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Senate Standing Committee on Economics, SG.64
PO Box 6100
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22 January 2014

Dear Sir/Madam

Tax Laws Amendment (Research and Development) Bill 2013 – Submission

Please find attached the Deloitte submission in respect of the proposed *Tax Laws Amendment (Research and Development) Bill 2013* that was referred to the Senate Economics Committee (the Committee) for enquiry on 5 December 2013 to report by 17 March 2014.

We have a number of key concerns that are set out in the following annexure and urge the Committee to reflect on the comparative disadvantage that the proposed provisions would, if enacted, inflict on Australia's future prosperity.

Should you wish to discuss our submission in greater detail, please do not hesitate to contact me

Yours faithfully

Serg Duchini
National Leader of R&D and Government Incentives

Director
Deloitte Tax Services Pty Ltd

Enc: Submission on the *Tax Laws Amendment (Research and Development) Bill 2013*

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Annexure: Submission in respect of the *Tax Laws Amendment (Research and Development) Bill 2013*

We submit the following key concerns in respect of the proposals for your consideration, which are each discussed in further detail below:

- The strong likelihood of large business Australian R&D being offshored to other preferential R&D jurisdictions
- The negative impact on employment, productivity, collaborative R&D and smaller businesses that support the R&D activities undertaken by larger businesses in Australia, especially in the manufacturing sector
- The creation of an unenviable and damaging international precedent for large business especially in light of other governments starting to enhance their innovation support
- The associated conflict with international best practice – a significant concern given recent robust studies which reveal a direct correlation between a government's commitment to its R&D tax policies and the ability to attract innovative organisations, grow the economy and create employment opportunities
- The discrimination against multi-national groups resident in Australia or with larger operations based in Australia – these will be discriminated against whilst similar companies resident elsewhere will still benefit
- Practical issues and discrimination against certain industries in the calculation of assessable income
- The long-term impact of uncertainty, retrospective change and continued legislative amendments – these will negatively impact on the Australian based innovation strategies of large business especially in the face of further reviews to come. Enacting the proposed legislation will create long-term instability and lack of confidence in Australia's commitment to innovation and investment
- The lack of consideration of credible alternative possibilities; critical given the falling ranking of Australia in global innovation indices and other recent studies referred to herein
- The lack of authoritative support, limited consultation and lack of commitment to date for other measures to support R&D which could alleviate business concerns plus the reversal of stance of the current government

1. Likely offshoring and flow-on impact on SMEs

A justification for the proposed legislation appears to be underpinned by the belief that large Australian-based companies will undertake the same level of R&D within Australia irrespective of the availability of government incentives for R&D. This proposition is flawed and fails to consider:

- The current and anticipated high level of competition in the global and Asia-Pacific region to attract foreign investment
- The high probability that affected businesses may with ease relocate a high proportion of the Australian R&D offshore, especially in the service industry where intellectual capital is relatively mobile
- The significant flow-on impact on collaborative R&D and the supply chain implications which could exponentially impact upon a perceived initial reduction.
- The impact of the loss of timing benefits in respect of investment in new technology; the removal of the R&D tax incentive on development of intangibles will mean depreciation over time rather than immediate deductions, a factor that will play a prominent part in reinvestment considerations and cycles of R&D

We submit that 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 such tax policy decisions within the context of globally mobile flows of labour and capital; with knowledge-based R&D being a prime example of mobility.

In such a global context, Australia is not alone in offering the critical operational prerequisites to successfully conduct cost-effective R&D. 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, especially within Asia, 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 (see point below). R&D tax incentives are an important component of all of these strategies which are now also being supported by complementary 'patent box' models to support the resulting commercialisation of the R&D undertaken. 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 probable that the enactment of this legislation will lead to an overall reduction of R&D activities being carried out in Australia, with consequential investment reductions, reduced economic activity and stimulus and a significant increase in unemployment and job losses.

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 this will lead to a significant reduction in high value Australian based R&D activities for those critical sectors.

The proposed measure also fails to acknowledge the significant part that large business R&D actually plays in its greater capacity to both access the effective means to progress research and to effectively exploit the results of innovation.

