RE: THINK
BETTER TAX SYSTEM, BETTER AUSTRALIA

Response to the Discussion Paper

June 2015

RESEARCH AUSTRALIA
AN ALLIANCE FOR DISCOVERIES IN HEALTH

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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INTRODUCTION

Health and medical research relies on government funding, public donations and private investment, and Research Australia's members are drawn from across the not for profit, government and corporate sectors. As a consequence Research Australia's submission necessarily addresses a number of different aspects of the tax system but a common theme is the role that the tax system can play in promoting Australian health and medical research and improving the health and wellbeing of Australians. Research Australia welcomes this opportunity to make a submission to the Tax Review.

Research Australia agrees with the key principles for tax systems outlined on page 6 of the Discussion Paper:

Principles for tax systems

It is accepted that a well-designed tax system will meet its revenue raising objective, while balancing the core principles of equity, efficiency and simplicity:

- **equity — fairness in the distribution of the tax burden;**
- **efficiency — economy in tax collection so as to have the lowest possible cost over and above the revenue that is raised; and**
- **simplicity — the tax system should be easy to understand and simple to comply with.**

Beyond these principles the tax system can play an important function in encouraging certain behaviours and discouraging others. Research Australia proposes that this function should have two key objectives:

1. Encourage innovation and productive investment
2. Reduce harm from activities that are not illegal but are undesirable.

Encouraging innovative and productive investment is critical to Australia's future. Much of the Government's current policy framework is geared to this objective and yet our tax system provides incentives for non productive investment and saving. This needs to change. Several of Research Australia's recommendations for reform are intended to encourage productive investment, particularly in innovative, research intensive 'start up' companies.

The role of the tax system in helping to reduce harm is also well established. The role of tobacco excise in Australia's multi faceted campaign to reduce smoking rates over several decades is perhaps the best example. The use of taxation in this manner as a tool of public policy needs to be recognised and its legitimacy acknowledged, even where it may be contrary to the principles for tax systems contained in the Discussion Paper.

LIST OF RECOMMENDATIONS

1. **To the extent that savings are to be taxed differentially, this should be done in a manner which favours the use of savings for productive investment.**

2. **Individuals should be provided with tax incentives to invest in small innovative, research intensive companies.**

3. **Superannuation funds should be provided with tax incentives to invest in small innovative research intensive companies.**

4. **The existing provision for the deduction of self education expenses should be retained.**

5. **The R&D Tax Incentive should be retained.**

6. **Research Australia opposes the measure proposed in the 2015 Budget to reduce the rate of the refundable and non refundable R&D Tax Incentive rates by 1.5%.**

7. **Quarterly payments of the non-refundable R&D Tax Incentive should be reinstated.**

8. **The Australian Innovation and Manufacturing Incentive should be implemented.**

9. **Eligibility for the Employee Share Scheme should be extended to include listed companies that are eligible for the Refundable R&D Tax Incentive.**

10. **Retention of the tax deductibility of donations to research institutes and higher education institutions, and for charities raising funds for research.**

11. **Donations for health and medical research should be exempted from any future requirement that tax deductible donations must be spent in Australia.**

12. **The not for profit income tax exemption for research institutes and higher education institutions, and for other not for profit organisations conducting research should continue.**

13. **Retention of specific taxes on tobacco and alcohol as part of a continuing campaign to reduce smoking rates and alcohol consumption in Australia.**

14. **The primary focus of taxation policies in respect of alcohol and tobacco should be harm reduction, and existing taxes on alcohol should be reformed in line with this objective.**

15. **The tax system should remain flexible enough to accommodate future taxes designed to influence public behaviour in the public interest.**

ENCOURAGE INNOVATION AND PRODUCTIVE INVESTMENT

> **This section addresses Question 38 in the Tax Discussion Paper: *In what circumstances is it appropriate for certain types of businesses to be subject to special provisions? How can special treatment be balanced with the goal of a fair and simple tax system?***

Innovation and productive investment are key to Australia's future. As the Discussion Paper notes, the *'economic benefits of innovation are well recognised, including productivity enhancements, job creation and ultimately, improvements in living standards.' (page 101)*

The Industry Innovation and Competitiveness Agenda recognises the importance of entrepreneurs and start-up companies to this future:

'While established businesses that have already had commercial success will be vital to Australia's future, the Government understands the importance of encouraging entrepreneurship. Entrepreneurship and a flourishing start-up community promote job creation and productivity growth.'[1]

One of the critical issues for SMEs, and start- up companies in particular, is access to capital. While debt financing might be a suitable option for SMEs which have a ready income from inception, for many start-ups seeking to commercialise a new product this is not the case. Faced with years of research and development before they are able to generate income, debt financing is not a viable option.

