

TAX AND SUPERANNUATION LAWS AMENDMENT (2014 MEASURES NO. 5) BILL 2014

Submission to the Economics Legislation
Committee on the proposed reduction in the R&D
Tax Incentive

October 2014

ABOUT RESEARCH AUSTRALIA

Research Australia is an alliance of 160 members and supporters advocating for health and medical research in Australia. Research Australia's activities are funded by its members, donors and supporters from leading research organisations, academic institutions, philanthropy, community special interest groups, peak industry bodies, biotechnology and pharmaceutical companies, small businesses and corporate Australia. It reflects the views of its diverse membership and represents the interests of the broader community.

Research Australia's mission is to make health and medical research a higher priority for the nation. We have four goals that support this mission:

- A society that is well informed and values the benefits of health and medical research.
- Greater investment in health and medical research from all sources.
- Ensure Australia captures the benefits of health and medical research.
- Promote Australia's global position in health and medical research.

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TAX AND SUPERANNUATION LAWS AMENDMENT (2014 MEASURES NO. 5) BILL 2014

SUBMISSION TO THE ECONOMICS LEGISLATION COMMITTEE ON THE PROPOSED REDUCTION IN THE R&D TAX INCENTIVE

INTRODUCTION

Research Australia is pleased to have the opportunity to make this submission in respect of the proposed amendments to the R&D Tax Incentive contained in Schedule 3 of the *Tax and Superannuation Laws Amendment (2014 Measures No. 5) Bill 2014* (the Bill).

The current R&D Tax Incentive was introduced with effect from 1 July 2011. While there is currently little publicly available data about its effectiveness it is clear that the take up has been greater than expected and anecdotally it has provided an important boost to Australian private sector research and development (R&D). The current proposal to reduce the rate the R&D Tax Incentive by 1.5% is purported to be necessary to preserve the R&D tax incentive's value relative to the proposed lower company tax rate of 28.5%. This argument ignores the fact that the reduction in the company rate is linked to the introduction of the Government's proposed Paid Parental Leave (PPL) scheme and neither of these measures is certain; and for larger companies the reduction in the tax rate will be offset by the new PPL levy.

More importantly, many smaller companies which receive the refundable R&D Tax incentive are paying little or no tax because they are in a research intensive start up phase. The reduction in the corporate tax rate will not offset the reduction in the R&D Tax Incentive for many of these companies.

For these reasons research Australia is opposed to the proposed reduction in the R&D tax incentive.

SUPPORTING AUSTRALIAN R&D

Fundamentally, the R&D Tax Incentive is an industry support measure rather than a tax measure. The Tax system may be the mechanism by which this support is delivered but it is designed to provide government support for industry R&D.

The current scheme was introduced with effect from 1 July 2011, with the aim of providing a more targeted and streamlined scheme for the support of productive Australian R&D. It consists of two components, the Refundable and Non-refundable R&D Tax Incentives.

While the Budget Papers state that ‘Consistent with the Government’s commitment to cut the company tax rate from 1 July 2015, the Government will preserve the relative value of the of the Research and Development Tax Incentive by reducing the rates ...’ it is nonetheless clear that the reduction in R&D Tax Incentive is not revenue neutral for companies engaged in R&D, with the measure ‘estimated to provide a gain to the Budget of \$620 million in fiscal balance terms over the forward estimates period.’¹

And this will be occurring at a time when overall Australian Government support for R&D is already at historically low levels.²

Why support R&D?

The recent closure of the car industry in Australia has helped to make Australians more conscious of our reliance on the resource industries. In an address to the Sydney Institute on 9 September 2014, the Industry Minister, the Honorable Ian MacFarlane made the following observation

‘From an economy that was historically built around farming and agriculture, through to heavy manufacturing and commodity based industries that have been the mainstay of our economy in recent decades, we are now on the cusp of a third wave – the transition into higher value-added industries that are based on innovation, research and the sophisticated skills base of our workforce.’

In the same speech, the Minister outlined the Government’s strategy.

‘The Abbott Government has taken significant strides down this road, ending the mentality of Government knows best and heavy Government intervention in industry through endless cash programmes and handouts. Certainly, Government programmes have a role to play in assisting Australian industry through its next phase. But the focus of those programmes should be to set the right context for investment and industry-led growth – not to interfere or mandate the course for businesses through subsidies or handouts.’

The R&D Tax Incentive is a great example of this approach. It provides an incentive for innovative companies to spend money on R&D in areas they determine, without the Government mandating what areas the R&D should apply to or ‘picking winners’.

