Chapter 8

Estimated impacts of the bill

The impact on usage of the scheme

The number of supported companies

8.2 The Treasury was quite clear that the number of assisted firms will increase:

> …it makes cash refunds available to more firms…[1]

8.3 Innovation Australia was also explicit on this point:

> I would expect that there would be an increase in the number of companies that were registering for the R&D tax credit or offset, if only because the quantum of the benefit they can get is greater.[2]

8.4 An example is Z-Filter, an SME developing innovative filtering technology, who submitted:

> The global financial crisis has reduced Z-Filter's (and other SMEs') access to capital via debt and equity markets, therefore the refundable tax credit is absolutely vital as the lifeblood for SME undertaking innovative activities.[3]

Sectors likely to attract less support

8.5 The Treasury commented:

> This bill does not seek to distinguish between industries…I would characterise it as a fairly neutral impact, because you are not necessarily favouring one sector or another and you let the commercial imperatives out there take the research where it might go.[4]

8.6 This does not, of course, mean that the impact will be equally spread across industries. The changes in the bill will mean industries that do more genuine research will benefit at the expense of those who have previously claimed for activities only tangentially related to research.

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1 Mr Paul McCullough, General Manager, Business Tax Division, Treasury, *Proof Committee Hansard*, 20 May 2010, p. 46.

2 Mr Peter Thomas, Chair, Tax Concession Committee, Innovation Australia, *Proof Committee Hansard*, 21 May 2010, p. 51.

3 Z-Filter, *Submission 24*, p. 1.

4 Mr Paul McCullough and Mr Gerry Antioch, Business Tax Division, Treasury, *Proof Committee Hansard*, 20 May 2010, p. 46.

Large versus small companies

8.7 The changes in the bill will, by design, shift support towards smaller firms:

> …there is unquestionably a move towards supporting R&D which is carried on by SMEs.[5]

> It's clear the Government is focused on rebalancing and retargeting the R&D tax credit for the SME market, rather than the big end of the market.[6]

8.8 The change to a refundable credit will benefit more small firms than large as small start-ups are more likely to be in a tax loss position. But this is not discrimination against large firms. There is an explicit decision to offer a somewhat higher rate of assistance to firms with a turnover below $20 million.

8.9 By contrast, the current scheme appears to concentrate unduly on a small number of larger firms:

> There is no doubt that the majority of R&D concession is held in the hands of very few claimants.[7]

Support for research versus development

8.10 The Treasury said:

> Contrary to some public commentary, the bill recognises that R&D is often done alongside business-as-usual production activities. It does not skew the tax incentive towards pure research…[8]

8.11 It does, however, shift emphasis towards research generating new knowledge with more widespread benefits, and away from development work of benefit only to the company undertaking it. This is the policy intent.

Estimated economic impact

8.12 The changes are expected to increase the total amount of R&D by increasing the size of the incentives and making them more attractive to small firms. KPMG do not expect the changes to definitions to have any material effect on research undertaken. Their report:

> …does not factor in the proposed changes to definition, as this is likely to have less impact on pure and academic research.[9]

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5 Mr Peter Thomas, Chair, Tax Concession Committee, Innovation Australia, *Proof Committee Hansard*, 21 May 2010, p. 50.

6 Mr Yasser El-Ansary, quoted by Senator Cameron, *Proof Committee Hansard*, 20 May 2010, p. 16.

7 Ms Tracey Murray, Partner, BDO Australia, *Proof Committee Hansard*, 20 May 2010, p. 38.

8 Mr Paul McCullough, General Manager, Business Tax Division, *Proof Committee Hansard*, 20 May 2010, p. 46.

8.13 Over the medium term, increased R&D and innovation will boost productivity, economic growth and national income.

The KPMG study

8.14 The Treasury tabled a report by KPMG, *Competitive Alternatives 2010*: *Special Report: Focus on Tax*, which comments:

> Comparing the rankings [of ten OECD economies for tax on R&D operations] in 2010 to 2008, the most dramatic change is for Australia, moving up from fifth place in 2008 to first in 2010. The change is the result of Australia adopting a new R&D tax credit system as of July 1st 2010 that is refundable for corporations that meet defined revenue limits.[10]

8.15 KPMG themselves were somewhat more cautious in interpreting the results of their research, making the caveat that the report 'did not purport to rank countries by how well their respective tax systems support commercial entities that undertake R&D as part of their wider operations, but rather, how well the tax system supports pure R&D entities'.[11]

Will the bill be revenue-neutral?