This issue was recognised in the Interim report of the Financial System Inquiry:

'Access to external debt funding is not a major issue for most SMEs. In general, the majority are successful in getting a loan application approved. Since 2006–07, approval rates have been well above 80 per cent. Approval rates are much lower for new ventures, which reflect the relative riskiness of lending to such enterprises. New ventures usually lack collateral and sufficient proven credit history to qualify for a loan. Such firms can also lack sufficient cash flow until their product can be commercialised.' [2]

If debt financing is difficult or impossible to obtain, then the alternative is equity financing. But here there are also difficulties:

> *'Venture capital and private equity funds tend to finance more innovative and high-growth firms. These firms are drivers of long-term productivity growth. Australia's venture capital and private equity markets are small, and there are barriers to generating significant investor interest.*
>
> *New ventures can typically take several years of development before any cash flows are generated from their activities, and failure rates are high. As a result, new ventures have limited access to credit, and market-based financing can be inaccessible or too costly to acquire.'*[3]

The Final Report of the Financial System Inquiry confirmed this finding, but apart from supporting crowd-sourced equity funding it provided no recommendations to improve the access of start-up companies to capital.[4] Crowd-sourced equity funding could prove useful over time but is likely to continue to be a 'niche' funding source suitable only to some start up companies.

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[1] Australian Government, Industry Innovation and Competitiveness Agenda, 2014, p.v

[2] Australian Government, Financial System Inquiry Interim Report July 2014, p. 2-60

[3] Australian Government, Financial System Inquiry Interim Report July 2014, p. 2-65

[4] Australian Government, Financial System Inquiry Final Report November 2014, p. 177-180

In several areas, the tax system is a key influence on how resources are utilised in the economy, and an objective of the tax system should be to promote the utilisation of resources for innovative activities and productive investment. The following recommendations are made with this objective in mind.

> **The following section addresses Question 40 in the Tax Discussion Paper: *What other tax incentives including changes to existing measures, are appropriate to encourage investment in innovation and entrepreneurship?***

Individuals- incentives for productive investment

Chapter 4 of the paper concludes that taxation of savings is unlikely to affect the aggregate level of savings but it can affect where and how individuals save.

From a tax perspective different forms of saving are treated quite differently depending on the form they take, but there is no overall rationale for this differential treatment. Housing for example, which is one of the least productive forms of investment, is given the most tax favoured treatment. If capital was abundant this would not necessarily be a problem but it is not; as the Discussion Paper notes, Australia is a net importer of capital. In this environment, the tax system should provide a bias in favour of savings being used for productive investment rather than encouraging less productive investments.

Research Australia submits that to the extent that savings are to be taxed differentially, this should be done in a manner which favours the use of savings for productive investment.

Research Australia submits that individuals should be provided with tax incentives to invest in small, innovative, research intensive companies.

The UK's Enterprise Investment Scheme (EIS), Seed Enterprise Investment Scheme and Venture Capital Trusts provide useful models for such incentives, enabling individual to receive an immediate tax benefit in return for eligible investments. These schemes allow a tax deduction for a percentage of the funds invested in the year the investment occurs, subject to a number of limits and restrictions on eligibility. Australia's Exploration Development Incentive is another model worth considering to encourage investment in specific areas.

These schemes offer the advantage of being able to target the incentives to particular industries. The Government's Industry Innovation and Competitiveness Agenda has already identified Australia's key competitive strength areas; eligibility for the schemes could be limited to innovative, research intensive start ups in one or more of these sectors. The medical devices and pharmaceuticals sector is particularly well suited to benefit from such a scheme. An incentive for early stage investment in innovative research intensive companies would complement the refundable R&D Tax Incentive and registration for the Refundable R&D tax Incentive could be a threshold requirement for any new scheme, helping to simplify the administration.

