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Committee Secretary
Senate Economics Legislation, SG. 64
PO Box 6100
Parliament House
Canberra ACT 2600

22 January 2014

Dear Sir/Madam

INQUIRY INTO TAX LAWS AMENDMENT (RESEARCH AND DEVELOPMENT) BILL 2013

BDO welcomes the opportunity to provide a submission to the Senate Economics Legislation Committee inquiry on the provisions of the Tax Laws Amendment (Research and Development) Bill 2013.

The bill proposes to amend the *Income Tax Assessment Act 1997* to limit the research and development (R&D) tax incentive to companies with aggregated assessable income of less than \$20 billion for an income year, and will apply this change to income years starting on or after 1 July 2013. The bill also proposes a consequential amendment to the *Industry Research and Development Act 1986* to provide that companies remain eligible to claim R&D activities conducted outside of Australia for income years in which they fall below the \$20 billion threshold.

On 17 February 2013 the Gillard Labour Government released *A Plan for Australian Jobs* (APAJ). Included in APAJ were proposals to help small and medium enterprises (SMEs) to grow and create new jobs. It included the proposal to target SMEs for additional R&D support and cited the experience in other jurisdictions to support the case that the R&D spending of small firms is more responsive to R&D tax incentives than larger firms. It went on to state that very large companies with aggregated assessable income of \$20 billion or more would no longer be entitled to the non-refundable 40 per cent R&D tax offset. However APAJ included no proposals to redirect that funding towards SMEs. Accordingly, it is our understanding that this is a cost saving measure with limited policy intent.

BDO does not currently provide R&D tax incentive services to any of the 15 or so corporate groups that will be directly affected by this bill and accordingly our clients have no tax concessions at risk. Nonetheless, BDO has chosen to make submissions to this inquiry due to specific concerns with this policy.

As elaborated upon in the **annexure** to this letter, our submissions are as follows:

- We understand the Government's desire to look for areas for budget savings. However there is little analysis to substantiate the asserted \$1.1 billion in savings. It is BDO's view that changes



to the R&D Tax Incentive should only be made following a review process and consultation with industry

- The proposed changes implicitly assume that smaller firms are more responsive to government incentives. Our experience is that larger companies are more likely to plan their R&D around technical and commercial risk and access to government incentives. Larger companies also have the capacity to choose where in the world to fund and perform their R&D activity
- The R&D Tax Incentive program should be perceived domestically and internationally as a stable and reliable incentive program. Recent OECD reports have noted that the effectiveness of R&D tax incentives depends on the stability of the policy regime over time.
- The proposed changes set a precedent that the government can make changes to the R&D Tax Incentive without consultation with industry, and will act as a disincentive for investment in R&D activity in Australia
- The changes may drive R&D activity to be outsourced overseas or to other companies that may be entitled to the 40% or 45% offsets. This may reduce the level of jobs, intellectual property and product development in Australia, ultimately reducing the level of tax revenue in Australia
- The application of the proposed changes is inconsistent with the thresholds used for the delivery of the benefit and favours overseas companies conducting R&D in Australia rather than Australian based companies.
- The retrospective 1 July 2013 start date provides further uncertainty in the current economic climate

Please see the **annexure** to this letter for more details discussion of the above submissions.

Should you have any questions, or wish to discuss any of the comments made in these submissions, please do not hesitate to contact me

Yours sincerely

BDO (QLD) Pty Ltd

Nicola Purser
Director



Annexure - BDO Submission in respect of the Tax Laws Amendment (Research and Development) Bill 2013: R&D Tax Incentive - Targeting Access

1. Flawed rationale

The Tax Laws Amendment (Research and Development) Bill 2013 together with an Explanatory Memorandum ("EM") proposes to amend the *Income Tax Assessment Act 1997* by limiting the research and development (R&D) tax incentive to companies with aggregated assessable income of less than \$20 billion for an income year, and will be applied to income years starting on or after 1 July 2013. The amendment is said to better target the R&D tax incentive to businesses that are more likely to increase their R&D spending in response to government incentives, delivering a greater return for taxpayer funds.

The introduction of the changes is stated to provide an estimated \$1.1 billion of savings to the budget. There has been no detailed analysis to substantiate calculation of such asserted savings. With many of the companies impacted by the proposed changes having a December financial year end, it is likely that there is little conclusive data on the level of R&D expenditure under the R&D Tax Incentive program incurred that would be impacted by the changes. This is further exemplified by the lack of current guidance material on the scope of eligible activities and treatment of certain expenditures under the new law.

Furthermore there has been a lack of industry consultation that can allow appropriate consideration of the impact that such changes will place on innovation and R&D activity in Australia. Australia has a more complex tax system than many other jurisdictions that offer R&D incentives, has an expensive labour force and is more isolated from its neighbours than other jurisdictions, factors which should be understood before any major changes to the R&D Tax Incentive are implemented.

Finally, whilst the stated aim in the EM states that the aim of the changes is to better target the R&D tax incentive, there is no evidence to suggest that any proposed savings achieved will be redirected back to those small and medium businesses which the changes are 'targeting'. Whilst we welcome and endorse the proposed review of the performance of the R&D Tax Incentive after two years as legislated, we do not believe that the introduction of legislation prior to the completion of this review and consultation with industry is in the best interests of Australia's innovation culture and infrastructure.

