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The Secretary
Senate Standing Committee on Economics
PO Box 6100
Parliament House
CANBERRA ACT 2600

Our ref Tax Laws Amendment RnD Bill 2013 - Submission to senate committee 6 December 2013.docx

6 December 2013

Dear Sir

Tax Laws Amendment (Research and Development) Bill 2013

Please find enclosed KPMG's submission in respect of the Tax Laws Amendment (Research and Development) Bill 2013 referred to the Senate Economics Committee for inquiry on 5 December 2013.

We are disappointed the Government has decided to proceed with the former Government's proposal to deny access to the Research & Development (R&D) incentive for large companies with annual assessable income of $20 billion or more. We urge the Government to reconsider its proposed changes in support of which we provide the following submission on the Tax Laws Amendment (Research and Development) Bill 2013 which was tabled on 14 November 2013.

Whilst brief, the legislation's potential impact is complex and deserves further consideration than the nine day period of consultation allowed by the previous Government. We are pleased that the Bill has been referred to the Senate Economics Committee for inquiry.

The estimated savings of $1.1 billion gained by the proposed changes are flawed and will provide the Government with at best a small increase in consolidated revenue now at the price of longer term growth in Australia in future.

Both large and small companies make R&D investment decisions typically over the medium to long term. Frequent changes to R&D tax incentives diminish confidence in the stability of the incentive and may deter foreign investment in R&D leading to decisions to relocate R&D offshore, which directly contradicts the underlying policy intent.

KPMG's key concerns with the legislation are that the proposed changes are:

- failing to recognise the strategic value of R&D;
- discriminatory against Australian companies;

KPMG, an Australian partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity.

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- failing to recognise the indirect benefits of R&D expenditure by larger companies, including the 'spin off' impacts and employment, particularly in contracted SMEs;
- principally based on the old R&D tax concession, rather than the new R&D tax incentive with which there is little historical experience;
- inconsistent across different industries due to differences in calculating assessable income;
- impractical as they rely on a definition of assessable income, 'which is determined after 'year-end'';
- likely to create a loss of base income tax deductions for companies;
- likely to lead to unintended and impractical outcomes; and
- not based on any strategic consultation process with industry.

The attached submission provides further information on the key concerns that industry is likely to face.

We urge the Government to reconsider the proposed changes as they have the potential to undermine Australia's R&D performance.

Yours faithfully

David Gelb
National Partner, R&D Incentives

Enclosures:
Submission on Tax Laws Amendment (Research and Development) Bill 2013

The Secretary
Tax Laws Amendment (Research and Development)
Bill 2013
6 December 2013

R&D Tax Incentive – targeting access

The Government has tabled Tax Laws Amendment (Research and Development) Bill 2013 ("the legislation") together with an Explanatory Memorandum (*"EM"*). The content of these documents has not been amended from the Bill tabled in Parliament by the former Government earlier in 2013. Having reviewed both, the following issues are raised.

Unprecedented exclusion and damaging to Australia's international reputation

To the best of our knowledge, Australia will be the first country in the world to exclude such a specific and targeted subset of large companies from claiming an R&D tax incentive, which is an entitlement to all other companies. There are over 2 million companies in Australia. This legislation, according to the previous Government, targets 15[1] of Australia's largest and most successful entities.

However, the proposed legislation goes further and not only excludes successful companies, it discriminates against successful companies with large operations in Australia, and Australian resident companies.

Innovation is the dominant factor in economic growth and patterns of world trade.[2] The proposed exclusion is likely to reflect poorly upon us internationally, lessen Australia's innovation credentials, and increase the cost of domestic R&D thereby driving R&D activities offshore where it will be undertaken in the most after-tax cost effective country.

It should be noted that large companies are the entities that traditionally undertake large scale transformational or nation building projects, with elements of R&D. Further, they are inextricably linked to broader supply chains and create 'spin off' and 'flow on' impacts to employment. Such activities require stable and predictable R&D tax regimes. By changing the R&D tax incentive so quickly after its introduction, the Government is undermining its stated commitment to innovation. The message being sent to big business is that Australia cannot be relied upon to support R&D and that it should invest elsewhere. If this proposal does not achieve the desired savings, will the Government look to expand the exclusion to smaller companies?

Since introducing its R&D assistance regime, the United Kingdom has increased support for small companies; extended the program to large companies; enabled all companies to report R&D assistance as an 'above the line' benefit; and provided refundable benefits to both large and small companies. This expansion of its R&D program has occurred during a tough economic period for the United Kingdom, however the promotion of R&D assistance across all sectors is considered as beneficial to the economy.

