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26 July 2018

Mr Joshua Toohey
Manager
Small Business Entities & Industry Concessions Unit
The Treasury
Langton Crescent
PARKES ACT 2000

By Email: *RnDamendments@treasury.gov.au*

Dear Joshua

TREASURY LAWS AMENDMENT (RESEARCH AND DEVELOPMENT INCENTIVE) BILL 2018 AND EXPLANATORY MATERIALS

1. Thank you for the opportunity to provide comments on the Exposure Draft Legislation ("**ED**") *Treasury Laws Amendment (Research and Development Incentive) Bill 2018,* the Explanatory Memorandum ("**EM**") thereto as well as the Consultation Paper ("**Consultation Paper**") dealing with the proposed changes to the operation and application of the Research and Development Tax Incentive ("**Tax Incentive**").

2. Pitcher Partners specialises in advising taxpayers in what is commonly referred to as the middle market. Accordingly, we service many clients that would be impacted by the proposed changes to the Tax Incentive.

3. We would like to highlight that we have significant reservations on certain aspects of the provisions contained in the ED. The current Tax Incentive is already very complex. We are concerned that the proposed amendments would increase the level of complexity and would create significant ambiguity, in particular, through the R&D Intensity premium calculation.

4. We are concerned that the additional complexity and the reduction in the attractiveness of the Tax Incentive will ultimately result in many Australian tax resident companies seeking to move their R&D activities offshore to more competitive regimes in other jurisdictions. Our Government is on record stating that they would like our Fintech and Innovation Industry to be "the best in the world". However, we do not believe that this outcome can be achieved if our Tax Incentive is not as competitive as our major trading partners and is significantly complex and subjective in nature. In this context, we highlight the proposed changes that are to be made to

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the New Zealand R&D regime, which in comparison could render our R&D system uncompetitive and could result in significant amounts or R&D spend being offshored.

5. We have provided our main comments to the ED in an Attachment to this letter. We would be happy to discuss any aspect with you. Please contact either Alexis Kokkinos on (03) 8610 5170 or Ali Suleyman on (03) 8610 5520.

Yours sincerely

A M KOKKINOS
Executive Director

Ali Suleyman
Executive Director

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ATTACHMENT – COMMENTS

A. GLOBALLY COMPETITIVE TAX INCENTIVE

6. It is our view, that any reforms to the Tax Incentive should help to ensure that Australia remains globally competitive within the research and development ("**R&D**") space to attract business and industries to complete their R&D in Australia and not offshore (for example in neighbouring jurisdictions, such as New Zealand).

7. Our government has been on record promoting Australia as a Fintech and Innovation Hub. However, we believe that the proposed amendments to the provisions will reduce the competitiveness of our regime as compared to other regimes offered by our trading partners.

8. For example, New Zealand has recently announced changes to its Tax Incentive regime, which will increase the competitiveness of its R&D regime as compared to Australia. That is, the proposal:

   8.1. Provides for a 12.5% non-refundable tax credit on eligible expenditure incurred from 1 April 2019.

   8.2. Would allow the tax credit to be available to any type of entity conducting R&D activities (not just companies).

   8.3. Has proposed an incentive rate having regard to the median tax credit available in OECD Countries.

   8.4. Would apply the Tax Incentive to all eligible R&D expenditure and would not be restricted to incremental spending.

   8.5. Would provide an imputation credit equal to the tax credit, which can be allocated to investors when dividends are distributed.

   8.6. Rejected an "intensity" rule due to the "inherent complexity" of the such a rule.

9. In comparison, we note that the Australian government has made the opposite call, which will reduce the amount claimed under the Tax Incentive through the "intensity" calculation, as well as significantly increase the complexity and ambiguity of the provisions. This is in stark contrast to the New Zealand proposals.

10. We believe that the ramification of moving ahead with our R&D proposals will be that our innovative companies will seek to move their R&D work offshore. We understand that this is a policy decision and is outside of Treasury's hands. However, we believe it is incumbent on Treasury to at least raise this with the government before they proceed with the measures.

11. Furthermore, not only should Treasury ensure that complexities of the ED are addressed, but we believe that Treasury should also seek to ensure that the provisions

do not inadvertently result in claims for the Tax Incentive being uncertain by being based on subjective information such as accounting expenditure.

