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## **R&D Tax Incentive: “Targeting Access” Submission – Preventing Companies With Over \$20 Billion Assessable Income from Accessing the R&D Tax Incentive**

Ernst & Young welcomes the opportunity to comment on the proposed amendments targeting access to the R&D tax incentive.

In short, we do not support the Government’s proposed plan to deny access to the R&D tax incentive for large companies / groups. On both a policy and tax law basis, it is poor legislation with uncertain and incidental outcomes, and will reduce the incentive to conduct R&D in Australia.

In this submission we have set out a number of comments in relation to the proposed amendments and explain why such changes are undesirable in our view.

### **1. Policy Considerations**

#### **1.1 Innovation Is Not the Sole Preserve of Small Companies**

It has been stated that small businesses are more innovative than large companies, and this has formed part of the basis for this change in policy. The reasoning is that R&D tax incentives should be tailored to provide support only to small and medium enterprises, so as to maximise public spill-over benefits while minimising tax revenue forgone. While this seems to make good policy sense, in reality, the idea that only small companies are innovative is an oversimplification, as is the notion that these small companies provide disproportionate spill-overs compared to larger company R&D.

Several advantages arising from size means that often innovation only makes financial sense for large companies. Large companies are more able to exploit the benefits of invention as they can quickly supply to a greater number of customers; they gain greater reward for innovation as compared to a small inventor. Risks of innovation are reduced as research costs are defrayed by exploitation of existing supply chains and infrastructure. Large companies also have more resources to devote to converting good ideas into products or services (i.e. have greater capability to commercialise).

Smaller innovators are less able to enjoy the fruits of their invention before imitation erodes their competitive advantage, and they may be less able to access intellectual property protections. Smaller innovators may also be less able to access technical expertise or draw on overseas progress. These factors mean that where they are able to innovate, smaller innovators often undertake *different* research than larger companies.

It is likely that the importance of big business R&D will continue to grow, given the greater reliance of modern economies on high technology and a global footrace to exploit that technology. This can be seen in a range of industries including in the field of medicine where R&D and associated commercialisation

possibilities are out of reach of smaller inventors. These companies must operate on national or global scales and yet remain innovative to foster and exploit these new platforms.

Large global companies have the ability to move resources to Australia, and assist in job creation and knowledge transfer. In addition, the scale of international competition, which can often include competition with state supported enterprises, means that only large businesses are able to successfully compete and profit from the results of innovation. Finally, innovation in the future may tackle large and complex problems, such as climate change, education or health care (for example, interactive education or health care over broadband). Very large companies (and governments) have a greater level of resources to devote to these problems.

The proposed changes will reduce the level of innovation conducted by large companies in Australia, and detract from the positive spill-overs to the general population as a result.

### 1.2 The Budgetary and Economic Impact of the Proposed Change is Uncertain - No Formal Cost / Benefit Analysis Has Been Provided

The culmination of the factors discussed above means that if the proposed legislation is passed, it will discourage R&D spending in Australia. From a taxpayer perspective, this arises due to the uncertainty introduced by the legislation (both from the short time since introduction and a technical tax perspective).

There is uncertainty around the net economic impact of the change. The rationale for the change is net reduced governmental tax outlays however whether this will eventuate is far from certain. The reduction in R&D conducted in Australia (for the reasons mentioned above) will result in less R&D spending in Australia. It will reduce the pool of technical excellence available within Australia, and stifle the development of centres of excellence. All these changes will result in less spending in the short term and lower economic productivity in the long term. The flow-on effect of this change is significant and likely to result in reduced current and future tax revenue. There has been limited modelling of the actual impact of the proposed changes and more analysis of cost / benefit should be undertaken.

### 1.3 De-incentivising Collaborative R&D

It is common place in industry to collaboratively undertake R&D activity, to share benefits, burdens and risks between corporate entities seeking to conduct R&D. These can take place in partnership, joint venture or within CRC arrangements - all a feature of the Australian business innovation landscape.

