

By Email

General Manager
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Email: randdtargetingaccess@treasury.gov.au

20 May 2013

Dear Sir / Madam

Re: Submission re draft legislation on targeting access to the R&D tax incentive

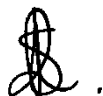
We appreciate the opportunity to respond to your request for submissions on the draft legislation that will restrict the access of large business to the R&D incentive provisions contained in Division 355 of the *Income Tax Assessment Act 1997*.

Although we understand the revenue pressures on the Federal Government in the current economic climate, we believe that there are credible and less discriminatory alternatives to the proposed legislation that would produce equivalent savings. The enclosed annexure sets out what we believe are critical policy issues that require further consideration before proposed legislation of this magnitude is put before Parliament. We have not sought to address the specifics of the draft legislation at this stage given the level of policy concerns.

We hope that these comments prove useful in finalising the proposed legislation on this issue.

Should you wish to discuss our submission in greater detail, please do not hesitate to contact either me on (03) 9671 7376 or alternatively Roisin Arkwright on (02) 9322 7412.

Yours sincerely



Serg Duchini
Director
Deloitte Tax Services Pty Ltd

Annexure

Overall the comments made in this submission focus on the following interlinked areas of consideration:

- The lack of alignment of the proposed legislation with international best practice and existing worldwide R&D regimes in seeking to limit the maximum benefit of R&D incentives for specific claimants
- The globally discriminatory nature of the threshold as it will apply to multi-national groups depending on the level of their turnover which is assessable in Australia rather than overseas, and the resulting likelihood of knowledge based R&D being offshored to other R&D jurisdictions
- The lack of consideration of credible alternative possibilities in the face of the falling ranking of Australia in global innovation indices

International background to implementation of R&D incentives

It is an accepted tenet derived from studies of international R&D incentives, economic theory and empirical analysis that R&D government incentives play a key role in achieving productivity gains and economic growth, and that the social return of the investment is higher than the private return to the investing firm.

Further analysis of the recognised literary reviews and studies on R&D that have been undertaken to date, which encompass country comparisons and international best practice, demonstrates that there are several accepted ways in which such tax credits or incentives can be credibly implemented.

These internationally recognised methods include:

- A simple volume based tax credit of a certain percentage of R&D expenditures regardless of their level of R&D expenditure
- A tax credit offered where a certain minimum limit is set (in either lump sum amount or in percentage of R&D expenditure) and a tax credit allowed if the company exceeds that limit
- A two tiered tax credit where a certain level of R&D expenditure (or turnover) would give a certain percentage of R&D tax credit and any amount exceeding that limit would give a lower (or higher) percentage of tax credit
- The imposition of an expenditure cap or ceiling to limit the maximum benefit available where necessary.

The relevant studies often conclude that two tiered credits can create high administrative costs and that ceilings to cap the maximum creditable amount should be used where excessive cost for a country's tax revenues may be an issue.

Currently therefore, in line with such international studies and other international best practice, Australia's R&D tax incentive regime since 2011 has embraced a number of these factors, being a tax credit for expenditure in excess of \$20,000 on the basis of a simple percentage of eligible R&D expenditure, and that percentage increases for small to medium sized entities with worldwide annual aggregate turnover of less than \$20m.

Subsequent to the introduction of the new R&D regime and recent international studies, a 2012 discussion paper of the Business Tax Working Group (BTWG), at that time headed by the current Commissioner of Taxation, raised a range of potential changes to the newly introduced Australian R&D tax incentive to enable a reduction in the rate of company income tax for small to medium sized enterprises.

The mooted options included:

- A reduction in the percentage rate of the R&D tax incentive from 40% to 37.5% (thereby maintaining the 7.5% benefit available under the former R&D tax concession)
- Imposing an expenditure cap such that R&D expenditure over a certain limit would not be eligible, or
- Imposing a cut-off turnover threshold at a relatively high level – notably the introduction of this option represented both a new concept in the history of Australian R&D incentives and a departure from the internationally recognised methods discussed above.

However the BTWG did not arrive at any recommendations or conclusions which were suitable to engineer such revenue neutral tax changes. As such, no competent consultation, analysis or discussion on any of the above suggestions was undertaken.

Therefore, aside from the introductory BTWG discussion paper, it is evident that no other independent consultation or studies have discussed or recommended a system which would entirely and completely exclude access to such a regime for entities with a certain level of turnover or gross income.

However less than a year later, a hasty announcement of an arbitrary threshold has resulted in draft legislation seeking to pursue an aggressively new option such that, as discussed in the literature surrounding the current proposal, Australia will effectively have a three tiered system with the top tier having an effective rate of 0%.

Given all of the above, it is unclear upon what credible basis or recognised findings that the current proposal rests.

Comparison with current worldwide practice

In addition to reviewing international best practice and consultation, it is also critical to undertake a review and analysis of the existing R&D government incentives that have actually been implemented and are currently operating on a worldwide basis.

On undertaking such an analysis, it is significant that there is currently not a single country worldwide which has implemented any form of an R&D tax incentive or subsidy where certain entities are denied access to the regime on the basis of an arbitrary threshold limit.

