Senate Standing Committees on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

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

13 October 2014

Submission on Tax and Superannuation Laws Amendment (2014 Measures No 5) Bill 2014

Dear Sir/Madam

PricewaterhouseCoopers (PwC) appreciates the opportunity to provide input to the Senate Economics Legislation Committee's inquiry into the Tax and Superannuation Laws Amendment (2014 Measures No 5) Bill 2014 ("the Bill").

Our specific focus is on the proposed changes in the Bill to the rates of the tax offsets available through the Research and Development (R&D) Tax Incentive.

While PwC commends the Government's continued support of the R&D Tax Incentive, we are concerned that these changes to the offset rates will give rise to undesirable and unintended consequences – and therefore diminish some of that support.

Further detail on our position is attached.

Yours faithfully

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1. Background

As part of the 2014-15 Federal Budget, the Government announced that, in line with the 1.5 per cent cut to the company tax rate to 28.5 per cent from 1 July 2015, it intended to maintain the relative value of the R&D Tax Incentive. It proposed to achieve this by making corresponding reductions to the rates of the refundable and non-refundable R&D offsets by 1.5 percentage points, with effect from 1 July 2014.

These changes were based upon reducing:

- the refundable R&D tax offset from 45 to 43.5 per cent (for eligible companies with turnover of less than $20 million); and
- the non-refundable R&D tax offset from 40 to 38.5 per cent (for eligible companies with turnover of greater than $20 million).

The difference in the time at which the decreases in the R&D tax offset rates apply and the reduction in the corporate tax rate (1 July 2014 and 1 July 2015 respectively) will create a real decrease in benefit of 1.5c in the dollar for 12 months for every company that benefits from the R&D Tax Incentive. It is our view that any reduction in the R&D tax offset should coincide with the reduction in the company tax rate to minimise distortion in the net outcomes to companies.

However, in some cases as explained below, some companies will be impacted by the reduction in the R&D tax offset rates **on a permanent basis rather than for just one income year**.

At least two (significant) sets of companies will permanently sustain this full 1.5 per cent cut to their R&D benefit, instead of merely experiencing a short-term (12 month) decrease and then an adjustment coinciding with the corporate tax rate reduction. Namely:

i. companies with more than $5 million in taxable income, and
ii. SMEs and startups with carry forward income tax losses.

In the first case, this is because they will be required to pay another 1.5 per cent in tax following the introduction of the Paid Parental Leave (PPL) Scheme. In the latter case, because the companies receive the R&D benefit as a refund and the rate of that refund is not linked to the corporate tax rate.

In effect, the PPL will neutralise the overall corporate tax cut for those companies subject to the PPL and will mean that their effective tax burden will remain at 30c in the dollar. For those among them that access the R&D Tax Incentive, **this will also cause a permanent reduction in their R&D benefit of 1.5c in the dollar**.

Separately, there will be a full and permanent 1.5 per cent reduction for a range of small companies that receive the R&D Tax Incentive as a refundable offset. This is because these companies forego a tax deduction in favour of receiving a benefit from the R&D Tax Incentive at the full incentive rate, and the amount of their offset is therefore not linked to the corporate tax rate. As a result, **the reduction in the Incentive rate for these companies from 45 per cent to 43.5 per cent will be permanent**.

PwC also notes that one of the reasons for the shift in 2011 from the old tax concession to a tax credit regime was specifically to ensure the Incentive remained unaffected by any revisions to the corporate tax rate.

2. Examples of Application of Current Law

The following examples demonstrate the operation of the law as it currently stands. In effect, there are three separate scenarios across which the Incentive operates.

