REA Group

Manager
Small Business Entities & Industry Concessions Unit
The Treasury
Langton Crescent
PARKES ACT 2600

Delivered via email to: RnDamendments@treasury.gov.au

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To Whom It May Concern

Re: Government's 2018-19 Budget measure – 'Better targeting the research and development tax incentive' – Request for Feedback and Comments

REA Group Limited (**REA**) is pleased to provide feedback and comments in response to the *Treasury Laws Amendment (Research and Development Incentive) Bill 2018* (Cth) and Explanatory Materials (**R&D Incentive Bill**).

REA's feedback and recommendations in relation to the R&D Incentive Bill are seeking to ensure the sustainability and effectiveness of the R&D tax incentive program and stimulation of innovative R&D in Australia. In our view, achieving these objectives involves:

- striking a balance between cost and ensuring the program continues to incentivise desired behaviour; and
- encouraging Australian companies to invest in cutting-edge R&D projects which contribute to the intellectual property of the Australian digital technology industry.

REA's primary concern is that the definition of 'expenditure' outlined in the R&D Incentive Bill for determining a company's 'intensity threshold' is currently unclear and may result in foreign multinational companies obtaining greater R&D benefits to the detriment of Australian headquartered businesses. To the extent the Government intends to introduce an intensity threshold, its implementation may have unintended implications which do not align with the Government's stated policy intention. We believe further detailed analysis and guidance may be required and, in this context, provide some of our thinking in the attachment to this letter.

Thank you again for the opportunity to provide our comments. If you have any queries in relation to our submission, please contact me on (03) 8486 5198.

Yours sincerely

Clint Collins
REA Group Limited
Enc.

REA Group

Consultation on the draft Treasury Laws Amendment (Research and Development Incentive) Bill 2018

Feedback & Comments

REA Group

REA Group – An Australian driver of Technical Innovation in the Global Digital Economy

REA is an Australian business which traces its founding origins to a Doncaster garage in the eastern suburbs of Melbourne. The REA business, pioneered by its flagship listings portal realestate.com.au, has since evolved into a multinational business, generating in excess of $750M in Australian revenues per year, with profits growing at a rate of approximately 20% p.a. REA's global headquarters are based in Richmond, Victoria and the business employs over 1,000 people within Australia, with an additional 400 employees employed throughout the greater Asian region.

In Australia, REA operates (among other things) the residential property website www.realestate.com.au and the commercial property website www.realcommercial.com.au, as well as equivalent mobile sites and mobile device and watch apps for iOS and Android operating systems (together the **REA platforms**).

REA prides itself on its reputation and integrity as a taxpayer which complies with the relevant tax laws. REA is also committed to investment in the latest cutting-edge technology to ensure it connects consumers to its state of the art platforms. New knowledge generated from research and development activities enables REA to develop the latest software and technologies, resulting in the direct creation of Australian owned intellectual property and jobs in the Australian economy.

REA continues to face considerable pressure to fund and attract experienced technology workers necessary to complete R&D projects. Key global markets such as Silicon Valley in California and rival technical hubs established in competing countries, including Singapore and Israel, create intense competition for the attraction of skilled IT professionals available in Australia. Equally, the significant financial resources of foreign based tech giants such as Facebook and Google present extensive challenges to REA as it aims to be 'first to market' to launch new-age technological products for Australian consumers on REA platforms.

REA is a strong advocate of increasing the fairness and robustness of the R&D tax incentive regime and supports reform which continues to incentivise Australian companies to invest in R&D. REA is also a strong advocate of transparency in the Australian tax system and supports the Voluntary Transparency Code. However, any reform undertaken needs to balance public confidence in the R&D Tax Incentive Program, encouraging voluntary compliance and protecting the strategic, confidential and market sensitive information of a participant in the Program.

We hope that the following feedback will aid in assisting Treasury analyse this balance.

REA Group

Comment on the R&D Tax Incentive Review Report Findings and Recommendations

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

The new 'intensity threshold' presents several significant compliance challenges. These have been outlined below:

1. **Increased complexity and compliance burden for technical engineers and in-house tax teams**

   The complexity associated with predicting a company's total spend, as well as R&D spend, for an income year means that some companies may be practically unable to determine whether they are eligible for the R&D incentive (or what proportion of expenditure may be eligible for incentivised treatment) prior to the end of the financial year. This would reduce the 'incentivising' effect of the incentive, as such companies will be unsure if they are able to claim R&D expenditure at the time when they are making R&D investment decisions.

