Business Council of Australia

SUBMISSION

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

November 2018

OVERVIEW

The Business Council of Australia welcomes the opportunity to make a submission to the Senate Economics Legislation Committee Inquiry into the Treasury Laws Amendment (Making Sure Multinationals Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018. The Bill contains several measures, and this submission responds to the proposed changes to the Research and Development (R&D) Tax Incentive. The Business Council strongly believes that all business in Australia must meet their tax obligations and where arrangements do not keep pace with community norms, they should be reviewed

Many factors influence companies' decisions on locating R&D investment, such as a skilled workforce – which counts in Australia's favour. A competitive company tax system, which includes the company tax rate and R&D Tax Incentive, is also critical for attracting investment. The R&D Tax Incentive has had a significant impact on corporate Australia's ability to invest in R&D, and delivered benefits through the commercialisation process.

Global R&D investment is mobile and operates in an intensely competitive environment as countries seek to attract this investment. Australia's company tax rate remains unchanged for companies with turnover above $50 million and there are no plans to reduce it. In contrast, other countries have been reducing their company tax rates while Australia has stood still. Indeed, further company tax rate reductions are planned for Argentina, Belgium, France, Netherlands, Sweden and the UK. 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.

It is imperative that changes to 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. This is particularly critical given digitalisation, artificial intelligence and automation all have the potential to transform industries and occupations. The changes have been proposed "to better target the program, and improve its effectiveness, integrity and fiscal affordability". The Business Council endorses these objectives, but the combined effect of the proposed intensity measure, budget savings and the increase in complexity and compliance costs will be to reduce the overall level of support for R&D by large companies. This may ultimately be at the expense of new R&D investment – notwithstanding that some individual businesses will receive higher levels of support.

Under the proposed changes, the tax benefits for many large companies will more than halve, while compliance costs are estimated to increase. There is a risk that the marginal R&D investment dollar moves overseas, particularly as international company tax rates decline and more competitive measures to attract R&D are introduced abroad.

To maintain support for R&D, the budget savings from the Bill should be redirected to promoting innovation and stimulating business R&D. For example, the introduction of a collaboration premium of up to 20 per cent on non-refundable tax offsets could incentivise collaborations between industry, public research organisations and universities, which in turn, would increase the potential for significant knowledge transfer and wider benefits to the economy.

Tax incentives for R&D have been changed, or threatened with change, multiple times in recent years, making it difficult for businesses to plan confidently. This uncertainty has likely limited the success of various schemes in terms of incentivising companies to invest in R&D.

Business expenditure on R&D should be supported, particularly at a time when it has continued to fall

The Business Council acknowledges the Bill's objective of increasing R&D additionality. However, under the proposed intensity measure the tax benefit for many large companies will more than halve at a time when R&D expenditure is declining.

The R&D Tax Incentive reduces the marginal costs of a firm's R&D activities to encourage businesses to invest in and carry out R&D. It recognises 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.

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.[1] Total spending on R&D as a share of GDP has been falling in Australia for several years, and is below the OECD average.[2] Limiting R&D support for larger businesses could be counterproductive as ABS data show that they have a greater propensity to innovate.[3]

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

Recommendations

- 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.[4] This would go part of the way towards increasing the value of collaborations between these bodies.

- 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. Any changes should be supported by a publicly available performance and accountability framework, suitable oversight and a robust dispute resolution process.

- In measuring R&D intensity, 'total expenses' should reflect 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.

[1] ABS cat. no. 8104.0.

[2] OECD, *Gross domestic spending on R&D (indicator)*, 2018. doi: 10.1787/d8b068b4-en (Accessed on 01 November 2018)

[3] ABS cat. no. 8158.0.

[4] As recommended by *Australia 2030: Prosperity through Innovation* and *Review of the R&D Tax Incentive, 2016*

- 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. The R&D tax offset amount claimed should be disclosed instead of notional deductions, as this will better reflect the benefit received by companies.

R&D intensity should be carefully assessed

The Bill proposes that R&D intensity be calculated as eligible R&D expenditure expressed as a ratio of total expenses. The use of current year expenditure will introduce uncertainty and make it difficult to plan for access to the R&D Tax Incentive. This is because 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 previous years, to provide claimants with more certainty.

The intensity measure would also better reflect commercial realities by including operating expenses and costs of goods but excluding borrowing costs and foreign exchange contracts. This would at least make calculation of the expenditure base neutral with respect to debt and equity finance.

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 large companies have a larger cost base which limits claimable R&D and R&D intensity. For very large companies, the cap means they will be unable to exceed the 2 per cent threshold regardless of their R&D expenditure, resulting 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, contrary to the intent of the legislation. 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.

Compliance costs should be minimised

The R&D Tax Incentive Review noted the $437 million of compliance costs borne by business in the R&D Tax Incentive scheme. Changes to the scheme are an opportunity to reduce administrative complexity to lower compliance costs including fees to tax agents and external consultants. This could also be supported through greater clarity around scope of eligible activities, including case studies, public rulings and guidance notes.

In contrast, the Explanatory Memorandum estimates the proposed changes will increase the average annual regulatory costs by $25 million for business – further eroding support for business R&D.

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 (if material). As at 5 November 2018, there are 70 Business Council member companies who have signed up to the TTC and 152 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 Bill proposes to make public the name of the R&D Tax Incentive claimant as well as its ABN and R&D notional deductions. However, R&D notional deductions represent the amount on which the tax offset is calculated, not the tax benefit derived – which will depend on the size of the company and its R&D intensity (and will not otherwise be known by the public). The distinction between R&D notional deductions and the tax benefit derived is important as R&D expenditure is fully deductible for company income tax purposes. We recommend the amount of R&D tax offset claimed be disclosed instead of notional deductions, as this will better reflect the benefit received by companies.

The Explanatory Memorandum explains that the purpose of this change is to “improve public accountability for R&D claimants and encourage voluntary compliance”. Unfortunately, the proposal is not likely to improve public accountability but instead introduce additional confusion as to how the scheme, and the broader company tax system, operate. This is particularly the case with the two-year delay in publication which, while welcome, potentially compounds this confusion. To illustrate, the existing annual ATO 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. Companies reporting under the TTC would also be providing added context (where material) to their R&D tax offset. An additional ATO publication of R&D notional deductions would relate to yet another different reporting period.

Transition and a period of stability

Tax incentives for R&D have been changed, or changes have been mooted, 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 new arrangements are followed by a period of stability.

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.

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