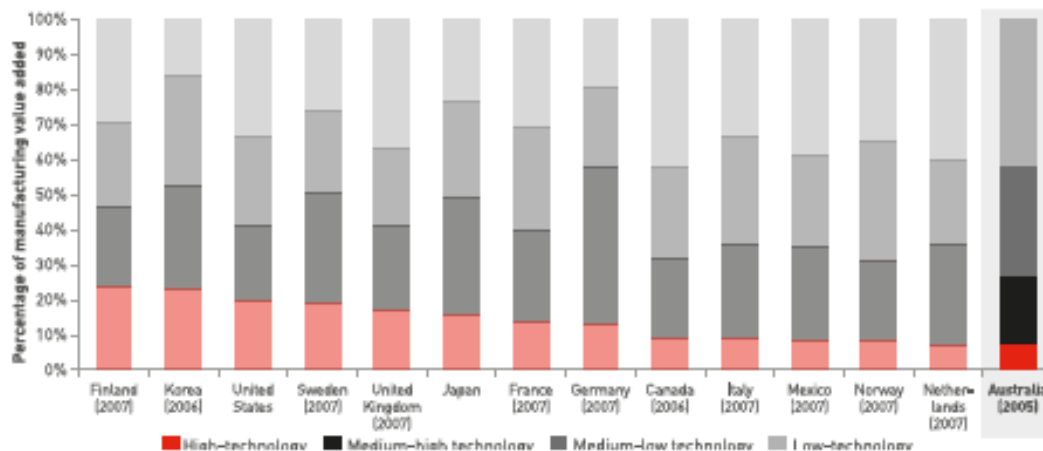
Research Australia shares the Minister’s view that Australia’s manufacturing future lies with higher value-added industries. Globally, manufacturing in developed countries is shifting towards high tech industries.

¹ Australian Government, *Budget Papers No.2 2014-15*, p.18

² Parliament of Australia, Department of Parliamentary Services, 17 September 2014 *Australian Government Support for R&D, 1978-79 to 2014-15*

The proportion of Australian manufacturing that is high tech is lower than our peers, as the following table demonstrates.³

**Chart 1.2 Value added in manufacturing output, by technological intensity classes, 2008, by country
(As a percentage of manufacturing value added)**



Sources: OECD Structural Analysis Database (STAN); ABS (2009) Experimental Estimates for the Manufacturing Industry, cat. no 8159.0.

Note: The chart is based on the Technology intensive classification of manufacturing as part of the International Standard Industrial Classification (ISIC)— Revision 3.⁴²

Australia’s top 20 manufactured goods in 2012-13 were still dominated by low to medium technology exports, notably refining of minerals and food, but there is evidence that this is changing. Our exports with highest growth in value are in high technology fields. The largest increases were in scientific instruments (largely medical), and medicinal and pharmaceutical products as the following table illustrates.⁴

³ Department of Industry, 2013, Australian Innovation System Report 2013, p.27

⁴ Prime Minister’s Manufacturing Taskforce, 2012, Smarter manufacturing for a Smarter Australia- report of the non-government members, p. 23.

