KPMG submission

Exposure Draft

Treasury Laws Amendment (Research and Development Incentive) Bill 2018

26 July 2018

Contacts: Grant Wardell-Johnson +61 2 9335 7128
David Gelb +61 3 9288 6160

Executive Summary

KPMG is grateful for the opportunity to provide feedback on the exposure draft of *Treasury Laws Amendment (Research & Development Incentive) Bill 2018* ("ED"), its draft explanatory materials ("EM") and accompanying consultation paper.

Part A of the enclosed submission addresses the questions in the consultation paper and Part B provides additional feedback on other provisions within the ED which are not canvassed by the consultation questions.

We urge the Government to reconsider the proposed significant cuts to the research and development tax incentive ("RDTI"), as we are concerned that the intensity threshold in its proposed form may lead to a significant reduction in Business Expenditure on R&D as a percentage of gross domestic product.

Our fear is that the proposed intensity measure may accelerate the current negative trajectory in business expenditure on R&D, and that the 4% rate would not be sufficient to represent a genuine incentive to undertake additional R&D.

International experience, and indeed Australia's prior experience, indicates that a base rate of at least 7.5% needs to be in place in order for business to regard it as a genuine incentive.

We support the need to have a well-balanced and fiscally viable RDTI.

Summary of comments on consultation paper

1) We recommend deferral of the implementation of the intensity provisions until 1 July 2019. This will allow taxpayers time to adjust their R&D investment plans in response to the proposed law changes which were announced in May 2018.
2) The Bill should clarify the definition of "expenditure" for the purpose of the denominator in the R&D intensity calculation, in terms of its relationship to accounting standards. Expenditure is not a defined term in Australian accounting standards.
3) Consideration should be given to excluding certain expenditure from the "expenditure" denominator in the intensity calculation. In particular financing costs (otherwise entities would have a different intensity based on whether they can self-fund R&D or need to borrow) and those costs which are specifically ineligible to be treated as R&D.
4) The Bill should ensure that the unique status of life insurance businesses does not result in unintended outcomes in terms of the R&D intensity calculation for those businesses.
5) Entities that are not required to prepare audited accounts should be allowed to use the aggregate of their allowable deductions as the denominator in their intensity calculation.
6) Integrity concerns in relation to the intensity calculation could be reduced by extending the expenditure amount to cover that of a broader economic group.
7) However it would also be important to provide a mechanism for the Commissioner of Taxation to approve a member(s) of a diversified group as a separate "R&D sub-group", where its R&D activity would not benefit the other group members outside the R&D sub-group.

8) The definition of "clinical trials" for the purpose of the exception to the $4 million annual refundable cap should specifically include the "in-human" trialling of medical devices.

9) The definition at 3) should also be modified to specifically include certain R&D activities which must occur in order for in-human trials to be possible, such as toxicology analysis and the short-run manufacturing of the treatment or device that is to be trialled.

10) Reliance on the findings process for identification of clinical trials expenditure could be reduced via the publication of further guidance material by the Australian Taxation Office and Innovation & Science Australia. Where a findings process is used, it should cover both the analysis of whether the activity is eligible R&D, and also whether it is a clinical trial.

11) The Bill should make clear that additional assessable income arising from a feedstock or clawback adjustment is not "ordinary income" and will therefore not be included in the calculation of the annual turnover of the entity.

Additional comments on the ED

12) Proposed section 3G *Taxation Administration Act 1953* should be modified such that the Commissioner of Taxation is not required to publish claimant information until at least 12 months after the end of the income year. This is to protect commercial confidentiality.

Introduction

KPMG welcomes the opportunity to comment on the Exposure Draft (ED) of *Treasury Laws Amendment (Research and Development Incentive) Bill 2018* and associated Explanatory Memorandum as published by Treasury on 29 June 2018. Part A of this submission directly addresses the consultation questions and Part B provides additional feedback on other provisions within the exposure draft legislation not canvassed by the consultation questions.

Part A – Response to consultation questions

1. Question 1: *Do you see any implementation and ongoing compliance challenges arising from the proposed calculations of R&D intensity?*

1.1 Deferral of the implementation of the intensity test

Following the announcement of the proposed intensity test in May 2018, taxpayers have had little time to react to the announcement in terms of planning for the financial year commencing 1 July 2018 (which is when the measure is proposed to take effect).

Given the current uncertainty about how the intensity calculation will operate, as is acknowledged in Treasury's consultation paper and discussed in section 1.2 of our submission, it would be prudent to defer the implementation of this measure until 1 July 2019 at the earliest.

