AUSTRALIAN ACADEMY OF TECHNOLOGICAL SCIENCES AND ENGINEERING

SUBMISSION ON THE CONSULTATION PAPER ON REVIEW OF BUSINESS TAXATION

The Australian Academy of Technological Sciences and Engineering (ATSE) believes there is a need for Business Tax Reform. In particular the Academy strongly supports any measures which will -

- increase business investment in research and development,
- increase investment in the commercial development in Australia of Australian developed technology,
- ensure continuing strong non-inflationary economic and productivity growth, through Australian industry being encouraged to continually invest in technological improvements, and
- ensure the taxation revenue base is adequate to provide the necessary public support for high quality education and research activities and facilities.

Clearly there are a number of areas in the Consultation Paper which impact on these objectives but this submission will be confined to comment on -

- the accelerated depreciation trade off with an overall lower corporate tax rate (Chapters 1 & 2)
- taxation of capital gains (Chapters 11 & 12)
- investment in Australia by non residents (Chapter 30)
- concessional tax treatment for research and development (not mentioned).

The Academy comments are guided by the view that the tax system needs to be simple, transparent, economically efficient and structured so that Australian industry can operate competitively internationally.

It noted that the Consultation Paper is aimed at revenue neutrality and essentially this submission attempts to honour this objective. The Academy does believe there are sound arguments for further Government support for science and technology but recognises that these will need to be mounted in a different forum.

Accelerated depreciation vs 30% Company Tax rate

The Academy's objective to encourage Australian industry to invest in new technology leads it to support any measures which will favour capital investment rather than persevering with repairing and maintaining obsolete equipment. As maintenance expenditure, unlike capital, is fully and immediately tax deductible, a more favourable treatment of capital outlays on productive plant and equipment will increase the likelihood that Australian industry will remain technologically competitive.

In an ideal world free depreciation (immediate expensing against current earnings) would be the ideal and accelerated depreciation the next best option. It is recognised that as the cost to revenue of such options could be considerable and that a 30% company tax rate is highly desirable, some compromise is necessary.

The option of capital intensive industries being able to retain accelerated depreciation and pay a higher tax rate while others can choose the 30% rate would have some attractions but has been ruled out by the Treasurer, presumably due to complexity and revenue loss.

A simpler option which would still allow firms to choose to maximise cash flow in the first few years after a major capital outlay picks up on the concept in the discussion paper that accelerated depreciation is akin to an interest free loan from government (2.4 - p.117). If a firm choosing to claim accelerated depreciation was charged long term bond rate interest on the 'excess' depreciation component (perhaps by reducing the total depreciable capital amount) then in theory revenue neutrality would be maintained and a 30% tax rate made possible. The attraction to a company exercising this option would be increased early stage cash flows through effectively cheaper loan funds, with less balance sheet impact.

ATSE recommends consideration be given to -

- establishing a 30% company tax rate to make Australian industry competitive internationally and increase funds available for investment.
- allowing firms to choose to accelerate the rate at which they depreciate new assets for tax purposes on the basis that they pay interest at the Government's borrowing rate on the 'excess' component of their depreciation claim.
- the interest be paid in later years as a tax surcharge or by reducing the depreciable value of the asset.

Taxation of Capital Gains

The current tax system makes investment in companies paying franked dividends more attractive than those with little or no dividend stream but high rates of growth in capital value. Particularly in the case of small, rapidly growing technology based companies which will eschew dividends in early years to retain earnings to invest in growth, the present Capital Gains Tax (CGT) system is a massive deterrent to investors. For such high risk companies investors inevitably realise their returns through selling their shares to another company or into a public offering, In Australia, for private investors, this means losing nearly half of their potential returns while being restricted to writing off any loss they make (not an uncommon outcome) against more successful gains they make elsewhere. It is no wonder that international investors shun Australian technology stocks and Australian investors find blue chip shares and property more attractive.

