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AUSTRALIAN SENATE

ECONOMICS LEGISLATION COMMITTEE

**CONSIDERATION OF LEGISLATION
REFERRED TO THE COMMITTEE**

***TAXATION LAWS AMENDMENT
BILL (NO. 3) 1997***

JUNE 1997

Parliament of the Commonwealth of Australia

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Senate Economics Legislation Committee

(as at 3 June 1997)

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Contents

Membership of the Committee	iii
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REPORT

Background to the inquiry	1
The status quo	1
The bill	2
Comment of Senate Standing Committee for the Scrutiny of Bills	3
Financial implications	3
Issues raised in submissions	3
The Government's view	4
Comment	4
Summary and recommendations	4
Minority Report	5
By Senators Jacinta Collins, the Hon. Peter Cook and the Hon. Nick Sherry	
Appendices -	
Appendix 1: list of submissions	9

Abbreviations

IR&D Act	<i>Industry Research and Development Act 1986</i>
R&D	research and development

Report

Background to the inquiry

The bill was introduced into the House of Representatives on 26 March 1997. On 13 May the Senate, on the recommendation of the Selection of Bills Committee, referred schedule 11 of the bill (relating to industry research and development) to the Economics Legislation Committee for examination and report by 16 June.

The Committee invited submissions from those who gave evidence on the same matter at a hearing (22 November 1996) on *Taxation Laws Amendment Bill (No. 3) 1996*. The Committee received 2 submissions (see APPENDIX 1).

The status quo

The *Industry Research and Development Act 1986* (IR&D Act) and related amendments to the *Income Tax Assessment Act 1936* established a scheme of tax concessions for industry research and development (R&D). In July and August 1996 the government changed the scheme in various ways intended to improve its cost-effectiveness and contain the growth of the tax expenditure. These changes were debated in this Committee's inquiries into the *Industry Research and Development Amendment Bill 1996* and the *Taxation Laws Amendment Bill (No. 3) 1996*. The Committee's reports on these inquiries should be consulted for details.¹

The present bill makes further minor changes on two matters - the transitional provisions associated with the abolition of syndicated R&D, and the deductibility of core technology by partnerships.

Abolition of syndicated research and development - transitional provisions

One element of the R&D tax concession scheme was the facility for companies to register jointly under section 39P of the IR&D Act - popularly known as 'syndication'. Syndication usually involved a research company and a financier, and in essence worked by allowing a research company with accumulated tax losses to exchange them for R&D funds. The government abolished R&D syndication on 23 July 1996, saying:

'... current arrangements with regard to syndication have become focussed on tax minimisation rather than the provision of genuine R&D.... These unintended tax benefits have made it impossible for the Government to allow further syndication of R&D.'²

Legally, the change was effected by *Taxation Laws Amendment Act (No. 3) 1996*, which changed the IR&D Act to prohibit the Industry Research and Development Board from registering companies jointly.³ There are some transitional provisions, of which the one

¹ Senate Economics Legislation Committee, Report on Industry Research and Development Amendment Bill 1996, October 1996; Report on Taxation Laws Amendment Bill (No. 3) 1996, December 1996

² *Government Closes R&D Syndication*, joint statement by Treasurer and Minister for Industry Science and Tourism, 23 July 1996

³ *Taxation Laws Amendment Act (No. 3) 1996* received royal assent on 19 December 1996 and (on this matter) is retrospective to 23 July 1996, the date of the government's announcement.

relevant to the present bill is that under certain conditions the Board may extend the registration of an existing syndicate to allow it to complete an existing project. If the Board later comes to the view that the syndicate is breaching a condition of the extended registration, it must give a certificate to the Commissioner for Taxation detailing the breach.

Deductibility of core technology

Under the pre-23 July 1996 scheme core technology was deductible in full in the year of purchase - a concessional element since otherwise it would normally only be deductible over its whole life. Under the post-23 July 1996 scheme core technology expenditure is only deductible in any one year to a limit of one third of the related R&D expenditure in that year (undeducted amounts of core technology expenditure may be carried forward). The reason for the more restrictive rule was that the government considered that immediate deductibility of core technology, coupled with speculative and unverifiable core technology valuations, was a key driver of syndicates' excessive tax benefits.⁴

Legally, the change was effected by *Taxation Laws Amendment Act (No. 3) 1996*. However the government wished to exempt existing syndicates from the new rules, as a fair transitional provision. In the bill for the *Taxation Laws Amendment Act (No. 3) 1996* this was done by expressing that the new core technology rules did not apply to partnerships; and by defining 'partnership' as limited to • a syndicate of companies jointly registered under section 39P of the IR&D Act, or • a Co-operative Research Centre. The effect of this would be that existing syndicates are exempt from the new core technology rules, but since no new syndicates are being registered, the number of partnerships (as defined) with rights under the old core technology rules would gradually reduce as existing syndicates wind up.

In the course of amendments to the bill the restrictive definition of 'partnership' was deleted, but the clause exempting partnerships from the new core technology rules was retained. This has the unintended effect that companies individually registered under the IR&D Act can form partnerships to avoid the new core technology deduction rules.