Superannuation funds- productive investment

Superannuation funds are ideally placed to invest in small innovative companies, but face barriers in doing so. These include the higher investment costs associated with the small scale of many such investments and the need to undertake significant due diligence and engage specialist assistance to mitigate investment risk. Tax incentives modeled on those proposed above for individuals would help to overcome the disincentives to invest in this area and potentially provide a valuable source of venture capital for small research intensive start-up companies. While potentially high risk, these investments also offer the potential of high returns and have a role in a superannuation fund's investment strategy, as the success of the Medical Research Commercialisation Fund has demonstrated.[5] Risk can be further managed by investing in a portfolio of these companies.

Research Australia recommends that superannuation funds be provided with EIS type tax incentives to invest in small, innovative research intensive companies.

> **The following section addresses Question 15 in the Tax Discussion Paper: *To what extent do our arrangements for work-related expense deductions strike the right balance between simplicity and fairness? What could be done to improve this?***

Individuals- retain the deduction for self education expenses

Just as Australia's future depends on financial capital for innovation, it requires an investment in intellectual capital; a well educated and skillful workforce able to conceive, invent, adapt and manufacture the solutions required to meet future challenges and demands. Individuals need to be supported in life long education and development of skills to ensure that we maintain and build this intellectual capital.

Research Australia recommends that the existing provision for the deduction of self education expenses be retained.

R&D Tax Incentive

> **The following section is relevant to Question 39 in the Tax Discussion Paper: *Does the R&D tax Incentive encourage companies to conduct R&D activities that would otherwise not be conducted in the absence of Government support? Would alternative approaches better achieve this objective, and if so, how?***

Research Australia notes the request in the discussion paper to provide data on the effectiveness of the R&D Tax Incentive in supporting innovation in Australia. Research Australia is unable to provide any data as evidence of the effectiveness of the program. Anecdotally it seems the Incentive has been instrumental in increasing and accelerating R&D activity by small companies and to boosting R&D activity in the Australian subsidiaries of multinational companies. The fact that the forecasts for expenditure on the Refundable R&D Tax Incentive and numbers of companies registering are regularly revised upward suggests that the program is proving useful in encouraging R&D.

Research Australia recommends the retention of the R&D Tax Incentive.

Research Australia is aware of the current Bill before Parliament to reduce the R&D Tax Incentive rate by 1.5%. First proposed in the 2014 Budget, the reduction was promoted as reflecting the proposed reduction in the corporate tax rate. As Research Australia argued at the time, in the case of the Refundable R&D Tax Incentive many of these companies are not yet profitable enough to be paying tax and so the argument of alignment with the reduction in the tax rate does not make sense. The reduction in the rate of the Refundable R&D Tax Incentive simply reduces the funds available to small, innovative research intensive companies to spend on R&D and delays their progress to profitability.

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[5] http://www.mrcf.com.au

Research Australia opposes the measure proposed in the 2015 Budget to reduce the rate of the refundable and non refundable R&D Tax Incentive rates by 1.5%

Recognising the critical issue of poor cash to small, innovative research intensive companies, the R&D Tax Incentive originally provided quarterly payments of the Refundable R&D Tax Incentive. This element of the scheme was subsequently removed.

Research Australia recommends the reinstatement of quarterly payments of the non-refundable R&D Tax Incentive.

Australian Innovation and Manufacturing Incentive

> **The following section addresses Question 40 in the Tax Discussion Paper: *What other tax incentives including changes to existing measures, are appropriate to encourage investment in innovation and entrepreneurship?***

Research is the development of new knowledge; the second stage is the application of this knowledge to the development of new products and services. The final step is the manufacture of these new products and their sale to consumers.

Australia aspires to be a manufacturer and exporter of high value added goods but there are several barriers to manufacture in Australia including geographic isolation, a small domestic market, relatively high labour costs and a corporate tax rate that is higher than many of our competitors. One way to improve Australian competitiveness in manufacturing and to make the most of our investments in research and development is through the adoption of the Australian Innovation and Manufacturing (AIM) Incentive.

The AIM incentive is designed to provide an offset against the tax payable on profits derived from the innovation and manufacture in Australia of qualifying patented/licensed products. The patents/licences would have to a connection to Australia to qualify for the Incentive. Further detail is available at http://www.aimincentive.com.au

The introduction of the AIM incentive would help to complete the transition to a more innovative economy which supports the scientific research needed to develop new knowledge, promotes the innovation needed to apply that new knowledge, and encourages domestic manufacture of the products that creates jobs and generates export revenue.

Research Australia recommends the adoption of the Australian Innovation and Manufacturing Incentive.

