MEDICINES Australia

Better Health through Research and Innovation

Submission to the Department of Treasury Re:Think Tax Discussion Paper

June 2015

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Introduction

Medicines Australia represents the research-based pharmaceutical industry in Australia, which brings new medicines and vaccines to the Australian market. Our industry has the potential to be one of the key innovative industries for Australia's future. In 2014, Australian pharmaceutical exports declined by 18 per cent to $2.9 billion, compared to $3.6 billion in the year before[1]. With a highly-skilled labour force, a world-class infrastructure, a history of excellence in manufacturing innovation and, above all, a long-standing and well-justified reputation for developing and manufacturing safe, high-quality medicines and vaccines, pharmaceutical development and manufacturing are precisely the sorts of activity that Australia should excel at. To achieve this potential, it is critical that the Government establish and support an appropriate policy environment for businesses to invest and grow.

Medicines Australia welcomes the opportunity to join the national conversation on tax reform and make a submission to the Tax White Paper Taskforce of the Department of Treasury in respect of the '*Re:think*' tax discussion paper to create a better tax system that delivers taxes which are lower, simpler, fairer (the "Tax Discussion Paper").

Medicines Australia's submission addresses a number of issues and questions raised in the Tax Discussion Paper. These include:

- The competitiveness of Australia's Corporate Tax Rate in attracting foreign investment
- The rate and tax base of the Goods and Services Tax (GST) system;
- Innovation & the Research & Development Tax Incentive;
- Striking the right balance with the Fringe Benefits Tax system;
- Enhancement of Employee Share Schemes; &
- Reform Opportunities for State Taxes.

1. The Competitiveness of the Australian Corporate Tax Rate

Company income tax is the second largest source of revenue for the Australian Government, with $70 billion forecast to be raised in 2014-15. Company income tax has two main roles:

- It reduces the incentive for shareholders and/or company owner-operators to reduce their personal income tax by retaining earnings within companies.
- It is the primary method of taxing foreign equity investments in Australia.

It is noted in the Tax Discussion Paper that the economic burden of company tax is ultimately shared among its shareholders, consumers and employers, and that, in the long run, over half of the economic burden of corporate tax is likely to be shifted away from shareholders through lower wages for employees and higher prices for consumers.

Company income taxes increase the required pre-tax return for investments and reduce incentives to invest. This can result in smaller domestic capital stock and lower productivity and wages over time, depending on the openness of an economy.

In recent decades OECD countries have consistently reduced company income tax rates (which apply to taxable profits) so as to attract foreign investment. While Australia followed this trend (reducing its company income tax from 49 per cent in the mid-1980s to 30 per cent in 2001), the rate has since remained unchanged. Currently, Australia has one of the highest company tax

[1] Australian Bureau of Statistics 2015, 'International Trade in Goods and Services', March 2015

rates in the OECD[2] and collects a higher share of company income tax as a percentage of GDP relative to most OECD countries. It is also one of the highest in the Asia Pacific region where much of Australia's trading partners are located.

Re:think - The Tax Discussion Paper

As noted in the Tax Discussion Paper, as the mobility of capital increases, Australia's high corporate tax rate can deter investment and ultimately lead to lower wages and prosperity. Compounded by Australia declining terms of trade and subdued global economic growth, the country faces the prospect of a period of below-average income growth, relative to the years leading up to the global financial crisis. Tax Reform, in that context, is seen to offer an opportunity to significantly improve productivity and foster jobs, growth and opportunities.

The recent Federal Budget announced changes to lower the corporate tax rate of small businesses[3] to 28.5% as from 1 July 2015. This was foreshadowed in the 2014 Federal Budget where it was part of a wider corporate tax rate cut for all companies (the wider cut does not appear to be proceeding unless it forms part of this tax reform process). The 28.5% rate falls short of the corporate tax aspirations of *Australia's Future Tax System Review* (the 'Henry Review') to have a corporate tax rate of 25 per cent. Further, limiting these changes to small businesses is not likely to attract significant levels of foreign investment. Indeed, the Tax Discussion Paper itself cites comparative jurisdictions' experiments with reduced corporate tax rates for small companies which proved to be 'ineffective and costly'[4] and produced disincentives for small companies to grow above those thresholds.

