



Tuesday, 25 September 2012

Submission by the
American Chamber of Commerce in
Australia
to the
Business Tax Working Group

**Regarding the Discussion Paper of August
2012**

American Chamber of Commerce in Australia

Suite 9, Ground Level | 88 Cumberland Street | Sydney NSW 2000 | Australia

T: +61 2 8031 9000 | F: +61 2 9251 5220

Website: www.amcham.com.au

The American Chamber of Commerce in Australia wishes to set out its views on the matters discussed by the Business Tax Working Group (BTWG) regarding the means by which reforms of the Australian tax laws may assist the Government in funding a reduction in the tax rate applied to companies.

Tax Rate

The company tax rate of 30% has been noted by the BTWG as being high when compared with tax rates applicable in other developed countries. If business in Australia is to benefit equally by a reduction of the tax rate, a proper design feature of tax reform to fund that reduction should be an equal sharing of the costs of such reform. There is a significant risk that industries bearing significant capital costs, funding significant expansion or investing in future technologies will suffer by far the most from the proposed reforms. It is noted that the companies investing in industries where these aspects are dominant are often owned by Parent Companies established in the United States. Hence there is an apparent bias in the reforms as presently proposed.

Should the BTWG propose to “fund” a reduction of the rate by the amendments to deductibility of three significant business expenses incurred in conducting operations in Australia, then AmCham would recommend that the views of its members be considered as set out below. The three amendments commented upon are

- Deductions for interest costs
- Deductions for capital allowances
- Concessions for Research and Development

Interest Deductions

Introduction

Paragraph 98 concludes in relation to thin capitalisation that “the Australian rules could be seen as overly generous” This seems to be based on an assessment against the rules in other countries and unexplained flaws in the arm’s length debt test (ALDT).

We accept that it has been more than a decade since the Australian thin capitalisation rules have been changed and that a number of countries have revised their rules over this period. On this basis, a review of the thin capitalisation rules may be warranted. However, we do not feel that the DP provides any compelling evidence that Australia’s existing rules are “overly generous”. By way of example there are many Australian and foreign owned groups which could borrow significantly more than the safe harbour amount because of their borrowing power attributable to the goodwill of their business which is not an asset included for calculation of the 75% of assets test.

Other Considerations

We believe that it is important to emphasise that:

1. The ATO is seeking to challenge well established and widely supported positions in relation to the operation of Australia’s thin capitalisation and transfer pricing rules which may well lead to litigation in the Courts. We understand such positions by the ATO may well also lead to disputes between the Government of Australia and our tax treaty partners. The likelihood of ATO failure in relation to these matters should not influence the BTWG’s decision in relation to thin capitalisation.
2. Any judgement about the “generosity” of the current Australian thin capitalisation rules should be based upon a detailed and current study of the rules internationally. We would recommend that an international firm be appointed by the BTWG to undertake this study.
3. In undertaking international comparisons of other thin capitalisation regimes, the BTWG should take into account design features of:

- a. The particular thin capitalisation rule. For example:
 - i. Germany provides an “equity escape clause” in addition to an EBITDA test¹.
 - ii. The US has a balance sheet test and an arm’s length alternative in addition to an EBITDA test. The EBITDA test allows for the carry-over of denied deductions and excess cashflows. In addition, the US rule seeks to adjust only related party (included guaranteed) debt and provides a transfer pricing interest rate safe-harbour. It also reduces the deferral to the extent withholding tax has been paid.
- b. The tax system of the country more generally. For example, in the context of judging if the thin capitalisation rules “strike the right balance between revenue protection...and allowing firms to structure their finances as they see fit” it would be relevant to consider rules relating to, inter alia, debt creation, debt/equity, withholding tax, interest deductibility, taxation of foreign income, safe-harbours, anti-avoidance and transfer pricing. In our view, a focus solely upon thin capitalisation rules in Division 820 is not sensible. In addition, we think it is important to avoid mistakes of the past where particular tax reforms have not addressed the flow-on consequences to other aspects of the tax system². This has lead to anomalous and unanticipated consequences.