8.16 The Committee heard conflicting views on whether the bill introduces a revenue-neutral change (ie that the budget deficit is unaffected by moving from the old to the new scheme) as intended.

8.17 Michael Johnson Associates told the Committee that:

> …we have supplied modelling to all the Treasury submissions in relation to the drafts, and our modelling on the publicly available figures suggested that, with the increased rates of credit and introduction of foreign-owned IP, offset by the cost savings of the incremental provisions—which we think are about 30 to 35 per cent of the current cost of the program—you have already got a revenue-positive result, and that is before you start to look at the apparently restrictive impacts of the new definition.[12]

8.18 The Advanced Manufacturing Coalition put a similar view:

> The concerns we have raised above will have the effect of substantially reducing the quantum of eligible R&D activities across all claimants in the future. We do not believe that the increased value of the tax offset would

9 KPMG, *Submission 9*, p. 6.

10 KPMG, *Competitive Alternatives 2010*: *Special Report: Focus on Tax*, p. 19.

11 KPMG, *Submission 9*, p. 6.

12 Mr Kris Gale, Managing Director, Michael Johnson Associates, *Proof Committee Hansard*, 20 May 2010, p. 27. See also their *Submission 5*, p. 7 and Attachment B.

> compensate for this reduction. It therefore follows that…this change is likely to represent a net gain to the Commonwealth revenues.[13]

8.19 Some accounting firms also suspected the bill would increase government revenue:

> …the abolition of incremental 175 provisions that save hundreds of millions of dollars. Conversely, there is rate and threshold increases, particularly at the SME level that costs money. There have been tightening measures that have occurred, dominant purpose, feedstock and other areas, but no modelling has been done that I am aware of that shows this policy intent, which I understand and respect, has actually been achieved.[14]

8.20 In stark contrast, Treasury, who have done modelling on this question and have the experience in this kind of assessment, stated that the changes will be revenue-neutral:

> …this whole bill has been designed…to be revenue neutral…the dominant purpose test and things of that nature… yield some savings and they are broadly offset by the increase in the rates. [15]

8.21 Treasury believe that the numbers bandied about as reductions in eligible claims (such as 30 to 60 per cent) may be true for some individual categories but are vastly overstated for industry as a whole.[16] Their own modelling suggests there will be around a 15-20 per cent (around $300 million) reduction in revenue foregone as a result of tightening eligibility offset by a similar increase due to the higher rates on existing projects and the additional projects induced by those higher rates.[17]

8.22 One of the key factors in assessing whether the changes are revenue-neutral is the extent to which the current scheme is undeservedly rewarding expenditures only tangentially related to R&D (or 'rorts' to put it less kindly).

8.23 MJA provide one piece of evidence on the responsiveness of firms to the size of concessions:

> …the effective halving of the available benefits under the Concession in the 1996 Budget saw program participation rates drop by some 30% in the next 3 years…[18]

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13 Advanced Manufacturing Coalition, *Submission 2*, p.