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[1] Prime Minister Julian Gilliard, Transcript of Joint Doorstop Interview, 17 February 2013, http://www.pm.gov.au/press-office/transcript-joint-doorstop-interview-5

[2] Minister for Industry, Science and Tourism, "*Science and Technology Budget Statement 1996-97*", AGPS, Canberra, August 1996.

Singapore introduced its R&D regime in recent years and has since increased the level of benefit to all companies in a bid to encourage further investment in Singapore by multinationals and local operations.

Flawed reasoning underpinning proposed exclusion

The EM to the legislation states that there is broad support internationally for the view that small firms are more likely to increase their R&D spending as a result of Government initiatives and deliver a greater return for taxpayer funds (EM at 1.6). No references or further information is provided to support these assertions. In fact, there is evidence to the contrary; R&D tax credits stimulate investment in large firms more when compared with medium firms which are driven more by demand or sales factors.[3] The Government's research showed greater R&D in Australia by international companies which has had a positive flow-on effect on smaller companies and overall national growth.[4]

We are not aware of any evidence which shows that small and medium businesses have a greater chance of commercialising R&D more profitably, quickly or efficiently than larger, more experienced companies. Larger companies often invest in riskier and more radical R&D which involves significantly higher costs than adapting or evolving R&D typically undertaken by smaller companies.[5]

Further, the recent introduction of the R&D tax incentive has already refocused and reduced R&D claims for large companies, by restricting the extent and value of eligible activities. The practical impact of the existing R&D tax incentive is that R&D expenditure will and has decreased among these firms, with a higher percentage of the eligible expenditure being for labour costs when compared with old R&D tax concession.

This labour represents Australian jobs; employment which also generates revenue through income tax, indirect taxes (payroll, workcover, GST, etc) and income which is then expended by those same employees on Australian property, goods and services. Larger companies receive a 40% notional R&D deduction which, after tax, provides a 10% return on R&D expenditure. This means that a company will receive a $10,000 tax offset for $100,000 spent on R&D. If $80,000 of that is spent on wages, the Government will receive around $17,000 back in income tax alone (not including indirect taxes and flow-on benefits to the economy). The financial benefit to the Government and the Australian economy is likely to be far higher in practice, easily outweighing the current cost of the R&D tax incentive. By excluding the companies that spend the most, usually strongly weighted towards labour, the Government is discouraging investment in R&D and potentially impairing Australian jobs and international competitiveness.

The EM suggests that the proposed changes will enhance Australia's R&D tax incentive and that it will not lead to any reduction in R&D activities in Australia. Such assertions should be

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3 Koga, T., "*Firm size and R&D tax incentives*", Technovation, vol.23, pp.643-648, 2002.

4 Innovation Australia, "*Section 2 Our Programs*", Annual Report 2009-2010.

5 Australian Department of Industry, Tourism and Resources, "*The R&D Tax Concession – Impact on the Firm Report on a Survey of 116 Firms*", Canberra, October 2005.

supported by evidence and debated publicly to give all stakeholders the opportunity to comment on a matter of strategic importance such as R&D.

The Dyson Report[6] in the UK, found that large companies undertaking R&D are likely to engage with academia and smaller companies to collaboratively undertake R&D and generally foster innovation in those around them. For instance, larger companies:

- Engage smaller companies to assist them with their R&D. This benefits both.
- Join with Universities and Cooperative Research Centres (CRCs), leading to innovation which benefits all and which filters down to smaller companies.
- Have the resources to undertake large, high risk R&D projects which others are unable to do.

By limiting access to the R&D tax incentive, the Government would be penalising larger companies for undertaking R&D. Those companies may reconsider undertaking R&D, or more likely, they will consider undertaking R&D in jurisdictions which reward them for it.

We are aware of one company, which will be excluded from the R&D tax incentive program as part of this measure, that contractually obliges its vendors to undertake at least 45% of its R&D activities in Australia. Part of the rationale for this contractual clause is that the company recognises the spillover benefits that will accrue to it and the local development community by undertaking a substantial portion of the project in Australia even though it may be more expensive to do so. The benefits available to this company under the R&D tax incentive program are routinely considered as part of its development investment decisions. Without the 10% funding assistance provided by the Federal Government under the R&D tax incentive program it is likely that this company may reduce its R&D expenditure and will reduce or remove this contractual clause, thereby increasing the level of development undertaken offshore in comparatively cheaper jurisdictions.

Recognising this fact, the French Minister for Innovation responded to Australia's earlier announcement and invited large companies to undertake their R&D in France instead of Australia (Australian Financial Review, 12 March 2013).

