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Manager
Small Business Entities and Industry Concessions Unit
The Treasury
Langton Crescent
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26 July 2018

Dear Sir / Madam,

Submission on June 2018 R&D Tax Incentive Consultation Paper

We welcome the opportunity to respond to the questions posed by Treasury in the Consultation Paper released on Friday 29 June 2018 concerning the proposed changes to the R&D Tax Incentive regime.

Our comments on both the Treasury Consultation Paper and the Exposure Draft (ED) legislation released at the same time are detailed in the attached Annexures.

However, we would also like to comment at the outset that we believe the incentive component of the R&D Tax Incentive regime will be irreparably harmed should certain aspects of these policies be enacted as drafted - a policy that will result in only a 4 per cent rate of incentive for large swathes of key Australian industries can at best be labelled marginal.

In a globally mobile environment, we believe that such a substantial diminution in incentives can do nothing other than harm Australia's economic and financial prospects. Notably, in our capacity as advisers, we are aware of large corporate taxpayers that are already considering shifting R&D activities to New Zealand which is in the process of introducing a R&D regime with a more attractive R&D incentive rate for large taxpayers (12.5% tax credit available for eligible expenditure) or other jurisdictions. This should be contrasted against the trend that we have observed over the last 7 years of the R&D Tax Incentive assisting foreign capital being drawn to Australia to be used for the development of intellectual property in Australia.

Our observation is that the current global trend is for economies to introduce or enhance R&D tax regimes. Whilst New Zealand is an obvious recent example, we are also aware that Hong Kong and Germany are also both considering either enhancing (Hong Kong) or introducing (Germany) R&D tax incentive regimes.

Moreover, it is troubling that the intended revenue savings will not be redirected to funding direct government grants as recommended in the Australia 2030 Prosperity through Innovation report (2030 Report). The aim of the overall recommendations in the 2030 Report was to increase business expenditure on R&D (BERD) which has been falling year on year – and the enactment of part measures (as proposed) will only continue the trend of reducing BERD.

We have previously made a number of detailed submissions as part of the tax reform process and the previous reviews into the R&D Tax Incentive program. The proposed changes as announced do not alleviate a number of these ongoing

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policy concerns, and we have taken the opportunity to raise the more significant key policy issues in the relevant parts of this submission.

Our response also details a number of specific areas of concern with respect to the Exposure Draft (ED) legislation including the fact that the proposed R&D intensity calculation is neither workable in practice, nor would meet the stated policy objectives.

We hope that our observations and comments are helpful. Should you wish to discuss any details of our submission in greater detail, please do not hesitate to contact me.

Yours sincerely,

Greg Pratt
Partner
Deloitte Tax Services Pty Ltd

1 Response to specific Consultation Paper Questions

1. *Do you foresee any implementation and ongoing compliance challenges arising from the proposed calculation of R&D intensity?*

Yes – we believe there will be significant and ongoing challenges if the R&D intensity measures are introduced in their current form.

Previous recommendations of an intensity threshold in the 2016 Review of the R&D Tax Incentive and the 2030 Report have both resulted in the widespread identification of myriad issues and difficulties that would arise in practice. It is widely recognised that the pursuit of this ‘academic’ recommendation will undoubtedly be fraught with difficulties and will give rise to substantial obstacles and poor economic and policy outcomes.

It is also important to understand that the proposed measures in no way support the policy objectives of an incentive premium, since very few taxpayers can realistically achieve the intensity thresholds proposed. The examples provided by Government to date demonstrating the intensity thresholds are unrealistic and irrelevant to the vast majority of claimants.

a) Proposed definition of expenditure

The proposed legislative methodology to calculate an R&D entity’s ‘Expenditure’ has been set out in the ED legislation in new section 355-115 and defines this as:

355-115 Working out an R&D entity’s expenditure

- (1) An *R&D entity’s expenditure 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 expenditure incurred by the *R&D entity for the income year worked out in accordance with the *accounting principles;*
 - (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).*

We believe that the proposed implementation of this calculation is from the outset utterly unsatisfactory and inappropriate, and that the introduction of a clear jurisprudential approach is the only possible option should an R&D intensity design be pursued for the reasons outlined below.

In Australia, there is no systematic connection between the income tax law and accounting concepts or standards, and we believe that there are many potential hazards of using such a hybrid of specific tax and accounting rules.

