Corporate Tax Association

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Senate Economics Legislation Committee
Parliament House
CANBERRA ACT 2600

Dear Committee Members

SUBMISSION TO THE INQUIRY INTO THE TREASURY LAWS AMENDMENT (MAKING SURE MULTINATIONALS PAY THEIR FAIR SHARE OF TAX IN AUSTRALIA AND OTHER MEASURES) BILL 2018

The Corporate Tax Association (**CTA**) welcomes the opportunity to make a submission to the Senate Economics Legislation Committee inquiry into the Treasury Laws Amendment (Making Sure Multinationals Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018 (the Bill). This submission deals solely with the proposed changes to the research and development (R&D) tax incentive.

Background

The CTA's membership consists of 125 of the largest corporations in Australia with approximately 75% listed on the Australian stock exchange. CTA members cover all industry sectors which between them account for approximately 54% of all corporate income tax collections for businesses covered by the ATO's public tax transparency disclosures at around $21 billion. A list of members can be found on our website at http://corptax.com.au/member-companies/.

Our comments below focus on aspects of the non-refundable tax offset intensity threshold and the transparency measure. We suggest four changes to the proposed R&D provisions, namely:

1. Changes to the intensity thresholds to better reflect the real cost of the R&D incentive to budget outcomes;
2. Redefining total expenses to refer to total Australian expenses;
3. A change from a current year expense figure to a prior year expense figure in the intensity threshold denominator; and
4. Publication of the tax effect of, not notional deduction amount of eligible R&D expenditure.

The CTA is extremely disappointed with the policy change to the incentive

Whilst the CTA is fully cognisant of the cost increases to the budget bottom line of the R&D incentive in the past, we are firmly of the view that the design of the proposed intensity test is not the best way to deal with budgetary cost pressures which are driven predominantly by increased revenue costs and integrity concerns in the refundable (small business) offset space.

In our view, issues around the integrity of the system should be addressed by introducing the proposed changes to Part IVA and providing additional compliance and advisory resources for Innovation and Science Australia and the ATO, rather than radically reducing the R&D incentive for those taxpayers who are compliant with the spirit and intent of the current incentive. Whilst affordability and incentivisation is always going to be a question of balance, the proposed changes to the incentive for large corporates tips the scales too far to the former and do not consider the medium and longer term impacts to the wider Australian economy of reducing the incentive.

Australia's tax rules are becoming increasingly uncompetitive

In our view, the proposed R&D changes need to be considered in the context of Australia's overall corporate tax policy framework, including the impact of imputation.

Given Australia's high corporate tax rate, the proposed changes are sending a very strong message that Australia is not open for business and is not seeking to attract incremental R&D investment for almost all large corporate groups. It should be noted that in conjunction with the proposed changes to the R&D incentive, the Government is also contemplating the merits of a digital services tax (DST). A DST will directly impact both domestic and foreign businesses involved in developing and enhancing their digital footprint in a globalised market. Many of these groups, including Australian based companies, currently make R&D incentive claims.

Whilst we fully appreciate the policy driver behind the R&D incentive is based off encouraging additionality and spill over benefits, a 4% effective tax benefit for eligible R&D expenditure for all but a handful of large taxpayers is more than a 50% reduction in the incentive, even with the introduction of the $150 million expenditure threshold. **A recent survey of our membership indicated that many will cease or reduce the level of R&D they will undertake in Australia. Members who have a presence in New Zealand are undertaking reviews as to the feasibility of moving their R&D activities to New Zealand (NZ) which has recently changed its R&D incentive to attract R&D activity conducted in NZ.** Such outcomes send a very clear message that Australia does not want incremental R&D activity or any potential future investment to be undertaken in Australia by corporates with turnover greater than $20 million. Whilst the proposal in the draft law provides a marginally better outcome for larger corporates than that proposed in the initial *2016 Review of the R&D Incentive* report, at a practical level, many CTA members have indicated the proposed changes will not drive incremental R&D activity and in fact it may do the opposite. **A number of our member survey**

participants have also confirmed that the compliance costs associated with R&D claims, which in the current environment almost always involve a challenge from Innovation Australia and therefore the additional cost of defending claims, will simply render R&D incentive claims inaccessible.

Apart from NZ, it is worth noting the US and UK (two of the largest capital importers into Australia and the two largest investment destinations of Australians)[1] have introduced changes to tax rules that actively encourage R&D activities to be undertaken within their jurisdictions at the same time as Australia is proposing to introduce rules that reduce the incentive to undertake R&D activities for all but a handful of large corporates. US GILTI (global intangible low tax income) rules encourage the repatriation and exploitation of intangibles within the US by having an effective tax rate of 10.5% UK tax rates are reducing to 17% in 2020 and the UK rules have an 11% R&D expenditure credit for qualifying R&D activities.

It is also worth noting that the R&D incentive in the context of Australia's imputation system is a timing difference only for domestic companies, as profits eventually generated from successful R&D activities would flow to shareholders as an unfranked dividend and taxed at the shareholder level. It does not appear that the projected $2.4 billion over the forward estimates reflect this clawback of the budgetary cost of the incentive, given the likely time frame for successful R&D to be reflected in income tax payable.

Recommendation 1

In our view intensity ranges and premiums should be recast as follows:

Intensity range	R&D Premium
0-5%	6%
5-10%	9%
10+%	12%

This still satisfies the government's objective of incentivising incremental R&D but simplifies the intensity ranges and better reflects that the cost of the R&D incentive is of a timing nature for domestic companies.