In addition, it is critical for the cost analysis to recognise that small businesses and research bodies also rely significantly on the R&D of large businesses in either a collaborative manner or by undertaking work as contractors. The removal of large business R&D will consequently affect the productivity and financial success of small and medium sized entities, a detrimental outcome to Australia's long-term growth prospects. The loss of spill over benefits needs to be considered.

2. Other governments are enhancing innovation support

Australia's current R&D benefit to large business is currently 10% of eligible R&D expenditures, a benefit that has been significantly eroded since the initial introduction of the R&D tax concession. The after tax benefit in 1987-88 stood at 24.5% and did not fall below 10% until August 1996. This level of support is relatively modest given the level of importance of innovation and R&D undertaken by all Australian business that was recognised by the 2008 Cutler Review.

As alluded to above, it is important to compare this to existing R&D government incentives that are currently available on a worldwide basis as this will impact on the likelihood of Australian R&D being moved offshore.

An initial analysis first highlights that there is currently no other country worldwide which has an R&D tax incentive or subsidy where certain entities are denied access to the regime on the basis of a domestic turnover threshold. Rather, the following table summarises the provisions in 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.

This table 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.

Secondly, the level of generosity of the incentives available also needs to be compared.

A recent report by the Organisation for Economic Co-operation and Development (OECD) entitled *Supporting Investment in Knowledge Capital, Growth and Innovation* dated 10 October 2013 is instructive in providing some objective information on recent developments.

By 2011, 27 of the OECD's 34 members provided tax incentives to support business R&D compared to less than 17 in 1995. Other large economies including Brazil, China, India, Singapore and South Africa have also been identified as introducing new tax provisions to stimulate investment in business R&D. Singapore in particular has recently increased the level of benefits available to all companies in an effort to stimulate investment.

This means that there are an increasing number of competing countries seeking to attract R&D investment. Additionally, overall it is reported that the global R&D tax incentives have also become more generous with the OECD reporting that at least half of the 23 countries with complete data available increased their generosity between 2005 and 2011, with R&D tax support rising by almost 25 percent in some countries.

Overall the OECD report demonstrates that over a relatively short period of time, R&D tax incentives have become among the most widely used global policy instruments to promote innovation including in multinational firms.

In a specific country example, the UK government, despite its ongoing recession, has recently made strong efforts to increase its lack of representation on the Top 100 Global Innovators list (see below) by introducing its self-styled Patent Box legislation which cuts the tax rate for income derived from patented technologies to 10%. This has also been supported by a general cut in the UK corporate tax rate to 20% and other local initiatives to demonstrate its patent box incentives to internationally mobile companies.

Patent box models have also been introduced in Ireland and China, with these countries continuing to compete strongly for high-value jobs. Belgium has also introduced a Patent Income Deduction resulting in a 6.8% maximum effective tax rate.

Subsequently GlaxoSmithKline recently invested £500m into its UK manufacturing operations based on the introduction of the UK patent box legislation. Recent UK filing records in late 2013 also reflect a move of many Australian technology companies (including Atlassian) to reincorporate in the UK; an early and significant indication that the Patent Box model and generous R&D tax breaks are indeed being successful in attracting its targeted internationally mobile capital to take advantage of the 10% patent box tax rate.

Cutting the rate of company income tax on targeted income derived from technologies developed in Australia would encourage more multi-national businesses to carry on the commercialisation of their R&D activities in Australia and retain the resulting intellectual property onshore – however this would be a redundant move in attracting large business if this proposed legislation was enacted beforehand.

In summary, there are no jurisdictions worldwide that exclude any business outright from accessing the R&D tax incentives available; rather other governments are seeking to expand their innovation policies and increase their generosity. It is therefore clear that Australia would be creating an unenviable international precedent in respect of large businesses by enacting the proposed legislation rather than seeking to create an environment that will foster innovation across all levels of business.

3. International background to implementation of R&D incentives

It is an accepted tenet in studies of international R&D incentives, economic theory and empirical analysis that R&D government incentives play a key role in delivering productivity gains and economic growth, and that the social return of the investment is higher than the private return to the investing firm.¹

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

¹ Institute of Fiscal Studies, August 2001

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 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

More complex systems including tiered credits can create high administrative costs and many studies discuss ceilings to cap the maximum creditable amount where excessive cost for a country's tax revenues may be an issue.

