Michael Johnson Associates

Suite 4, 332 Darling St, Balmain
PO Box 542 Balmain NSW 2041
W mjassociates.com.au
T 02 9810 7211
F 02 9818 2297

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General Manager
Small Business Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

R&D Tax Incentive: "Targeting Access" Submission

Michael Johnson Associates (MJA) welcomes the opportunity to comment on the proposed amendments targeting access to the R&D Tax Incentive (the Incentive).

MJA is opposed to the changes contained in the proposed amendments which seek to prevent company groups with over $20 billion assessable income from accessing the Incentive. This opposition stems primarily from the negative impacts that we believe the proposed amendments will have on the Australian innovation system. It also is based on the marked lack of consultation and detail provided around the changes. We are also further concerned that the draft legislation is inconsistent with what was originally announced in the joint media release of 17 February 2013.

Context in which the amendments are being proposed
We would like to make some preliminary comments regarding the environment in which these changes are being proposed and in which this submission is being made:

- The Incentive was the result of the 2008 Cutler Review of the Australian Innovation System which went on to underpin the Federal Government's innovation policy announcements in May 2009.
- Cutler clearly identified and articulated the need to encourage more businesses to do more R&D and thereby help create a better future for Australia as a vital plank of the Government's policy on innovation, science, research and technology. This included all Australian company groups and this has been the Government's public position until the 17 February 2013 announcement.
- In 2012, the Business Tax Working Group (BTWG) visited the issue of excluding company groups from the Incentive based on size of turnover and did not recommend any such change be made.
- The first claims for the Incentive are only now just being made. To seek to change the Incentive again will create more uncertainty amongst the entire innovation community, well beyond those companies directly affected.
- There is insufficient data to determine the impacts of the new Incentive, let alone any proposed changes to it.
- Evidence from the introduction of the R&D Tax Concession (the Concession), the cutting of the R&D benefit in 1996, its reinvigoration in 2001 and various studies done by or for AusIndustry and the Productivity Commission on the effectiveness of the former Concession shows that, ultimately, a reduction in the incentive for businesses to do R&D will reduce R&D done in Australia and this may reduce economic growth and future tax revenue.
- The 17 February announcement is not the result of any consultation and stands in marked contrast to the consultative processes associated with Cutler and the BTWG. Yet the Explanatory Memorandum (EM) contends that there is a policy basis for making the changes beyond a simple revenue saving measure. The EM provides no evidence for the policy assertions contained therein.

- The lack of consultation has been reinforced by the short timeframe afforded to those wishing to respond to the draft legislation and EM. The request for submissions went out on 7 May 2013 and closed on 20 May 2013, effectively providing only 9 working days for the preparation of responses. Given that the changes arguably directly remove 20% of the value of Australia's flagship innovation program, along with any downstream effects, the current process cannot be seen as involving good governance under any criteria.

Why we need the R&D Tax Incentive

The need for the Incentive is shown in the history of its predecessor, the Concession. Prior to the introduction of the Concession in 1985, Australian Business Expenditure on R&D (BERD) was only 0.39% of GDP. The success of the program in encouraging BERD that might not otherwise have occurred is shown in the growth of BERD to 1.35% of GDP by 2008. Further proof that businesses need encouragement to invest enough in R&D was shown in 1996 when the rate of encouragement was halved and eligibility tightened. BERD fell significantly and did not fully recover until corrective action was taken in 2001. A number of studies were undertaken by AusIndustry and the Productivity Commission up to 2007. All these studies identified that the Concession helped contribute more to taxation revenue than it ever cost.

Despite this clear evidence, some still stay that the Incentive does not encourage businesses to invest more in R&D because much of that R&D would have occurred anyway and that this is particularly the case with larger companies. The changes since 1985 and in 1996 show this claim to be unjustified. Further, such comments reflect a misunderstanding of the additionality argument. MJA has repeatedly submitted that additionality is primarily about the increased amounts of R&D that companies perform on R&D projects that they had already decided to undertake; it is far less about enabling the R&D projects that companies had previously rejected as being marginal on internal risk/return criteria. By reducing project costs, the Incentive funds more of the R&D already being undertaken while also bringing in some R&D that would otherwise have not occurred.

The policy issues contained in the draft legislation and the EM

The title of the EM uses the words "targeting access". Paragraph 1.1 of the EM goes on to assert that the amendment "better targets" the Incentive to businesses more likely to increase their R&D spending in response to government incentives resulting in a greater return on taxpayer funds.