Medicines Australia's members support the continued reduction of corporate tax rates in accordance with the Governments' previous commitments and the findings of the Henry Review. It regards this as a positive way to increase foreign investment in Australia, increase productivity through increasing the level of high value manufacturing in Australia and a means to continue to support and grow the number of highly-skilled jobs in Australia.

For Australia to remain competitive and attract investment, including investment in technologically advanced manufacturing and clinical trials within Australia, Australia needs to have an internationally competitive tax regime. A reduction in the company tax rate would reduce the required rate of return on Australian investments and encourage greater inflows of investment into Australian companies.

Even after offsetting a corporate tax cut through increases in other taxes (so as to maintain a revenue neutral outcome), the cut in the company tax rate would be the single most beneficial tax reform to the Australian economy.

2. The Rate and Tax Base of the GST system

On and from 1 July 2000, the Australian Government replaced the existing wholesale sales tax system with a multi-staged, broad based goods and services tax (GST). The Australian GST is based on the "value added tax" model adopted by nearly all OECD member countries and more than 80 other countries[5] .

The Australian GST, like many other countries' GST or VAT systems, has unique features. These features either evolved, were necessary to take account of our legal and political system,

[2] Source: http://www.oecd.org/tax/tax-policy/tax-database.htm#C_CorporateCaptial

[3] Entities that that have an aggregated annual turnover of less than $2 million

[4] Re:think, Tax Discussion Paper - p.119

[5] Tax Reform: not a new tax, a new tax system – p.80

or have their genesis in the overarching principles that governed the design of the Australian GST law.

Among the key policy decisions made during 1998 and 1999 was to treat the supply of medicines and medicinal preparations as GST-free if they are:

- sold on prescription to individuals;
- restricted medicines supplied by a medical practitioner to individuals;
- determined by the Health Minister to be GST-free; or
- subject to approval under paragraph 19(1)(a) of the Therapeutic Goods Act 1989 or otherwise covered by that Act in circumstances prescribed in subsection 38-50(6) of the *A New Tax System (Goods and Services Tax) Act 1999* ("GST Act").

We note that the GST Act prescribes a series of medical and health services to be GST-free. The following submission makes some broad observations in relation to the application of GST to the health sector. However, the submission's primary focus is the GST treatment of medicines and medicinal preparations that are subject to the Pharmaceutical Benefits Scheme ("PBS") and are currently GST-free.

The Tax Discussion Paper

Relevant to this submission, the Government in its Tax Discussion Paper made the following observations in relation to the Australian GST system and welcomed interested parties to put forward proposals to change the GST:

- Australia's GST rate is one of the lowest among developed countries;
- Exemptions to Australia's GST means that GST was paid on only 47% of the consumption of goods and services in 2012; and
- The main categories of consumption that are GST-free are fresh food, health (including medicines), education, childcare, water, sewerage and drainage services;

Importantly, the Tax Discussion Paper states the following:

> *"When the GST was introduced, health and education, for example, were made GST-free because of the significant public sector provision of these goods and services and concerns that applying GST to them would put private providers at a competitive disadvantage."*

Medicines Australia supports the existing GST treatment of pharmaceuticals and health services for the reasons set out below. Consequently, any increase in the GST rate while maintaining the existing GST treatment of medicines and health services would meet with the support of Medicines Australia, particularly if the increased rate is used to partially fund an expansion of research and development incentives, a reduction in corporate tax rates and the removal (or reduction) of inefficient state taxes such as payroll tax.

Broadening the GST base – health and medicines

There are relatively few areas in which the GST base could be broadened. As pointed out in the Tax Discussion Paper, under the current GST law the GST-free supplies that comprise the greatest Australian consumption expenditure are food, education services, medicines and health services, water, sewerage and drainage.

Given the complexities associated with applying GST to supplies that are currently GST-free, Medicines Australia proposes to confine its comments to the health sector and the GST treatment of medicines in particular. Medicines Australia does note that if the Government decides to broaden the GST base to include supplies of goods and services that are currently GST-free, it should carefully consider providing appropriate levels of compensation to low income earners and welfare recipients to compensate them for the consequential increase in prices of affected goods and services.