B. CALCULATION OF R&D INTENSITY PREMIUM

12. We do not support the current mechanism used in calculating the R&D Intensity premium as contained in the ED. The proposed definition of an "R&D entity's expenditure" as covered by section 355-115 contains a number of complexities, including the following.

    12.1. The ED provides that, when calculating expenditure for the purposes of the R&D Intensity premium for an entity, the entity is required to use accounting principles. The Consultation Paper appears to suggest that the calculation should be based on income tax return disclosures (i.e. Section 6 which includes accounting numbers). We highlight similar comments were made with respect to the ESIC provisions[1]. However, subsequently, the ATO have confirmed that the tax return disclosures are not determinative, and that appropriate application of accounting standards is required irrespective of the tax return disclosures[2]. We believe this will give rise to an increase in R&D disputes about the application of the accounting standards in determining the intensity percentage.

    12.2. Most private groups are not required to apply the accounting standards. The amendments will therefore result in a significant increase in the costs of complying with the R&D provisions for private groups.

    12.3. The ED proposes to include both capital and operating expenditure (i.e. total expenditure). In addition to the complexity of calculating the premium using an accounting base, we are concerned that including "capital expenditure" will be difficult to calculate, measure and validate. Furthermore, if this is required on a "group" basis, this would be extremely difficult to ascertain on an annual basis.

    12.4. The ED proposes to determine expenditure using the concept of "incurred". This term is not used for accounting purposes and will require scrutiny of each expenditure to determine whether it meets the technical meaning of this term from a tax perspective. This will require entities to appropriately understand which items of expenditure have been accrued (i.e. not incurred); have arisen due to the issue of shares (i.e. not incurred); or have resulted from a gift of assets by another party (i.e. also not incurred).

    12.5. The provisions currently can result in a duplication of the same amount, whereby section 355-115(2)(a) includes accounting amounts "for the income year" and section 355-115(2)(b) includes notional deductions "for the income year" not included in paragraph (a). To the extent that an asset is acquired in Year 1 and its cost is included in the denominator, when the asset is depreciated in Year 2, a portion of the cost (being depreciation), will once

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[1] Para 1.89 of the EM to Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016

[2] ATO Let's Talk - Tax Incentives for early stage investors – "Discussion paper issue: meaning of the phrase 'incurred total expenses' in the early stage innovation company tests"

again be included in the denominator. Over the life of the asset its cost will therefore be duplicated when determining the entity's total expenditure.

12.6. The use of capital expenditure in the numerator will have a counter effect on R&D spend. That is, capital expenditure (being included in the numerator) would ultimately result in a lower intensity threshold and a lower R&D claim. Accordingly, this will not provide the incentive to invest in R&D capital.

13. We note that the above issues become more significant to the extent that "grouping" of expenditure is required (see Section C below). We are concerned that the issues above (if not addressed) could result in significant uncertainty, compliance costs, litigation and dispute.

14. It is our strong view that the measurement of an "R&D entity's expenditure" should be simple and should not be subjectively based on accounting numbers. We believe that the issues outlined above can be addressed if the amounts used in section 355-115 are based on tax amounts that can be properly ascertainable from the tax return of the relevant entity. We critically believe that the current ED needs to be modified to take into account this recommendation.

C. GROUPING

15. The Consultation Paper raises the question as to whether expenses should be aggregated within the group for the purpose of the R&D Intensity premium calculation.

16. We have significant concerns as to the impact of grouping the R&D entity within private groups and subsequently aggregating the expenses of the private group. As outlined below, we note that we do not have similar concerns with respect to public groups.

17. As Treasury would be aware, private groups generally operate using different types of entities, including discretionary trusts, unit trusts, partnerships and companies. Where the aggregated turnover of the R&D entity exceeds $20 million, it is likely that the private group will contain a number of entities, without common ownership (especially where discretionary trusts are included in the group).

18. The practical complications of grouping expenditure for a private group include:

18.1. Uncertainty as to whether an entity should be included in the group. We note discretionary trusts are generally excluded from being an affiliate under section 328-130, but may be included as being a connected entity under section 328-125 depending on the circumstances that apply to the trust for the relevant income year (e.g. pattern of distribution). It is often difficult to determine whether the entity should, or should not, be included in the group and there have been many cases over time that have considered the complexity of this issue.

