R&DTI – SENATE COMMITTEE APPEARANCE (31 JANUARY 2019)

Questions taken on notice

1. **Obviously, there has been a cost blowout in this measure that we've been referring to throughout the hearings since it was introduced in 2011. I'm wondering—and I think I might have asked this on notice—whether you have a breakdown of how the R&D tax incentive is distributed across industries.**

This answer was provided separately.

2. **I can put it on the record now, if you like. The tax office told us that, in 2015-16, there was $6.8 billion in claims made; in 2017, it was $6.1 billion; in 2018, it was $5.1 billion; and, on average, there were around 13,000 organisations that made those claims. I'm wondering, of those 13,000 organisations, what industries they fell in, in dollar terms and, I suppose, in numbers too—because it would also be interesting to know what size companies are making these claims. Are they small companies? Are they start-ups? Are they large and established companies? My concern, I suppose, is that the R&D tax incentive seems to be a one-size-fits-all instrument that we are using across a number of very different and often quite new and nuanced industries. I wonder whether that was something that was considered when the policy that we have before us today, particularly the intensity measure, was put together.**

This answer was provided separately.

3. **You might, however, be able to give me an indication about the second half of that question, which is: how, when the policy was being developed, was the difference in industries that claim the R&D tax incentive considered, in particular with regard to the intensity measure, which seems to be the most controversial part of the legislative change?**

The 2016 Review found that among larger companies, those with greater R&D intensity are more likely to reinvest the tax benefit provided into additional R&D and so provide greater spillover benefits to the Australian economy. The program is being better targeted towards these high R&D intensity companies to induce more additional R&D expenditure, realise greater spill-over benefits and provide a better return for the support provided by the taxpayer.

For taxpayers who don't conduct high-intensity R&D, unlike alternative intensity proposals put forward by the Review and the Innovation and Science Australia (ISA) 2030 Plan, the R&D Premium provides a minimum four per cent rate of support to encourage companies to undertake R&D. This will provide claimants with some certainty as to their minimum benefit under the program.

4. **We've heard from many submitters that they support the intent of the bill, but many are concerned about the way that R&D intensity is calculated. Specifically, they claim that it discriminates against companies with certain business structures compared to others. It punishes companies with a high cost of goods sold, such as commodities businesses such as agribusiness, because the high cost of goods sold dilutes their R&D intensity; and, indeed, it favours organisations that might offshore their manufacturing, like the car industry, which has R&D onshore in Australia but doesn't manufacture here. I'm wondering how the formula for measuring the R&D intensity used in this bill was decided upon.**

The intensity measure is intended to incentivise high-R&D intensity companies, an approach that the Review found would provide the greatest spill-over benefits to the Australian economy. The Review also found that by "directing policy toward high-potential entrants and R&D-intensive companies, greater overall additionality could be achieved per dollar of tax revenue forgone." Excluding certain expenditure or expenses would not reflect the true R&D intensity of the firm and would be inconsistent with the Review's findings.

Tailoring to individual industries, for example, by creating specific exclusions from total expenditure, increases complexity for both the claimants and the ATO. Allowing exclusions would also increase integrity risks to the system.

As noted in the Review, "the sectoral breakdown of R&D intensity can be expected to vary over time as technology matures in some sectors and new technology emerges in others. *This helps to make an intensity measure more robust to sectoral biases over time* than within a particular year."

In addition, significant direct support is provided for key sectors which conduct R&D, such as through the Export Finance and Insurance Corporation (EFIC), and the Northern Australia Infrastructure Facility (NAIF). In the 2017-18 Budget the Government provided $100 million over five years to establish an Advanced Manufacturing Fund.

All eligible larger businesses will continue to receive at least 4 percentage points of support above their company tax rate, in recognition of the valuable R&D they undertake. While rewarding companies with higher R&D intensity, the R&D Premium still supports companies that undertake lower-intensity R&D activities.

5. **Thank you. Could you also, please, let us know whether any alternative formulae were considered, because there have been some submitters that have suggested alternative formulae. Dulux suggested that intensity could potentially be measured—it's a little bit like golf; you play against yourself as opposed to a broader industry—based on last year's results and how much R&D you are doing this year compared to last year rather than how much R&D a paints and chemicals organisation like Dulux did compared to an organisation that does agribusiness or a fintech, for instance.**

The Review recommended the introduction of an intensity threshold in the order of 1 to 2 percent for recipients of the non-refundable component of the R&D Tax Incentive, such that only R&D expenditure in excess of the threshold attracts a benefit. The Review noted that "the most straightforward way to define R&D intensity is as a proportion of total business expenses (including R&D expenditure). This approach takes advantage of information already collected for income tax purposes minimising additional complexity."