MJA has two major points of disagreement with the above contentions:

1. Not one dollar saved by the amendments is reallocated under the Incentive to support R&D conducted by company groups with assessable incomes below $20 billion. The support going to those companies is determined by what they spend and is in no way affected by the removal of the large company groups. As acknowledged elsewhere in the EM, this is a savings measure and to brand it as better targeting of the Incentive is misleading.
2. The EM provides no evidence to support its contention that companies with assessable income below $20 billion are more responsive to government incentives than large ones. At Paragraph 1.6, there is mention of the broad international support for the view that small firms are more responsive than large firms to government R&D incentives but not one piece of authority is offered in support of this argument. In the same paragraph, the assertion is repeated that the changes better target "small to medium enterprises" which thereby infers that such enterprises have an assessable income of less than $20 billion. It is an absurdity to characterise companies with a turnover less than $20 billion as small to medium enterprises and highlights now flimsy the policy positions are in the EM.

Looking at some of the policy concerns in greater detail,

<u>Lack of modelling of impacts of proposed changes</u>

The proposed amendments set a dangerous precedent for a process by which changes can be made to Australia's largest innovation support program. In this instance, there is a complete lack of financial modelling and data to justify the changes and to outline the expected impacts on R&D spend and the various tax revenue dimensions.

Exploring this issue a little further, the Incentive offers company groups with assessable income greater than $20 billion an after-tax benefit of 10 cents in the dollar. This is roughly comparable with what was most recently available under the Concession (a hybrid of 7.5 cents and 22.5 cents) but well below what was first provided when the Concession began in 1985 (24.5 cents in the dollar).

As highlighted earlier, no data is yet available as to what the impact of the Incentive regime has had on R&D behaviour in any Australian company and the EM offers no evidence that larger organisations were historically less responsive under the Concession. In addition, there is no modelling provided in terms of the savings expected from the amendments or of the lost taxation revenue associated with any R&D that might not occur. No indication is given of the type or number of company groups likely to be affected.

The EM indicates that part of the savings from the measure will be used to fund other Government “priorities” including the recently-announced Industry and Innovation statement but it does not say how much of the (undisclosed) savings will be so used and what the priorities to be funded are beyond the reference to the statement.

<u>The largest Australian companies are a critical part of our innovation system</u>
It can be argued that the Government supported the immediately above statement prior to the 17 February media release. Now these companies are seen as not requiring the support provided by the Incentive to address the market failures associated with R&D nor generate the externalities customarily associated with those performing R&D.

A number of arguments can be put in counter to the assertions that small companies are more innovative than large companies and that they are more responsive to R&D incentives. These include the advantages afforded large companies through scale, deep access to supply chains and connections to research communities. The competitive environment regarding innovation outputs is one where large companies are the preferred medium to establish and complete in international markets of global dimension.

To remove the Incentive from these organisations will not only reduce the R&D being performed directly by these groups, it will threaten the basis on which these organisations engage in collaborative R&D with smaller companies, Co-operative Research Centres (CRCs), universities and other research institutes. The predisposition of large organisations to be involved in joint ventures, partnerships and the like will be compromised by the absence of the Incentive and the interests of the relevant parties will be defined to some extent around the tax benefits available. For example, if the operator of a joint venture is effectively excluded from the Incentive, it is far less likely to assist other venturers in the meeting of their obligations required to successfully claim the Incentive.

The Cutler Review emphasised the need to fully integrate all the components of the Australian innovation system and an attractive R&D incentive was seen as playing a key role in this integration. The company groups likely to be excluded from the Incentive are often the customers of the smaller companies that the Government is seeking to assist. These smaller companies often supply research inputs to the R&D projects that the very large companies conduct. Demand for these inputs will fall in line with the falls in the R&D spends of their largest domestic customers.

The change in circumstances may well lead the excluded companies to source their R&D inputs and collaborations in overseas jurisdictions.

<u>The Incentive is an issue of international competitiveness</u>
Government incentives for R&D are offered in a multitude of overseas jurisdictions. None exclude large corporates in the manner proposed in the amendments. Given that large corporates are highly mobile in the location of their R&D, it stands to reason that Australia will be put at a distinct competitive disadvantage by failing to offer any incentive to conduct R&D locally.

Time precludes detailing the programs in other regimes but the recent trend, particularly in the Asian region, has been to increase the value of the offerings. Further, evidence can be put forward that the presence of an R&D tax incentive does impact on decisions regarding location of R&D and the associated knowledge-based workers to carry out the projects.
The timing of the removal of this support seems particularly ill-advised as we seek to establish our points of difference in the 21st Century Asian economy.