2. Responsiveness of smaller firms

In paragraph 1.12 of the EM, it is stated that the changes deny access to the R&D tax incentive for very large entities, which are less likely to engage in additional R&D in response to government incentives. This implicitly assumes that smaller firms are more responsive to changes in government incentives. Whilst we understand that research has shown some evidence of this there appears to be little evidence that this translates into great productivity gains. In fact the 2013 OECD report "Supporting Investment in knowledge Capital Growth and Innovation" (2013 OECD report) recognises that "*whilst smaller - but not necessarily younger - firms tend to be more responsive to R&D tax incentives than larger firms, the aggregate impact of R&D incentives might be dwarfed if such firms focus on niche markets.*" (p85)



In addition, it is our experience across a broad spectrum of industries that larger companies plan their R&D around risk and incentives. There would be little incentive for these companies to undertake riskier projects should access to government incentives be denied, and yet it is these type of activities that the R&D Tax Incentive is trying to promote. In large organisations it is common for projects to compete for funding. Our experience is that it is only the very large organisations, including those targeted by these proposed changes that include R&D tax incentives in their highly sophisticated investment decision models.

3. Stability

The introduction of legislation prior to the completion of the proposed review undermines a principal objective of the program, being to 'provide business with more predictable, less complex support' as highlighted by AusIndustry's *R&D Tax Incentive Customer Information Guide (AusIndustry sections)*. Furthermore, recent OECD reports have noted that the effectiveness of R&D tax incentives depends on stability of the policy regime over time.

With many jurisdictions in the Asia Pacific region now offering similar incentive programs, the proposed exclusion is likely to provide a disincentive for foreign and domestic companies seeking to extend their R&D activity in Australia. The uncertainty in Australia's innovation program could reduce Australia's innovation credentials, and drive R&D activities offshore where they will be undertaken in the most cost beneficial country. It is BDO's view that the R&D Tax Incentive program should be perceived domestically and internationally as a stable and reliable incentive program.

4. Precedent

The introduction of legislation prior to the completion of the legislated two year review undermines a principal objective of the program, being to 'provide business with more predictable, less complex support' as highlighted by AusIndustry's *R&D Tax Incentive Customer Information Guide (AusIndustry sections)*. Furthermore, the introduction of the proposed changes without consultation with industry will be perceived by many as a precedent that the government will make future changes to the program at any time without public consultation.

5. True Cost Benefit

Although the government asserts that the introduction of the changes will provide significant tax savings for the government, there is little analysis of the true flow on impact that such a change would have on the commercial and economic benefits to Australian companies. The companies likely to be impacted by the proposed changes already have access to international markets where there are a number of overseas research organisations. Resulting outsourcing of R&D activity could lead to the loss of Australian jobs and subsequent revenue through income tax and indirect taxes (payroll, workcover, GST etc.). Furthermore, outsourcing the R&D activity to an overseas entity may limit the benefits to Australia of the resulting intellectual property and any royalty stream obtained from it, as well as the expertise for future activity. As concluded in the 2013 OECD report (at page 88):

"other things being equal, more generous R&D tax incentives abroad are associated with lower levels of domestic R&D. This is because R&D tax incentives tend to tilt MNEs decisions on the location of their R&D activities."



The changes could also have an impact on the nature of joint venture arrangements for new ventures. For example, should the R&D activity be undertaken in Australia by an Australian entity entitled to claim the R&D tax offset, that entity could contract in such a way as to receive the benefit instead of the larger company. Depending on the group turnover of the outsourced entity in this scenario, the offset received by the entity under the R&D Tax Incentive may actually be greater than (in absence of the changes) the large company would have received. It is unclear if any such analysis has been undertaken.

6. Assessable Income Test

The application of the proposed legislation creates a number of problems that have not been addressed in the current draft legislation. The application of the \$20 billion assessable income threshold is inconsistent with the threshold used to determine the offset obtainable (which uses a turnover test), and is unfair to large companies who will not know whether their assessable income is over the threshold until after the end of their financial year. We note that other recent changes to *the Income Tax Assessment Act 1997* such as Division 230 - the Taxation of Financial Arrangements (TOFA) provisions use a prior year test.

The application of the assessable income threshold also favours foreign entities. For foreign entities, assessable income is only income derived in Australia. Therefore, large Australian owned groups are disadvantaged, and very large foreign owned groups with Australian operations under the \$20 billion threshold are advantaged. There are many situations where Australian companies affected by the changes are in joint venture with foreign entities. It is BDO's view that it is anomalous that the foreign entities will be able to continue to enjoy Australian R&D incentives whilst, in this example, their Australian joint venture partners will not. This seems to contravene the intention of a benefit that targets Australian companies.

7. Application of Amendments

The Bill states that the amendments will apply to income years commencing on or after 1 July 2013. For the very large corporates R&D incentives are not only modelled into future investment decisions but are accounted for on a near contemporaneous basis. The majority of large listed corporates book R&D incentives to half year accounts which, for 30 June year end companies, would currently be being finalised and, by the time the Bill receives Royal Assent (should it proceed) will likely have been published. Whilst we do not agree with this Bill in principle, at a very minimum, a prospective start date should be considered.