Rather, the following table summarises the provisions within other jurisdictions that have been implemented to limit the maximum benefit of the available R&D incentives where businesses may have high levels of R&D expenditure:

Country	Relevant limiting provisions
Singapore	The limitations applied to the section 14DA enhanced deductions and the combined total claims are all based on an actual expenditure cap or based on a percentage of total expenditure
Japan	The available standard R&D tax credit is limited to 30% of the company's national corporate income tax liability and the additional tax credit is limited to 10% of the company's national corporate income tax liability
Netherlands	The WBSO incentive that targets reductions in wage tax and social security for employees engaged in research is limited by an expenditure cap
UK	There are no caps for large businesses but a cap on small and medium sized enterprises (SME) to limit the additional tax benefit arising from being an SME to a specific amount.

Significantly this analysis demonstrates that each method of restriction utilises an expenditure cap methodology rather than the complete denial of access to the regime by an entity that exceeds a turnover threshold.

Consequently, since there are no jurisdictions that exclude any business outright from accessing the R&D tax incentives available, it is clear that Australian would be creating an international precedent by enacting the proposed legislation.

Global discriminatory nature of threshold and resulting offshoring of R&D

The justification for the proposed legislation appears to be underpinned by the mistaken and naïve belief that large Australian-based companies will undertake the same level of R&D within Australia that currently occurs regardless of the availability of any government incentives.

However like many other tax policy issues, it is insufficient to have regard to domestic issues in isolation; rather, as has been seen in many other areas of income tax, it is imperative to view tax policy decisions within the context of globally mobile flows of labour and capital.

It is also critical for policy-makers to recognise that Australia is not alone in offering the critical operational prerequisites to successfully conduct cost effective R&D. That is, a significant number of countries now offer multi-national groups access to growing markets and customer bases, human capital talent, intellectual property protection, a stable economy and government and an information technology infrastructure.

Indeed, an increasing number of countries are actively promoting themselves as an optimal location for the relocation of internationally mobile R&D operations as part of their innovation-led economic development strategies. R&D tax incentives are an important component of all of these strategies. This is apparent in an analysis of the correlation between tax based incentives and the level of business investment contribution to total R&D spend as a percentage of GDP across a number of major countries.

Given this global context and the nature of the Australian industries being targeted, it is a strong possibility that the successful introduction of this legislation may lead to an overall reduction of R&D activities being carried out in Australia.

That is, it will be comparatively simple for the targeted multi-national groups head-quartered in Australia to offshore or relocate ongoing knowledge based R&D overseas to existing sites in more favourable R&D jurisdictions and as such this is likely to lead to a significant reduction in high value Australian based R&D activities for those critical sectors. This may also extend to supply chain implications which could exponentially impact upon the perceived initial reduction.

By way of example, many of Australia's large banks have already set up shared service or extended delivery centres overseas particularly in Asia. The move to locate knowledge-based R&D to such jurisdictions with more favourable R&D regimes in the light of the new Australian legislation cannot be far behind.

In the reverse situation, the new threshold would still allow multi-national groups with a turnover of more than \$20 billion, but less than \$20 billion taxable in Australia, to access the Australian R&D tax incentive. This inherent bias may be deliberate policy intent to attract multi-national entities that do not have Australian assessable income of less than \$20 billion, and encourage them to carry out R&D in Australia and access the R&D incentive.

However recent OECD studies have found that the attraction of brand new inbound R&D is recognised as being attracted by macroeconomic stability, supportive legal and regulatory frameworks, skilled labour and labour market flexibility, well- developed infrastructure, and business opportunities tied to market size. As such, non-tax factors are central drivers to such decisions and the availability of tax incentives may not be an important factor influencing location decisions, especially when there may be existing R&D incentives where they are already located – there will be no push factor akin to the one proposed to be introduced in Australia.

Conclusions

A review of the Global Innovation Index produced on an annual basis by INSEAD and the World Intellectual Property Organisation (WIPO) reveals that the ranking of Australia in the Global Innovation Index rankings in the last three years is as follows:

- 2012 – 23rd
- 2011 – 21st
- 2010 – 18th

Given such falling rankings in innovation, potentially due to the falling net value of R&D support in recent years, and the international comparisons and global risks discussed above, we would strongly recommend that either the regime is left as it currently stands, or that one of the other options proposed by the BTWG is instead given serious consideration as a credible alternative to create the same level of tax savings.

For example, we would more actively support the introduction of an R&D expenditure cap, of for example, \$100 million per claimant group. This would prevent the totality of the discrimination against certain clusters of industries that is evident in the current proposals. The enactment of such an alternative would also allow significant flexibility to be maintained within the provisions since the level of the cap could easily be adjusted between income years in line with government surplus and deficit targets.

Bracket creep would also invisibly reduce the value of the net R&D benefit to large business over time if it were not increased.

It lacks credibility that this legislation will be introduced on the basis of the following sole subjective statement made in the explanatory material that *“Internationally, there is broad support for the view that small firms are more responsive than large firms to increasing their R&D spending as a result of Government incentives.”* given that these discriminatory provisions are likely to adversely impact Australia's total R&D activities especially in the face of falling global rankings.

It is also arguable that the modelling of the anticipated economic benefit is based on flawed assumptions since it is unlikely that the estimates on forward revenues have taken into account the resulting movement of activities from Australia.

In conclusion, in the current climate of economic uncertainty and an increasing need to stimulate the non-mining industries, it would indeed be both premature and shameful to see the increased focus on innovation that in reality has only just 'opened for business' be wiped away by the imposition of an artificial ceiling purely to achieve the political needs of the current government, especially when there has been limited economic modelling or consultation to support the validity of either the proposed methodology or the cost/benefit analysis undertaken.