In relation to the potential application of GST to goods and services supplied in the health sector, the Tax Discussion Paper correctly points out that the sectors includes private operators directly competing with public sector providers. This, and the fact that the sector receives significant Government subsidies and is heavily regulated, was identified in the Government's 1998 tax reform White Paper, "Tax Reform: not a new tax, a new tax system", where the Government observed the following at page 93:

> *"The health sector in Australia has significant government involvement through direct subsidy and regulation. Many health services are provided to patients free of any direct charge or by means of a co-payment that is a fraction of the total cost of providing the service.*
>
> *Applying taxes to health care would place the private health sector, with its heavier reliance on direct fees, at a competitive disadvantage with the public health system."*

Medicines Australia understands that there has not been any material change in the structure of the health sector since the introduction of the GST that should cause the Government to consider a change in GST health policy. That is, State and Commonwealth governments continue to regulate and subsidise health services, and the private and public sectors continue to operate and compete in the same market.

Clearly, new health related technologies, pharmaceuticals and medicines have been developed, marketed and used in the health sector (and by individuals) during this period. True to its design, the GST has been agnostic to these developments. That is, the GST has done what it was designed to achieve; allow businesses to develop and sell "product" without it being a factor in business decisions made by those entities.

Medicines Australia notes that health subsidies (including the PBS) are increasing and will continue to increase as new medicines are developed and the Australian population ages. A decision to apply GST to health services (and health insurance) would directly increase the price payable by the public for health care, potentially increasing pressure on the public health system at the expense of private operators. Consequently, broadening the GST base to include health services will need to be considered with broader public health and competition policy issues.

Similarly, a decision to broaden the GST base to include pharmaceuticals and medicines that are currently GST-free will increase the cost of these products to consumers. Medicines Australia's preferred position is that the GST treatment of pharmaceuticals and medicines remains as it is, GST-free.

Subsidies and GST

The abundance of subsidies in the health sector poses a number of difficult and vexed issues if the Commonwealth Government proposes to apply GST to health services, pharmaceuticals and medicines. These issues include the following:

- which (if any) subsidies would, for the purposes of the GST law, be treated as third party consideration (and therefore, effectively part of the price) for medicines and health services supplied to individuals; and
- to what extent (if any) would the taxable GST treatment of medicines and health services have on the nature and quantum of the subsidies paid by government.

The PBS

The PBS is a government subsidy that directly affects the price and availability of affordable pharmaceuticals and medicines in Australia. If the Government proposes to include prescription pharmaceuticals and medicines within the GST base, it should unambiguously exclude payments made under the PBS from its scope. The PBS is a key pillar of Australia's health system. It allows Australians access to affordable and reliable pharmaceuticals and medicines to improve the length and quality of their lives. The scheme ultimately relies on the ingenuity, investment and the quality of the product developed by members of Medicines Australia and the commitment to access to medicines through the National Medicines Policy and health technology assessment structures that ensures value for money.

Medicines Australia submits that any decision to apply GST to pharmaceuticals and medicines currently GST-free should not be done at the expense of the PBS.

3. Innovation & the Research & Development Tax Incentives

For decades, the pharmaceutical industry has been a crucial component of Australia's innovation system. By investing in research and development (R&D) partnerships, clinical development and high-tech manufacturing, the industry has not only facilitated and enabled the development and commercialisation of important Australian discoveries, such as the human papillomavirus vaccine for cervical cancer, but also brought high quality medicines and vaccines to consumers around the world. Today, patients in more than 30 countries rely on pharmaceutical products manufactured in Australia to maintain and improve their health.

Medicines Australia represents the research-based pharmaceutical industry in Australia, which has a long and proud history in this country, stretching back more than a century. Today, over 50 global pharmaceutical companies, along with around 400 locally-owned medical biotechnology firms, operate in Australia. Together, they generate around$3 billion[6] in exports each year and employ approximately 40,000 Australians in high-value jobs[7]. Many of these employees work directly in R&D activity in advanced manufacturing and/or other highly-skilled fields, and the R&D Tax Incentive plays a very important role in assisting to maintain and grow these jobs.