The use of accounting principles and standards for these purposes within the confines of the R&D tax law is unsatisfactory, since accounting standards are significantly less precise than the taxation laws, and accounting standards do not require transactions to be measured on an arm’s length basis.

An informed examination of the implementation of the tax consolidation regime alone demonstrates that a mix of accounting and jurisprudential approaches can lead to greater complexity, than if it were designed on one basis alone. Indeed, it is unlikely that the coherence of this proposed law would in any way minimise complexity and associated compliance costs as may be intended.

Indeed, we believe that the hazards that could result are adequately demonstrated by the conflation in proposed subsection 355-115(2)(a) of the tax terminology of ‘incurred’ together with accounting standards, which themselves distinguish between expenses and expenditures, and rely on the concept of matching rather than incurred.

More specifically, such a definition of expenditure does not seek to distinguish between revenue and capital expenditures. This could lead to double counting with the inclusion of all accounting capital expenditures on assets, as well as any tax decline in value that is included in R&D notional deductions. The mechanism would also discourage the borrowing of funds to undertake R&D due to increased interest expenses, negatively impacting the motivation of entities to pursue additional R&D, an outcome obviously against the intended policy desire.

Discussions with larger corporate taxpayers reflect their confusion on the amounts that would need to be included in both the numerator and the denominator of the proposed intensity calculation, and how to identify the additional R&D amounts that had not been identified under accounting principles. We are also aware of more complex situations such as discounts to customers being treated as revenue for book or accounting purposes, and as an expense against revenue for income tax purposes (for example).

In addition, accounting rules do not need the recognition of expenditure to be consistent with transfer pricing rules. Hence, when an entity is required to make transfer pricing adjustments pursuant to review or audit activity for historical years which could be substantial, in theory there should be a mechanism in place to reduce 'overall' expenditure for those historical back years, and amend the R&D claim to receive a higher offset. However, the accounting standards may only require such adjustments to be disclosed in the current year financials.

Discussions with our client base also revealed a strong preference that 'expenditure' does not include cost of goods sold (COGS) since this would significantly reduce the R&D intensity for companies with high valued COGS, or lower margin sectors generally. Many of Australia's most successful R&D companies will have significant COGS (one could argue reflective of the success of prior R&D endeavours); the inclusion of COGS within the definition of expenditure materially disadvantages these companies and may discourage R&D activities along with creating distortions across sectors as outlined below, to the detriment of the R&D Tax Incentive being a 'broad based' program).

b) Resulting policy outcomes

From a policy perspective, we are strongly of the opinion that the recommendation as implemented would not achieve its stated objectives. Rather, the pursuit of this policy in the name of additionality would merely serve to discriminate between Australian based manufacturers who export products, in comparison to Australian based groups that seek to offshore manufacturing (incurring COGS expenses outside Australia) whilst retaining head office facilities and costs in Australia.

Although the mechanism proposed to be adopted is not as blunt as was originally anticipated, as drafted this amendment will still unduly discriminate against companies with high levels of general "total expenditure", largely in industries such as mining, manufacturing and fast moving consumer goods (FMCG).

This arbitrary mechanism, if enacted, would continue to isolate such industries as perceived low R&D intensity entities in accordance with the proposed calculation of expenditure and, as presumably intended, provide a significantly reduced tax benefit going forward. Other companies that arbitrarily, in accordance with their level of expenditure, have a high R&D intensity will receive an increased benefit.

In fact, we would also argue that the nature of the calculation will actually serve to reward over the longer term taxpayers who achieve poorer commercial performances (evidenced by lower manufacturing costs) – again an outcome which flies in the face of the need for strong policies that would improve Australia's poor track record in commercialising strong Australian innovations.

c) Compliance challenges

From a compliance perspective, it is disappointing that taxpayers would again have to expend considerable compliance costs and time in establishing a benchmark threshold, which in and of itself, would provide no benefit to the taxpayer.

It must also be recognised that on the basis of any definition of expenditure, the revised regime will undoubtedly in all cases create ongoing uncertainty for taxpayers given the inability to forecast the level of the incentive available for each income year. Practically, the claimant will need to complete their accounts, conduct R&D expenditure calculations and then determine the resulting intensity threshold to be able to consider the likely resulting incentive rate – detracting from the overall intended outcome of the program, i.e. as an incentive to conduct additional R&D activities. This needs to be contrasted with other global programs, where the rate of benefit is relatively clear at the outset of innovation investment.

d) Alternate models

We understand that the consultation groups have explored possibilities as to how any existing accounting or tax expenditure labels in the company income tax return labels could be identified and used for these calculation

purposes. We ourselves have examined these possibilities and conclude that there are no easy ‘shortcuts’ that could make this policy recommendation a viable policy option.