14 Mr Robin Parsons, Partner, Ernst & Young, *Proof Committee Hansard*, 20 May 2010, p. 13.

15 Mr Paul McCullough, General Manager, Business Tax Division, *Proof Committee Hansard*, 20 May 2010, p. 50.

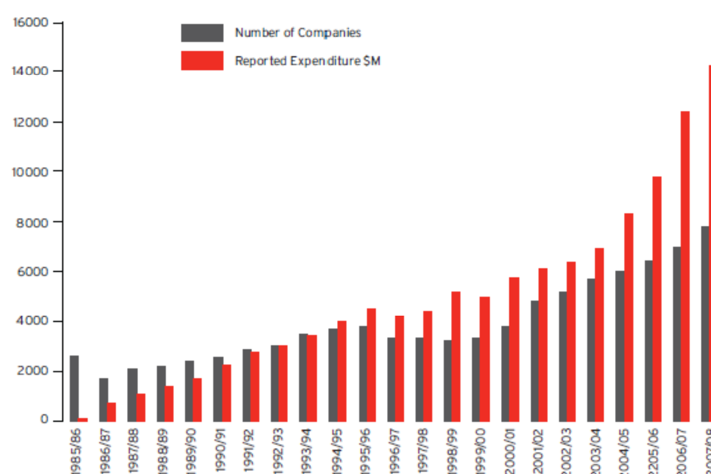
16 Mr Gerry Antioch, Manager, Business Tax Division, *Proof Committee Hansard*, 20 May 2010, p. 50.

17 Mr Paul McCullough and Mr Gerry Antioch, Business Tax Division, Treasury, *Proof Committee Hansard*, 20 May 2010, pp 58-59.

18 Michael Johnson Associates, *Submission 5*, p. 7.

8.24 This seems broadly consistent with the data shown in Chart 8.1.

Chart 8.1: Summary of registration data from 1985-86 to 2007–08



Source: Innovation Australia, *Annual Report 2008-09*, p. 22.

8.25 Some back-of-the-envelope calculations suggest that Treasury's estimate that the changes will be revenue neutral is at least plausible. It is estimated that the existing concession costs around $1500 million in 2009-10 so:

- Abolishing the 175 per cent incremental tax concession saves around $350 million per year[19];
- Tightening the eligibility criteria will lead on Treasury's estimates to a 20 per cent saving, or around $250 million per year.
- Effectively increasing the rate of the former 125 per cent tax concession represents a doubling of the benefit for small businesses and a one-third increase for large businesses. While smaller businesses (under $20 million annual turnover) are the majority of the recipients by number, by value the majority of the benefit goes to just 100 firms, suggesting the increase in cost will be much closer to a third than double. Applying this increase to the 20 per cent smaller base adds around $300 million to $400 million per year to the cost.
- If, as suggested in MJA's calculation above, a 50 per cent change in benefits led to a 30 per cent change in take up, then a 33 per cent change in benefits could lead to a 20 per cent change in take up. Allowing for the larger effect on smaller firms, this could add around $250 million to $300 million per year to the cost.
- Summing these suggests the change to the budget balance could be between a saving of $50 million and a cost of $100 million.

19 Information provided by DIISR.

8.26 There is inevitably a significant degree of uncertainty around these estimates. The Cutler Review referred to 'the inherent difficulty of accurately forecasting the effects of changes to a tax instrument'.[20]

8.27 The Corporate Tax Association also recognises the uncertainty around any modelling exercise and suggests:

> If the law is to be changed on the basis of the Bill as currently drafted, we strongly urge the government to monitor the level of claims – particularly for large business. In the event that the level of claims drops in a way that was not anticipated the government should move quickly to fine tune the eligibility rules so that an appropriate level of industry support is restored.[21]

Committee view

8.28 The Committee expects the bill will increase the amount of R&D by small firms and in time this should lead to stronger economic growth. The Committee accepts Treasury's modelling that the net budgetary impact will be about revenue-neutral, although it is hard to be precise. Given these uncertainties the operation of the bill should be reviewed after it has been operating for some time.

Recommendation 7

8.29 The Committee recommends that the Senate pass the bill, with the amendments proposed in the earlier recommendations, before the end of June 2010. The operation of the bill should be monitored on an ongoing basis and reviewed after two years.

Senator Annette Hurley

Chair

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20 *Venturous Australia*, 2008, p. 101.

21 Corporate Tax Association, *Submission 14*, p. 1.