Within our industry, decisions about whether to undertake R&D activity (and where to undertake it) are typically based on a range of factors.

Among these, the levels of support and strategic policy settings offered by governments are very significant and are closely and carefully scrutinised. They have also become increasingly important considerations as the competition between countries' governments for the innovation dollar has become more intense in recent years. Increased R&D tax credits and enhanced direct support of innovation within the Asia Pacific region have diminished the attractiveness of Australia to conduct R&D.

Our industry already undertakes more than $1 billion of medical R&D annually in Australia[8]. This high level of investment has myriad important benefits for the country, including enhancing the physical health and welfare of Australians and helping to reduce health costs. It has been estimated that a dollar invested in Australian health research and development (R&D) will return an average health benefit of $2.17[9]. Additional investments in R&D or high-tech manufacturing also generate new intellectual property, enhanced local infrastructure and production capacity, and new jobs in advanced manufacturing and other highly-skilled fields in Australia.

There is significant scope for further expansion of our industry's medical R&D activity in the short to medium term, particularly in light of continued rapid growth in the Asia Pacific region and a predicted near-doubling of the global pharmaceutical market by 2020. Indeed, if our industry can capitalise effectively on these trends, it represents a unique and significant opportunity for pharmaceutical manufacturing and R&D in Australia, which is not only conveniently located but has a well-established reputation in the Asia Pacific region (and around the world) for manufacturing safe, high-quality medicines and high quality research.

However, this expansion will by no means be automatic – and there is a significant risk that we may lose the opportunity if we do not appropriately recognise and value the importance of continuing to attract high and growing levels of investment in medical research in Australia. Moreover, it will only happen if Australia distinguishes itself as a desirable and genuinely competitive location in which to perform such research.

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[6] Australian Bureau of Statistics 2015, 'International Trade in Goods and Services', March 2015

[7] IBIS World, Melbourne, 2014, Pharmaceutical Product Manufacturing in Australia: Market Research Report

[8] Australian Bureau of Statistics 2012, 'Business Expenditure Report on R&D'

[9] Department of Health and Ageing 2013, 'Strategic Review of Health and Medical research'

Changes to the R&D Tax Incentive introduced by the Tax Laws Amendment (Research and Development) Bill 2013, less than three years after it was first implemented, undermined Australia's reputation as a stable and predictable business environment. This could impact our ability to attract R&D investment in the future. It could also create a precedent for more changes in the future that could further limit the eligibility criteria for the Tax Incentive and undermine the very purpose of the system, which is to increase Australia's ability to attract investment (including foreign investment) in research and development.

The R&D Tax Incentive, which was implemented after nearly three years of extensive community consultations, was specifically designed to make access to tax benefits more efficient and predictable. Above all, the R&D Tax Incentive provides a globally competitive tax incentive for conducting R&D activities in Australia. To that end, Medicines Australia strongly contends that the continued existence (to at least the present level) of the R&D Tax Incentive is critical.

The programme stimulates extra R&D spending and activity that would not have otherwise occurred and increases Australia's attractiveness as a location in which to perform high-level R&D.

Long Term Sustainability

The existing R&D incentive programme must be retained and bolstered further in order to ensure Australia remains competitive. Through the incentive programme, access to tax benefits is efficient and predictable. Importantly, the scheme has been made more competitive and these features must be retained, including removing the requirements to demonstrate:

- year-on-year growth in their R&D expenditure in order to claim; and
- intellectual property from eligible R&D projects to be held in Australia.

That said, it is concerning that the programme has continued to be the subject of reviews and potentially sweeping changes almost from the time it was established.

More long-term certainty and stability should accompany the programme's operation. In our view, the Government should commit to freezing the programme from further major changes for a defined (and, ideally, sustained) period of time. This direction has been taken in some other countries, and it provides a much greater degree of assuredness and confidence in relation to long-term planning and investment decisions.