The new law, insofar as it denies R&D incentives to significant contributors to Collaborative R&D, will jeopardise some R&D collaboration, or at the very least change the way the R&D is conducted. One major party no longer incentivised to undertake R&D due to being denied the R&D Incentive will withdraw from, or re-prioritise, the R&D effort - adversely affecting the entire R&D project. This will have a far greater multiplier effect across all participants in the collaboration - not just the denied entities. As such, the proposed change will also act as an impediment to other government initiatives and policy announcements to promote increased industry and industry-government research collaboration - acting in this contradictory manner presents wasted resources and confused government signalling to business.

Where the denied entity is the operator of the R&D collaboration, say in a joint venture scenario, this is compounded. Non-operators who are eligible for the R&D Incentive will need to work with an operator who is not - and face practical problems in accessing relevant documentation and support in R&D claims.

The effect of this is a reduced incentive to locate R&D in Australia, which will have a flow on negative impact on Australian jobs (which is against stated policy intent). This will also impact negatively on the

development of “innovation hubs” which are well established as a pathway to enhanced R&D outcomes. Large companies are able to provide the scale and resources necessary to anchor the location of innovation hubs within Australia, which cannot be achieved by a group of smaller participants.

#### 1.4 Staying Competitive in the Global Tax Landscape

There have been other concerns expressed about the decreasing willingness of international companies to invest in Australia. In a survey of multinational business leaders in Australia, innovation support ranked as number three on a list of reform priorities.<sup>1</sup> A failure to properly support innovation and R&D may lead to lower wages and job movements overseas, as well as represent a lost opportunity to re-invent industry.

Many other countries utilise tax incentive schemes intended to encourage additional R&D, including: Austria, Belgium, Brazil, Canada, China, France, Germany, Hungary, India, Ireland, Israel, Japan, Malaysia, Mexico, Netherlands, Russia, Singapore, South Africa, South Korea, Spain, the United Kingdom and the United States. None exclude large corporates as proposed. Larger multinational corporations which will be excluded by the proposed changes are the very ones who have the flexibility to choose where to locate their R&D (especially in global trade exposed sectors such as pharmaceuticals, oil and gas, ITC, manufacturing and finance) and one factor they consider when they choose the location of R&D is the attractiveness of tax based incentive schemes. As the R&D incentive is a critical attractant to foreign investment, it is crucial that the scheme is not modified to exclude large multinationals looking to spend R&D dollars.

There is significant evidence that the presence or absence of an R&D tax incentive can influence the decision of where to locate R&D. For example, a study of US state based R&D tax credits found that firms shift R&D spending to the state or states with cheaper R&D costs (including tax incentives).<sup>2</sup> Another study conducted in the UK supports this finding.<sup>3</sup> Bloom and Griffith found evidence that the R&D in one country responds to the change in the price of R&D in “competitor” countries. As multinationals often conduct their activities (including R&D) in several locations, they may be able to shift R&D between these locations at low cost. This finding has greater import in light of empirical evidence suggesting that R&D spill-overs are localised.<sup>4</sup> It follows that countries wishing to reap the (localised) social benefits of R&D must ensure they have policies in place which reduce the cost of R&D for business. These policies must apply to large businesses capable of shifting R&D overseas to take advantage of lower R&D costs elsewhere.

The risk of companies off-shoring R&D as a result of this policy change is exacerbated by the increased R&D tax incentives in other countries, most notably in Asia, over the last few years. As an example, Singapore introduced a 400% R&D tax incentive in 2010 specifically to boost the country’s R&D intensity by encouraging local and multinational companies to undertake more R&D activities in the country. Japan, as of 2013, has also done the same with the introduction of a 40% tax credit for R&D activities. In short, as the Government prepares Australia and Australians to thrive in the “Asian Century”, it appears counter-productive to be pulling back on incentivising R&D activities for our largest companies, just when the Asian region appears to be heading in the opposite direction when it comes to R&D tax policy.