The ISA 2030 Plan considered that the intensity threshold recommended by the Review should be replaced with a trigger set at 1 per cent of total annual expenditure, such that all R&D expenditure is claimable (subject to any other limits) once the trigger level is reached.

An R&D intensity threshold, as recommended by the Review, would have reduced the R&D offset for all large companies claiming R&D and removed the R&D offset altogether for a significant number of companies below the intensity threshold. The ISA 2030 Plan recommendation would have also removed the R&D offset altogether for many companies below the intensity threshold. Compared to the two alternatives the Government's reforms continue to provide support to all claimants, with a minimum 4 percentage point rate of support for low intensity companies and a greater benefit to companies with higher R&D intensities.

In relation to applying specific intensity rates to different industries, the Review noted that "the sectoral breakdown of R&D intensity can be expected to vary over time as technology matures in some sectors and new technology emerges in others. *This helps to make an intensity measure more robust to sectoral biases over time* than within a particular year."

A measure which compares R&D intensity between years, such as that suggested by Dulux, may be open to manipulation, for instance, through the timing of investment decisions. The previous R&D Tax Concession program in 2001 compared R&D expenditure between years and, on review, was found to be manipulated by claimants. The review noted that investment decisions were being driven more by financial reward rather than by business R&D imperatives. It was removed from the program with the introduction of the R&D Tax Incentive in 2011.

6. **There is also a little bit of concern that the capping of the refundable portion of the R&D tax incentive at $4 million will punish smaller companies, particularly start-ups and emerging miners. That is the one we heard most of. The Association of Mining and Exploration Companies has claimed that this will be an impediment to successful mining in Australia and will force it to be less internationally competitive, particularly for some of those industries that in all other circumstances we are trying to encourage—things like rare earth. Where did the decision to cap the refundable portion of the R&D tax incentive come from? How did you land at $4 million?**

The Review recommended the introduction of a $2 million cap on annual cash refunds. The ISA 2030 Strategic Plan recommended instead a $4 million cap on cash refunds, with a $40 million lifetime limit on cash refunds. After extensive stakeholder consultation and feedback, the Government is introducing a $4 million annual cap on cash refunds, with no lifetime limit and with eligible R&D expenditure on clinical trials not counting towards the cap.

Under the proposed reforms, in order to reach the $4 million annual cap, a company would need to spend in excess of $9.75 million on eligible R&D in 2018-19. Companies with the capacity to spend this much on R&D while in tax loss are generally sophisticated businesses, as they are likely to have access to resources or finance that may allow them to incur the R&D expenditure in advance of receiving the tax offset. Treasury estimates that approximately 20 companies will be affected by the $4 million annual cap, out of a population of over 10,000 SMEs currently accessing the refundable element.

The Government also provides a range of tax incentives to the mining sector, such as the Junior Minerals Exploration Incentive and immediate deduction for depreciating assets used in exploration or prospecting. In addition to tax incentives, the Government provides direct support through the Export Finance and Insurance Corporation (EFIC) and the Northern Australia Infrastructure Facility (NAIF).

7. If this bill is implemented, how will our R&D tax incentive stack up to similar tax incentives in other developed nations?

Any comparison of R&D tax incentives across countries is complex and should be done with caution as it necessitates looking beyond the headline rates of support. Companies take into account a number of factors when considering where to undertake their R&D, such as the regulatory environment, corporate taxation, access to a skilled workforce and factors related to intellectual property. Tax incentives are only one element in this complex assessment.

Consideration needs to be given to other relevant factors such as the type of tax concession on offer (volume based, incremental or some other variant), what expenses are allowed within the tax incentive and whether there are any limits or caps, in addition to other economic considerations such the level of company tax and other available concessions.

Details on R&D tax incentives can be found in the OECD *Compendium of R&D Tax Incentive Schemes: OECD Countries and Selected Economics, 2017.* The report notes that South Korea and Japan have intensity components in calculating the rate of support for large companies.

The 2016 Review found that the program's definition of R&D, which is based on the Frascati manual, meets international best practice and that it is fit for purpose. Australia's R&D Tax Incentive has one of the broadest definitions of eligible R&D expenditure, and as such R&D expenditure that would attract a benefit in Australia may not attract a benefit in other countries.