BUDGET SAVINGS (OMNIBUS) BILL 2016

Submission to the Economics Legislation Committee on the proposed reduction in the rates of R&D Tax Offset

September 2016

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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TABLE OF CONTENTS

BUDGET SAVINGS (OMNIBUS) BILL 2016

SUBMISSION TO THE ECONOMICS LEGISLATION COMMITTEE ON THE PROPOSED REDUCTION IN THE RATES OF R&D TAX OFFSET

Introduction

Research Australia is pleased to have the opportunity to make this submission in respect of the proposed amendments to the rates of R&D Tax Offset contained in Schedule 22 of the *Budget Savings (Omnibus) Bill 2016* (the Bill). Research Australia is opposed to the proposed reduction in the R&D tax incentive.

The current R&D Tax Incentive was introduced with effect from 1 July 2011. While there is currently little publicly available data about its effectiveness (the report of a review of the R&D Tax Incentive commissioned by the Government in 2015 has yet to be made public) it is clear that the take up has been greater than expected and anecdotally it has provided an important boost to Australian private sector research and development (R&D). The original proposal in the 2014-15 Budget to reduce the rate the R&D Tax Incentive by 1.5% was purported to be necessary to preserve the R&D tax incentive's value relative to the proposed lower company tax rate of 28.5%.

Importantly, many smaller companies which receive the refundable R&D Tax incentive are paying little or no tax because they are in a research intensive startup phase. The reduction in the corporate tax rate will not offset the reduction in the R&D Tax Incentive for many of these companies. A reduction in the tax rate for larger companies, while mooted by the Government, has not been legislated.

Research Australia also wishes to highlight the scope for additional targeted research to improve the effectiveness and efficiency of Australia's health system, and thus help to curb the growth in future Commonwealth Government health expenditure.

This submission provides an overview of Australian health and medical research, identifies Commonwealth government sources of funding and support, the role of State Governments, the importance of the H&MR research sector to the economy, and the role H&MR can play in assisting the Commission in its task of addressing waste and duplication in Commonwealth Government expenditure.

This submission reflects the arguments put by Research Australia to the Senate Economics Legislation Committee's Inquiry into the *Tax and Superannuation Laws Amendment (2014 Measures no. 5) Bill 2014*.

Supporting Australian R&D

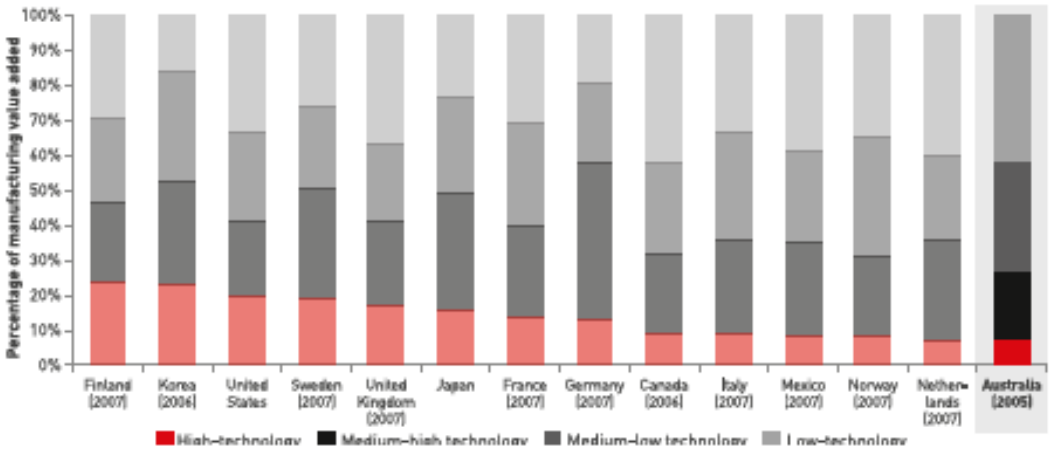
Fundamentally, the R&D Tax Incentive is an industry support measure rather than a tax measure. The Tax system may be the mechanism by which this support is delivered but it is designed to provide government support for industry R&D.

The current scheme was introduced with effect from 1 July 2011, with the aim of providing a more targeted and streamlined scheme for the support of productive Australian R&D. It consists of two components, the Refundable and Non-refundable R&D Tax Incentives.

Why support R&D?

The imminent closure of the car industry in Australia has helped to make Australians more conscious of our reliance on the resource industries. Research Australia is of the view that Australia's manufacturing future lies with higher value-added industries such as advanced manufacturing, medical technologies and pharmaceuticals. Globally, manufacturing in developed countries is shifting towards high tech industries. The proportion of Australian manufacturing that is high tech is lower than our peers, as the following table demonstrates.[1]

Chart 1.2 Value added in manufacturing output, by technological intensity classes, 2008, by country (As a percentage of manufacturing value added)



Sources: OECD Structural Analysis Database (STAN); ABS (2009) Experimental Estimates for the Manufacturing Industry, cat. no 8159.0.