Reform Options

For the purposes of the discussion below, we have assumed that the BTWG has addressed each of our points noted above and identified clear evidence that the thin capitalisation rules should be revisited. In that context, we provide observations in relation the reform options:

1. The current balance sheet safe harbour rule could be adjusted from 75% to some other percentage which is internationally competitive.
2. Removing the arm’s length test (ALDT) entirely is not appropriate. In simple terms, this is because there are likely to be a considerable number of situations (particularly in the infrastructure sector) where this would jeopardise interest deductions in respect of third party debt. In addition, it would be necessary to consider if this approach would breach the OECD’s view in relation to thin capitalisation provisions³. For example, the OECD recognises that there is interplay between tax treaties and domestic rules on thin capitalisation⁴.
3. The ALDT (in its current form) does suffer from some difficulties of interpretation, but has been applied by both taxpayers and the ATO on many occasions. Hence it is not all clear why the Discussion Paper recommends its withdrawal be considered. Nevertheless if the ALDT is removed, then an alternative means of measuring the independent borrowing power of the Australian group must remain. A “profit or cash flow” alternative might be introduced as an approximation that has ease of administration and calculation. It would particularly cater for companies that do not have balance sheet assets sufficient to satisfy the safe-harbour. For example, this might be applicable to a long existing services company which might have relatively low asset values (goodwill cannot be revalued under the current safe-harbour rule) on its balance sheet but substantial cashflow.
4. While the EBITDA model is one form of a cashflow model which we submit could be used as a substitute for the ALDT (and, in effect, a proxy for the ALDT) it has significant anomalous outcomes for certain industries and projects critical to the development of Australian resources. The debt facilities during

¹ References to an “EBITDA test” are intended to be a loose reference to cashflow style tests used in a number of countries. The design features vary (for example the US measures Adjusted Taxable Income) but in broad terms the intention is to identify free cashflow available to service debt obligations.

² There are many examples including Division 820 and Division 13, tax consolidation and various other provisions (eg demerger, Division 855, Division 124-M, Division 974), section 23AJ and section 25-90, Division 13 and Australia’s tax treaties.

³ For example, the OECD stipulates that thin capitalisation rules are acceptable provided “their effect is to assimilate the profits of the borrower to an amount corresponding to the profits which would have accrued in an arm’s length situation”.

⁴ Refer commentary to Article 9, paragraph 1 to the Model OECD Tax Convention and the OECD report on Thin Capitalisation (adopted by the OECD Council on 26 November 2006).

construction and/or development often provide for roll up of interest secured by the appreciating value of the project based upon the significant cash flows that only commence after construction and/development are complete. An EBITDA model would imply no debt could be adopted until the cashflows commenced. Hence, in this instance, the EBITDA model is a poor surrogate for an ALDT. As a minimum there should be a retention of the ALDT principle for projects in excess of a certain significant value, say \$500m.

5. A further possibility aimed particularly at anomalies highlighted above in relation to third party debt would be to limit only debt deductions in respect of related party debt.
6. In our experience the worldwide gearing test is rarely used and could be removed.
7. A safe-harbour interest rate rule should be introduced. In essence, this rule (available in the US) would ensure that a “base rate” of interest (based on publicly available information) is beyond challenge by the ATO. This would reduce compliance costs significantly without raising revenue concerns. Naturally, where the foreign lender is subject to an arm’s length transfer pricing rule that deems the yield to take into account the credit risk of the borrower, as required by the OECD model approach, there may be basis for the further discussion as there is the risk of double taxation.
8. Transitional rules (eg grandfathering or phasing-in) must be considered by the BTWG. Many financing arrangements with third parties have break clauses. The financing may be subject to specific assets secured such that a mere relocation of debt from Australia to the foreign group’s parent or some other foreign related entity may be both practically difficult and expensive. A period of two years to reorganise such debt would be a minimum in many instances.
9. We comment only on the “general” thin capitalisation issues. Separate consideration will be necessary in relation to banks and other financial entities.

It is recognised that there is an overlap between the thin capitalisation and transfer pricing rules. Most recently, this was recognised in the retrospective “stage 1” transfer pricing reforms⁵. It will be necessary to be conscious of this overlap in any amendments to the thin capitalisation rules.

Capital Allowances

Introduction

The key issues to be highlighted with the proposed options to reform the capital allowance regime are:

- A cut in the corporate tax rate is seen as a positive reform. However any benefit from the reduction in tax rate appears to be offset for many taxpayers by the disadvantages of the options put forward for consideration by the BTWG, particularly those taxpayers in capital intensive industries such as the resource sector. We are aware that for many projects, a reduction of at least 5% in the corporate tax rate would be required to offset the cost to business of the options proposed to fund such a rate reduction.
- The timing of the proposed reform is poor given the current stage in the lifecycle of Australia’s resource sector, with the recent commitments to various large scale investments – for example, Final Investment Decision, or FID, has recently been taken on numerous liquefied natural gas (LNG) projects and other major capital projects and these decisions were made having regard to the current fiscal regime. In addition, other projects are due to make FIDs in the near term and the proposed base broadening options will impact the viability of such projects.
- The impact of taxation is critically important to establishing the commercial viability of projects, in valuing projects and also in establishing the international competitiveness of a project. In addition, investment decisions are typically analysed on an after tax basis. As such, the BTWG must have regard to the tax impact on investments and in particular, the net present value (NPV) rather than nominal impact of any reforms.