The large companies which this legislation targets, employ a significant number of people both directly and through contracts with Australian companies and research entities in undertaking their R&D activities. As these companies may typically have a global presence, decisions as to where to undertake R&D activities may be considered with every project. Consideration is often given to a number of factors and it is incorrect to assume that R&D incentives do not play a part in these decisions. As noted by Medicines Australia, winding back the R&D tax incentive

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[6] Dyson, J., "*Ingenious Britain: Making the UK the leading high tech exporter in Europe*", March 2010, http://www.dyson.co.uk/insideDyson.

will diminish investment in R&D in Australia; "Australia must decide whether to encourage innovation or merely profit from digging things out of the ground."[7]

The EM contends that companies with assessable income below $20 billion are more responsive to government incentives than large ones stating there is broad international support for the view that small firms are more responsive than large firms to government R&D incentives but cites no evidence to support this contention. Whether or not the R&D incentive encourages large companies to undertake R&D, it certainly encourages them to undertake the R&D activities in Australia (either directly or through contracted R&D with small and medium enterprises). Such activities create jobs in Australia and result in employment income, profits and transactions which are taxable in Australia.

The stated aim in the EM is to better target the R&D tax incentive, but there is no evidence to suggest that any savings achieved through preventing a small number of larger companies from claiming will be redirected back to those small and medium businesses. Instead, the proposed change will penalise larger businesses and leave small and medium businesses at best, no better off.

Australian companies disadvantaged

The legislation has based the exclusion on 'assessable income'.

This is different to basing the exclusion on 'aggregated turnover', a term which is already used by the R&D tax incentive to determine whether a company can access the 40% or 45% R&D tax offset.

This approach may inadvertently capture even more taxpayers than initially announced and produced some unusual and possibly unintended consequences.

Assessable income is a complex term which encompasses both common law and statutory income. This already hints at its complexity and the difficulties its use will impose on companies trying to determine 'aggregated assessable income' for themselves and other entities with whom they are connected.

In broad terms, it is income which is assessable under Australian taxation laws and will include all income of Australian residents, whether derived in Australia or overseas. For foreign companies, assessable income is only that derived in Australia.

This means that for an Australian and a foreign company, both with income exceeding $20 billion, the foreign company may be eligible for Australian Government R&D support, whilst the Australian one will be prevented from accessing the R&D tax incentive. This is a perverse outcome of the policy and it is difficult to see how this 'targeting of Australian larger companies' is beneficial to Australia.

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[7] Medicines Australia, "*Winding back R&D tax credit would threaten jobs*", August 2012, http://medicinesaustralia.com.au/2012/08/14/winding-back-rd-tax-credit-would-threaten-jobs/.

The R&D tax incentive is only one factor in encouraging foreign investment in Australian R&D activities. A major factor is capability to undertake the work. If significant investment by Australian companies is discouraged and unrewarded, then over a very short timeframe, this capability may dramatically diminish. This lack of capability may well be a stronger deterrent to foreign investment and, when combined with good R&D incentives and strong capabilities in other locations, may lead to a reduction in foreign companies undertaking R&D in Australia.

The flow-on effect of this reduction in Australian capability may then impact smaller firms who are not able to access global resources and may then have a dwindling pool of resources in Australia.

Given the current concerns in relation to the level of tax paid by foreign companies on Australian income, it appears contrary to allow such companies to access the Australian R&D tax incentive and yet prevent Australian companies of a similar or smaller size from doing so.

Inconsistent and impractical industry application

As noted above, 'assessable income' is a complex term and draws a far wider net than turnover. For instance, the food industry in Australia uses hedge funds to protect itself from fluctuations in food prices and weather conditions.

Another such instance is in relation to life insurance companies, which hold members' funds directly rather than through managed funds. Such a company must include all of the funds held as assessable income rather than merely including only the fees earned which are in fact the real turnover and monies accessible to the company.

Under the proposed changes, these companies may be excluded from claiming the R&D tax incentive, even though their actual turnover is well below the $20 billion threshold.

Even at the most practical level, the use of aggregated assessable income is flawed – companies are only able to calculate their assessable income after the end of the financial year; after conducting the R&D activities which they might be ultimately excluded from claiming. In such circumstances, large companies which consider that they may be excluded may consider conducting their R&D activities in countries which offer greater certainty.

Further, given that this is an incentive, companies factor this in to their R&D investment decisions, well before even the commencement of the year in question.