The definition of total expenses needs clarification

The current proposal is for R&D intensity to be calculated by reference to the ratio of notional deductions to total expenses. The Explanatory Memorandum (EM) mentions at paragraph 1.39 that "An R&D entity's total expenses are reported in their company income tax return. The expenses reported at item six of a company income tax return are the expense amounts taken from the company's financial statements". These expenses appear to include all pre-tax domestic and foreign accounting expenses that appear in financial statements and would include for example:

[1] The US and UK account for 50 % of inbound investment and 45% of outbound investment. See: http://www.abs.gov.au/ausstats/abs@.nsf/mf/5352.0

- cost of goods sold including those related to foreign sales
- all expenses including salary and wages of foreign based employees
- foreign accounting depreciation expenses
- costs that are recharged to foreign affiliates at arm's length
- unrealised foreign exchange gains and losses
- unrealised losses on holding foreign and domestic assets.

Item 12 of the draft bill defines total expenses by reference to accounting principles.

355-115 Working out an R&D entity's total expenses

(1) For the purposes of subsection 355-100(1A), an *R&D entity's total expenses for an income year is the sum of the amounts covered by subsection (2).

(2) The following amounts are covered by this subsection:
  (a) the *R&D entity's **total expenses** for the income year worked out in accordance with:
    (i) the *accounting principles; or
    (ii) if accounting principles do not apply in relation to the R&D entity—commercially accepted principles relating to accounting;
  (b) any amount the R&D entity can deduct for the income year as mentioned in subsection 355-100(1), to the extent the amount is not covered by paragraph (a) for the income year.

Paragraph 1.40 of the EM states that the Framework for the *Preparation and Presentation of Financial Statements* defines expenses (at paragraph 70(b)) as:

> "decreases in economic benefits during the accounting period in the form of outflows or depletion of assets or incurrences of liabilities that result in a decrease in equity, other than those relating to distributions to equity participants".

This definition would appear to include all realised and unrealised costs such as income tax (both foreign and domestic), losses on sales of foreign assets, movements in accounting provisions and asset impairments regardless of where they are incurred. As the definition appears to operate, the following example shows the intensity outcome for two companies that undertake the same level of R&D activity in Australia, but Company 2 happens to have foreign based expenses. In this example, Company 1 (which could be foreign owned or Australian owned but with no foreign operations) would have an intensity ratio 4% whilst Company 2 (with Australian and foreign operations) has a ratio of 2%. Effectively the total expenses denominator discriminates against Company 2 when it is the entity that is taking its R&D to the world to generate future economic benefits for the Australian community relative to a foreign owned entity with operations solely in Australia. From a policy perspective, this seems counter intuitive.

	Company 1	Company 2
Notional deductions	1,000,000	1,000,000
Total Australian Pre Tax Expenses	25,000,000	25,000,000
Total Non Australian Pre Tax Expenses		25,000,000
Total Expenses	25,000,000	50,000,000
R&D intensity	4%	2%

Recommendation 2

In our view, to ensure the numerator and denominator in the intensity test do not by their workings discriminate against Australian companies that have decided to maintain manufacturing or service-based activity in Australia, the total expenses definition should be recast and make reference to a pre-tax "Australian expense" concept.

An Australian expense definition could be designed by reference to Australian accounting principles but exclude those pre-tax expenses referrable to the production of goods or the provision of services undertaken in Australia that are exported or related to foreign activities. For example, if Company X had total pre-tax expenses incurred in Australia of $100 and 10% of such expenses relate to the production of goods for export and 10% for head office costs charged to offshore affiliates as a service, the denominator in the intensity threshold should be $80, not $100. In our example above, both Company 1 and 2 would have a consistent 4% intensity threshold if such a definition was to operate.

Expenditure should reference prior year(s) and not current year expenses

A design feature of the R&D system is early registration of eligible claims and the planning of R&D activity well in advance of undertaking the activity. This will, in many cases, require knowledge of the estimated amount of R&D incentive that may be claimable before the claim is lodged. A current year expense denominator is susceptible to changes that are beyond a company's control such as interest rates, foreign exchange rates or input prices (such as commodity prices). This makes planning R&D activity and registration problematic.

Recommendation 3

In our view, alternatives to current year expenditure should be considered, such as the previous years' expenses, or an average of several previous years, to provide claimants with the certainty needed to plan R&D activity. Prior year expenses could be increased by an inflation factor if it was felt necessary to have the numerator and denominator on a like-for-like basis. This would also minimise the cost of compliance given such expense figures are known (and audited) and gathered from tax returns that have been lodged. We note that any integrity concerns related to taxpayers "gaming" expenses year on year is highly unlikely in the context of large public groups and if detected could be dealt with under the proposed changes to the general anti-avoidance rules. Indexation of costs would also help in this regard.

Tax transparency

The draft legislation contains measures to make public the name of the R&D tax incentive claimant in addition to its ABN and R&D notional deductions, regardless of company size. Notional deductions are of course not the sole determinant of the size of a refundable or non-refundable R&D offset claim. R&D notional deductions represent the amount from which the tax offset is calculated, not the tax benefit received. It is also worth noting that R&D expenditure is generally fully deductible for company income tax purposes, so the benefit (as is shown in the recoupment rules proposed) is in fact the tax offset amount above the corporate tax entities' underlying tax rate.

In our view, without having knowledge of an entity's turnover, it is not possible for the community to understand the size of individual R&D tax offset claims, nor in fact, the total cost to the community of the scheme.

<u>Recommendation 4</u>

We would recommend that any publication of R&D data should only reflect the tax benefit for each company above that entity's underlying corporate tax rate and not the notional deduction amount. This will provide more meaningful data for the community and should equally address the integrity aspects behind the introduction of the measure.

Should you wish to discuss any aspect of this submission in further detail, please do not hesitate to contact myself or [redacted] of this office.

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