⁵ Refer paragraph 1.104 of the Explanatory Memorandum to Tax Laws Amendment (Cross-Border Transfer Pricing) Bill (No. 1) 2012

- Capital intensive projects with long lead times, such as those in the resources and infrastructure sectors, will be adversely impacted by the proposed base broadening options. The NPV impact of these changes is far greater than any NPV benefit from a reduction in corporate tax rate due to the delay in being able to claim the decline in value of assets.
- The proposed options to broaden the tax base will not enhance Australia's international competitiveness, which is already declining due to the burden of Government regulation⁶, the increasing cost of doing business in Australia (primarily due to the increase in labour costs and other regulatory obligations – Australia is considered the highest cost country for LNG projects) and the emergence of competing markets (for example cheaper sources of gas worldwide). This means that existing tax measures including capped effective lives and accelerated depreciation are required more now than when they were first introduced.
- United States investors currently represent the largest source of foreign investment in the Australian oil and gas sector and as such, will be significantly impacted by the proposed base broadening options. International competition for investment is strong, with unconventional gas in America and Canada, as well as other gas projects in Indonesia, providing a lower cost alternative than Australian projects. Further reductions in the NPV of projects in Australia are likely to cause investment to be taken offshore to these other jurisdictions.
- A reduction in the corporate tax rate alone will not achieve the growth required by the Australian economy or attract further foreign investment. The removal of the current measures for capital intensive industries (including accelerated depreciation and capped effective lives) will further inhibit the ability for such industries to attract the foreign investment required to maintain the current level of activity, much less to fund future growth.
- Any reduction in the corporate tax rate must be funded through a fair broadening of the tax base, rather than measures that adversely impact the strong performing sectors of the Australian economy such as the resource sector. These options have the real potential to stifle economic growth as a result of the direct impact they will have on the viability of some existing and proposed Australian projects in the resource industries – if the incentives to keep exploring and drilling are removed, entire sectors of the economy could shut down. This would also have a detrimental flow on impact to various related sectors of the economy, including for example the significant services sector supporting the resource industry and Australian financial institutions that provide funding to such industries. Given the significance of US investment for the Australian economy, any such impact is of real concern for the Chamber and its members.
- The impact on the resource sector of the proposed changes must be considered having regard to the already heavy burden that has been placed on the industry due to the other recent changes implemented by the Government, including the carbon pricing regime and the expansion of the PRRT and introduction of the MRRT. The constantly changing fiscal environment is creating significant uncertainty and is likely to impact on investment in the sector.
- The proposed changes are contrary to the recent views of the Government, which acknowledged the importance of maintaining a stable environment for investment. In its Draft Energy White Paper released on 13 December 2011⁷, the Government stated in order to meet its aims of “providing a stable, attractive and open economy that facilitates international trade and investment” it was necessary to provide stable policy and without it, it would be “difficult or more costly to attract the necessary investments to meet our [Australia’s] energy needs”. Further, the Australian Government’s Policy Transition Group (PTG) paper released on 1 October 2010 also highlighted the need to ensure that “a pipeline of resource projects is secured for the benefit of future generations.”⁸

⁶ Schwab, K., *The Global Competitiveness Report 2011-2012*, World Economic Forum

⁷ *Draft Energy White Paper 2011—Strengthening the Foundation for Australia’s Energy Future*

⁸ Australian Government, Policy Transition Group, “*Issues Paper – Technical Design of the Mineral Resource Rent Tax, Transitioning Existing Petroleum Projects to the Petroleum Resource Rent Tax and Policies to Promote Exploration Expenditure*” 1 October 2010, p105

- Some of the options proposed by the BTWG in the Discussion Paper to broaden the tax base are unlikely to fund a permanent reduction in the tax rate. For example, the changes to accelerated depreciation and capped effective lives only impact the timing of the revenues received by the Government from these measures, rather than the total amount of the revenue.
- For taxpayers in the broader energy sector, they currently do not benefit from any of the additional write-offs that can be obtained by other investors (including immediate deductions for exploration, capped effective lives etc). The proposed measures that will impact on this sector, combined with the existing issues facing this sector, mean that taxpayers in the broader energy industry will be worse off. This is likely to result in a lower NPV for projects, which would lead investors to either accept lower returns or make less investments.