Employee Share Schemes

Research Australia welcomes the Government's recent decision to amend the Employee Share Scheme. The lack of a revenue stream presents real difficulties for early stage research intensive companies, and the opportunity to include shares in the remuneration package of staff is vitally important to this group.

Research Australia is generally supportive of the measures outlined in the Tax and Superannuation Laws Amendment (Employee Share Schemes) Bill 2015. Currently, however, the Scheme excludes listed companies. This exclusion fails to recognise that many early stage research intensive companies list on the securities exchange because of the difficulty of securing other forms of capital. Many of these companies are still relatively poorly capitalised and struggle to adequately remunerate and attract staff.

Research Australia recommends that eligibility for the employee share scheme be extended to include listed companies that are eligible for the Refundable R&D tax Incentive.

NOT FOR PROFIT SECTOR

> **The following section addresses Question 47 in the Tax Discussion Paper: *Are the current tax arrangements for the NFP Sector appropriate? Why or why not?***

The NFP sector is critical to Australia's economy and future. Many NFP organisations and philanthropic organisations are working to improve society.

Health & medical research and DGR status

Most basic research in Australia is undertaken in NFPs: higher education institutions and research institutes. Most of these have DGR status, whether they be registered as public universities, health promotion charities or otherwise. Donations are a vital source of funding for not for profit health and medical research.

Research Australia recommends the retention of the tax deductibility of donations to research institutes and higher education institutions, and to charities raising funds for research.

In recent years the Government has considered tightening the criteria for DGR status. In particular it has proposed requiring that donations be utilised 'in Australia'.

Modern health and medical research is by its very nature collaborative. While Australia has a long established expertise in health and medial research we are a relatively small country. Success in health and medical research is best achieved by collaborating with other researchers and research organisations, and in many cases the most appropriate collaborators are overseas. International collaboration between institutions almost invariably involves the collaborating institutions undertaking activities, and spending funds, overseas. Examples include:

- researchers from Australian research institutions working for periods in the research facilities of overseas partner institutions (the reverse also occurs); and
- researchers attending meetings overseas with international partner organisations.

Even where research is undertaken without international collaboration there are a range of circumstances in which money is expended overseas. These include:

- contracting overseas laboratories to undertake analysis of samples that cannot be undertaken in Australia due to a lack of specific expertise or equipment; and
- professional development through attending overseas conferences.

In many cases these activities are partly or fully funded with donations. Although the funds are expended overseas there is a clear Australian public benefit from these activities through the improvement in the quality of Australian research and assisting the professional development of Australian researchers.

Research Australia recommends that donations for health and medical research be exempted from any future requirement that tax deductible donations must be spent in Australia.

Income Tax exemption

Income tax is equally important. Income earned from commercialisation of research is an important source of income for many research institutions. Where profits arise the tax exemption allows these to be wholly directed into further research. Charities conducting health and medical research are not competing with the private sector, and so concerns about unfair competition with the private sector are not relevant.

Research Australia recommends the retention of the income tax exemption for research institutes and higher education institutions, and for other not for profit organisations conducting research.

Fringe Benefits Tax

The discussion paper highlights that the biggest concession to the NFP sector is FBT, far larger than the cost of the DGR concession. Research Australia accepts that there is scope for an overhaul of existing FBT exemptions and concessions, which are very complex. Many are in place for historical reasons and may no longer have the same rationale they had in the past.

There has been an increasing use of NFPs to deliver Government services and programmes over recent decades. The Discussion Paper highlights that Government funding now accounts for 38% of NFP revenues and probably a higher proportion of employment related expenses. Any reduction in FBT concessions will reduce after- tax incomes in the not for profit sector, creating pressure for wage and salary increases which will have implications for Commonwealth, State and Territory Governments, and the cost to Governments of delivering programmes through the not for profit sector. This needs to be considered when looking at FBT exemptions/rebates.

CHANGING BEHAVIOUR- CORRECTIVE TAXES

> **The following section addresses Question 54 in the Tax Discussion Paper: To what extent does Australia have the appropriate mix of taxes on specific goods and services? What changes, if any, could improve this mix?**

Reducing the smoking rate has been a major health initiative in Australia and one in which we have been world leaders. It has been a multi-pronged approach, including:

- restrictions on sales, advertising and packaging;
- limitations on where cigarettes can be smoked;
- prominent public health campaigns about the dangers of smoking;
- public subsidy for measures to quit smoking; and
- taxes to make smoking less affordable.