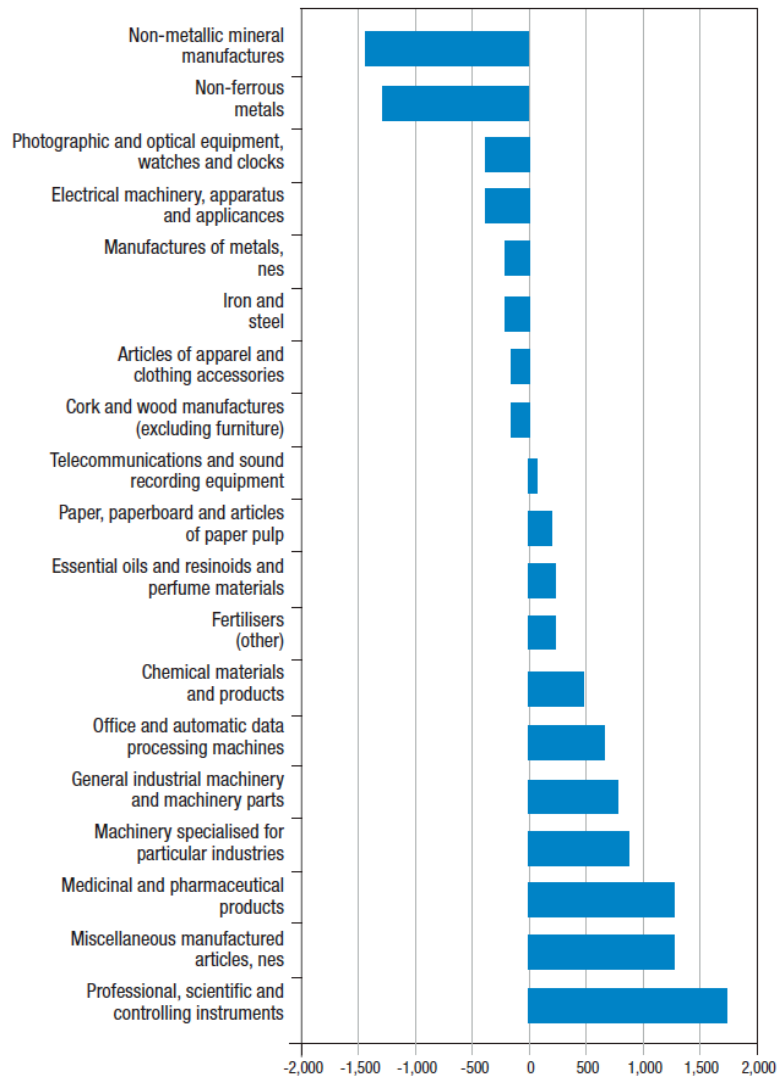


Figure 2.15
SELECTED AUSTRALIAN MANUFACTURED GOODS EXPORTS
Change from 2002 to 2012, annualised from June quarter to March quarter, chain volume measures – \$m

Source: 5302.0 Balance of Payments and International Investment Position, Australia, Table 103. Merchandise exports, chain volume measures, March quarter 2012.

All of these areas are underpinned by scientific research, and are R&D intensive. They all benefit from the R&D Tax Incentive.

Lack of Capital

One of the critical issues facing innovative, research intensive Australian companies is a lack of capital.

The below table highlights the relatively low availability of risk capital to support innovative Australian start up companies.⁵

⁵ Ibid, p.76

Figure 5: Top world start-up ecosystems, 2012



Source: Author's elaboration, based on Telefónica Digital and Startup Genome, 2012.
Note: The bubble size indicates the positioning of each territory in the total ranking, where Silicon Valley ranks at the top (i.e., 20) and Santiago at the bottom (i.e., 1). In each index, Silicon Valley is assumed to be the reference and it ranks at the top (i.e., it scores 20). The funding index measures the availability of risk capital in each start-up ecosystem, while the talent index ranks the skills of the start-up founders in each territory, taking into account different variables including age, education, work experience, and industry domain expertise, among other factors.

More recently, the Australian Bureau of Statistics has reported that a lack of funds was a barrier for innovation for 20% of Australian businesses.⁶

The R&D Tax Incentive helps to address this issue, particularly the Refundable Tax Incentive available to smaller companies. It provides access to additional capital, linked directly to the company's expenditure on R&D. If the Australian Government is serious about boosting Australian R&D and promoting higher value added industries, cutting the R&D Tax Incentive is not the way to go about it.

Research Australia submits that the reduction in the rates of the Refundable and Non-refundable R&D Tax Incentives should be rejected by the Senate because it will reduce an important form of Australian Government support for the industry led R&D that is essential to commercialising Australia's investment in research and developing Australia's high value manufacturing sector.

REFUNDABLE R&D TAX INCENTIVE

The most significant component is the Refundable R&D Tax Incentive. Available only to entities with annual turnover of less than \$20 million, it provided \$4.96 billion in support for R&D by these companies over the first three financial years of its operation, from 2011-12 to 2013-14. Over the same period, the Non-refundable R&D tax incentive provided \$2.53 billion in support to companies with annual turnover in excess of \$20 million. In other words, two thirds of the total expenditure on the R&D Tax incentive has been to smaller companies through the Refundable component.⁷

This is important for a couple of reasons. First of all, it shows that the support is being directed to where it is most needed- to small companies seeking to develop new products. And the reason that this scheme

⁶ ABS, Cat. No. 8158.0, Innovation in Australian Business 2012-13

⁷ Australian Government, 2014-15 Science, Research and Innovation Budget Tables, Table 4

provides a refundable benefit is because the **tax offset can exceed the income tax payable** by these companies.

This point is critical when considering the rationale for the reduction in the rate of the R&D tax offset by 1.5%, which is to maintain relativity with the proposed 1.5% reduction in the company tax rate. Putting aside the concerns about whether the reduction in the company tax rate will actually occur, on face value it appears that the reduction in the rate of the R&D tax incentive will be revenue neutral for the companies involved- i.e the benefit of the R&D tax incentive will be reduced by 1.5% but this loss will be made up by a corresponding reduction in income tax paid. However, this reasoning is fundamentally flawed; it assumes that the companies receiving the refundable R&D tax incentive are paying sufficient income tax to receive the benefit of the reduction in the tax rate. This is clearly not the case; many of these companies are paying little or no income tax because they are operating at a loss for many years while they are in the process of developing products for market. This fact is recognised in the design of the R&D Tax incentive, and is the reason why the refundable component is refundable- i.e. it is **expected** that the value of the R&D tax incentive will exceed the value of the tax payable. In this situation, the reduction in the rate of the R&D tax incentive is not 'revenue neutral', and in fact results in a direct reduction in the support provided to small innovative companies in their early stages when need it most.