Note: The chart is based on the Technology intensive classification of manufacturing as part of the International Standard Industrial Classification (ISIC)— Revision 3.[42]

Australia's top 20 manufactured goods in 2012-13 were still dominated by low to medium technology exports, notably refining of minerals and food, but there is evidence that this is changing. Our exports with highest growth in value are in high technology fields. The largest increases were in scientific instruments (largely medical), and medicinal and pharmaceutical products as the following table illustrates.[2]

[1] Department of Industry, 2013, Australian Innovation System Report 2013, p.27

[2] Prime Minister's Manufacturing Taskforce, 2012, Smarter manufacturing for a Smarter Australia- report of the non-government members, p. 23.

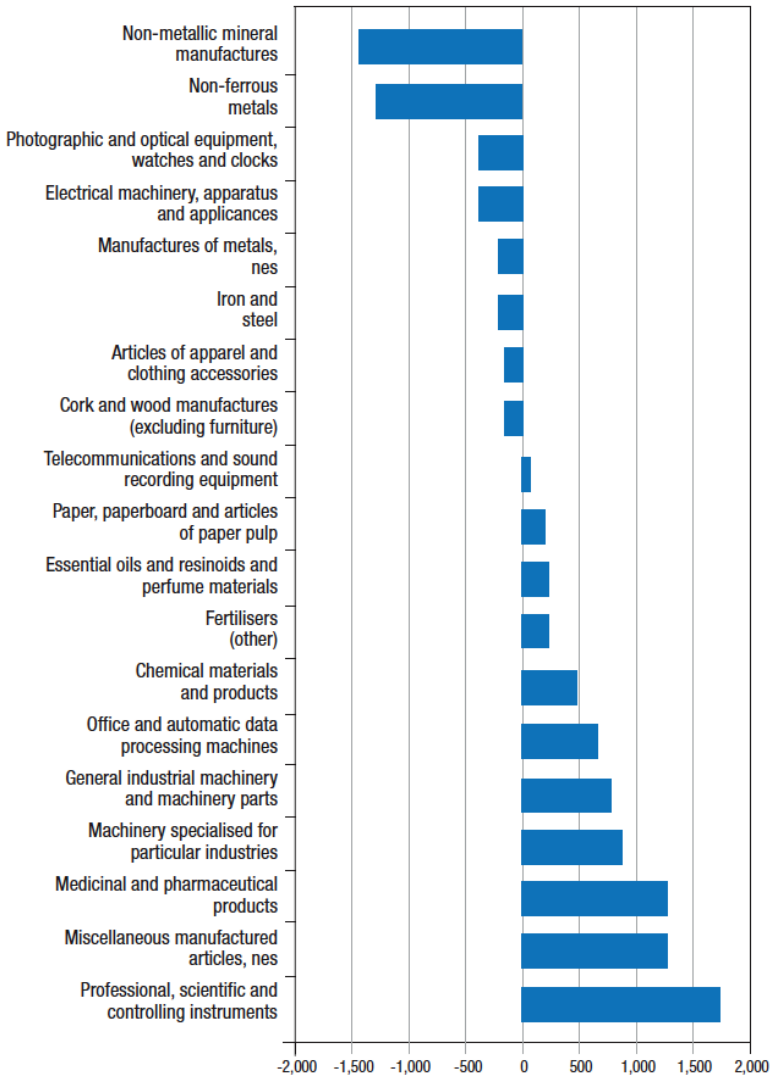


Figure 2.15

SELECTED AUSTRALIAN MANUFACTURED GOODS EXPORTS

Change from 2002 to 2012, annualised from June quarter to March quarter, chain volume measures – $m

Source: 5302.0 Balance of Payments and International Investment Position, Australia, Table 103. Merchandise exports, chain volume measures, March quarter 2012.

All of these areas are underpinned by scientific research, and are R&D intensive. They all benefit from the R&D Tax Incentive.

Lack of Capital

One of the critical issues facing innovative, research intensive Australian companies is a lack of capital.

The below table highlights the relatively low availability of risk capital to support innovative Australian startup companies.[3]

Figure 5: Top world start-up ecosystems, 2012

Source: Author's elaboration, based on Telefónica Digital and Startup Genome, 2012.
Note: The bubble size indicates the positioning of each territory in the total ranking, where Silicon Valley ranks at the top (i.e., 20) and Santiago at the bottom (i.e., 1). In each index, Silicon Valley is assumed to be the reference and it ranks at the top (i.e., it scores 20). The funding index measures the availability of risk capital in each start-up ecosystem, while the talent index ranks the skills of the start-up founders in each territory, taking into account different variables including age, education, work experience, and industry domain expertise, among other factors.

More recently, the Australian Bureau of Statistics has reported that a lack of funds was a barrier for innovation for 20% of Australian businesses.[4]

The R&D Tax Incentive helps to address this issue, particularly the Refundable Tax Incentive available to smaller companies. It provides access to additional capital, linked directly to the company's expenditure on R&D. If the Australian Government is serious about boosting Australian R&D and promoting higher value added industries, cutting the R&D Tax Incentive is not the way to go about it.