Together these measures have been very successful in reducing the rates of smoking in Australia. Between 1991 and 2013, the proportion of the adult population that are daily smokers almost halved from 24.3% to 12.8%[6]

Reforming alcohol taxation

With the growth of the public debate on domestic violence, and Rosy Batty named Australian of the Year, awareness is rising of the role of alcohol abuse as a key contributor to domestic violence and street violence. Alcohol consumption is also one of the four modifiable risk factors for chronic disease, along with tobacco use, poor nutrition and physical inactivity.[7]

Population-wide alcohol control policies can both generate increased revenue for the Australian Government to manage the increasing cost of healthcare, and also reduce alcohol harms and the long-term cost of these harms. Alcohol taxation is one of a suite of measures to restrict the consumption of alcohol together with:

- the licensing of premises and other restrictions on purchase;
- the public funding of alcohol rehabilitation programs; and
- public health campaigns about the dangers of excessive alcohol consumption.

Considerable gains can be made through reforming the alcohol taxation system, which was described by the Henry Tax Review as 'incoherent', and is described in the Discussion paper as complex. The Discussion Paper recognises that part of this complexity is due to the competing different policy objectives of 'raising revenue, reducing the social costs of excessive alcohol consumption, and supporting wine producers and independent beer producers' (p.158) The Discussion Paper also recognises that price differences influence the consumption of alcoholic beverages, indicating the taxation of alcohol is an effective tool for influencing consumption patterns.

The taxation of alcoholic products could be simplified and improved by focusing on harm reduction**.** The Foundation for Alcohol Research and Education (FARE) made a detailed pre-budget submission to Treasury on this issue, and two of their proposed measures are highlighted below.

1. **Replace the Wine Equalisation Tax (WET) with a volumetric tax**
   Projected savings: $3.4 billion over four years

   a. Replace the Wine Equalisation Tax (WET) with a volumetric tax rate equivalent to the full strength draught beer rate, and gradually increase it until the taxation applied is consistent with other products of a similar alcohol content. (The rate will be between the full strength packaged beer rate and the spirits rate.)

   b. Tighten the definition of products taxed under the WET to ensure that alcohol products which imitate spirits are taxed in the same way as spirits.

   c. Remove cider from the WET and tax cider using the current beer taxation arrangements, as cider has a similar alcohol content. Where cider has added flavours it should continue to be taxed as a ready-to-drink beverage

[6] 2013 National Drug Strategy Household survey, cited at http://www.aihw.gov.au/risk-factors-tobacco-smoking

[7] Australian Institute of Health and Welfare 2012. Risk factors contributing to chronic disease. Cat No. PHE 157. Canberra: AIHW.

(RTD).

2. **Abolish the Wine Equalisation Tax (WET) rebate**
Projected savings: $1.12 billion over four years

The total savings of $4.52 billion could be used in part for alcohol and other drug services, domestic violence refuges and to fund the MRFF. This could be positioned as a postive preventive health and harm program.

More details can be found in the FARE submission to Treasury, February 2015.8

Research Australia recommends retaining specific taxes on tobacco and alcohol as part of a continuing campaign to reduce smoking rates and alcohol consumption in Australia.

Research Australia recommends that the primary focus of taxation policies in respect of these products should be harm reduction, and existing taxes on alcohol should be reformed in line with this objective.

The role of excises of this kind should be recognised in any future tax system and remain a policy tool available to address other issues in the future. For example, Australia is recognising the increasing public cost of obesity, with the rise of chronic illnesses like diabetes and heart disease linked to obesity. Taxes on specific foods should be part of the 'armory' of tools available to policymakers to address obesity.

Research Australia recommends that the tax system remain flexible enough to accommodate future taxes designed to influence public behaviour in the public interest.

This includes the option for higher taxes on certain foodstuffs based on their fat and sugar content, with revenue available to fund relevant research and public health programs.

[8] http://www.fare.org.au/wp-content/uploads/2011/07/FARE-Pre-budget-submission-2014-15-final.pdf

CONCLUSION

Research Australia welcomes the Review of Australia's tax system and is pleased to have had the opportunity to make this submission. Our Tax system is large and complex and has evolved over decades. It affects the way in which Australians interact and transact with each other, for both good and bad. Research Australia is keen to see reform of some aspects of our system but is equally keen to ensure that unintended consequences for Australian health and medical research, our economy and Australians' health and well being are avoided.

We would welcome the opportunity to discuss any aspect of this submission further and to provide additional information.

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