Our comments in relation to some of the specific options proposed by the BTWG are set below. We have not addressed all options and instead have addressed those that have the most significant impact on US investors, particularly in relation to investors in the energy and resources sector that will be most impacted.

Removal of capped effective lives

AmCham does not support any of the alternatives presented in relation to this option. The removal of capped effective lives, particularly for the oil and gas industry, will have a detrimental effect on the viability of current and future projects due to the significant impact on the NPV of these projects of such measures.

Other reasons supporting the view of AmCham are set out below:

- The cap on effective lives was originally introduced to enable Australia to be more competitive on an international stage. The removal of these measures will have a significant impact on the ability for Australia to remain competitive and in many instances in the oil and gas sector would result in projects being uneconomic. As a result, investments will be redirected towards other projects where the NPV of investments will be higher due to lower costs of construction and relatively stable fiscal regimes – for example unconventional gas projects in the United States and Canada will be favoured compared to more conventional gas projects in Australia where the costs are substantially higher (as much as up to 3 times more expensive).
- The Explanatory Memorandum to the Taxation Laws Amendment Bill (No 4) 2002 introducing these measures outlines the Government's rationale for the introduction of capped effective lives for oil and gas assets. In this document, it is quite clear that the Government considered the potential impact of increases in the Commissioner's effective lives on investment in capital intensive projects and, in consideration of the broader national interest in this context, the Government decided to establish effective life statutory caps to ensure appropriate capital allowance deductions remain available for taxpayers in affected industries.
- There has been no change to support a removal of capped effective lives; instead the current economic conditions (including rapidly rising costs) mean that the viability of various projects has become more marginal and there is a strong argument for further measures to be introduced to support investment in these projects.
- Treasury estimates regarding the financial impact of this measure appear to be too low and do not take into account assets for projects that have been committed to but whose start time will not be until after May 2013.

Reduce the diminishing value rate for depreciation from 200 per cent to 150 per cent

AmCham has real concerns about the impact such an option would have on many US companies doing business in Australia. The impact of the removal of accelerated depreciation will differ significantly across industries, with the biggest impact being felt by capital intensive industries and in particular, those in the resource sectors. This option will be a blow to capital intensive industries at a time when the government should be encouraging investment.

For US investors, which are heavily represented in the energy and resources sector, this measure could impact on the viability of their investments and direct future investment decisions away from Australia.

Other reasons supporting the concerns of AmCham are set out below:

- The accelerated depreciation measures were originally introduced in 2006 to address long standing issues with the ability for Australian capital intensive industries to compete internationally and to remain productive. These measures have been successful in achieving their aims to date and must be maintained on the basis there has been a further decline in the state of the Australian economy since 2006. The accelerated depreciation measures are required now more than when they were first introduced.
- The reduction of the accelerated depreciation to 150% does not align with the intention of the BTWG to recommend taxation reform for the purpose of increasing productivity and growth in Australia – the removal of this measure will impact those sectors that are driving the current growth in Australia. A strong and expanding resources industry will continue to make a significant long term contribution towards Australia's economic growth.
- The 200% diminishing value rate more accurately reflects the use to which many assets are put in capital intensive industries. For example, the petroleum industry sees higher production in the earlier years of a project, which will taper off over time. Accordingly, the 200% diminishing value rate aligns the depreciation deductions with the period over which the assets are primarily used to produce petroleum.
- Treasury estimates of the financial impact of this measure are not accurate as they are based on historical data. The impact of this measure is significant – for example, estimates will need to include depreciation relating to assets that will only be commenced to be constructed after May 2013 for the large LNG projects in Australia, in which a number of US companies are the operator of, or a major participant in. Assets for these projects will take a number of years to construct and taxpayers already have a significant delay in accessing depreciation claims on such assets due to the starting time rules.

Further, if such a change were even to be considered appropriate, the transitional measures required for capital intensive industries that have already committed to projects (particularly those in the resource sector with a long lead time) would necessarily be complex to ensure those projects are properly protected from the adverse impact of any such change as described above.