Rather, if such a policy is to be pursued, we would strongly advocate for a satisfactory jurisprudential definition, in particular one that does not rely on the examination of accounting principles, but on other, more well understood tax concepts.

One alternate possibility is to use a denominator that is an exponent of the numerator, being the R&D expenditure. Such an exponent would need to reflect a consistent measure of the entity’s R&D intensity, and could, for example be a function of the proportion of FTEs that are committed to R&D activities, or a function of a rolling average of increases in R&D activities over time. Such an approach would also ensure that the numerator and denominator were comparing “apples with apples”.

However, if an expenditure model continues to be pursued, we believe that it would need to encompass some or all of the following features:

- A clear distinction between capital and revenue expenditure for tax purposes.
- A focus on identifying operational expenditure amounts, including tax depreciation, where the costs are incurred strictly for current operations.
- The exclusion of COGS from the definition of expenditure.
- The use of a prior year or base year expenditure level or a “rolling 3-year average” rather than a current year definition, for the purposes of certainty and smoothing out anomalous spikes. As drafted, companies will be consistently tracking a moving expenditure target, as well as a moving R&D expenditure amount. The use of an earlier period benchmark could also assist situations where adjustments have to be made to prior year returns, given that earlier periods are likely to be settled before later ones. It will also allow R&D calculations to be undertaken even where current year accounts have not yet been finalised.

Although under such a definition, some capital expenditures may be included in eligible R&D expenditure and not in expenditure, we believe that this anomaly should be allowed to stand. The inclusion of some capital expenditures is a deliberate policy design feature of the R&D Tax Incentive, and should not thereby be to the detriment of calculating an overall R&D intensity level.

In a final conclusion, given all of the substantial theoretical and practical challenges that are clearly presenting themselves in pursuing any form of this academic policy recommendation, we respectfully suggest that an intensity mechanism is abandoned, and an alternate revenue savings model is pursued, that will result in less arbitrary discrimination.

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

Should such an intensity policy still be pursued, in the face of the challenges clearly identifiable, we believe that any proposed method of calculating R&D intensity will then also be subject to key integrity risks.

This is inevitable given the potential advantages or benefits that could emerge from the commercial structuring of an eligible R&D entity, within the context of a wider economic group, as incurring little in the way of non-R&D expenditure.

Despite the proposed strengthening of the general anti-avoidance provisions in Part IVA, it is still to be expected that taxpayers will seek to properly structure their affairs to maximise the availability of the R&D Tax Incentive if possible.

It is likely therefore that the introduction of this regime will result in significant efforts being expended in the future on discerning the fine line between commercial structuring and contrived arrangements to maximise the tax benefits available under the R&D Tax Incentive regime.

As such, in the medium to longer term we believe that it may be appropriate to issue a Taxpayer Alert or Practical Compliance Guidelines (PCG) in a manner similar to the recent Central Management and Control PCG – this could address and acknowledge the practical aspects of low risk situations whereby Part IVA would not be invoked. Such

a PCG could over time also address other higher risk aspects of the R&D program that cannot be addressed within the confines of the legislation itself.

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

As discussed above in Question 2, it is likely that broader economic groups may seek to commercially structure an eligible R&D entity, within the context of the wider economic group, and seek to incur as little as possible in the way of non-R&D expenditure.

It is therefore understandable to consider pre-empting such behaviours with specific integrity measures that would require expenditure to be considered across a wider group, as currently occurs with the aggregate turnover grouping rules within Division 328 of ITAA 1997.

However, at the outset it is important to state that both the numerator and the denominator in the calculation of R&D intensity should be based on the same entity, or range of entities – given the need to be “comparing apples with apples”. We do not accept that an approach would be acceptable where the denominator is calculated on a different basis to the numerator. As such the expenditure should be based on circumstances of the claimant R&D entity.

We also believe that any such an approach would further aggravate the perception of grievance in the significant reduction in support for innovation. Defining these expenditures across a wider group would further discriminate against wider economic groups in a likely further dilution of their R&D intensity. Such an approach would condemn any R&D activities in such groups to a 4 per cent net tax benefit in perpetuity. Rather than encourage any incremental R&D activities, this could perhaps instead discourage the carrying on of any peripheral R&D activities.

