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26 July 2018

Manager
Small Business Entities & Industry Concessions Unit
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Sir/Madam

Consultation on Treasury Laws Amendment (Research and Development Incentive) Bill 2018

Cochlear welcomes the opportunity to make a submission on the Exposure Draft of the above Bill.

Cochlear is in the top 30 global companies for research and development (R&D) in the healthcare equipment sector (expenditure vs sales revenue). We are also one of the largest Australian corporate investors in R&D – both by value and intensity.

Cochlear spends around 12% of its annual revenue on R&D every year. Since financial year 1998-99 we have invested around $1.7billion on R&D, the bulk of this in Australia. In 2016-2017 Cochlear spent over $160 million on R&D globally or around 10% of our total global expenditure.

Cochlear generates 95% of its revenue offshore but pays 75% of its global tax in Australia. Our tax is largely paid in Australia because around 80% of our R&D is performed here and the consequent intellectual property (IP) resides here.

We support the Government's policy objective of targeting Government R&D incentives in a way that encourages 'additionality' and spill-over benefits rather than simply supporting business as usual activities. We also acknowledge the Government's need to balance the cost of the research and development tax incentive (RDTI) with competing priorities.

However, we urge the Government to direct budget savings achieved from the reform of the RDTI toward other programs or incentives that support innovation. For example, the government could broaden the suite of incentives to include competitive grants programs and/or introduce a collaboration premium of up to 20% to incentivise collaborations between industry and public research organisations and universities (as recommended by Innovation & Science Australia in its Australia 2030 Report).

Calculation of R&D intensity – total expenditure

The definition of 'total expenditure' for the purposes of calculating R&D intensity needs to be further clarified and made more specific.

Item 12 of Schedule 1 provides for the R&D entity's expenditure for an income year as "the expenditure incurred by the R&D entity for the income year worked out in accordance with the accounting principles".

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The Exposure Draft consultation paper states that total expenditure will be based on the 'claimants own tax return'.

Cochlear is of the view that total expenditure should only include those expenses related to the Australian business operations and only expenses that are operational in nature. From an annual report perspective, operating expenses includes selling, general and administration expenses (SG&A), costs of goods sold (COGS) but would exclude costs not directly reported as operating expenses such as interest, finance costs and settlement of foreign exchange (FX) contracts.

Removing these items from the calculation ensures neutrality for different funding strategies adopted by businesses and addresses the uncertainties around movements in global foreign exchange rates on underlying earnings. If expenditure is to be worked out by reference to the total expenses figure from the claimant's tax return, as suggested in the consultation paper, this would require an adjustment to remove those items of expenditure.

Cochlear suggests the following total expenditure calculation:

$$\text{R\&D intensity} = \frac{\text{eligible R\&D expenditure}}{\text{Total expenditure}}$$

Where eligible R&D is notional R&D deductions; and
Total expenditure is:
Total expenses as reported in the claimant's Australian tax return reduced by:

- Finance costs
- Net interest expense
- Net FX loss on FX contract settlements

Cochlear is aware of and recognises concern from other businesses that including costs of goods sold as part of total expenditure may lead to inequitable outcomes. For example, a business carrying out manufacturing as well as R&D in Australia would likely return a lower intensity ratio compared to a technology or software business spending the same amount on R&D but with significantly lower raw material and production costs and therefore likely lower proportional total expenditure.

It is suggested that Treasury model an appropriate further reduction to total expenditure for cost of goods sold where the business also has significant raw materials and production costs. It may be that an additional proportionate reduction is introduced for those businesses that for example, have at least 40% of their total expenses attributed to COGS.

While this approach makes the calculation for total expenditure more complex, it is a potential avenue to reduce the inequitable impact on many Australian manufacturing businesses as compared to companies operating in the technology and other sectors.

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Increasing the expenditure threshold to $150 million

Cochlear supports the increase in the annual maximum expenditure threshold from $100 million to $150 million. Due to the success of our business and growth in R&D expenditure, Cochlear has started to hit the $100 million cap.

Without an imminent increase in the cap (or threshold) the relative attractiveness of Australia as a place to perform our R&D would continue to fall. Cochlear has global R&D capability and other countries frequently offer Cochlear incentives to increase our investment.

While the increase is welcomed, a cap or maximum threshold at any level is arbitrary and effectively acts as a disincentive for any company investing large amounts into R&D to invest in Australia over that cap.

Publication of R&D expenditure/tax incentive claims

Cochlear was an early adopter of the Tax Transparency Code and we publish a Tax Contribution Report (Tax Report) every year alongside our Annual Report. Our yearly Tax Report discloses Cochlear's R&D tax benefit for our Australian tax consolidated group.

Cochlear supports the objective of bringing greater transparency to, and therefore public confidence in, the RDTI scheme. However, we share concerns of other stakeholders that publishing companies R&D notional deductions (as per Schedule 3, Item 1 of the Exposure Draft) may actually create further confusion about how the scheme is operating. Cochlear suggests publication of the actual tax benefit received is more aligned with the Government's objectives.

If you require further information please contact Brooke O'Rourke, Senior Government Affairs Manager (borourke@cochlear.com / 0431252024).

Yours sincerely

Brent Cubis
Chief Financial Officer

About Cochlear

Cochlear is the global leader in the development and manufacture of implantable hearing solutions and related technology to address moderate, severe to profound hearing loss. Over 475,000 people of all ages from more than 100 countries now hear because of a Cochlear product.

We are an Australian headquartered global company with over 3,500 employees across 30 countries. Around 1,600 of Cochlear's employees are based in Australia with the majority working in manufacturing, logistics and research and development.