One of the changes continually mooted in Australia is the lowering of the value of the incentive. This proposal is counterproductive because it would deter (and accordingly decrease) investment in high quality R&D in Australia, at the very time when entrepreneurship and innovation have never been more important to the country's economic and social future. With the increasing liberalisation of trade and investment throughout the region, through successive Free Trade Agreements, and increasing competition for highly skilled workforce, the need to foster such entrepreneurship and innovation is only increasing.

Members of the Government, including the Prime Minister, have made many welcome remarks[10] over recent years about the substantial importance of medical research to Australia's future. We believe that it sends a contradictory signal whenever a measure that genuinely encourages further medical R&D is weakened.

'Above the line' Accounting of R&D Incentives

Ongoing improvement to our tax system is required to ensure Australia remains competitive; one immediate and positive step would be to allow a revision to companies' accounting treatment of their receipt of the incentive. Specifically, Medicines Australia recommends to the Government that changes be made to the current arrangements for 'above the line' accounting treatment of the offset. Presently, the credit is non-refundable for all companies with greater than $20 million

[10] https://www.pm.gov.au/media/2015-03-15/joint-press-conference-sydney-0 15 Mar 2015

in annual turnover and they are therefore unable to account for it above the line. This is unnecessarily inflexible and unwieldy; they should be presented with the option of ‘above the line’ treatment. It is noted that this has been implemented in France and is soon to commence in the UK, where the credit will be able to be recorded in companies’ accounts as a reduction in the cost of R&D, thereby achieving ‘above the line’ treatment.

Such a change would benefit Medicines Australia members directly. In addition, it would have a wider overall application and benefit for R&D investment in Australia. In particular, we believe it would allow many businesses to directly factor decisions about potential R&D projects into their financial modelling and planning cycles. Many companies assess R&D investments on an EBIT basis, with the consequence that the benefit of the Australian R&D Tax Incentive is not included in the financial analysis of the cost/benefit of locating an R&D investment in Australia. The impact of modifying the programme so that the benefit is taken ‘above the line’ is likely to be significant for affected companies, without any detrimental effect to the Government’s own bottom line.

4. Striking the right balance with the Fringe Benefits Tax system

Fringe Benefits Tax (FBT) is payable on the ‘taxable value’ of fringe benefits provided to an employee by their employer in respect of their employment. While FBT is levied on and paid by employers, it relates to the non-cash payments received by employees. Whilst FBT constitutes a small component of the Commonwealth Government’s total tax collection, it upholds integrity to the taxation of remuneration, specifically relating to non-cash benefits. Nevertheless, the FBT is overly complicated and creates additional tax compliance costs relative to other forms of taxation and revenue raising methods considered as part of the wider Tax Reform discussion. Further, the provisions can inadvertently capture costs that are incidental to business related activities that fail to meet specific artificial thresholds (e.g. a seminar that goes for more than 4 hours[11]).

In reviewing the current FBT system as to whether it maintains effectiveness, consideration needs to be given to simplicity and fairness.

- **Simplicity** – administrative burden for employers to comply with the legislation and the FBT legislation is overly complicated with a significant number of exemptions and concessions that add to its overall complexity and cost of compliance.
- **Fairness** – there is inequity caused by imposing the top marginal tax rate on fringe benefits provided to employees, where the majority of these employees could be on a lower tax bracket.

A solution that has been raised to counteract the above concerns is to treat fringe benefits provided as being taxable in the employees’ hands. However, the level of non-compliance and tax leakage that brought about the introduction of the FBT system originally would likely emerge again if the taxation of benefits was transferred back to employees. This would suggest that such a revision is not advisable.

Medicines Australia’s recommendation is to continue the existing FBT system, with measures to make the system simpler and fairer including:

- **Simplicity** – target specific administrative simplification of the provisions so as to reduce complexity. For example, currently the deductibility (and thus incidence of FBT) for entertainment, travel and accommodation that is ‘reasonably incidental’ to the provision of either a ‘seminar’ (but not a ‘business meeting’) that runs for ‘at least 4 hours’, is inherently complex and could be greatly simplified by limiting fringe benefits to those provided outside of business related activities (such as business meetings or in-house business relevant training activities).