1.2 Identification of "expenditure" for the purpose of the intensity calculation

Proposed section 355-115 of the ED indicates that "expenditure" for the purpose of the denominator of the R&D intensity calculation should be:

"Expenditure incurred by the R&D entity for the income year worked out in accordance with the accounting principles;"

For this purpose, accounting principles generally mean the applicable accounting standards (as defined in the *Corporations Act 2001).*

There is no accounting standard definition of expenditure or expenses. The International Accounting Standards Board's publication *The Conceptual Framework for Financial Reporting* does include a discussion of what constitutes "expenses", but this document is not itself an accounting standard.

The consultation paper suggests that it will be easy to identify the expenditure amount from the entity's tax return, which infers that the expectation is that the profit and loss account information disclosed in the tax return (and compiled according to accounting standards) would be the source of the expenditure amount.

In view of the importance of the expenditure amount in calculating an entity's R&D intensity threshold, we recommend that to support implementation of the calculation, the Bill should state more precisely how the expenditure amount is to be ascertained.

1.3 Consider removal of certain expenditure (eg. financing costs) from the intensity calculation

Consideration should be given to excluding certain expenditure from the denominator of the intensity calculation fraction, in order to avoid distortive outcomes for the RDTI.

For example, interest on funds borrowed would be a material component of many R&D entities' expenditure. If financing expenditure were included in "expenditure" for the purpose of the R&D intensity calculation, then an entity that had borrowed money to fund its R&D activity would have a lower intensity (other things being equal) than an entity that had been able to fund the R&D from other sources.

It is not clear whether these different outcomes would be consistent with the overall policy intent.

In our view, excluding financing expenditure from the expenditure calculation would provide a more genuine measure of intensity, in terms of R&D expenditure as a percentage of operating and capital expenditure.

In addition, it would be reasonable to exclude from the "expenditure" denominator all expenditure that would not be eligible for categorisation as R&D, due to a specific legislative provision (for example, expenditure on "core technology").

It is increasingly the case that businesses experience unpredictability in their per-unit energy costs. Consideration should be given as to whether overall policy objectives of incentivising R&D would be better supported by excluding such items that are subject to significant price-volatility from the expenditure calculation.

1.4 Life insurance entities - expenditure

The unique profile of life insurance companies should be taken into account.

Life insurance companies hold investments on behalf of policyholder interests in carrying out superannuation and funds management type activities. These policyholder investments are owned by the life insurance company but economically accrue to policyholders.

The measure of expenditure for the R&D intensity test should exclude expenses of a life insurance company that represent the allocation of investment earnings or contributed investment capital to policyholders. These expenses are not representative of true expenditure of the life insurance company. Structural bias between life insurance companies and other entities conducting a similar type of business (superannuation trustees, investment managers) would be created if these expenses are not excluded from the R&D intensity test.

1.5 Small proprietary companies that may not be required to prepare audited accounts

Certain private companies (usually with turnover of less than $25 million) may not be required to prepare audited accounts, or even apply Australian accounting standards in maintaining their financial records.

Therefore certain R&D entities with turnover above $20 million, but below $25 million could be faced with considerable additional cost in calculating their intensity threshold, as they may otherwise not have needed to acquire expertise in the application of accounting standards to their financial position.

The expenditure amount for R&D intensity purposes may also not be required for the income tax return of such a company, and so will not be so easy for the Australian Taxation Office to identify as is envisaged in the consultation paper.

A solution could be to allow companies that are not required to prepare audited accounts to treat the aggregate of their allowable deductions per the income tax return (other than financing costs) as the measure of their expenditure for the purpose of the intensity calculation

2. *Question 2: Does the proposed method of calculation of R&D intensity pose any integrity risks?*

2.1 Corporate groups and related entities

The intensity threshold could be exposed to integrity risks where the only expenditure taken into account was at the R&D entity level. For example, an entity that solely carried out R&D activity on behalf of other related entities would have a different intensity level from one which also carried on some of the other business activities pursued by the group of related entities.

The ED's proposed additions to the anti-avoidance provisions of the *Income Tax Assessment Act 1936* reinforce the defences against "artificial" structuring to increase the R&D intensity level.

However there will be situations where other commercial reasons support the establishment of a "special purpose" R&D entity among a group of related entities, which could be outside the scope of the anti-avoidance provisions. These situations could give rise to outcomes that are inconsistent with the ED's intent if they result in a higher R&D intensity than if the R&D activity had been dispersed among the members of the related company group.

3. *Question 3: Could total expenditure be aggregated across a broader economic group? Would this create any implementation and ongoing compliance challenges?*

3.1 Broader economic group

Where the R&D activity is carried out by a member of a tax-consolidated group, it would generally appear reasonable for the total expenditure to be aggregated across the members of that group.

In other cases, any inclusion of a broader economic group should use existing terminology (for example it could include expenditure from a 'connected entity' which relies on existing and relatively well understood definitions in section 328-125 ITAA 1997).