What makes the current CGT regime even more nonsensical is the relatively high investment the Australian Government makes in R&D in organisations such as CSIRO and the RIRDCs, and through programmes such as the CRCs and START. To encourage research yet discourage the commercialisation of the outcomes of this research through a penal taxation system is mystifying.

Intellectual property and the people involved in commercialising new technology are internationally mobile, as is venture capital. New companies will find it easier to raise their required capital in regimes where investors perceive the highest potential reward is available relative to the risks entailed. It is impossible to explain to an international provider of venture capital why Australia should be considered for an investment when the competition includes Singapore, Israel and in particular the USA.

The Academy is concerned that the uncompetitive nature of the Australian capital gains tax is inhibiting commercialisation of new technology in this country. In some cases it has made it necessary to take ideas off-shore, so denying Australians most of the economic and social benefits and the employment creation potential of research work undertaken here. The Academy would welcome any measure that would reduce the tax on capital gains in Australia to be at least equivalent to that applying in the USA in the eyes of international investors.

The Academy is aware that there are studies in existence which indicate that in the USA that reductions in CGT have historically increased tax revenue but as the net effects are unclear it would support any concession being confined to business assets only and to require the investment be held for at least one year, possibly two. Clearly there are a range of broader considerations which are of no direct concern to the Academy but its more narrow objectives would be met by a CGT system implied in the options in the consultation paper and which included -

- Removal of indexation on asset values (at least while inflation remains within the Reserve Bank target range).
- An exemption of 50% on the marginal tax rate for individuals and entities for capital gains on business assets (including shares sold into an IPO or takeover) held for more than two years. The UK definition of business assets could be used as a guideline.
- Provision for scrip-to-scrip transfers not to trigger CGT and consideration be given to exempting other revenue neutral movements between similar types of business investments. This would include private and unlisted companies becoming owners of shares in listed companies as a result of a merger or acquisition.

Although administratively more complex, the Academy would endorse as an alternative a CGT system with a UK type sliding scale, taxing short term gains as they are at present but longer term (10 year) gains at 20% or less. The guiding principle must be that whatever scale is developed it must be competitive with that prevailing in the USA, particularly as perceived by USA based investors.

Investment in Australia by non-residents

USA tax exempt pension funds are a significant source of capital for new technology based ventures in the USA. In any changes to the rules for foreign investment in Australian companies, it would be desirable for the tax regime faced by these funds to be competitive with that applying in their domestic market, or at the very least with other off-shore opportunities in Canada or Europe.

Limited Liability Partnerships are the favoured vehicles for large US pension funds to invest in start-up companies. Allowing these to be treated as partnerships rather than companies, as they are at present, while at the same time recognising the tax exempt state of the investor, would potentially attract significant funds into Australian technology ventures. There would be little loss to revenue as the present CGT system now in place means none of this investment is currently taking place.

It is recognised that this is a complex area so no specific recommendations are made in respect to other classes of overseas investors, apart from the general observation that risk capital is very mobile and if Australia is to see new businesses grow from its investment in research and development the tax regime needs to be internationally competitive. There is no reason to believe that Australian technology development is in any way inferior to that in Israel where the more friendly foreign investment environment has managed to attract more than US$2 billion of venture capital from the USA in recent years, creating new industries, new jobs and flow-on investment.

<u>Taxation concessions for Business Expenditure on R&D (BERD)</u>

It is disappointing that the Consultation paper did not address the question of tax concessions for R&D. As the 1997 Review of Business Programs Going for Growth pointed out, the social returns from business R&D exceed the private benefits which is the rationale for the widespread practice around the world of providing some type of government support through the taxation system or by other means. The Academy was alarmed to read in the Australian Financial Review on March 22, 1999 that the Chairman of the Review of Business Taxation stating that the R&D tax concession 'could be sacrificed' as part of the trade-off for the 30% corporate tax rate.