   Implementing this change will also impose an additional compliance burden on companies, increasing program cost and reducing the incentive to participate in the R&D program. In addition to the legal and investor relations compliance (outlined in section 3 below), imposing this requirement may increase business planning complexity. Consequently, companies will have to make a technical determination in advance on what might or might not qualify as an R&D eligible activity (i.e. a technical function), as well as make an assessment of likely expenditure over an entire organisation (i.e. the finance function). This is an undesirable distortion as it increases the administrative tasks companies need to undertake, taking away resources available to core business functions.

2. **Confidentiality of Business Strategy**

   Confidentiality of business strategy is paramount in the digital technology industry. In particular, ensuring competitors do not have access to details in relation to current and planned strategic expenditure is critical to business success.

   The proposed measure of publishing an entity's R&D notional deductions claimed potentially discloses to the public and competitors confidential information which could provide competitor companies with sensitive data regarding the company's strategic direction. This could lead to a distortion in competition.

3. **Forecasting Financial Results**

   As an ASX listed company, REA is subject to strict reporting and disclosure requirements such as the ASX Listing Rules and the Corporations Act. These requirements restrict the release of forecasted financial results for future years.

Historically, quantifying R&D eligible spend could be achieved by undertaking an assessment of the R&D eligibility criteria outlined in Division 355 of the Income Tax Assessment Act 1997 (‘ITAA97’). The challenge the intensity threshold now poses is that the quantum of the R&D incentive can be dramatically impacted by non-R&D expenditure. This presents a significant challenge, particularly in relation to ‘one-off’ expenditures incurred by Australian businesses.

To the extent that the R&D tax incentive is impacted by such one-off expenditures, listed companies may, pursuant to their continuous disclosure obligation, be required to update the ASX on financial guidance. This represents an increase in both the time and cost associated with legal and tax compliance obligations, as well as managing the ‘flow on’ impact to investor relations stakeholders.

Recommendation:

Ensure the proposed R&D rules do not result in an increased compliance burden to companies and that public transparency in respect of an Australian business’ R&D activities does not indirectly result in market sensitive information, such as strategic project spend, being accessible to competitor businesses through public channels.

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

Whilst implementation of an intensity threshold may reward some (but not all) companies which invest in innovative R&D projects, there are several ‘flow on’ impacts which are potentially contrary to the Government’s policy objectives for the proposed R&D rules and broader Australian tax policy generally.

1. **The new R&D rules disproportionately favours foreign multinational companies**

   ‘Home-grown’ companies such as REA incur significant overhead costs for non-core elements of its business, primarily due to the company’s global head office being headquartered in Australia. Non-core costs include, but are not limited to, salaries for senior personnel in strategic leadership positions (e.g. Chief Executive Officer, Chief Financial Officer), group finance costs, expenditure associated with investor relations and higher rent and utility bills due to larger size and scale. Conversely, multinational groups which maintain regional or global head office headquarters in jurisdictions outside Australia do not incur these costs in Australia, or at a minimum, incur such costs on a significantly smaller scale. Consequently, Australian headquartered companies may be at a strategic disadvantage to foreign inbound multinational companies in being eligible to apply for R&D tax incentives under the proposed rules, despite such foreign multinationals potentially maintaining a lower headcount in non-core areas of the business. This would appear to be contrary to the Government’s policy intent on implementing a better tax system which delivers taxes which are lower, simpler and fairer[1]’.

[1] ‘Stronger growth to create more jobs’, Budget 2018-19, Commonwealth of Australia 2018.

<u>Recommendation</u>:

Ensure Australian companies with a global headquarters in Australia are not subject to a strategic disadvantage in claiming the R&D tax incentive.

2. The definition of 'expenditure' is unclear

Considerable uncertainty remains in relation to the definition of 'expenditure' defined in the R&D Incentive Bill including:

(a) Income Tax

From a technical AIFRS standpoint, income tax could arguably be classified as 'expenditure' for the purposes of calculating an R&D entity's expenditure under section 355-115 of the ITAA97. From a R&D incentive standpoint, this would appear to contradict the Australian Government's underlying tax policy intent, as the new R&D rules would practically operate to reduce R&D benefits to Australian taxpayers that pay a higher quantum of tax and increase R&D benefits to taxpayers which pay minimal or no income tax.

<u>Recommendation</u>:

Ensure any proposed R&D rules do not disadvantage or disincentivise Australian companies from investing in technological R&D projects, by the mere virtue that such companies already pay a significant quantum of Australian tax.

(b) Interest

Almost all digital companies, particular those in an intensive stage of technological product development, require external funding in order to progress eligible R&D projects. Funding is generally provided on a debt or equity basis or on a broader investment scale such as an initial public offering and listing on a public stock exchange. Interest on debt is a necessary cost of obtaining funds to progress key projects through the various stages of technical research, development, spike testing and alpha and beta test launches.