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<sup>1</sup> Greber, J., Anderson, F., 2012. ‘Global CEOs wary of Australia.’ The Australian Financial Review, 15 August 2012

<sup>2</sup> Wilson, D. J., 2007. ‘Beggars thy Neighbor? The In-State, Out-of-State, and Aggregate Effects of R&D Tax Credits.’ Federal Reserve Bank of San Francisco Working Paper, San Francisco

<sup>3</sup> Bloom, N., Griffith, R., 2001. ‘The Internationalisation of UK R&D.’ Fiscal Studies, vol. 22, no. 3

<sup>4</sup> Bloom, N., Griffith, R., 2001. ‘The Internationalisation of UK R&D.’ Fiscal Studies, vol. 22, no. 3

### 1.5 Global mobility of labour

Another reason why this policy is bad policy is because it fails to consider the longer term trend in the global mobility of knowledge-intensive labour markets. In particular, we refer to increasingly mobile knowledge workers who have options as to where to work, live and stay. As a matter of fact, the largest Australian companies are also the largest employers of Australian workers. For those industries that employ a large number of knowledge based workers to conduct R&D in Australia, the rising Australian dollar and wage costs means that this policy will only give employers reason to review their R&D cost structures and consider other countries where they are able to achieve similar business outcomes at a lower cost. We fear that this will lead to companies increasing the scale to which off-shoring occurs. The loss of R&D intensive, knowledge based jobs to other locations where costs are lower, or where there are “better” tax incentives can only mean a loss of both jobs and new knowledge out of Australia.

While the policy statement that supports this legislative change refers to “R&D activities that these large companies will do anyway”, it fails to consider the make-up of the labour effort of that activity. By that, we mean that this policy is likely to lead to a subtle but clear shift in R&D labour activity away from Australia. In our view, this is clearly a poor policy outcome in light of the Government’s rhetoric in supporting and developing the knowledge economies of the future.

### 1.6 Benefit Has Been Eroded Over Time and Level of Support is Modest

As the superseded R&D Tax Concession was tied to the corporate tax rate, the benefit to companies has fallen over time, and the current 10% after tax benefit to large companies is modest and sustainable compared to the fiscal incentive provided in the past.

Financial Year(s)	Tax Rate (%)	Incentive Rate (%)	After Tax Benefit
87-88	49	150	24.5
88-89 to 92-93	39	150	19.5
93-94 to 94-95	33	150	16.5
95-96 to Aug 96	36	150	18.0
96-97 to July 2001	36	125	9.0
01-02 to 10-11	30	125	7.5
11-12 to current	30	40 (Offset)	10.0

source: Cutler, 2008

The current incentive level is two and a half times less than when tax incentives for R&D were initially introduced. As R&D is linked to increasing levels of productivity, a downward trend in innovation support is undesirable. The proposed reform reverses some of the modest gains made by the introduction of the R&D Tax Incentive.

### 1.7 Rapid Changes Undermines Efficacy of Legislation to Effect Behavioural Change

The effectiveness of tax based incentives appears to rely on certainty; that is, changes to the scheme or uncertainty about the continuation in the regime may result in a reduction in the additional R&D induced. This uncertainty may also act as a signal for large multi-national corporations to conduct their R&D overseas<sup>5</sup> even if the proposed legislation is never introduced. By representing a change in the R&D tax incentive at a time very close to its inception, the proposed legislation is reducing the incentivising impact for all participants, even those not directly impacted.

<sup>5</sup> Hines, J. R., 1994, ‘No Place Like Home: Tax Incentives and The Location of R&D by American Multinationals’ in Tax Policy and the Economy, Volume 8, ed J. M. Poterba, MIT Press, Cambridge, MA

### 1.8 Introduces Uncertainty / Reducing Incentive

The proposed change is also undesirable as it introduces significant uncertainties into the regime. As discussed in the tax technical discussion below, the definition of grouping and use of assessable income concepts in the determination of whether a company exceeds the \$20 billion turnover cap means companies may be practically unable to determine whether it is eligible for the R&D tax incentive, prior to the end of the financial year. This would reduce the incentivising effect of the tax incentive, as the company will be unsure if it can claim R&D expenditure at the point when it is making R&D investment decisions. The companies playing in this space are also likely to otherwise have invested significantly in R&D expenditure, while also having the capacity to easily shift R&D activities off-shore.

If the clear aim of these changes is to only provide an incentive where it is absolutely certain to sway the R&D investment decision, then we would suggest a move to a pre-approval system for large companies with over \$20 billion aggregated assessable income. This would allow large companies to present their proposed R&D Tax activities and seek approval from government prior to expenditure being incurred, if approval is given. This would provide certainty for claimants and allow them to employ relevant staff/resources. If not approved then these companies can make an informed decision about whether it is worthwhile to proceed without an incentive or not proceed at all.