The bill

Abolition of syndicated research and development - transitional provisions

The intended scheme of the *Taxation Laws Amendment Act (No. 3) 1996* is that the IR&D Board certifies to the Commissioner for Taxation a breach of conditions of extended syndicate registration, and the Commissioner uses the certificate as the basis for denying deductibility of ineligible expenditure. The bill for the *Taxation Laws Amendment Act (No. 3) 1996* included a section giving the Commissioner this power, but during amendments this section was inadvertently removed.⁵ The present bill replaces it.

Deductibility of core technology

⁴ Senate Economics Legislation Committee, *Report on Taxation Laws Amendment Bill (No. 3) 1996*, December 1996, p95-6

⁵ *Taxation Laws Amendment Bill (No. 3) 1996*, schedule 4 division 2 p48; *Votes and Proceedings of the House of Representatives*, 12 December 1996 pp1043,1046

The *Taxation Laws Amendment Act (No. 3) 1996*, which enacted new, more restrictive rules for deducting core technology expenditure, has the unintended effect that companies individually registered under the IR&D Act can form partnerships to avoid the new rules. The present bill closes this loophole. It is retrospective to 13 December 1996, the date of the Treasurer's announcement that the government would introduce legislation to close the loophole.⁶ Existing syndicates remain exempt from the new rules, as the government always intended. The government has abandoned its previous intention to exempt Co-operative Research Centres from the new rules.⁷

Comment of Senate Standing Committee for the Scrutiny of Bills

The Senate Standing Committee for the Scrutiny of Bills has a brief to inspect all bills and report on (among other things) whether they trespass unduly on personal rights and liberties. The Committee had no concerns about the research and development provisions of this bill.⁸

Financial implications

The government comments -

'The amendments should largely restore the expected revenue gains from the R&D measures proposed in Taxation Laws Amendment Bill (No. 3) 1996.'⁹

Issues raised in submissions

One submission opposed the bill (submission 2, Technology Resources Australia). Its arguments are about government policy on R&D generally, and the merit of the new core technology rules in principle - matters debated in this committee's inquiry into the bill for the *Taxation Laws Amendment Act (No. 3) 1996*. The submission does not address the particular question of this bill - that is, why companies in partnership should be able to use the old core technology rules while companies not in partnership cannot.

The submission of Axiom R&D Management Pty Ltd supported the bill, as being appropriate to close a loophole in the *Taxation Laws Amendment Act (No. 3) 1996* (submission 1).

⁶ Costello, the Hon. P, *House of Representatives Hansard* 12 December 1996 p8544

⁷ That is, the clause of of *Taxation Laws Amendment Bill (No. 3) 1996* defining 'partnership' to include a Co-operative Research Centre has no correlate in the present bill. *Taxation Laws Amendment Bill (No. 3) 1996*, schedule 4, item 11

⁸ Senate Standing Committee for the Scrutiny of Bills, *Alert Digest* 6 of 1997, 7 May 1997, p28

⁹ Costello, the Hon, P, *Taxation Laws Amendment Bill (No. 3) 1997 - Explanatory Memorandum*, p7

The Government's view

The government's reasons for the bill are expressed in the government's second reading speech:

'On 13 December 1996 the Treasurer announced that the Government would move amendments to the R&D tax concession to ensure that companies in partnerships could not recreate undesirable syndicate like features. To that end, the Bill ensures that limits on core technology deductions that came into effect on 23 July 1996 will apply to companies in partnership in the same way as to other companies. One of the worst aspects of syndicated R&D related to the immediate deduction of expenditure on overvalued core technology. The Bill also authorises disallowance of deductions of R&D syndicates, where an extension of the syndication period has been granted but the syndicate has breached a condition of that extension.'¹⁰

Comment

The present bill does no more than remedy unintended effects of the *Taxation Laws Amendment Act (No. 3) 1996*, effects caused inadvertently by amendments made to the bill for that act.

Summary and recommendations

THE COMMITTEE RECOMMENDS that the bill should be passed.

Senator Alan Ferguson
Chairman

¹⁰ Miles, the Hon. C, *House of Representatives Hansard* 26 March 1997 p3206

Minority Report on the Taxation Laws Amendment Bill (No. 3) 1997

Overview

This legislation arises from the Government's short-sighted and counterproductive attack on industrial research and development (IR&D) both before and as part of the 1996-97 Budget.

Labor opposed the main elements of this attack, the reduction of the R&D tax concession from 150 per cent to 125 per cent and the cessation of R&D syndication. Although it was able to win some concessions on retrospective aspects of the measures last year, Labor was not successful in defeating these anti-innovation, anti-growth and anti-job decisions.

Australia is already seeing the tragic impact of these decisions on the national IR&D effort.

According to the Government's own *Science and Technology Budget Statement 1997-98*, Government support for IR&D will fall to \$487 million in 1997-98, half the level reached in 1995-96.¹¹

Of particular concern is emerging evidence of a collapse in the amount of R&D being carried out by industry. Labor warned last year that the axing of the R&D tax concessions would mean that business would walk away from R&D in Australia, particularly as some countries offer incentives of up to 200 per cent.