Technical tax concerns with the draft legislation
There are a number of concerns that we would like to reflect upon in terms of the technical tax impact of the draft legislation.

The exclusion test should be based on turnover, not assessable income
MJA believes that the draft legislation contains a major departure from what was announced in the 17 February media release. We believe that the use of the concept of 'aggregated assessable income' in the determination of the $20 billion cut-off is a variation from the '$20 billion **turnover** or more' principle announced on 17 February which apparently applied to less than 20 company groups.

We have seen advice that sets out the differences between turnover and assessable income. In short, this advice is that assessable income is a broader concept in Australian tax law including a number of elements excluded from the concept of turnover including statutory income, sales of retail fuel and amounts derived from dealings with connected entities and affiliates. We understand that another party is making detailed submissions regarding this issue and we recommend that submission to you.

In addition, the 17 February release indicated that the exclusion test was to be based on annual **Australian** turnover while the draft legislation clearly captures foreign income of both Australian residents and Permanent Establishments in Australia.

Should the legislation proceed in spite of the arguments we have set out earlier, we submit that the draft legislation be rewritten to give accurate voice to the original announcement of an Australian turnover-based test.

Not all the expenditure of the excluded entities will be able to access deductions under the R&D provisions
Certain types of non-plant expenditure such as the creation of intellectual property, are unlikely to be deductible under the R&D rules and will be subject to far less favourable treatment than with the Incentive. This will introduce an additional bias against the performing of R&D by the excluded companies in the Australian jurisdiction.

The draft legislation should be amended to confirm across-the-board access to an R&D tax offset rate of 30%.

There is a complete lack of detail as to what will be required from excluded taxpayers to secure a 30% R&D tax offset
There is **no** detail in the legislation in the draft legislation and the EM as to what will be required of the excluded taxpayers in order to access a 30% R&D tax offset, the so-called third tier.

There is no indication as to what will be required of the excluded companies under the current AusIndustry/Australian Taxation Office (ATO) compliance framework. Relevant considerations include the need to register, the preparation of an R&D schedule for the company tax return, the need to maintain contemporaneous records and involvement in the risk review and audit system.

It is inexplicable as to why these issues are not addressed in the EM. Affected taxpayers are being left completely in the dark on these matters. It is possible that full participation will be required of the excluded companies and they will be subject to full compliance costs to secure no permanent after-tax benefit.

This omission is a glaring example of the lack of thought and detail that has gone into the EM to support the proposal.

The application of the exclusion is unpredictable for taxpayers close to the $20 billion threshold
The use of the concepts of assessable income and grouping will make the potential application of the threshold highly unpredictable for company groups in the vicinity of the $20 billion figure.

The Incentive is designed to impact the type and level of investment decisions at the time they are made. The fact that the Incentive may subsequently not be available because a combination of circumstances sees a company group exceeding the $20 billion threshold where it is not certain that this will be the case will deter these groups from making R&D decisions on anything other than the conservative assumption that the Incentive will not apply.

This introduces additional uncertainty into the system and will be an additional dampener on levels of R&D investment.

In addition, thought should be given to indexation of the threshold to preserve the current notion of $20 billion as being the appropriate determinant of exclusion.

Other tax technical concerns
We have seen advice that raises some additional concerns around the '40% grouping test' being set too low causing issues where there is an understandable lack of transparency between connected entities and with an incorrect calculation method used in Example 1.2 in the EM.

MJA understands that these issues are fully explored in another submission being provided to the Treasury and we recommend that submission to you.

Conclusion
MJA supports any process by which the Incentive can be shown to deliver improved outcomes for Australian taxpayers. We understand the need to address issues of fiscal responsibility as well as innovation policy. We pride ourselves on our participation and contribution to the various processes that ultimately resulted in the Incentive.

Our opinion is not swayed by our direct business interests. For example, we always argued vigorously against the Incremental component of the old Concession even though we accessed these benefits daily for our clients. We recently made a submission regarding the quarterly credits legislation that set out our deep misgivings about the system even though we believe it will attract business in the short term.

In this instance, we oppose the legislation on the basis that it utilises unsubstantiated policy assumptions. Perhaps more significantly, we oppose these changes because they have not been the subject of any analysis, scrutiny or debate. The extremely short timeframe for responses regarding these changes has meant that no real consultation has been possible. Given the alarming impacts we believe that the changes could occasion on the Australian innovation system, we cannot in good conscience support them.

We greatly appreciate the opportunity to make this submission. Should you have any questions regarding the above, please contact me or Ian Ross-Gowan on (02) 9810 7211.

Yours sincerely

Kris Gale
Managing Partner
Michael Johnson Associates