Hear now. And always

5 November 2018

Senate Standing Committee on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

economics.sen@aph.gov.au

Dear Senators

Inquiry into the Treasury Laws Amendment (Making Sure Multinationals Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018

Cochlear welcomes the opportunity to make a submission on the above Bill, specifically the proposed changes to the Research and Development Tax Incentive (RDTI) as they relate to larger businesses (R&D entities with a turnover of $20 million or more).

Cochlear is the global leader in implantable hearing solutions including cochlear, bone conduction and acoustic implants. We have now sold over 550,000 implants helping a growing number of people of all ages across more than 100 countries hear and be heard.

We are a proudly Australian, globally successful company. Headquartered at Macquarie University in Sydney we undertake most of our research and development (R&D) and manufacturing in Australia, mainly at our Macquarie University campus but also at Lane Cove, East Melbourne and in Brisbane. Around 1,600 (approx. 45%) of Cochlear's employees are based in Australia with the majority working in manufacturing, logistics and R&D.

Cochlear's investment in R&D

Cochlear is in the top 30 global companies for R&D in the healthcare equipment sector (based on expenditure vs sales revenue). We are also one of the largest Australian corporate investors in R&D – both by value and intensity – and one of only four Australian companies to make the world's top 1000 global R&D spenders[1].

Cochlear spends around 12% of its annual revenue on R&D every year. Since financial year 1998-99 we have invested around $1.7billion on R&D, with most of this in Australia. During FY17-18 Cochlear invested over $160 million in R&D globally.

While over 95% of our sales revenue is from outside Australia, in FY17-18 we paid 83% of our corporate taxes ($84 million) *in* Australia. Our tax is largely paid in Australia because most of our R&D is performed here and, as a result, most of our intellectual property is generated here.

[1] Price Waterhouse Coopers, Global Innovation 1000 Study, 2017

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Government must support increased business investment in R&D

Australian based R&D is the foundation of Cochlear's success and position as a global leader. We strongly believe that Government has a vital role to play in encouraging business investment in R&D including through the RDTI. However, recent data indicates Australian business expenditure on R&D continues to decline which suggests current policy settings are not achieving their aims[2]. It is also arguable the long period of uncertainty about potential changes to the RDTI - with over two and a half years lapsing between the initial announcement of the Review of the R&D Tax Incentive and measures in this Bill being announced in the May 2018-19 Budget - have contributed to this decline. Cochlear urges the Senate to ensure this Bill is passed in a form that will not leave it open to further amendments in the next Parliament and can deliver policy certainty for the sector.

Introduction of intensity premiums

Cochlear supports the Government's policy objective of targeting the RDTI in a way that encourages 'additionality' and spill-over benefits rather than simply supporting business as usual activities. We also support the introduction of an 'intensity measure' as a reasonable means of achieving this outcome. Cochlear acknowledges that some companies with high costs of goods in Australia may be disadvantaged as an unintended consequence of the 'sliding scale' proposed in the Bill and we have proposed a potential mechanism to address this below.

However, the Bill should remain focused on increasing the incentive for businesses to conduct additional R&D in Australia rather than providing a benefit to businesses for simply making a minimal investment in R&D. The RDTI must target R&D focused companies who are driving genuine innovation and who will drive the growth of the Australian economy.

Increasing the expenditure threshold to $150 million

It is also imperative that the cap on expenditure is either lifted entirely or is lifted from $100 million with the increase to $150 million proposed in the Bill a bare minimum. Cochlear started hitting the cap in FY17-18. We have global R&D capability and other countries regularly offer Cochlear incentives, over and above standard incentives, to perform R&D outside Australia. With the $100M cap in place we are more likely to place new R&D offshore, which will lead to IP moving offshore which means more tax paid offshore and high paying R&D jobs being added outside Australia.

Directing savings to expanded suite of programs supporting business R&D

The Explanatory Memorandum to the Bill notes that the proposed changes to the RDTI will generate a net gain to the budget of $2.4 billion over the forward estimates. These savings should be re-directed toward other programs or incentives that support Australian R&D. For example, the government could broaden the suite of incentives to include competitive grants programs and/or introduce a collaboration premium of up to 20% to incentivise collaborations between industry and public research organisations and universities (as recommended by Innovation & Science Australia in its Australia 2030 Report)

[2] Australian businesses spent $16.7 billion on R&D in 2015–16 compared to $18.9 billion in 2013–14, a decrease of 12 per cent in current prices. Australian Innovation System Report 2017, Office of the Chief Economist, p 70

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While we support better targeting of the RDTI program and making it more fiscally affordable, it should not lead to an overall reduction in Government financial support for business R&D.

Comments on the detail of the Bill

Calculating R&D intensity – total expenses
The Bill proposes that, for the purpose of determining R&D intensity, an R&D entity's total expenses are those reported in their Company Income Tax Return. Cochlear is of the view that total expenditure should only include those expenses related to the Australian business operations and only expenses that are operational in nature. From an annual report perspective, operating expenses includes selling, general and administration expenses (SG&A), costs of goods sold (COGS) but would exclude costs not directly reported as operating expenses such as interest, finance costs and settlement of foreign exchange (FX) contracts.

Removing these items from the calculation ensures neutrality for different funding strategies adopted by businesses and addresses the uncertainties around movements in global foreign exchange rates on underlying earnings. Cochlear recommends adjusting the proposed definition of total expenses to exclude these items. This approach would result in the following total expenditure calculation:

$$\text{R\&D intensity} = \frac{\text{eligible R\&D expenditure}}{\text{Total expenses}}$$

Where eligible R&D is notional R&D deductions; and
Total expenditure is:
Total expenses as reported in the claimant's Australian tax return reduced by:

- Finance costs
- Net interest expense
- Net FX loss on FX contract settlements

Cochlear is aware of and recognises concern from other businesses that including costs of goods sold as part of total expenditure may lead to inequitable outcomes. For example, a business carrying out manufacturing as well as R&D in Australia would likely return a lower intensity ratio compared to a technology or software business spending the same amount on R&D but with significantly lower raw material and production costs and therefore likely lower proportional total expenditure.

We suggest Treasury models an appropriate further reduction to total expenditure for cost of goods sold where the business also has significant raw materials and production costs. It may be that an additional proportionate reduction is introduced for those businesses that for example, have at least 40% of their total expenses attributed to COGS.

While this approach makes the calculation for total expenditure more complex, it is a potential avenue to reduce the inequitable impact on many Australian manufacturing businesses as compared to companies operating in the technology and other sectors.

Publication of R&D expenditure/tax incentive claims

Cochlear was an early adopter of the Tax Transparency Code and we publish a Tax Contribution Report (Tax Report) every year alongside our Annual Report. Our yearly Tax Report discloses Cochlear's R&D tax benefit for our Australian tax consolidated group.

Cochlear supports the objective of bringing greater transparency to, and therefore public confidence in, the RDTI scheme. However, we share concerns of other stakeholders that publishing companies R&D notional deductions, as per Schedule 3, Item 1, subsections 3G (3) and (4), may actually create further confusion about how the scheme is operating. Cochlear suggests publication of the actual tax benefit received is more aligned with the Government's objectives.

Cochlear would be pleased to provide further information as required. Please contact [redacted], Senior Government Affairs Manager on [redacted]

Yours sincerely

[redacted]

Dig Howitt
Chief Executive Officer