A mechanism (the R&D advance ruling system) already exists and is managed by AusIndustry; it would not prove difficult to adapt this system to pre-approvals for large (\$20 billion of aggregated assessable income) claimants. To avoid issues with cost / benefit, this could be applied for projects over a certain threshold (eg \$10 million) with smaller (and less costly to the revenue) projects still eligible without pre-approval.

### 1.9 Direct Impact On Smaller Companies / CRC / Universities

Many large multi-national corporations employ specialised local companies, CRCs and universities to carry out R&D activities on their behalf. They may do this in preference to off-shoring particular aspects of R&D where local expertise is readily available, and the cost of developing and transferring knowledge from overseas is higher. The proposed changes may result in less direct investment by large multinational corporations in local entities, directly impacting the profitability and viability of local firms conducting R&D including smaller businesses, CRCs & universities.

## **2. Technical Tax Considerations - Legislation Issues**

We offer the following comments in relation to the draft legislation itself. Note that the making of these comments should in no way be seen to detract from, diminish or prejudice the force of our concerns and arguments set out above which considers policy implications should the draft legislation be introduced.

### 2.1 Aggregated Assessable Income

The draft legislation utilises the concept of 'aggregated assessable income' to define the nature of the \$20 billion cut-off. We question the appropriateness of this concept for this purpose, for reasons which are explained below.

The joint media release of 17 February 2013 in which this change was announced stated that the changes would apply to 'very large business' with 'annual Australian turnovers of \$20 billion or more', and that "The change will affect less than 20 corporate groups and will ensure this support is better targeted at small to medium business"

The concept of 'turnover', as originally announced, and as currently used in the Income Tax Assessment Act<sup>6</sup> (including in the R&D tax incentive in determining eligibility for the refundable tax offset versus the non-refundable tax offset), is a concept quite different from that of assessable income. The turnover concepts that are included in Subdivision 328-C<sup>7</sup> include at their core, the concept of turnover and aggregated turnover that:

1. **Are based on ordinary income derived in the ordinary course of carrying on a business**<sup>8</sup>. In this way, this concept reflects the 'ordinary business' turnover of the entities, untainted by extraordinary and unusual events or transactions (including one-off asset sales). As such, this concept is reflective of the true and consistent 'size' of the business, as measured by its turnover, and it provides a high degree of certainty to business. Based on the statements made in the joint media release above, it is apparent that this concept is an appropriate measure.
2. **Do not include amounts derived from the sales of retail fuel**<sup>9</sup>. Our understanding is that this exclusion exists because retail fuel sales are characteristically high in volume and low in profit margin, and so tend to exaggerate or distort turnover for this industry, compared to other industries.
3. **Exclude amounts derived from dealings with connected entities and affiliates**<sup>10</sup>. This adjustment prevents double counting of income amounts relating to transactions between entities that are grouped together, when aggregating their turnovers. It is essential to ensure that an aggregated turnover amount is not overstated.

Assessable income, on the other hand, **does** include:

1. **Ordinary income, and statutory income**<sup>11</sup> (but excludes exempt income). Statutory income includes a multitude of amounts, as listed in Section 10-5. A notable inclusion in this category is capital gains, pursuant to section 102-5. Inclusion of capital gains in this 'turnover' concept has the potential to reclassify a medium 'turnover' company to a high (>\$20 billion) 'turnover' company, simply because of the sale of a part of this business or some of its assets. We do not consider that such one-off, extraordinary transactions that do not reflect the business size should be included. We can see no valid policy reason as to why support under the R&D tax incentive for a medium turnover company should be withdrawn in a particular year, simply because the sale of a long term capital asset.
2. **Sales of retail fuel**. The rationale which operated in removing these sales from the Division 328 concept of turnover is equally valid and relevant to the R&D tax incentive turnover concept (note that the Division 328 turnover concept is already used in the R&D tax incentive, in section 355-100).
3. **Amounts derived from dealings with connected entities and affiliates**. As we note above, failure to eliminate intercompany transactions between entities whose 'turnovers' are being aggregated results in an immediate distortion (inflation) of the aggregate turnover.