Even though projects have or will be committed to in the near future, depreciating assets will not commence to be held not be held for many years. This issue is even more significant with unconventional oil and gas projects, where the projects require large amounts of capital expenditure to be incurred throughout the life of the project and well beyond the time the investment decision is made. The time and resources required to be committed to such a transition process will negate any benefit from the proposed measure for Treasury.

Exploration expenditure

AmCham has real concerns in relation to the options regarding the income tax treatment of exploration expenditure. Exploration activities are critical to the continued growth of the resources sector, which in turn is a fundamental contributor to the health of the Australian economy.

We make the following additional comments:

- As noted above, the Australian Government's PTG Issues Paper released on 1 October 2010 highlights the importance of exploration expenditure given its role in ensuring "a pipeline of resource projects is secured for the benefit of future generations."⁹ The PTG paper conducted an in-depth review of arguments for and against Government intervention in relation to policies to promote exploration expenditure. While the PTG ultimately did not find that there was "a compelling case at present for fiscal incentives to promote exploration", it should be noted that this was in the context of a "current climate of high commodity prices".¹⁰ Perhaps, most importantly, after conducting their extensive review, the PTG made no recommendation to the Australian Government that the incentives for exploration should be reduced or removed. This contrasts distinctly from the options put forward for consideration by the BTWG.
- The level of exploration activities is affected by a range of factors, including the international competition for funds and fiscal regime applicable to such activities. Any changes to the current treatment of exploration expenditure will impact on investment choices, potentially directing investment away from Australia.
- Exploration is a fundamental activity required for the ongoing success of the resource sector – it is important to ensure a strong exploration sector contributes to a pipeline of new investment opportunities. Due to the nature of exploration activities and the inherent risk involved, maintaining the existing treatment of exploration expenditure is appropriate and essential for the ongoing conduct of these activities. Any changes would reduce the overall exploration effort in Australia. Furthermore, exploration expenditure is in the nature of recurrent expenditure and arguably deductible under the normal deduction provisions in any event.
- The treatment of exploration expenditure in Australia is not advantageous in comparison to other international locations. Generally speaking the overall impact is similar across many jurisdictions, even though some specific details can vary. An analysis of the general treatment of exploration expenditure in some of these jurisdictions is set out below:

Location	Treatment of Exploration Expenditure
United States	70% deduction in first year for integrated producers and a 100% deduction for independent producers
United Kingdom	100% upfront deduction for exploration expenditure
Canada	100% upfront deduction for exploration expenditure

- Given the resources industry is a global industry and US and other multinational companies operate in highly competitive industry (for example, the strength of the competition that exists in relation to the growth of unconventional hydrocarbon industry in countries such as the US and Canada among others), Australia needs to encourage further investment. In addition, more exploration is required in order to locate new energy resources in order to meet energy demands and help maintain Australia's competitiveness. Any changes to the current treatment of exploration could adversely impact on these objectives.

⁹As above

¹⁰See note 8, p5

- Any amendment to the treatment of exploration expenditure for income tax purposes must be considered in light of the impact not only on the corporate tax regime but also the secondary regimes, including the PRRT and MRRT regimes. Although there has historically been a similar treatment of exploration expenditure for the purpose of income tax and PRRT, and this would also be adopted for the purpose of the MRRT, AmCham does not support any move to adjust the treatment of exploration for PRRT or MRRT purposes.

Our specific comments in relation to the proposed changes to the first use deduction include:

- There has been no change in economic conditions since the first use measures were introduced to support the removal of this measure. The first use deduction has been instrumental in driving growth in the resource sector in Australia and it needs to be retained to ensure the ongoing success of the resource industry, particularly given the current difficulties being experienced in a time of rising costs.
- Changes to the first use measure are of particular relevance in relation to farm ins. Any changes to the regime in this regard would undermine the ability for taxpayers at the very early stage of exploration to attract additional investment from other parties to help fund further exploration activities.
- It appears that there is concern within Government that the first use deduction rules are used often in respect of the acquisition of plant and equipment. In fact, this is not the case.

Research and Development Concessions

R&D tax credit regimes worldwide have been shown to be effective at spurring additional research and development activities within those economies. Studies have shown that these R&D regimes are instrumental to boosting economic growth. More countries are now using tax incentives than a decade ago. As of today more than 20 OECD governments provide fiscal incentives to sustain business R&D, up from 12 in 1995 and 18 in 2004.¹¹

In the current economic climate, governments around the world are reforming tax incentive regimes in order to encourage greater R&D activities. As such, creating conditions in Australia for boosting innovation is more critical than ever before. Any proposal to wind back government funding of the R&D Tax Incentive in Australia could undermine Australia's innovative efforts and work to the detriment of private-sector R&D investment. Indeed such wind back is contrary to announcements of The Treasurer, Mr Swan and upon which companies have relied to continue to invest in R&D activities in Australia.