Savings based on old law, not new

The Government has stated that it will save $1.05 billion by excluding larger companies from the R&D tax incentive. We are interested to understand how this calculation was performed and contend that it is likely to be based on either:

- Assumptions made based on data pertaining from claims made under the old R&D tax concession. If so, such calculations over inflate the estimated saving as the R&D tax incentive provides larger companies with a reduced benefit.
- Assumptions and estimates made based on estimates of claims to be potentially claimed under the R&D tax incentive. The principal objective of the change from the tax concession

to the tax incentive, as stated by the Government at the time, was to reduce the size of claims made by large taxpayers. The R&D tax incentive legislation was specifically drafted to achieve this aim. At the time of calculating the potential savings from the above measure, the majority of affected taxpayers had not finalised their R&D expenditure calculations under the first year of the R&D tax incentive.

Loss of timing benefit

For some large companies, the R&D tax incentive's greatest advantage is the timing benefit derived from claiming R&D expenditure at the time it is incurred rather than depreciating it over a longer period of time. This is not an insignificant advantage and this will factor into the decisions as to whether to undertake R&D in Australia or not.

The practical impact of losing this timing advantage is a substantial reduction in cash flow. This will limit an organisation's ability to reinvest in further initiatives to advance the state of technology or productivity, and present employment.

Confusing and unnecessary terms

The R&D tax incentive currently offers two levels of incentive; a 45% refundable tax offset for companies with an aggregated turnover less than $20 million and a 40% non-refundable tax offset for companies with an aggregated turnover of $20 million or more. In broad terms, aggregated turnover includes the annual turnovers of the R&D entity and any entities connected with, or affiliates of, it, but excludes income derived from dealings between those entities.

Instead of using the existing terms to prevent companies with an aggregated turnover exceeding $20 billion from claiming, the legislation uses 'aggregated assessable income' to determine the $20 billion threshold. By failing to exclude income derived between related entities, the $20 billion 'aggregated assessable income' threshold will be reached far more quickly than the 'aggregated turnover' would be. This change will both lower the effective threshold of the limit and confuse businesses with yet another, subtly different definition to understand and apply.

Finally, the inclusion of both directions of affiliate relationship is inconsistent with the aggregated turnover definition and in practice, will have little further application. Aggregated turnover already encompasses any entity which on its own, its affiliates or together with its affiliates controls at least 40% of the R&D entity (whether directly or through interposed parties). Unless there is evidence to warrant this new inclusion, it would be preferable to use existing and accepted definitions such as relying on 'aggregated turnover'.

Unintended and Impractical Application

Not only is aggregated assessable income difficult to determine, but it is determined after the end of the financial year. This means companies will not know whether they are eligible or not at the time they conduct the R&D activities. For larger companies considering investing in R&D, this adds another layer of uncertainty. For those that choose to continue to invest in Australia, despite being excluded from the R&D tax incentive, there are other complications. R&D expenditure claimable under Div 355 will have to be divided across multiple other

specific divisions, increasing the administrative and compliance burden of conducting R&D in Australia.

Lack of consultation and proper consideration

The previous Government first announced the proposed restriction on larger companies on 17 February 2013. This was not followed by a public consultation period, rather, the then Government moved straight to drafting enabling legislation. Release of the Exposure Draft on 7 May 2013 was the first opportunity the Australian public has had to comment on it and submissions closed on Monday 20 May; 9 working days after they opened. Important changes such as this, which will impact billions of dollars in R&D expenditure and potentially cost Australia thousands of jobs, should not be passed without further consultation.

The short timeframe and absence of evidence of the purported benefits of these changes may negatively impact Australia's standing as a country which encourages innovation and invention R&D.

Conclusion

It is difficult to see how the proposed changes contained in the Exposure Draft will benefit Australian taxpayers. It does not include an increase in the incentive for small and medium business and the use of 'aggregated assessable income' is both confusing and unnecessary.

The proposed changes target Australian businesses over foreign ones; unfairly limiting those who pay tax here rather than overseas.

The Government provides significant non-tax incentives to various industries in Australia. Many of these exceed the entire value of the R&D tax incentive. Whilst we understand that there may well be valid reasons for doing this, it is difficult to reconcile with the proposed restriction on the R&D tax incentive - an incentive for companies to conduct R&D activities in Australia regardless of industry. Unlike some industry specific grants, the R&D tax incentive increases employment in Australia, generating intellectual property which benefits Australia now and in the future.

Finally, a key feature of Australia's R&D incentive, over the past 28 years, has been its accessibility to all Australian companies. The proposed elimination of this key attribute is likely to erode Australia's innovation and R&D infrastructure.