It is clear from the above discussion that the use of 'assessable income' as the basis for determination of the aggregated turnover of the relevant entities will result in the inflation of that amount over normal 'turnover' concepts, and, given that the Division 328 turnover concept is already used in the R&D tax incentive, no policy justification for this departure is apparent. It will introduce uncertainty for claimants and may have the effect of excluding entities that from year to year would otherwise be able to claim.

<sup>6</sup> for a multitude of purposes that are concerned with distinguishing the turnover 'size' of an entity or group of entities

<sup>7</sup> **Aggregated turnover** in section 328-115, and **annual turnover** in section 328-120

<sup>8</sup> Subsection 328-120(1)

<sup>9</sup> Subsection 328-120(3)

<sup>10</sup> Subsection 328-115(3)

<sup>11</sup> Division 6 ITAA 1997

## 2.2 Changes Will Lead to an Unintended Tax Bias Against R&D

The proposed changes introduce an additional and significant bias against R&D only evident by broader consideration of corporate deductibility rules. For certain non-plant expenditure (including expenditure on intellectual property and other intangible assets that are particularly relevant to companies performing R&D) deductions will not be accessible under the R&D rules and will consequently only be claimable under other provisions. These provisions, including project pooling provisions in Div 40 ITAA 1997, do not allow for an immediate deduction, instead providing only for depreciation over long periods (some as long as 15 years), which is much less attractive for companies. As companies engaged in R&D have disproportionate spend on such expenditure, this change would disproportionately affect expenditure on R&D. This means that these changes would generate an economic bias against R&D. Large companies will not only be non-incentivised to do R&D they will effectively be discouraged from engaging in R&D activities.

This perverse outcome is inconsistent with the 17 February media release which stated that companies with over \$20 billion turnover would still be able to access benefit at a non-incentivised rate of 30%. This disincentive to perform R&D may be prevented by continuing to allow the expenditure to be claimed at a non-incentivised tax offset rate of 30%.

## 2.3 Other issues

### *Captures Foreign Sourced Assessable Income*

The announcement of 17 February referred only to “very large business with annual **Australian** turnovers of \$20 billion or more.” The draft legislation, however, also captures foreign income of both Australian residents, and Permanent Establishments in Australia. This is clearly contrary to the announced proposal, and creates uncertainty for businesses especially where a foreign permanent establishment (PE) is involved.

### *Lack of Transparency Between Some Connected Entities - 40% Grouping Test Too Low*

There will be some instances where the application of this law will be exceptionally difficult and problematic to apply. An R&D entity may be connected with an entity in whom it holds an interest, or who holds an interest in it, **as low as 40%**, or may be an affiliate of, or affiliated with another entity, both of whom conduct completely separate operations. In such circumstances, the R&D entity may often have no ‘right’ or ability to obtain comprehensive, confidential information about the assessable income of that other entity, in order to assess its own entitlement to the R&D tax incentive.

Many companies that are 40% owned by another entity would not consider themselves grouped / connected with, and may not be able to access detailed tax and accounting information required by these calculations. We note that in other parts of the R&D Tax rules (and in a historical context under the R&D Tax Concession) that a “greater than 50% test” is used.

### *Indexation of Aggregated Assessable Income*

We are of the view that this turnover threshold should properly be subject to indexation each year. The consequences of ‘creeping’ over this cap through normal inflationary movements are severe, and will result in companies that are still of ‘medium’ size, relative to their larger counterparts, also being excluded, contrary to the announced policy (which was to ensure the incentive is targeted towards small and medium companies). Failure to implement indexation will mean that the announced ‘less than 20 companies’ affected by the measure will quickly spiral to much larger numbers as each year passes.



*Incorrect Calculation - Example 1.2 in the Draft Explanatory Memorandum*

The correctness of this example is questioned, in particular where it states that 'it is Goji's assessable income for this income year (running 1 January 2013 to 31 December 2013) that is used to work out GJP's aggregated assessable income for the 2013-14 income year'. Effectively, this example is suggesting that the aggregated assessable income can be determined by adding together the assessable incomes for different periods of time, for the connected entities, where they have difference accounting periods.