In conclusion, based on the analysis set out below, no changes should be made to the R&D Tax Incentive program in its current form.

Introduction

R&D incentives are an important tool in stimulating investment in innovation as a means to boost productivity, long-term economic growth and competitiveness. In recent years, governments around the world have been generally increasing and enhancing their R&D support (via grants and tax incentives) in order to drive more knowledge intensive, innovative and entrepreneurial economies, in efforts to make their economies attractive hubs for local and foreign R&D investments.

The financial crisis was the genesis of a wide range of new fiscal policies used to tightly focus their funding on specific sectors and development projects. As economies around the world struggle to recover from the impact of the global economic downturn, many governments are taking steps to make their R&D regimes attractive to multinational businesses.

Recently, R&D tax incentive regimes in particular have been the subject of reform and additional government support in an effort to stimulate additional R&D investment by businesses financially burdened by the severe

¹¹ "R&D tax incentives: rationale, design, evaluation", OECD, November 2010
 <<http://www.oecd.org/fr/sti/industrieetmondialisation/46586882.pdf>>

effects of the economic downturn, the capital intensity of conducting R&D, and the length of development cycles. Empirical evidence has shown that in the absence of government support, companies tend to under-invest in R&D relative to the social optimum¹². As such, tax incentives for R&D activities are extensively used as a policy tool designed to stimulate business R&D.¹³

The general trend among OECD countries has been to adjust their R&D tax incentives programs to make them more generous and simpler to use. Belgium, Ireland, Korea, Norway, Portugal and the United Kingdom have increased and sustained their tax credit rates or the ceilings of eligible R&D in recent years. Japan and the Netherlands have also increased temporarily the ceilings of eligible R&D. Some examples of worldwide R&D tax credit regimes and recent reforms are discussed below:

- China is now the second largest nation (after the US) in gross R&D spending¹⁴. The country has had a program for more than 10 years that currently offers a permanent deduction and tax exemption for R&D activity. Under the recent tax reforms, **China** stepped up its effort to enhance its R&D-related tax benefits for businesses by allowing a 150% superdeduction for qualifying R&D expenditures.¹⁵ There is also a business tax exemption for expenses associated with the transfer of qualified technology. China also offers a corporate tax rate of 15% (normally 25%) for companies granted high and new technology enterprise (HNTE) status.
- In 2011, the UK introduced a ‘patent box’ regime, in addition to amending its R&D tax incentive so that it is accounted for above the line. The UK offers a permanent superdeduction for qualified R&D activities¹⁶. Qualifying large companies¹⁷ are able to take a 130% superdeduction while SMEs who were entitled to claim a 175% superdeduction, are now, effective 1 April 2011, entitled to a 200% superdeduction¹⁸. Further, SMEs¹⁹ can receive cash credits of up to 25% of qualified expenditures if they are in a taxable loss position.
- Singapore improved its productivity and innovation credit to include an increased tax deduction for qualified R&D expenditure plus incentives for R&D carried out abroad.
- France replaced its more complex hybrid volume and incremental-based programs with simpler and more generous volume-based programs. France refunded all pending claims from the previous years in 2009. Previously, firms would have had to wait up to three years before getting the refund of their unused credit. It was predicted that this measure would increase forgone tax revenue to USD 6 billion (0.29% of GDP).²⁰
- In Ireland, the 2004 R&D Tax Credit was introduced in recognition of the fact that internationally, similar fiscal incentives are widely used to stimulate private sector R&D.²¹ The rate of this tax credit for incremental expenditure has since increased from 20% to 25%, such that the total tax relief available for qualifying R&D expenditure can be as high as 37.5%.
- The USA has stated that their program, the Research & Experimentation (R&E) tax credit encourages innovation and provides a powerful incentive for businesses to continue to invest in research projects. Investments in R&E produce technological advancements that drive productivity growth and

¹² For example, Jones & Williams (1998) suggest that this optimum level of investment is two-four times higher than actual investment in the United States.