Research Australia submits that the reduction in the rates of the Refundable and Non-refundable R&D Tax Incentives should be rejected by the Senate because it will reduce an important form of Australian Government support for the industry led R&D that is essential to commercialising Australia's investment in research and developing Australia's high value manufacturing sector.

[3] Ibid, p.76
[4] ABS, Cat. No. 8158.0, Innovation in Australian Business 2012-13

Refundable R&D Tax Incentive

The most significant component is the Refundable R&D Tax Incentive. Available only to entities with annual turnover of less than $20 million, it provided $6.79 billion in support for R&D by these companies over the first three financial years of its operation, from 2011-12 to 2014-15. Over the same period, the Non-refundable R&D tax incentive provided $4.25 billion in support to companies with annual turnover in excess of $20 million. In other words, over 60% of the total expenditure on the R&D Tax incentive has been to smaller companies through the Refundable component.[5]

This is important for a couple of reasons. First of all, it shows that the support is being directed to where it is most needed; that is to small companies seeking to develop new products. And the reason this scheme provides a refundable benefit, is because the **tax offset can exceed the income tax payable** by these companies.

This point is critical when considering the rationale for the reduction in the rate of the R&D tax offset by 1.5 %, which is to maintain relativity with the 1.5% reduction in the company tax rate. Putting aside the concerns about whether the reduction in the company tax rate will actually occur, on face value it appears that the reduction in the rate of the R&D tax incentive would be revenue neutral for the companies involved i.e. the benefit of the R&D tax incentive will be reduced by 1.5 % but this loss will be made up by a corresponding reduction in income tax paid.

However, this reasoning is fundamentally flawed; it assumes that the companies receiving the refundable R&D tax incentive are paying sufficient income tax to receive the benefit of the reduction in the tax rate.

This is clearly not the case; many of these companies are paying little or no income tax because they are operating at a loss for many years while they are in the process of developing products for market.

This fact is recognised in the design of the R&D Tax incentive, and is the reason why the refundable component is refundable i.e. it is **expected** that the value of the R&D tax incentive will exceed the value of the tax payable. In this situation, the reduction in the rate of the R&D tax incentive is not 'revenue neutral', and in fact results in a direct reduction in the support provided to small innovative companies in their early stages when need it most.

The consequence of the proposed amendment will be to reduce the level of Government support for the R&D undertaken by thousands of small research intensive companies, **regardless of a reduction in the corporate tax rate. Furthermore, the current proposal to implement the reduction in the offset with effect from 1 July 2016 will have an adverse impact on small companies' projected revenues and their planned expenditure on R&D for this financial year due to the refundable nature of the R&D Tax Incentive.**

Research Australia submits that the reduction in the rate of the Refundable R&D Tax Incentive should be rejected by the Senate because it will reduce an important form of Australian Government support for Australia's small innovative companies seeking to commercialise industry led R&D and which will not benefit from the reduction in the company tax rate.

[5] Australian Government, 2015-16 Science, Research and Innovation Budget Tables, Table 4

Non-refundable Tax Incentive

The Non- refundable tax R&D Tax Incentive is available to eligible companies with annual turnover in excess of $20 million, and as already noted, accounts for nearly 40 % of all expenditure on the R&D tax Incentive. While non-refundable, any unused portion can be carried over to future years.

The reduction in the rates of both the refundable and non-refundable R&D Tax Incentive proposed in the Bill will take effect from 1 July 2016 if the Bill is passed.

The proposed reduction in the company tax rate of 1.5 % is designed largely to offset the proposed reduction in the tax rate applied to large companies.

Research Australia submits that the reduction in the rate of the Non-refundable R&D Tax Incentive should be rejected by the Senate because there is no certainty that the measure to which it is linked – the reduction in the company tax rate- will be implemented, or when this will occur.

CONCLUSION

Research Australia has been pleased to have the opportunity to make this submission in respect of Schedule 22 of the *Budget Savings (Omnibus) Bill 2016 noting the unusually condensed timeframe for a response.*

Private sector R&D is critical to Australia's future prosperity as a nation. The R&D Tax Incentive is a relatively new scheme introduced to better target and streamline Australian Government support for private sector R&D and the indications are that it is succeeding, with the bulk of the funds flowing to small to medium sized companies.

The proposed reduction in the R&D Tax Incentive occurs at a time when Australia needs to boost rather than wind back its support for R&D, and when the report of a review of the effectiveness of the scheme, commissioned by the Government in 2015, has yet to be released. Applying the reduction with effect from the commencement of this current financial year introduces even greater uncertainty and affects current expenditure plans on R&D, particularly for small companies rely on the refundable offset. Research Australia is of the view that the proposal to reduce the R&D Tax Incentives is misconceived and lacks longer term risk-benefit weighting. In particular it is at odds with the stated intention to shift gears in laying the foundations for an economy that is not reliant on resources and heavy manufacturing. Research Australia submits that Schedule 22 of the Bill should be rejected by the Senate.

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