product development expenses. Any substantial reduction in support could see investors look for alternative locations that may have commercialisation grants, subsidised infrastructure and more generous R&D tax incentives.

Companies such as Lithium Australia and Northern Minerals have made representations to the State Government as well as publically, stating that the $4 million cap on R&D tax refunds for smaller businesses threaten to "destroy" the potential for Australia, and in particular Western Australia, to play a key part in the lucrative and growing global battery industry supply chain as they limit the amount of R&D these businesses can realistically fund.

Further, the retrospective nature of the Bill (caps are to be applied from the beginning of the 2018-19 financial year) will create a finance shortfall for many businesses that had cash-flow budgets already established based on the existing R&D tax legislation and brings a new and unexpected financial risk to several key projects in WA, particularly in the energy materials and renewable energy sectors.

In order to mitigate this unexpected financial risk it would be highly beneficial if existing projects (i.e. those projects that had raised investment finance to conduct R&D), where the current R&D arrangements have been used to finance the project, be exempt in the 2018-19 financial year. This would allow projects to be completed according to their planned financing structure. This option would support advanced existing projects but not future projects. This amendment would acknowledge the risk posed to advanced projects which have made investments and proceeded in reliance on the established RDTI.

In 2011 the RDTI was modified for the SME sector to allow SMEs to claim tax losses associated with R&D activities as an immediate cash payment. This allowed additional cash to leverage investor contributions without affecting equity or income. Prior to this change, the RDTI operated as a future tax credit which did not assist those SMEs that were in early development and commercialisation, making it hard to survive the commercialisation "valley of death" only after which the tax credits would have had any benefit.

The tax incentive is greater than the nominal tax rate to incentivise the creation of new knowledge and technology, which is beneficial for creating competitive technology based companies. Initially the threshold was set at a 13.5% premium when the SME tax rate was 30c in the dollar of profit. This premium was recorded in legislation at the combined rebate rate of 43.5%, however when the SME tax rate reduced to 27c in the dollar the rate was legislated at 43.5% so the notional rebate premium increased to 16%. This is proposed to be rectified and revert to a 13.5% premium.

Recommendation 1

- That the Federal Government reconsider the retrospective application of the Bill with caps proposed to apply from the beginning of the 2018-19 financial year. In order to mitigate the unexpected financial risk it would be highly beneficial if existing projects, where the current R&D arrangements have been used to finance the project, be exempt in the 2018-19 financial year. This would allow projects to be completed according to their planned financing structure. This option would support advanced existing projects but not future projects. This amendment would acknowledge the risk posed to advanced projects which have made investments and proceeded in reliance on the established RDTI.

4. Exemptions for Clinical Trials

There is a specific exemption from the $4 million cap which would be applied for clinical trials R&D expenditure. It is unclear what may be considered "clinical trials" as the definition used is extremely narrow. Further non-clinical trial medical research could be equally important but receive less support due to the cap on a refund.

The rationale for this exemption is understood to be that the Federal Government is trying to encourage more Australian medical research to be commercialised locally.

Like clinical trials, the critical minerals sector has been identified by the Prime Minister and the Commonwealth Government as of national and international importance. The Australian Government's Resources 2030 Taskforce has reported that a well-funded and targeted Australian Government R&D program is vital to the development of the nation's resource industry.

In a Western Australian context this also raises significant concerns regarding the competitive neutrality between industries that may not be granted exemptions from the proposed cap.

Key Western Australian growth industries would be fundamentally disadvantaged as they do not enjoy similar exemptions as are proposed for the clinical trials. By example, the energy and battery materials industry is a highly prospective sector of internationally strategic importance. Western Australia is well placed to seize global opportunities created by the accelerating uptake of electric vehicles and energy storage systems around the world. This will contribute to the creation of new high tech jobs and industries and improve energy security and environmental outcomes.

Several key industry stakeholders have sought State Government support for an amendment that would see the clinical trials exemption extended to projects that support the development of critical minerals and those associated with energy production and efficiency.

