SUBMISSION

Submission to the consultation on the draft Treasury Laws Amendment (Research and Development Incentive) Bill 2018 and Explanatory Materials

July 2018

The Business Council of Australia draws on the expertise of Australia's leading companies to develop and promote solutions to the nation's most pressing economic and social challenges.

OVERVIEW

The Business Council of Australia welcomes the opportunity to make a submission to the consultation on the draft Treasury Laws Amendment (Research and Development Incentive) Bill 2018 and explanatory materials.

Research and development (R&D) is undertaken in a global environment. A competitive company tax system, which includes the company tax rate and R&D Tax Incentive, is critical for attracting investment. The R&D Tax Incentive recognises that the wider productivity and economic benefits of much commercial R&D activity cannot be adequately recouped by those bearing the costs, resulting in under-investment from a whole-of-economy perspective.

The changes have been proposed "to enhance the additionality, integrity and fiscal affordability" of the R&D Tax Incentive.[1] The Business Council endorses these objectives, but the combined effect of the proposed intensity measure, budget savings and the likely increase in complexity and compliance costs will be to reduce the overall level of support for R&D by large companies – notwithstanding that some individual businesses will receive higher levels of support.

Maintaining overall levels of support for R&D is particularly important when business expenditure on R&D fell more than 13 per cent in the two years to 2015-16.[2] Total spending on R&D as a share of GDP has been falling in Australia for several years, and is below the OECD average.[3] Limiting R&D support for larger businesses could be counterproductive as ABS data show that they have a greater propensity to innovate.[4]

In view of these risks, the Business Council believes that the Bill should be subject to proper assessment, including a regulation impact statement.

The specific recommendations in this submission seek to ensure that the changes do not dilute and distort R&D effort and hence inadvertently reduce the R&D spillover benefits they seek to support.

If the proposed Bill is legislated, it will be even more critical that the full Enterprise Tax Plan is legislated to reduce the effective tax burden on new investment. Furthermore, the Business Council recommends that budget savings from the Bill should be redirected to promoting innovation and stimulating business R&D. One example is through the introduction of a collaboration premium of up to 20 per cent on non-refundable tax offsets to incentivise collaborations between industry and public research organisations and universities.[5]

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[1] The Australian Government the Treasury, *Consultation on the draft Treasury Laws Amendment (Research and Development Incentive) Bill 2018 and Explanatory Materials*, 2018.

[2] ABS cat. no. 8104.0.

[3] OECD, *Gross domestic spending on R&D (indicator)*, 2018. doi: 10.1787/d8b068b4-en (Accessed on 25 July 2018)

[4] ABS cat. no. 8158.0.

[5] As recommended by *Australia 2030: Prosperity through Innovation*.

Finally, tax incentives for R&D have been changed, or changes have been proposed, multiple times in recent years. This has created uncertainty and made it difficult for businesses to plan confidently, and likely limited the success of various schemes. It will be important that new arrangements are followed by a period of stability.

Key points and recommendations

- It is imperative that changes to the R&D arrangements do not discourage R&D from being undertaken in Australia, especially at a time when Australia's R&D effort has weakened.
- There are risks the proposed changes will bring unintended consequences including discouraging R&D and other value-added activity in Australia, add complexity and increase compliance costs.
- The proposed R&D intensity measure, defined as the ratio of R&D spend to company costs, is not neutral with respect to R&D expenditure as it can reward/penalise companies for their structure rather than R&D effort. This feature of the scheme could generate arbitrary and probably unintended effects, contrary to the intent of the legislation.
- Accordingly, the Bill should be subject to comprehensive assessment, including a regulation impact statement to evaluate its likely impacts on R&D undertaken in Australia.
- Specific measures to improve the Bill include:
  - In measuring R&D intensity, the definition of 'total expenditure' should only reflect expenditure in Australia and the previous year's expenditure, or a historical average, to provide claimants with more certainty. It should also better reflect commercial realities by including operating expenses and costs of goods, but excluding borrowing costs and foreign exchange contracts.
  - A better approach to promote public accountability than publishing claimed R&D expenditure would be to bring together the extensive public transparency and reporting measures that already exist.
  - Compliance costs under the scheme should be minimised by providing greater clarity around scope of eligible activities, including case studies, public rulings and guidance notes, and consistent and predictable administration. Appropriate transitional arrangements should be put in place.
  - The changes should be supported by a publicly available performance and accountability framework, suitable oversight and a robust dispute resolution process.