[11] Section 32-32 Item 2.1 of the Income Tax Assessment Act 1997

- **Fairness** – assessing employers at an FBT rate proportionate to the value of gross salary plus benefits received per employee. This should not create additional administration as employers are already required to assign specific fringe benefits to employees for reportable fringe benefit purposes.

5. Enhancement of the Employee Share Scheme

The Employee Share Scheme (ESS), prior to the 2009 changes, notably the taxing of shares/options upon issue instead of when a profit is realised, provided significant support to innovative start-up biotechnology companies. The changes in 2009 removed important support and undermined the ability of start-up companies to attract high-quality staff.

Once widely used in the pre-revenue biotechnology sector, the support of ESS was relied upon to attract quality employees by complementing cash remuneration and making salary packages more substantive and attractive, whilst also giving employees a vested interest in the success of their company.

If tax is charged pre-success or pre-gain, the shares/options come at a cost to the employee, with the tax payable before any value is generated. This is comparable to paying income tax before you earn any income or paying tax in advance for an income that you may or may not receive. This method of taxation is a disincentive and disadvantages start-up innovative companies, especially during the establishment and development phases.

The Tax Discussion Paper notes that the 2009 changes had reduced the attractiveness of ESS. As a result, the Government recently proposed changes to the taxation arrangement for employee share schemes as well as announced some additional concessions which 'provide generous incentives for new start-ups'[12].

Medicines Australia welcomes the change to the taxing point for options, so that employees of all companies will generally not be taxed on their options until they have converted them into shares. While the current proposed reforms have gone some way to reverse some of the concerns arising from changes to the taxation of ESS since 2009, and better aligns Australia with the global treatment of such awards, the most recent proposed changes have focused on 'start-ups' at the exclusion of other larger companies that are likewise innovative and equally seek to retain high quality employees in a globally competitive labour market.

Medicines Australia also welcomes the additional concessions, announced by the Government, that tax will not generally be payable up-front on shares or options that are provided by eligible employers to their employees at a small discount, as long as they are held by the employee for at least three years. Again, it would argue that these additional concessions should not be limited to start-ups.

More broadly, we would strongly recommend Government to take this opportunity to reduce tax complexity for the business community, encourage equity ownership by employees of all companies and further bring Australia in line with our international counterparts.

6. Reform Opportunities for State Taxes

Payroll Taxes

Payroll tax is imposed by state and territory governments on employers, based on components of their employee's remuneration. While the cost is often borne by their employers in the short term, it is ultimately borne by employees through lower salaries and wages.

Payroll tax is one of the largest sources of state-levied taxation revenue. It has become increasingly narrow as a result of competition between states. Assessing the impact of payroll taxes is complicated by the significant variations across the states and territories in terms of

[12] Refer p.iii of the Tax Discussion paper

exemptions and concessions. Their effectiveness is also reduced by the progressive increase in the payroll tax-free thresholds, which creates a disincentive for businesses to expand and further develop scale. As a result, these taxes potentially distort behaviour and limit productivity and growth.

Equally so, there are inefficiencies in the administration of the payroll tax system as employers are required to prepare separate payroll tax registrations, file monthly and annual returns for each state in which they operate. Employers would benefit from a uniform administration system, where businesses could go to a central location and input each states taxable wages or otherwise create a system whereby the taxable wages reported would be incorporated into the BAS reporting process.

Stamp Duties

Removal of stamp duty on business transactions would simplify taxation arrangements. It would improve efficiency by increasing the level of beneficial transactions and by improving the allocation of resources within the economy. It would also result in a substantial decrease in the excess burden of taxation, given that stamp duty is one of the least efficient forms of taxation. Any widening of the GST base and/or increase in the GST rate should be on the basis that these inefficient state and territory taxes are removed.

Concluding remarks

Medicines Australia once again thanks the Government for the opportunity to contribute to the Tax Reform Discussion Paper. It is a valuable and timely examination and we are pleased to contribute in this fashion.

Medicines Australia would be please to clarify and/or amplify these statements should the opportunity arise.

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