In line with numerous international studies and international best practice, Australia's existing R&D tax incentive regime from 1 July 2011 has embraced a number of these attributes; 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, 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 facilitate a subsequent 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
- 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 considered or recommended a system which would entirely and completely exclude access to such a regime for entities with a certain level of Australian-based turnover or gross income.

However less than a year later, an announcement of an exclusion 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 would effectively have a three tiered system with the top tier having an effective tax incentive rate of 0%.

Notably, even since the release of the original draft legislation, the findings of two further studies have cast further doubt on the validity of the proposal:

- A study published in October 2013 by Thomson Reuters² compiled the third annual list of the Top 100 Global Innovators which represents a cross-section of industries including semiconductors, computer hardware, automotive, telecom and pharmaceutical.

Most interesting from a tax policy perspective is the geographical analysis which revealed on page 6 of the report that *"There is a direct correlation between a government's commitment to innovation and its R&D tax policies to its ability to attract and retain innovative organisations."*

² Thomson Reuters 2013 Top 100 Global Innovators

The authors concluded that this was particularly evident in France, which is the European country with the highest number of companies on the Top 100 list, whilst the UK, with a similar sized economy, has none (for the second consecutive year). This is attributed by the study in large part to the presence of R&D tax credits and other government innovation stimulus, a position that the UK is now attempting to rectify (see above) with increased R&D incentives. In contrast, the US and Japan, which have the strongest representation on the list, both have a long history of governments seeking to stimulate innovation.

- The recent report by the OECD entitled *Supporting Investment in Knowledge Capital, Growth and Innovation* dated 10 October 2013 (referred to above) also recently concluded that countries would benefit from reforming or creating incentives for knowledge-based capital discovery, as innovation is increasingly being driven by knowledge-based capital such as skills, systems, data, software, designs and intellectual property assets (many areas of which will be in danger should the proposal go ahead).

The OECD analysis also suggests that other types of well-designed direct support such as grants, payroll credits and refundable tax incentives may be more effective in stimulating R&D than previously thought, especially for “young firms.” The report recommended that countries review aspects of their tax incentive programs including the scope of eligible R&D, eligible firms that qualify for the incentives and the treatment of large R&D performers, all issues that should currently be in the forefront of R&D incentive program design.

Given the above, it is clear that Australia’s existing system is in part commensurate with international best practice and the proposed measure is not one that would fall within such parameters.

The foreshadowed review process should be a welcome and much needed opportunity to examine Australia’s innovation system in its entirety. In the meantime it is unclear upon what basis the Government has decided to proceed with the proposal to impose a maximum threshold before such a review has even commenced.

4. Global discriminatory nature of threshold

The proposed new threshold would still allow multi-national groups with a turnover of more than \$20 billion, but less than \$20 billion assessable in Australia, to access the Australian R&D tax incentive. This inherent bias may be deliberate policy intent to attract multi-national entities that 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.

Recent OECD studies (including *Supporting Investment in Knowledge Capital, Growth and Innovation*, 10 October 2013)³ have found that the attraction of new inbound R&D is recognised as being influenced 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 also central drivers to such decisions and the availability of these factors plus innovation and tax incentives in other countries could prove to be the tipping factor in decisions of large business of where to locate R&D activities.

5. Discrimination against certain industries

There are some practical issues in the calculation of assessable income which at least generally is an amount which a company does need to calculate, albeit sometime after the income year end.

Key concerns in reviewing the draft legislation include but are not limited to:

- The extended definition of the term affiliate for these purposes. Ideally the definitions within the new law (if enacted) and Division 328 of ITAA 1997 should mirror each other

³ Supporting Investment in Knowledge Capital, Growth and Innovation, 10 October 2013

- Certain industries that undertake a large amount of production based R&D would seek to include a large amount of feedstock expenditure in their R&D claim which would result in a feedstock adjustment. The R&D expenditure will be 'added back' to the accounting profit to arrive at taxable income and the tax offset claimed later. The feedstock adjustment will also be included as assessable income and added back to the accounting profit. Both of these amounts will be included in the calculation of taxable income (and the entire 40% R&D benefit claimed after the company rate of tax has been applied).

