EY
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Dr Kathleen Dermody
Committee Secretary
Senate Economics Legislation Committee
PO Box 6100
Parliament House
Canberra ACT 2600

6 October 2014

By email - economics.sen@aph.gov.au

Dear Dr. Dermody,

Inquiry into Tax and Superannuation Laws Amendment (2014 Measures No. 5) Bill 2014

Ernst & Young (EY) welcomes the opportunity to comment on the proposed amendment to reduce the rates of the tax offset available under the research and development tax incentive by 1.5 per cent.

In this submission we have set out our observations with respect to the operation of the proposed amendment, its impact upon companies undertaking eligible research and development activity, and the additional implications for R&D entities claiming the R&D tax offset and receiving a Government recoupment for that expenditure.

In summary, we conclude that the proposed amendment to reduce the rates of the tax offset available under the research and development tax incentive by 1.5 per cent as set out in the Tax and Superannuation Laws Amendment (2014 Measures No. 5) Bill 2014 will negatively impact on the net benefit available to R&D entities by 1.5% for expenditure incurred on R&D activity within the financial year ended 30 June 2015. Further to this reduction in the net R&D benefit, the reduction in the rates of the tax offset will have an additional negative 1.5% outcome for R&D entities that access the 38.5% non-refundable credit and also obtain a recoupment from government for the expenditure.

The explanation as to our aforementioned observations and our recommendations with respect to preventing the negative consequences of this rate change are set out below.

Thank you, once again, for the opportunity to present our submission. Should you have any questions in relation to the above, please contact me

Yours sincerely

Robin Parsons
Partner

Research and development tax incentive: reducing the tax offset rates

Schedule 3 to the Tax and Super Laws Amendment Bill proposes to amend the Income Tax Assessment Act 1997 (ITAA 1997) to reduce the rates of the tax offset available under the research and development tax incentive by 1.5 percentage points. The higher (refundable) rate of the tax offset will be reduced from 45 per cent to 43.5 per cent and the lower (non-refundable) rates of the tax offset will be reduced from 40 per cent to 38.5 per cent. This measure, upon being passed into law, will apply to income years starting on or after 1 July 2014.

The intention of the rate reduction is to preserve the relative value of the research and development tax by introducing a 1.5% reduction to the R&D Incentive tax offset rates, consistent with the Government's commitment to cut the company tax rate.

As such, the proposed reduction to the R&D offset purports to achieve the same net benefit post rate reduction as is currently being received by R&D entities. However, the amendment to the R&D offset is planned to be established 12 months prior to the reduction in the company tax rate which will have a negative impact on R&D entities by reducing the R&D benefit by 1.5% for eligible expenditure incurred in the financial year ended 30 June 2015. By way of example, an R&D entity accessing the 38.5% non-refundable R&D offset will be receive a net benefit of 8.5% as opposed to the 10% benefit currently available. Furthermore, an R&D entity accessing the 43.5% refundable R&D offset will be receive a net benefit of 13.5% as opposed to the 15% benefit currently available.

The research and development tax incentive is the primary mechanism by which the Commonwealth seeks to encourage companies to undertake research and development activities in Australia. Thus it is our opinion that such companies should not be negatively impacted through the varying dates of the introduction of the rate changes and it would be in the interests of all parties to amend the rates on the same date.

Although it appears at first instance that the negative impact of a lower net R&D benefit to eligible companies should only occur for one financial year, there is no guarantee that the company tax rate reduction will be passed into law at the proposed time and should any delays or changes occur this would prolong the reduced net benefit for R&D entities. This type of inconsistency can discourage R&D investment by both small and large companies within Australia. As such it would be more consistent to enact both rate reductions from the same date.

Furthermore, provisions exist within the Australian Tax legislation to claw back the additional tax benefit provided by the research and development tax incentive for eligible expenditure where an entity obtains a recoupment from government for the expenditure (subdivision 355-G ITAA 1997). Section 12B of the Income Tax Rates Act establishes the rate of additional income tax for recoupments of R&D activities. This rate is set at 10%. We are not aware of any intention in the Tax and Super Laws Amendment Bill to amend or update this 10% rate. This suggests that an unintended consequence of the reduction of the R&D tax offset rates is a negative 1.5% outcome for R&D entities that access the 38.5% non-refundable R&D offset and also obtain a recoupment from government for the expenditure. In this scenario the entity would potentially be facing 10% recoupment tax but only receive 8.5% net R&D benefit.

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Our recommendations

To the extent that support for R&D cannot be increased by maintaining the R&D tax incentive offset rate, we recommend that the proposed reduction in the rates of the R&D tax offset by 1.5 percentage points be delayed and made effective on the same date as the corresponding reduction to the company tax rate. This would ensure that the R&D benefit levels are preserved. This would prevent the loss of benefit to companies carrying out eligible R&D activity within the financial year ended 30 June 2015.

We recommend continued support and certainty for the broad-based R&D Tax Incentive to drive innovation in all businesses. The alignment of the date of R&D incentive reduction to the company tax rate reduction will also prevent the additional loss to R&D entities that incur R&D expenditure and also receive a Government recoupment for that expenditure.

The above recommendation would be preferable, however should it not be possible to align the R&D incentive and company tax rate adjustments, we would recommend that Section 12B of the Income Tax Rates Act, which establishes a 10% rate of extra income tax for recoupments of R&D activities be amended to reflect the proposed change in the R&D offset rates.