¹³ <<http://www.hmrc.gov.uk/research/report107.pdf>>

¹⁴ [Figure 1.23](#), “OECD Science, Technology and Industry Scoreboard” *OECD, 2011*,

¹⁵ *China Corporate Income Tax Implementation Rules, Article 95*

¹⁶ [“Research and Development \(R&D\) Relief for Corporation Tax”](#) *Her Majesty’s Revenue and Customs*

¹⁷ Under the UK tax credit, a large company is defined as having 500 or more employees and either gross revenue of over €100 million or gross assets of more than €86 million.

¹⁸ Finance Act, 2011, §43), and to 225% on April 1, 2012 - *Her Majesty’s Treasury, Budget 2011*

¹⁹ Under the UK tax credit, a SME is defined as having fewer than 500 employees and either gross revenue of up to €100 million or gross assets of up to €86 million.

²⁰ “R&D tax incentives: rationale, design, evaluation” *OECD, 2010*

²¹ “Technology and Innovation 2006-2013.” *Strategy for Science*

- Improvement in US living standards.²²

The fact that many of the R&D tax reforms undertaken by various governments in recent years involved increasing funding and government support for private sector R&D investment attests to the view that positive benefits result from R&D tax incentive programs.

Empirical evidence demonstrates R&D tax incentives create additionality

There is growing evidence that R&D tax relief impacts and influences where companies choose to perform their R&D. A study of the state tax credit in California found that it not only induced Californian firms to spend more on R&D but also caused firms to relocate there.²³ Similar effects are also observed elsewhere internationally, whereby research has shown that R&D in one country responds to the change in price of another 'competitor' country.²⁴

Business innovation is viewed by many as a solution to Canada's productivity performance. Research reveals that tax incentives are effective in stimulating more R&D – that is Canada would have lower levels of business R&D in the absence of these inducements.²⁵

In the US, research has shown that the R&E tax credit produces a dollar for dollar increase in research spending in the short run, and it is expected that a permanent credit would result in at least an equal increase in private-sector research spending over the next decade.²⁶

R&D tax incentives may affect the overall level of R&D investment in a country by encouraging R&D by firms that have not previously invested in R&D. Empirical evidence on this issue suggests that the presence of an R&D tax incentive is associated with a higher probability of firms becoming R&D performers.²⁷

Research undertaken in the UK and elsewhere has found that providing R&D tax incentives increases the amount of R&D expenditure undertaken by business. It has also found that the user cost of R&D is a statistically significant determinant of R&D investment for companies. In other words, the amount a company invests in R&D is responsive to changes in the user cost of R&D and by implication changes in the generosity of R&D tax credit policy.²⁸ A study conducted by the OECD²⁹ also found that in most respondent companies there was a belief that the overall amount of R&D increased as a result of the R&D tax credit system. The suggestion made was that in the long run, as R&D tax credit claims are made and received, confidence grew in the availability of this source of funding which could be invested in future R&D projects.³⁰

Why the R&D tax incentive is necessary for Australia

*"The new R&D Tax Incentive will be critical to thousands of Australia businesses. The new R&D Tax Credit is the biggest reform to business innovation support for more than a decade. It will boost investment, support jobs and strengthen Australian companies so they can take full advantage of new opportunities as the economy recovers."*³¹

– Wayne Swan

²² "Investing in US Competitiveness: The Benefits of Enhancing the R&E Tax Credit" *US Department of the Treasury*

²³ Paff (2005), Wilson (2007) referenced within <<http://www.hmrc.gov.uk/research/report107.pdf>>

²⁴ Bloom & Griffith (2001) referenced within <<http://www.hmrc.gov.uk/research/report107.pdf>>

²⁵ PwC: *Rewarding Innovation: Improving federal tax support for business R&D in Canada*, September 2011

²⁶ "Investing in US Competitiveness: The Benefits of Enhancing the R&E Tax Credit." *US Department of the Treasury*

²⁷ Corchuelo, 2009 and Hægeland and Moen, 2007, reference within "Tax Reform Options: Incentives for Innovation, The International Experience with R&D Tax Incentives." OECD, September, 2011

<<http://www.finance.senate.gov/imo/media/doc/OECD%20SFC%20Hearing%20testimony%209%2020%2011.pdf>>

²⁸ "An Evaluation of Research and Development Tax Credits." *HM Revenue & Customs (HMRC)*

<<http://www.hmrc.gov.uk/research/report107.pdf>>

²⁹ "R&D tax incentives: rationale, design, evaluation." OECD, November 2010

<<http://www.oecd.org/fr/sti/industrieetmondialisatie/46586882.pdf>>

³⁰ Study commissioned by HMRC/BIS from Databuild investigated businesses' processes for making decisions about R&D, aiming to identify the effect on their behaviour of both R&D tax credits and government grants for R&D, referenced within <http://www.hmrc.gov.uk/research/report107.pdf>