However the above approach, while assisting with the integrity of the intensity calculation, may not always produce results which are consistent with the apparent policy intent.

For example, where a tax-consolidated group, or a group of connected entities, includes a number of diverse businesses with different levels of opportunity for R&D activity, it would not seem appropriate for the highest-intensity of these businesses to have its RDTI diluted by comparison to what it would have obtained as an independent entity.

A potential solution would be for one or members of a broader economic group to apply to the Commissioner of Taxation to be treated as an "R&D sub-group" within the group for the purpose of calculating the R&D intensity of that sub-group. Eligibility for sub-group status would be based on member entities' business being distinct from the businesses of the other group members, and there being little reasonable prospect of the sub-group's R&D being of benefit to those other members.

4. Question 4: Does the definition of clinical trials for the purposes of the R&DTI appropriately cover activities that may be conducted now and into the future?

4.1 Definition of clinical trials

The definition of clinical trials as contained in the draft legislation is particularly narrow and limited to 'in human' clinical trials.[1] The current wording may also lead to the interpretation that a clinical trial can only include a medicine, treatment or diagnostic procedure. This may lead some taxpayers to make the assumption that clinical trials involving interventions outside of these areas, for example medical devices, are excluded, which we believe is not the intention of the proposed definition.

The TGA also defines a clinical trial as *"an experiment conducted in humans in order to assess the effects, efficacy and/or safety of a medicine, medical device or procedure/intervention"*.

We encourage the government to consider a combination of TGA definitions to ensure there is no ambiguity on the types of interventions that fall into the definition. Alternatively, government may wish to consider the World Health Organisation's definition of a clinical trial which covers a range of interventions.

4.2 Essential activities supporting clinical trials

The accepted definition of clinical trials does not include essential R&D activities necessary to support a clinical trial, for example toxicology studies, manufacturing and supply of material for use in the trial, and regulatory activities.

These activities form critical elements of a clinical trial. At a minimum, we would encourage government to provide specific guidance on the types of related clinical trial activities and corresponding expenditure which would be included in the $4 million cap exclusion.

5. Question 5: Does the proposed finding process represent an appropriate means of identifying clinical trials expenditure for the purposes of the $4 million refund cap?

5.1 Clinical trial expenditure

As with the current advanced and overseas finding process, the proposed finding process for clinical trials relates to the nature of the R&D activities rather than expenditure. It is foreseeable that there will be issues as to what expenditure is 'on' clinical trials and what expenditure is 'on' related non-clinical trial R&D activities.

In this respect, guidance from the ATO is needed. We would anticipate that where greater clarity is provided on the definition of clinical trials in both the legislation and public

[1] The draft legislation is somewhat ambiguous but Government has confirmed it is intended to be limited to 'in human' trials and excludes animal and other laboratory based clinical trials.

determinations and general guidance provided by the Board of the ISA, there will be less requirement for taxpayers to access the clinical trial finding mechanism.

Where a company is seeking an overseas advance finding for clinical trials, we would recommend streamlining the two findings processes to cover both the eligibility of the overseas activity as either a core or supporting R&D activity, and a clinical trial. This will assist to reduce administrative complexity and burden.

6. ***Question 6: Do the draft feedstock and clawback provisions give rise to any unintended consequences that need to be addressed?***

6.1 *Additional assessable income resulting from the feedstock and clawback provisions*

Both the feedstock clawback and recoupment clawback provisions results in an increase in the assessable income of the R&D entity for the year in which the clawback occurs. In order to avoid unintended follow-on consequences of this, the Bill should make clear that such income is not "ordinary income' and is therefore not included in aggregated turnover for the purpose of the base rate entity or small R&D threshold calculations.

We are encouraged to see that the recoupment clawback provisions have been correct to ensure only the R&D offset related to the recoupment is included in the assessable income. This provides a more favourable outcome for companies that received grant payments that are not a 50:50 grant ratio.

Part B – Additional Commentary

7.1 The six consultation questions are limited to Schedule 1 and Part 2 of Schedule 2 of the draft legislation and do not canvas the proposed changes in Schedule 3 (Administrative Matters). Our comments on Schedule 3 follow.

7.2 Proposed section 3G *Taxation Administration Act 1953* would require that the Commissioner of Taxation publish certain information in relation to RDTI claimants as soon as possible after the end of the income year for which the claim occurs.

Presumably the Commissioner could not do this until after the claimants had lodged their tax returns, which may be six months or more after end of the income year.

While this gap would alleviate some concern in relation to commercial confidentiality, we recommend that the provision should be modified such that the Commissioner of Taxation is not required to publish claimant information until at least 12 months after the end of the income year.