Competition for R&D investment is intense

Global R&D investment is highly mobile and operates in an intensely competitive environment as countries seek to attract this investment. While many factors influence companies' decisions on locating R&D investment – some of which, like a skilled workforce, count in Australia's favour – the competitiveness of a country's tax system is nonetheless critical. As other countries become more attractive investment destinations, the risk is that the marginal R&D investment dollar moves overseas, particularly as international company tax rates decline.

Other countries are also introducing more competitive R&D tax incentives, such as New Zealand which also has a lower company tax rate. This is consequential in the context of relatively free movement of companies, capital and people between Australia and New Zealand.

The broader impacts of the proposed changes should be carefully considered

The proposed changes to the non-refundable R&D tax offset introduce multiple rates of tax offsets which increase with the intensity of the claimant's R&D expenditure. The stated purpose of the changes is to provide stronger incentives for companies to increase their overall R&D intensity.

While the Business Council acknowledges the objective of increasing R&D investment at the margin, under the proposed arrangements, the tax benefits for many large companies will more than halve, while compliance costs could increase.

Although a small number of companies are likely to benefit (some only marginally) overall support for R&D will almost certainly fall. This is the case even with the proposed increase in the expenditure threshold to $150 million. This is because the cap, by limiting claimable R&D, limits the measured R&D intensity of large companies – which, according to ABS data, have a greater propensity to innovate – with commensurately high cost bases and thus the rate of tax incentive. The cap means that very large companies will not be able to exceed the 2 per cent threshold regardless of their R&D expenditure, resulting in a reduction in support.

Furthermore, the proposed intensity measure is not neutral with respect to R&D spending across companies, generating arbitrary and probably unintended effects. It will not give the same marginal incentive to conduct R&D in Australia as the existing scheme or across companies, purely because of a company's structure.

For example, the proposed changes disadvantage very large companies that employ, operate, purchase materials and conduct R&D in Australia relative to companies that primarily conduct R&D. In other words, the new incentive structure rewards certain company structures, not necessarily R&D expenditure. Perversely, at the margin, this could discourage domestic production and employment because these costs would dilute R&D intensity and the rate of tax incentive. This could become yet another factor influencing business location and investment decisions.

It could also influence choices about business structure. The consultation paper notes that intensity "on a claimant level may not appropriately reflect the R&D intensity of the claimant as part of its broader economic group". This suggests that the expenditure base for measuring intensity might be broadened. The Business Council considers this would only introduce further distortions.

The expenditure base for measuring R&D intensity

The proposal is for R&D intensity to be calculated as eligible R&D expenditure expressed as a ratio of total expenditure. The consultation paper indicates total expenditure will be based on the claimant's income tax return, while the draft legislation proposes this be calculated by reference to accounting standards. This inconsistency should be addressed, as should other potential issues discussed below.

- Total expenditure should reflect expenditure in Australia, just as R&D expenditure is associated with Australian R&D expenditure (except in limited circumstances where R&D undertaken overseas can be claimed).
- The use of current year expenditure will introduce uncertainty and make it difficult to plan for access to the R&D Tax Incentive. Expenditure can change due to factors outside the control of a firm, such as interest rates, foreign exchange rates, intermediate input prices etc. Alternatives could include using the previous year's expenditure, or an average of several previous years, to provide claimants with more certainty.
- The definition of expenditure would better reflect commercial realities by including operating expenses and costs of goods but excluding borrowing costs and foreign exchange contracts. Consideration could also be given to excluding book depreciation expenses for depreciating assets (or at least, to exclude the non-R&D amounts included within). This would at least make calculation of the expenditure base neutral with respect to debt and equity finance.

