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.