The Academy believes that the external benefits of BERD need to be recognised by Government and is deeply concerned that after several years of healthy increases in outlays expenditure is now declining, coinciding with the reduction of the tax concession from 150% to 125% in the 1996/97 Budget. This appears to indicate that firms which were inclined to assume the risks in undertaking research when the effective subsidy was in the range 16.5 - 24.5 cents per dollar spent (1985-1995) have second thoughts when the subsidy drops to 9 cents. (BERD is a misnomer in itself, betraying the widely held prejudice that R&D is a cost; BIRD - Business Investment in Research and Development would be more appropriate nomenclature.)

Compliance costs are the same whatever the concession level might be and if there was no adjustment should the tax rate drop to 30%, at a 7.5 cent per dollar subsidy the net benefit would likely to be so low that many firms would find lodging claims not worth the effort.

It is recognised that the open-ended nature of a tax concession, while simple to administer, presents problems to the Government as it is reported as a cost rather than a revenue item. This betrays the problem that R&D is seen as a current cost rather than an investment, so no consideration is given to any longer term benefits to tax collection.

The Academy strongly recommends that provision be made to return the effective subsidy level for BERD to at least 15 cents in the dollar. At a 30% corporate tax rate this would imply a concessional rate of 150%. If the Review was more attracted to the type of approach taken on Going for Growth an 'Innovation Rebate' of at least 45 cents would be required (less than the 50 cents recommended in that report; this further increase would be argued for in a different context to taxation reform). Businesses will not commit to R&D expenditure unless they are convinced that it will increase their future taxable income by something considerably more than the cost so, although there may be a short term net cost to tax revenue, in the long term there will be a significant positive benefit.

A highly attractive alternative to the current tax concession scheme would be the adoption of the current Canadian system where a tax credit of 20% is provided for qualified R&D expenditure, increasing to 35% for 'Canadian controlled private companies' for the first C$2 million pa investment in R&D, with provision for small claimants to receive a cash payment in lieu of a tax credit.

Conclusion

The Review of Business Taxation provides the opportunity to greatly enhance economic growth and job creation by encouraging investment in new Australian developed technology in Australia, while increasing the Government's return on its existing outlays on research and development. The present taxation system actively discourages such investment due principally to the way in which capital gains are treated. In particular it makes Australia internationally uncompetitive in the market to attract mobile venture capital.

As well as expanding the R&D effort in the country and encouraging the commercialising of locally developed technology, the Academy is keen to see the treatment of new capital expenditure in the tax system encourage Australian customers for this technology to invest in updating their equipment and systems. Recent US experience has shown that increasing productivity through application of new technology is a key element in sustaining high rates of non-inflationary economic growth. Business taxation changes which encourage not only the development and commercialisation of new technology but also stimulate its application in industry will be of immense long term benefit to the Australian economy.

Users/jd/tax policy

President:
Mr M A (Tim) Besley AO FTSE

13 April 1999

The Secretary
Review of Business Taxation
Department of the Treasury
Parkes Place
CANBERRA ACT 2600

Enclosed is the submission from the Australian Academy of Technological Sciences and Engineering in Response to the second discussion paper released by the Review 'A Platform for Consultation'.

The Academy strongly supports the need for Business Tax Reform and believes the adoption of the measures outlined here would provide the opportunity to simultaneously lift the rate of productivity growth, improve Australia's attractiveness to overseas investors, expand local technological based industries and increase the returns made from the Government's significant existing investment in research and development.

The Academy is happy to have the entire submission treated as a public document.

Yours sincerely

M A Besley

Encl.

President:
Mr M A (Tim) Besley AO FTSE

13 April 1999

The Hon Geoff Prosser MP
Chair
House of Representatives
Standing Committee on Industry, Science and Resources
Parliament House
CANBERRA ACT 2600

Dear Mr Prosser

SUBMISSION ON THE CONSULTATION PAPER ON REVIEW OF BUSINESS TAXATION

Further to my letter of 30 March 1999 I am pleased to forward to you a copy of the ATSE submission to the Review of Business Taxation.

Yours sincerely

MA Besley

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