It would also require additional compliance calculations to be undertaken if the membership of a wider economic group defined for these purposes differed from the accounting consolidated group, since amounts of expenditure would need to be further broken down.

Discussions with our client base also reveal a preference for expenditure to be considered at the individual entity level and not at the economic group level since the inclusion of non-R&D entities would unfairly penalise the overall intensity threshold level able to be achieved. The attribution of the incentive benefit (at potentially different premium rates) would also prove difficult across broader economic groups if R&D expenditure was aggregated for the purposes of the intensity calculation.

Again, regardless of the measures adopted, it can still be foreseen that much effort is likely to be expended in the future on discerning the fine line between commercial structuring and contrived arrangements to maximise the tax benefits available under the R&D tax incentive regime.

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

This issue is one that will be more appropriately addressed by AusBiotech and other life science entities. However, in our opinion, we do believe that the definition will need to be carefully considered to ensure that key aspects of non-pharmaceutical clinical trials are not inadvertently excluded. For example, it is unclear whether preclinical and drug manufacture costs will be included – both critical to in-human clinical trials.

As an aside we understand that although the refundable carve out has been welcomed by industry, the expected impact of the non-refundable changes will reduce the overall attractiveness of Australia to global clinical trials. This will unfortunately come at a time when the growth in global clinical trials under the current R&D Tax Incentive has displayed both good additionality and well targeted spill overs that have maximised the fostering of collaboration with PFRO's within companies both small and large (through the growth in Phase I/II clinical trial activities).

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

Draft subsection 67-30(1A) is the operative provision which will ensure that any tax offset that is attributable to eligible clinical trials will remain refundable. There is no suggestion in this legislative requirement that a finding must be in place akin to claiming eligible R&D expenditure that has been incurred on overseas R&D activities – per existing subpara 355-210(1)(d)(ii).

Rather, ISA will have the power to make findings binding on the Commissioner of Taxation that an activity satisfies the definition of clinical trials, or can make a finding on the lodgement of an advance finding application by the taxpayer.

We believe that this combination of self-assessment by the taxpayer, supplemented by the availability to request an advance finding is appropriate. It is to be expected that ISA can make a finding as part of the registration process, as would be required for the purposes of allowing taxpayers to request a review of a reviewable decision under the provisions set out in Division 5 of the *Industry Research and Development Act 1986*.

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

As foreshadowed by the Budget announcement, adjustments were expected to the R&D clawback provisions including the feedstock adjustment mechanism as it is of course unsustainable to retain a 10% clawback for simplicity, in light of the substantially reduced tax benefits of the non-refundable R&D tax incentive from 1 July 2018.

Although the creation of a uniform clawback subdivision is admirable, and the elimination of the additional income tax amount is to be welcomed, we believe that the new uniform clawback rules are overly complex and, in practice, can be expected to lead to significant errors and the long-term over-claiming of expenditures.

Although this solution seeks to properly reverse the net tax benefits bestowed under the revised regime, the proposed solution merely adds yet more layers of complexity to an already complex and time consuming compliance calculation that, in and of itself, achieves nothing except the reversal of a deliberately conferred tax benefit.

The complexity of the existing rules led to the informal introduction in 2015 of an “administrative solution” which largely seeks to allow taxpayers to disclaim eligible R&D expenditure that would be categorised as energy or as feedstock input expenditure in respect of tangible products that are supplied to another entity or applied to their own use, and allows a tax deduction despite the operation of section 355-715.

In light of these experiences, we advocate for an alternative to a complicated clawback system, which realistically only serves to match such clawbacks to the income year of supply or use.

We respectfully suggest that amended provisions be used as proposed to legislatively identify the following expenditures:

- Expenditure incurred on feedstock input expenditures that are transformed or processed as part of R&D activities that result in a tangible product that is supplied to another entity, or applied to own use;
- Energy costs of conducting R&D activities that result in a tangible product that is supplied to another entity, or applied to own use; and
- Amounts received or entitled to be received in the way of government grants that is expended on registered R&D activities.

Once such amounts have been properly identified, then the legislation could be redrafted to quarantine these expenditure amounts so they cannot attract any premium amounts under proposed section 355-115. The amounts would then only attract a tax offset at the prevailing corporate tax rate under proposed subsection 355-100(1) like any expenditure in excess of \$150 million.

This alternative would effectively remove the need for any clawback adjustments to be calculated and included in assessable income, whilst still achieving the intended aim of the clawback provision. The four-year period of

review would allow the amendment of a company income tax return should a government grant be received in an income year after that of the R&D claim.