The Government appears to have severely underestimated the impact of these measures. In last year's *Science and Technology Budget Statement* the Government estimated that in terms of the tax concession cuts, "the effect of Government actions on the wider community" would be a reduction from \$810 million in 1995-96 to \$547 million in 1996-97.¹²

As significant as that cut was, this figure has now been revised downwards by a further \$200 million in this year's Budget Statement, to \$348 million, with a further fall expected to \$286 million in 1997-98.¹³

Clearly, industry has significantly wound-back its R&D effort, to a far greater extent than projected in the 1996-97 Budget.

The impact of the Government's actions appear to have fallen particularly heavily on manufacturing industry. As the submission from TRA notes:

- "Government support for manufacturing industry and R&D is forecast to fall by over 80% between 1996/97 and the year 2000.
- "In 1997-98, Government support will only be 69% of what it was in 1995/96 (\$1221.3m).

¹¹ Science and Technology Budget Statement, 1997-98, Summary Table.

¹² Science and Technology Budget Statement, 1996-97, pp. 3.18-19.

¹³ Science and Technology Budget Statement, 1997-98, pp. 3.18-19.

- "The 17.6% increase in support for manufacturing in 1997/98, excludes the effect of the dramatic reduction in the use and value of the taxation concession."

TRA went on to argue that "Taken together with the Government's series of earlier changes, TRA believes that Australia is moving close to a situation where there are net disincentives to carry out research and development in this country."¹⁴

Syndicated R&D

In terms of the Government's abolition of syndicated research and development, this was justified on the basis that the system was being 'rorted'.

Labor has always supported measures to ensure that tax concessions are used for the purpose for which they are intended. Indeed in the course of the debate last year on the *Taxation Laws Amendment Bill (No. 3) 1996*, Labor proposed a series of amendments to tighten up on the syndication arrangements. It is a matter of some note that the Government voted against these amendments.

Despite the Government's claims of 'rorting', not one genuine example was produced. The best it could do was four "actual case examples" - which officials later admitted were fabricated.

It is also noted that the Government amendments to *Taxation Laws Amendment Bill (No. 3) 1996*, which were supposed to resolve the retrospective elements of the Bill as they related to a number of syndication proposals, have not done so.

When these amendments were moved the Government stated that they would restore \$160 million to R&D over four years through the Strategic Assistance for Research and Development (START) program and fund 16 of the syndicated projects which had been in the pipeline when syndication was abolished. It was on this basis that the Senate supported the amendments.

However only two months later the Treasurer's mid-year review had reduced the \$160 million to \$20 million¹⁵ and, according to the TRA submission, "no company has yet signed a contract or received any funding [because] the current draft of the contract contains a number of extremely onerous conditions and companies are waiting a revised draft for their consideration."¹⁶

On this basis it is difficult not to reach the conclusion that the Government's amendments on retrospectivity were made in poor faith.

More broadly, the conclusion reached in TRA's submission bears repeating: "TRA believes that the above analysis and commentary provide sufficient evidence that Government is determined to eliminate the use of the R&D taxation concession altogether, while not offering any viable alternatives to industry, thus providing the wrong signal to industrial companies in relation to innovation in Australia."¹⁷

¹⁴ Technology Resources Australia, submission 2 pp.1,3.

¹⁵ Mid-Year Economic and Fiscal Outlook, 1996-97, p.59.

¹⁶ Technology Resources Australia, submission 2 p5.

¹⁷ Technology Resources Australia, submission 2 p5.

Anomalies in the legislation

The Government's poor policy on this issue has been compounded by poor Parliamentary practice. The legislation which passed in December 1996 (*Taxation Laws Amendment Act (No. 3) 1996*) contained anomalies resulting from the Government's refusal to accept the more responsible Labor R&D plan.

The intention of Labor's amendments, when taken as a whole, was to allow firms to continue to work in partnership and qualify for the tax concession, but only where the R&D was fully at risk and did not involve any element of guaranteed return to the investor.

Unfortunately, because of the Government's opposition in the Senate, only the first part of these amendments succeeded. The impact of the Government's opposition to Labor's amendments was to allow syndicate-like arrangements to continue in the form of partnerships, but without the necessary safeguards which Labor had proposed.

In addition, the legislation in its current form provides different taxation treatment for companies engaged in R&D separately, relative to the position of those operating in partnership.

The need to fix this mess, created by the Government's mishandling of the issue, has necessitated the current Bill.

Recommendation

This Bill seeks to correct flaws in legislation passed last year which enacts extremely poor policy. Labor remains opposed to that policy. But to the extent that this Bill clarifies measures already decided on by the Senate, Labor will not oppose Schedule 11 of this Bill.

Jacinta Collins
ALP Senator for Victoria

The Hon. Peter Cook
ALP Senator for WA

The Hon. Nick Sherry
ALP Senator for Tasmania

Appendix 1

List of Submissions

No.	Name	State
1	Axiom R&D Management Pty Ltd	VIC
2	Technology Resources Australia	VIC