By example, Northern Minerals Browns Range Heavy Earths Project was planned, financed and constructed relying on access to uncapped R&D Tax refunds under the Federal Government's long established tax incentive scheme. In an evolving global heavy rare earths market Northern Minerals has leveraged cash refunds on eligible R&D to gain private investor project finance. The proposed cap will force projects, such as Browns Range, to develop very slowly, if at all, and result in missed opportunities for the nation.

The term "clinical trials" is foreign to most industries outside biotechnology, however there are strong parallels in the processes implemented to reduce organisational and operational risk and drive confident investment decision-making.

The State has raised concerns with the Federal Treasurer regarding the potential negative affects the proposed changes will have on investment in the industry and is still awaiting a response.

Recommendation 2

- That the Federal Government apply the same annual cap exemption for the energy and battery materials industry as has been proposed to apply to clinical trials. This would send a positive signal to potential investors in this emerging strategic industry and support its development for the long term benefit of Australia.

5. Impacts on companies with over $20m in revenue

For all businesses with over $20m in turnover, the proposed amendments will result in a new more complicated calculation and reduction to the R&D benefit they receive. In many circumstances the benefit will be so small that the effort to claim it will not be worth the result of the claim and thus they will stop claiming.

Industry concerns have been raised with the State Government that this will have an unintended flow-on impact on a lot of the smaller manufacturing and supply companies (for example those servicing the mining industry) which may potentially reduce their R&D spend in WA as a result of the proposed changes.

5.1. Compliance Impacts

There remain a range of compliance issues particularly relating to what is considered Core and Supporting R&D Expenditure and administrative costs associated with the R&D.

Smaller companies that may not have the corporate resources to currently apply the Accounting Standards will have an additional compliance resource and cost burden to consider when intending to make R&D Tax claims.

The addition of R&D intensity calculations and reduced benefits over and above normal tax deductions for those companies that are making profits may see companies drop out of the R&D tax incentive and may also reduce research being undertaken in Australia.

Representations made by several leading accounting firms, including RSM Australia, Deloitte, Price Waterhouse Coopers and Ernst Young, are that there are some fundamental concerns regarding the conclusions reached by the Federal Government regarding the integrity, fiscal affordability, and additionality challenges of the current RDTI, and that there is a need for significant change.

Some of the key issues highlighted include assumptions around the actual cost to the economy and budget of the current RDTI has not been modelled to a complete extent, which if correctly modelled would demonstrate that the program has the nature of a loan made through the tax system from Government to companies claiming R&D tax.

Whilst it is acknowledged that there have been a small number of incorrect R&D Tax claims, and the ATO and AusIndustry are dealing with these, there has been no evidence or data presented to suggest that broad integrity issues exist.

There is an apparent lack of clarity surrounding the modelling of any proposed changes on various Australian industry segments as well as a lack of any detailed analysis of international innovation competition from other Governments in either tax or grant form.

As such the Federal Government should consider splitting the proposed changes to the RDTI from the broader Bill for separate consideration. This would enable a more comprehensive review of the economic impacts of the proposed changes to determine the true long-term cost that the proposed changes will have on Western Australia businesses.

Recommendation 3

- That the Federal Treasury considers splitting the proposed changes to the RDTI from the broader Bill for separate consideration; and
- undertakes a more comprehensive review of the economic impacts of the proposed changes to determine the true long-term cost that the proposed changes will have on Western Australia businesses.

6. Local knowledge

As cited earlier, the Western Australian State Government has a strong policy focus on economic diversification, productivity and jobs creation. To this end the State is exploring and supporting the development of a range of highly prospective new industries including energy materials processing, renewable hydrogen, renewable energy, advanced manufacturing, supply chain optimisation and digital technologies. R&D is a key component in driving these industries forward.

As a critical part of the nation's economy, and reflecting the sizeable expenditure within Western Australia on R&D, the Western Australian government would welcome the opportunity for the Senate Economics Legislation Committee to hold one of its hearings in WA to gain local Western Australian insights into the issues affecting the State's new and existing industries.

Recommendation 4

That the Senate Economics Legislation Committee consider holding one of its hearings in WA to gain local Western Australian insights into the issues affecting the State's new and existing industries.