This method of calculation will distort the 'real' level of taxable income due to the methodology of calculating the R&D tax benefit 'below the line' – this will discriminate against production based R&D industries since the very claiming of the R&D expenditure may indeed lead to a breach of the threshold itself and deny the claim – a circular incongruity whereby the desire to make a claim would actually lead to an inability to make the claim!

- The need for certain industries such as life insurance funds to calculate assessable income on a gross basis including member funds will also distort the 'real' level of net taxable income
- The high presence of banking and resource industries in the companies that will breach the threshold unfairly targets these industries at the expense of others. The cost of other industry grant schemes aimed at specific industries exceeds the expected total savings to be made at the expense of a few large and successful companies that drive the development of risky technologies and employ a large amount of SMEs in the process.

6. The long-term impact of uncertainty and continued amendments

There are a number of other inter-related issues in respect of the nature and timing of change. The proposed changes could be significantly retrospective given the timing of the federal election and the consideration by the Committee. Business decisions will have been made with an expectation of R&D tax credit support.

In addition to the timing of the implementation of this change, the constant and ongoing uncertainty is detrimental to the R&D planning cycle and expenditure allocation undertaken by large business when considering their global R&D strategies. OECD studies show that business expenditure on R&D is significantly reduced on the uncertainty and/or reversal of R&D tax policies.

Such uncertainty and signalling of intent to large business is likely to continue to drive large business overseas where they may indeed stay even if the policy is reversed. Long-term R&D strategies cannot easily be reversed and large business may not be tempted to do so where there is a history of inconsistent policy decisions that fail to recognise the importance of innovation and collaborative R&D.

7. Alternative recommendations in light of falling innovation rankings

A review of the Global Innovation Index produced on an annual basis by INSEAD and the World Intellectual Property Organisation⁴ (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

A recent European Commission study, *EU Industrial R&D Investment Scoreboard 2013*⁵, also highlights the substantial contribution that is made by large business in innovation and R&D in the US and Europe. The lack of any Australian company in the Top 50 countries worldwide also highlights the need for Australia to increase its visibility in the global innovation arena.

Given such falling rankings in innovation, potentially in response 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:

⁴ INSEAD and the World Intellectual Property Organisation, Global Innovation Index 2012

⁵ EU Industrial R&D Investment Scoreboard 2013

- the regime is left as it currently stands until the after the promised broader review of support for innovation and R&D, or
- that one of the other options proposed by the BTWG is instead given consideration and consultation as a credible alternative to create the same level of tax savings.

For example, an R&D expenditure cap, for example, of \$200 million per claimant group, would prevent the totality of the discrimination against certain clusters of industries that is evident in the current proposals yet still provide broad support for R&D investment in Australia.

The enactment of such an alternative would also allow significant flexibility to be maintained within the provisions since the level of the cap could be adjusted between income years in line with government surplus and deficit targets. R&D investment bracket creep would also invisibly reduce the value of the net R&D benefit to large business over time if it were not increased.

8. *Conclusions*

It is difficult to reconcile that this legislation should be introduced on the basis of the following 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 and potential for economic growth and productivity..

It is arguable that the modelling of the anticipated revenue savings is based on flawed assumptions as it is based on former R&D tax concession statistics and it is unlikely that the estimates on forward savings have taken into account the impact of the new incentive which is already reshaping R&D expenditure profiles.

In the current climate of economic uncertainty and an increasing need to stimulate the broader economy and industry sectors, it is difficult to justify in a country that is positioning itself as ‘opened for business’ the elimination of support for investment in R&D through the imposition of an assessable income threshold..

It is clear that attracting innovation and its contribution to domestic prosperity depends on more than favourable tax policy decisions but recent studies and recent anecdotal evidence certainly suggest that business expenditure on R&D is indeed strongly influenced by tax policies and direct grants.

Moving ahead with this proposal will damage Australia’s standing in the global R&D community.