Administration of the scheme

The Bill introduces several measures that aim to improve administration of the scheme, alongside additional resourcing and improved guidance for claimants.

- The changes should be supported by a publicly available performance and accountability framework, suitable oversight and a robust dispute resolution process. This will ensure administration of the system remains effective and consistent. The Administrative Appeals Tribunal is a costly appeals process that should only be used as a last resort.
- The Business Council supports allowing the Board of Innovation and Science Australia (ISA) to make binding determinations which have been developed in consultation with relevant stakeholders. These determinations should include all the relevant details, evidence and analysis, and stay within the letter and spirit of the law to promote the policy intent behind it. Similarly, where there are issues identified in claims, they should be clearly communicated to the applicant. If a three-month limit on extensions of time available from when applications, registrations and reviews are due, ISA should be similarly bound by this.

Compliance costs should be minimised

Changes to the R&D Tax Incentive are an opportunity to reduce administrative complexity to lower compliance costs including fees to tax agents and external consultants. The R&D Tax Incentive Review noted the $437 million of compliance costs borne by business in the R&D Tax Incentive scheme.

- Compliance costs could be reduced through greater clarity around scope of eligible activities, including case studies, public rulings and guidance notes.

As raised by Finding 9 of the Review of the R&D Tax Incentive, "The large compliance costs for companies registering in the programme reduce the effective level of public support flowing to business R&D."[6] Given the reduction in overall support being proposed, if compliance costs were to increase, the level of support for R&D would be further eroded. The compliance implications of the proposed changes in this Bill should be assessed against how they change the effective level of public support for business R&D.

Transition and a period of stability

Tax incentives for R&D have been changed multiple times, making it difficult for businesses to plan confidently. This uncertainty has likely limited the success of various schemes. Successful innovation policies overseas have been underpinned by frameworks that have been maintained for long periods.

- It will be important that the scheme is administered consistently and predictably to avoid undermining confidence in it.
- Consideration should also be given as to how to manage the transition to a new scheme given potential complexities in implementation of the numerous changes. This would also help avoid undermining current R&D plans including collaboration between companies and researchers.

Tax transparency

The Business Council has supported greater tax transparency and integrity measures in recent years, including encouraging members to sign the voluntary Tax Transparency Code (TTC). All companies must meet their tax obligations and where arrangements do not keep pace with community norms, they should be reviewed.

Among other elements, the TTC requires a reconciliation of accounting profit to tax expense and to income tax paid – which would capture the R&D Tax Incentive. There are 70 Business Council member companies who have signed up to the TTC and 140 companies have signed up in total. Business Council member companies that have signed up to the TTC paid over $21 billion, or 34 per cent, of all company tax in 2015-16.

The draft legislation contains measures to make public the name of the R&D Tax Incentive claimant as well as its ABN and R&D notional deductions. R&D notional deductions represent the amount on which the tax offset is calculated, not the tax benefit. Indeed, R&D expenditure is fully deductible for company income tax purposes. The additional tax benefit from the R&D tax scheme will depend on the size of the company and its R&D intensity.

The explanatory materials state this "will improve public accountability for R&D claimants and encourages voluntary compliance". But, of itself, this is unlikely to improve public accountability and will likely introduce additional confusion as to how the scheme, and the broader company tax system, operate. For example, the inclusion of the proposed details, including the quantum of the R&D notional deductions, into the existing annual ATO

[6] Ferris, B, Finkel A & J Fraser, *Review of the R&D Tax Incentive*, 2016.

publication of company tax data would be published at a time when companies are publicly reporting in respect of the subsequent financial year's data. Those reporting under the TTC would also be providing added context (where material) to their R&D tax offset. The publication of this expenditure data may also raise commercial confidentiality issues, particularly for smaller companies whose company tax data is currently not included within the scope of the ATO's publication of company tax data (excluding Petroleum Resource Rent Tax) and the TTC.

- We consider the extensive public transparency and reporting measures that already exist, in particular the voluntary TTC, would capture the R&D tax incentive, when the benefit is material for medium and large companies.

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