Draft subsection 355-103(2) states, however, that the R&D entity's (aggregated assessable income) amount **for the income year**, is:

1. Its assessable income **for the income year**; and
2. The assessable income **for the income year** of any entity that is connected with the R&D entity at any time **during the income year**; and
3. The assessable income **for the income year** of any entity that is an affiliate of the R&D entity at any time **during the income year**
4. The assessable income **for the income year** of any entity of which the R&D entity is an affiliate at any time **during the income year**

It is apparent that the first mentioned 'for the income year' is referring to the income year of the claiming R&D entity, as is referred to in draft subsection 355-103(1). A plain reading of this subsection would imply that each of the subsequent references to 'income year' in subsection 355-103(2) are referring to that same income year, ie the references to the assessable incomes to be included 'for the income year', and the references to the 'connection/affiliation' test period of 'during the income year'. The application of the latter 'connection/affiliation' test period (ie 'during the income year') would become problematic, if the first reference to 'for the income year' could represent a different period of time to this latter period (as implied in the example) - it is unclear which of these periods would be used to test for the relevant connection.

In relation to similar provisions under the R&D Tax Concession, the ATO has previously issued two ATO Interpretive decisions - ATOID 2003/989, and ATOID 2003/990. These decisions were concerned with two provisions that summed particular expenditure and turnovers (respectively) of the company and its group members 'for a year of income'. We note that 'year of income' under the 1936 Act is the equivalent term to 'income year' under the 1997 Act<sup>12</sup>. The decisions both concluded that the meaning of 'year of income' is that of a period of 12 months<sup>13</sup>, and that it the relevant year of income to be used in calculating the amount, is that of the eligible company claimant (even where the group members have a different year of income). Importantly, 'year of income' was not found to be a reference to the year of income in lieu of which a substituted accounting period was lodged (eg the 2013-14 income year), as is implied in example 1.2.

We are therefore of the view that the determination of aggregated assessable income of GJP would require that a (re-) calculation of the assessable income of Goji, for the income year of GJP (ie 1 July 2014 - 30 June 2015), would be required.

<sup>12</sup> Refer section 6, ITAA 1936, definition of 'year of income'

<sup>13</sup> Refer *Norwich Superannuation Services Pty Ltd v FCofT* (1998) 41 ATR 1091



### 3. Our Recommendations


1. **That the legislation should not be changed.** The proposed amendments result in inequitable and uncertain outcomes; it is bad law and bad policy. These amendments would send Australia down a path of **reducing** support for R&D at a time when we should be increasing support for R&D.
2. That there are concerns about the cost / benefit received and a detailed study should be undertaken to resolve this.
3. Though we fundamentally disagree with the changes, if these changes were to pass into law, then the current draft legislation should be amended as follows:
  - i. Larger claimants (over \$20 billion aggregated assessable income) should still be allowed to apply but for larger projects will need to obtain pre-approval (based on the current advanced approvals system). Certainty should be provided to incentivise smaller (lower cost to the revenue) projects which should remain eligible.
  - ii. Grouping provisions should only apply where companies own greater than 50% of each other. This is consistent with the historical law, and with the common commercial understanding of control.
  - iii. That a definition based on turnover should be used, as is done elsewhere in the R&D tax incentive (though it should be limited to Australian sourced amounts only), and indexed.
4. That at the very least, as a bare minimum and to ensure there is no active discrimination against R&D, all R&D amounts should be claimable under the current division, but should only be claimable at the 30% (ie normal corporate tax rate) for companies over \$20billion in aggregated assessable income. This avoids the imposition of a bias against R&D under the tax act, and is consistent with previous announcements.

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In summary we are unsupportive of this legislative change and believe it will introduce uncertainty for taxpayers result in a reduction in R&D conducted in Australia (with an associated reduction in spill-over benefits for the wider economy).

Thank you, once again, for the opportunity to present our submission. Should you have any questions in relation to the above, please contact me on (08) 9429 2251, Jamie Munday on (02) 9276 9087 or Ezra Heffer on (08) 9429 2293.

Yours sincerely



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