2.1 Businesses with Aggregated Turnover Greater Than $20 Million

R&D Spend (A)	$ 10,000,000
Tax Offset (Ax40%)	$ 4,000,000
Less Additional Tax Due[1] (Ax30%)	$ 3,000,000
Net Benefit (B)	**$ 1,000,000**
Benefit Rate (B/A)	**10%**

2.2 Businesses with Aggregated Turnover Less Than $20 Million but in Tax Payable Position

R&D Spend (A)	$ 1,000,000
Tax Offset (Ax45%)	$ 450,000
Less Additional Tax Due[1] (Ax30%)	$ 300,000
Net Benefit (B)	**$ 150,000**
Benefit Rate (B/A)	**15%**

[1] Additional tax due arises from the fact that amounts eligible for offset cannot be deducted.

2.3 Businesses with Aggregated Turnover Less Than $20 Million but in Tax Loss Position

R&D Spend (A)	$ 1,000,000
Tax Offset (Ax45%)	$ 450,000
Less Additional Tax Due (in tax loss)	$ 0
Cash Refund (B)	**$ 450,000**
Benefit Rate (B/A)	**45%**

It is important to note that, in the case of SMEs and startups in tax loss which are entitled to receive the Incentive as a refund, the rate of that refund bears no relationship to the corporate tax rate. Accordingly, as is set out below, any reduction to the rate of the Incentive will serve to reduce support provided to those companies regardless of any reductions to the corporate tax rate.

3. Examples of Application of Proposed Law

The following examples demonstrate the proposed future operation of the law as it will apply to each of the three separate scenarios across which the Incentive operates.

3.1 Businesses with Aggregated Turnover Greater Than $20 Million

R&D Spend (A)	$ 10,000,000
Tax Offset (Ax38.5%)	$ 3,850,000
Less Additional Tax Due[1] (Ax28.5%)	$ 2,850,000
Less PPL[2] (Ax1.5%)	$ 150,000
Net Benefit (B)	**$ 850,000**
Benefit Rate (B/A)	**8.5%**

It was intended that the benefit rate of the Incentive would return to 10c in the dollar when the corporate tax rate was reduced to 28.5 per cent from 1 July 2015. However, from this time, the Government also intends to introduce its PPL scheme which will impose a levy equal to 1.5 per cent of taxable income on companies with more than $5 million in taxable income. For the purpose of calculating the benefit of a tax offset, levies of this kind are applied before the offset. Accordingly, for companies subject to the PPL, the total effective tax rate will stay at 30c in the dollar. As a result, a reduction in the offset rate from 40 to 38.5 per cent will **cause a permanent reduction in the**

[2] Assumes company has taxable income greater than $5million and subject to the PPL. Although the legislation for the PPL Scheme has yet to be publicly released, levies are generally applied before offsets.

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Incentive rate.

3.2 Businesses with Aggregated Turnover Less Than $20 Million but in Tax Payable Position

R&D Spend (A)	$ 1,000,000
Tax Offset (Ax43.5%)	$ 435,000
Less Additional Tax Due (Ax28.5%)	$ 285,000
Less PPL[3]	$ 0
Net Benefit (B)	**$ 150,000**
Benefit Rate (B/A)	**15%**

Many companies with a turnover of less than $20 million are unlikely to have taxable income of more than $5 million. As a result, they are likely to have an effective tax rate of 28.5 per cent – and the reduction of the Incentive rate to 43.5 per cent will not cause a decrease in benefit.

3.3 Businesses with Aggregated Turnover Less Than $20 Million but in Tax Loss Position

R&D Spend (A)	$ 1,000,000
Tax Offset (Ax43.5%)	$ 435,000
Less Additional Tax Due (in tax loss)	$ 0
Cash Refund (B)	**$ 435,000**
Benefit Rate (B/A)	**43.5%**

Unlike the example immediately above, the rate of benefit for companies eligible to receive the R&D Tax Incentive as a refundable offset who have carry forward tax losses (generally small start-up enterprises), is not linked to the corporate tax rate. This is because these companies are not exposed to income tax due to their losses. Accordingly, a reduction in the Incentive rate from 45 to 43.5 per cent represents **a permanent fall in the level of Government support**.

[3] This assumes that the company does not have taxable income of greater than $5 million.