Under the current rules, anecdotally taxpayers prefer feedstock adjustments to be undertaken in the income year of claim, rather than in later years; an indication that any loss of timing benefits will not be missed by affected taxpayers.

2 Other observations

Additional comments on the proposed amendments are set out below, which include our wider observations and opinions on the policy issues underpinning these proposed changes.

2.1 Drafting of refundable offset rules

In proposed section 67-30(1A), we believe that the language of the provision in subparagraph 67-30(1A)(a)(ii) does not achieve the correct outcome.

It is clear that from a logical perspective that this should be identifying the difference between the tax offset in its entirety (not after disregarding the clinical trial component) and the tax offset available in para (i). We suggest that this provision is reviewed carefully and redrafted to ensure that it achieves the correct outcomes expected.

2.2 Characterisation of excess refundable R&D tax offsets

As anticipated by the Federal Budget announcement, the drafting of the provisions seeks to characterise otherwise refundable R&D tax offsets as non-refundable tax offsets in the event that they exceed the \$4 million annual cap, and are carried forward to be used in future income years, subject to satisfying the requisite loss utilisation tests.

However, we are firmly of the opinion that the carry forward amounts in excess of the \$4 million cap should retain their character as refundable offsets (and could be subject to an additional test requiring that the \$20m threshold test is also satisfied in the future income year). The re-characterisation of the offsets to ones of a non-refundable nature is against the ongoing legislative practice set out in subsection 65-35(2).

This provision asserts that carried forward tax offsets are applied as if they were a tax offset for that future income year. Subsection 63-10(2) then requires tax offsets arising in more than one income year to be deducted on a 'first-in, first-out' (FIFO) basis. The interaction of both of these provisions implicitly asserts that any excess tax offsets carried forward to future income years retain their character.

Indeed, aside from the conversion of current year excess franking credits to tax losses that can be carried forward under subdivision 36-C of ITAA 1997 (which does not fundamentally change the value or nature of the tax attribute), there are currently no other tax offsets that fundamentally change character on being carried forward.

The ability of carried forward amounts to 'fill up' unused caps of future income years is also not unheard of – this treatment would largely parallel the mechanism of the relatively new \$200,000 non-refundable Early Stage Innovation Companies (ESIC) annual cap.

If enacted as announced, these provisions will mean that offsets exceeding the annual cap cannot be cashed out in subsequent income years even where the annual cap for that respective year is not reached. Taxpayers will be required to expend even further planning efforts to schedule R&D activities accordingly to maximise the refund opportunities available against these annual caps.

2.3 Administrative amendments

We appreciate the reasons why a three- month limit may be considered appropriate – however we continue to believe that this remains an instance under which the Chairman of the Board's discretion could be exercised in exceptional circumstances similar to the Commissioner's discretion that can be found within the taxation laws. For example, there

may be situations where valid registrations are rendered ineffective by a subsequent valid election to consolidate for tax purposes, which will require a revised registration in the name of the head company entity.

2.4 Support for reintroduction of quarterly credits

We continue to believe that it would be beneficial for small companies if the government reintroduced the quarterly credit refund provisions that were abandoned in 2013, as subsequently recommended by the Murray report.

This policy is ultimately revenue neutral which, with the appropriate integrity measures that were adopted in the provisions as previously drafted, would serve to assist the cash-flow and R&D capacity of small business, thereby increasing the effectiveness of the program. This would likely also assist with contemporaneous substantiation.

The new amendments restricting refunds to \$4 million per annum naturally also reduce the level of risk involved with reintroducing such a policy.

2.5 Lack of international competitiveness

As noted in our covering letter, in the current global environment, we believe that international competitiveness is one of the most critical issues to be considered in evaluating the success and necessity for an R&D tax incentive in Australia.

It is notable that the enactment of this legislation would see the Australian tax incentive available fall from 24.5 per cent in 1986 to a marginal 4 per cent for many key Australian businesses.

Indeed, whilst Australia is seeking to substantially reduce the R&D tax incentives offered for the foreseeable future, other jurisdictions are either introducing R&D tax incentive regimes or increasing the benefits currently available.

From our experience and discussions with large corporate taxpayers, it is evident that with reduced support to be provided by the revised Australian R&D Tax Incentive, a significant number of taxpayers will undoubtedly consider shifting certain R&D activities overseas to jurisdictions with more supportive rules.