18.2. The calculations would require entities to properly consolidate the group entity expenditure and remove intragroup transactions. This may involve complex consolidation calculations.

18.3. Many entities within the group will have different lodgement dates to the R&D entity, which may require multiple amendments to be made to the intensity threshold and lodged tax returns.

18.4. Groups will have little certainty to be able to budget their intensity threshold as it will be completely dependent on group expenditure ascertained sometime after financial year end (e.g. for a 30 June 2018 taxpayer, this could be ascertained in May of the following year on lodgement of all tax returns).

19. We note that it is very common for private groups to structure an R&D entity as a standalone entity. This is done for a number of commercial reasons, including asset protection and for the protection of intellectual property. In such cases, the R&D entity will own the intellectual property and may use that property in the future (e.g. by way of a licence).

20. We understand the perceived integrity concern of not grouping expenditure. However, we have estimated the cost of non-grouping (at the full R&D intensity threshold) to be approximately $40 million[3]. In comparison to the total spend by Government on R&D, we do not believe that this would be a significant integrity concern with respect to private groups.

21. For R&D entities that are either a public company, or part of a public group, we believe it would be less likely that the group would operate outside of a corporate or unitised structure. Accordingly, groups will often consist of tax consolidated groups and would have more certainty around ownership and control of entities.

22. We believe that the issue of grouping is a complex one to resolve. Should Treasury wish to include grouping provisions for private groups, we would appreciate an opportunity to discuss the proposed methodology. We highlight that one possible method (that may work for both private and public groups) could be to include entities that may need to be consolidated for either accounting or tax purposes. This could assist in properly picking up public groups (who are required to prepare consolidated accounts as well as tax consolidation tax returns) and only those private groups that may be tax consolidated or are required to prepare consolidated accounts.

23. We would welcome the opportunity to discuss this issue with you further.

D. TECHNICAL ISSUES

24. In addition to the issues raised above, we highlight additional technical issues that we have identified with the ED if it is implemented in its proposed form.

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[3] We note that our estimate of this cost is on the assumption that large private companies would be entitled to the full uplift factor of 12.5%, calculated using the ATO company tax return statistics for 2015/16, Table 6A.

Tiered approach for Large R&D entities

25. We note that subsection 355-100(1A) seeks to introduce the concept of a tiered offset and that the first band (Item 1 of the table) for large R&D entities.

26. To the extent that Treasury proceeds with a grouping rule or does not amend the "R&D entity's expenditure" definition to tax concepts, we believe it would be difficult to calculate a tiered R&D intensity premium and may result in high compliance when "estimates" may show that the expenditure will not exceed the 2% intensity threshold.

27. If our proposed changes contained in this submission are not made, we would recommend that Treasury consider amending the first tier (i.e. the 4% tier) so that it is built into the base rate for the Tax Incentive (e.g. the corporate tax rate (30%) plus 4% (being 34%)).

28. Under this alternative approach, a large R&D entity could estimate its R&D intensity (on a group basis) and could effectively opt out of the R&D Intensity premium calculations if the estimates showed that the percentage was unlikely to exceed 2%.

29. We believe that this could help to reduce complexity in such situations. However, we highlight that it could mean that a significant number of companies would only opt out to receive a 4% premium, which may not be considered a significant benefit from conducting R&D activities. We again highlight that a 4% premium is comparatively low when measured against the New Zealand proposal of 12.5%.

Interaction with the ESIC provisions

30. In relation to the operation of Subdivision 355-G, which provides details of the clawback of R&D recoupments and feedstock adjustments, we note that the clawback amount is to be treated as assessable income (even though the amounts have never been claimed as deductions).

31. This can have an inadvertent impact on other provisions, for example, where an R&D entity is also an Early Stage Innovation Company that would otherwise meet the necessary requirements under Division 360 of the Income Tax Assessment Act 1997 with respect to turnover (see section 360-40).

32. We believe that this is an inadvertent outcome that should not occur. We recommend that in determining income "thresholds" for the purpose of the Tax Act, the clawback amount should be ignored.