Companies like Sementis Ltd, a Melbourne based biotech company working with the University of South Australia at the University's Experimental Therapeutics Laboratory to develop vaccines for a range of conditions.

Companies like Bionomics Ltd, a biopharmaceutical company dedicated to making better treatments for cancer, central nervous system disorders such as anxiety, depression and Alzheimer's Disease.

“The Australian R&D Tax Incentive is an important factor contributing to the success of Bionomics' partnering strategy. The cash refund enables Bionomics to undertake additional R&D than would otherwise be possible,” said Dr Deborah Rathjen, Bionomics' CEO and Managing Director.⁸

Companies like Pharmaxis Ltd., a specialist pharmaceutical company, founded on an Australian discovery, that researches, develops and commercialises new therapies for undertreated respiratory diseases.

These companies, like many others, have all been recipients in recent years of a refundable R&D Tax incentive that exceeded their tax liability.

The consequence of the proposed amendment will be to reduce the level of Government support for the R&D undertaken by these and thousands of other small research intensive companies, **even if the company tax rate is reduced by a corresponding amount.**

Research Australia submits that the reduction in the rate of the Refundable R&D Tax Incentive should be rejected by the Senate because it will reduce an important form of Australian Government support for Australia's small innovative companies seeking to commercialise industry led R&D and which will not benefit from the proposed reduction in the company tax rate.

⁸ Bionomics Ltd, ASX Announcement, 1
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NON-REFUNDABLE TAX INCENTIVE

The Non-refundable tax R&D Tax Incentive is available to eligible companies with annual turnover in excess of \$20 million, and as already noted, accounts for approximately one third of all expenditure on the R&D tax Incentive. While non-refundable, any unused portion can be carried over to future years.

The reduction in the rates of both the refundable and non-refundable R&D Tax Incentive proposed in the Bill will take effect from 1 July 2014 if the Bill is passed. This is despite the fact that the proposed reduction in the company tax rate to 28.5% will take effect from 1 July 2015.

Even if the PPL levy is introduced and the company tax rate is reduced, the effect on companies which are liable for the levy will be to reduce the net benefit they receive after the impost of the PPL levy is taken into account. The only companies that may not be adversely affected are those companies with annual turnover in excess of \$20 million that are not liable for the PPL levy.

Research Australia submits that the reduction in the rate of the Non-refundable R&D Tax Incentive should be rejected by the Senate because it will reduce an important form of Australian Government support for industry led R&D that is essential to commercialising Australia's investment in research and developing Australia's high value manufacturing sector. Many recipients of the Non-refundable R&D Tax Incentive will be adversely affected by this proposed change because the proposed reduction in the company tax rate will be offset by the imposition of the PPL levy

UNCERTAINTY SURROUNDING THE PAID PARENTAL LEAVE SCHEME AND THE REDUCTION IN THE COMPANY TAX RATE

The proposed reduction in the company tax rate of 1.5% is designed largely to offset the 1.5% levy on large companies which is intended to fund the PPL scheme. At this stage, no legislation is before the Parliament for either the PPL scheme, the associated levy or the reduction in the company tax rate. If the Bill to reduce the R&D Tax Incentive is passed by the Senate, there is a significant risk that the R&D Tax Incentive will be reduced without the concomitant reduction in the company tax rate.

Research Australia submits that the reduction in the rate of the Non-refundable R&D Tax Incentive should be rejected by the Senate because there is no certainty that the other measures to which it is linked – the PPL scheme and the reduction in the company tax rate- will actually be implemented, or when this will occur. Even if these other measures are implemented in some form there is a strong likelihood that the measures will be delayed or varied.

The rationale for the proposed reduction in the R&D Tax Incentive is entirely dependent on the passage of the other measures in the manner proposed and in the timeframe proposed. At a minimum, Schedule 3 of the Bill should be withdrawn and reintroduced if and when the reduction in the company tax rate is introduced to Parliament.

CONCLUSION

Research Australia has been pleased to have the opportunity to make this submission in respect of Schedule 3 of the *Tax and Superannuation Laws Amendment (2014 Measures No. 5) Bill 2014*.

Private sector R&D is critical to Australia's future prosperity as a nation. The R&D Tax Incentive is a relatively new scheme introduced to better target and streamline Australian Government support for private sector R&D and the indications are that it is succeeding, with the bulk of the funds flowing to small to medium sized companies. The proposed reduction in the R&D Tax Incentive occurs at a time when Australia needs to boost rather than wind back its support for R&D. The proposal to reduce the R&D Tax Incentives is misconceived and short sighted, and Schedule 3 of the Bill should be rejected by the Senate.

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