³¹ Joint Media Release with Wayne Swan and Kim Carr, *R&D Tax Incentive – Second Exposure Draft*. March 2010

Former Minister for Innovation, Industry, Science and Research, Kim Carr stated his desire to see global firms designing their research strategies around Australia. “*ABS data suggests that innovative businesses are 41% likelier to boost profits and more than twice as likely to boost productivity...As innovators, we have not done justice to that inventive strength. The latest data suggests that less than 45% of our business innovate. China's expenditure on R&D doubles every 5 years. India has pushed Australia out of the top 10 research nations.*”³²

Innovation is pre-eminent in India and China’s self-transformation. Many developed nations like Finland, Singapore and Korea have also responded by increasing their innovation effort. Meanwhile, the proportion of business expenditure on R&D financed by the Australian government fell by 23.3%, which increased the gap between Australia and the average of the top five OECD countries.³³

The Cutler review³⁴ argues that Australia must similarly increase their innovation effort in order to ensure that Australia’s most globally competitive industries (e.g. mining, agriculture, education and tourism) receive adequate research funding support to keep them at the cutting edge. This requires creating conditions that vigorously promote the capacity for businesses to innovate.

The evidence outlined above inescapably leads to the conclusion that it is probable that with sufficiently aggressive approaches to supporting innovation and durable R&D support for large firms, those large firms could regard Australia as an attractive location for substantial additional R&D investments.³⁵

Bibliography

1. “An Evaluation of Research and Development Tax Credit.” *HM Revenue & Customs (HMRC)* <<http://www.hmrc.gov.uk/research/report107.pdf>>
2. “OECD Science, Technology and Industry Scoreboard.” – *OECD, 2011*
3. *China Corporate Income Tax Implementation Rules, Article 95*
4. “Research and Development (R&D) Relief for Corporation Tax.” – *HM Revenue & Customs (HMRC)*
5. “Finance Act, 2011, §43), and to 225% on April 1, 2012.” – *Her Majesty's Treasury, Budget 2011*
6. “R&D tax incentives: rationale, design, evaluation” – *OECD, 2010* <<http://www.oecd.org/fr/sti/industrieetmondialisation/46586882.pdf>>
7. “Technology and Innovation 2006-2013” – *Strategy for Science*
8. “Investing in US Competitiveness: The Benefits of Enhancing the R&E Tax Credit” – *US Department of the Treasury*
9. “Rewarding Innovation: Improving federal tax support for business R&D in Canada” – *PwC*, September 2011
10. Corchuelo, 2009 and Hægeland and Moen, 2007, reference within “*Tax Reform Options: Incentives for Innovation, The International Experience with R&D Tax Incentives.*” *OECD, September, 2011* <http://www.finance.senate.gov/imo/media/doc/OECD%20SFC%20Hearing%20testimony%209%2020%2011.pdf>
11. *R&D Tax Incentive – Second Exposure Draft* – Joint Media Release with Wayne Swan and Kim Carr, March 2010
12. Kim Carr, “Innovate or perish” – *The Australian*, 15 September 2011
13. “*Australian Innovation System Report 2011*” – *Department of Innovation, Science and Research*, 2011
14. “*Venturous Australia – Review of the National Innovation System*”, Terry Cutler – August 2008
15. “*BERD in the Hand Paper – Supporting Business Investment in Research and Development*” – *Australian Business Foundation*, April 2011

³² Kim Carr, *The Australian – 'Innovate or perish'*, 15 September 2011

³³ *Australian Innovation System Report 2011*

³⁴ *Venturous Australia – Terry Cutler*, August 2008

³⁵ *BERD in the Hand Paper - Australian Business Foundation*, April 2011

Further contact:

Tony Clemens
Partner - Global Leader, International Tax Services
PwC Australia
Darling Park Tower 2 | 201 Sussex Street
Sydney NSW 2000 | Australia
T: +61 2 8266 2953
Email: tony.e.clemens@au.pwc.com

Charles Blunt
National Director
American Chamber of Commerce in Australia
Suite 9, Ground Level | 88 Cumberland Street
Sydney NSW 2000 | Australia
T: +61 2 8031 9000 | F: +61 2 9251 5220
Email: ceo@amcham.com.au