The Australian tax system currently has significant integrity measures under the thin capitalisation regime to ensure taxpayers do not use debt funding as a mechanism to artificially reduce a company's obligation to pay its fair share of tax. These rules have also been subject to significant reform in recent years, which includes a reduction in the safe harbor threshold to 60% and the removal of a taxpayer's ability to revalue its internally generated intangible assets.

It would seem inappropriate that by incurring interest costs a taxpayer should subsequently reduce its ability to access its fair share of the R&D tax incentive, compared to the alternative taxpayer who is primarily funded through equity.

Recommendation:

Ensure any proposed R&D rules do not create an unfair bias towards companies that fund R&D expenditure via monies received from equity investors, as opposed to companies which source funds through debt instruments.

(c) *Extraordinary Expenses*

The inclusion of extraordinary expenses such as impairment losses, capital losses, loan forgiveness and equity accounting adjustments (see paragraph (d) below) among others, would result in a significant and potentially unfair impact on the R&D intensity ratio of Australian companies undertaking activities for legitimate and innovative R&D projects. It would seem inappropriate that the incurrence of extraordinary expenses, particularly where such expenses are arguably beyond the operational control of the company or which give rise to notional losses, should result in a taxpayer being proportionately disadvantaged to other taxpayers under the proposed R&D rules.

Recommendation

Ensure a company's ability to claim and reasonably quantify R&D tax incentive amounts is not impacted by extraordinary or notional expenses which are beyond the operational control of a company.

(d) *Equity Accounting - Expenditure calculated for the purposes of AASB128*

Australian companies are required to recognise income or expenditure for an investment in a joint venture or associate company in accordance with AASB128. The accounting standard prescribes Australian entities use the equity accounting method to recognise gains and losses attributable to certain investments in joint ventures and associate companies.

A summary of the equity accounting method outlined in AASB128 is outlined in the paragraph below:

"The equity method is a method of accounting whereby the investment is initially recognised at cost and adjusted thereafter for the post-acquisition change in the investor's share of the investee's net assets. The investor's profit or loss includes its share of the investee's profit or loss and the investor's other comprehensive income includes its share of the investee's other comprehensive income."[2]

This creates two significant issues for consideration in relation to the application of the proposed R&D rules:

[2] AASB128, paragraph 3

1. *The proposed R&D Bill arguably penalises companies which incur 'notional' losses*

   A loss, calculated in accordance with AASB128, incurred by an Australian company's investment in a joint venture or associate company does not represent 'actual' expenditure incurred by a taxpayer in any given income year, but rather a notional loss calculated by reference to the investee's net assets.

2. *The proposed R&D Bill indirectly penalises companies making strategic investments in 'digital start-up' companies*

   'Start-ups' and developing digital companies will often incur a net operating loss for several years whilst a company is heavily investing its available funds into developing new digital technology. Australian companies will be significantly disincentivised from investing in new start-up or developing tech companies where the losses of these companies are required to be recognised by the investor company in its financial statements, potentially adversely impacting the investing company's R&D intensity ratio for existing eligible R&D projects.

Recommendation:

Ensure a company's ability to claim R&D tax incentive amounts is not impacted by equity accounting adjustments which are beyond the operational control of a company.

(e) *Capitalised Costs*

There is currently uncertainty as to whether capitalised costs should be included in the definition of 'expenditure'. If a broad view was adopted, any cash outlay could be considered expenditure in accordance with the relevant AASB standard or generally accepted accounting policies. This could include payments for capital assets (for example, computers, vehicles) and salaries which are attributable to certain projects.

Recommendation:

Provide further guidance to ensure greater clarity on the definitions outlined under any new proposed reforms to Division 355 of the ITAA97.

(f) *Philanthropic expenses, expenditure on government projects*

Philanthropic expenses incurred by corporate entities such as donations to charities are a vital revenue stream for funding programs targeted at the further betterment of the Australian community. Current tax rules permit tax deductions for such expenses (subject to certain conditions being satisfied) in order to promote and incentivise behaviours that encourage Australian companies to contribute back to the broader Australian community. Corporate funding of government owned / initiated programs is also pivotal in securing the necessary funds to implement such projects. If the incurrence of philanthropic expenses were to lead to organisations achieving less favourable outcomes under the proposed R&D rules,

companies are likely to be less incentivised to commit financial resources to charitable or community projects.

Recommendation:

Ensure any new reforms to R&D tax incentive rules continue to incentivise companies to actively contribute to community projects which promote sustainable social and economic progression in the greater Australian community.

(g) 'Unrealised and 'notional' expenditure

Expenses which are unrealised for accounting purposes (e.g., foreign exchange expenses) present a potential distortion on a taxpayer's ability to claim the R&D tax incentive. Unrealised or notional expenses often arise due to macro-economic factors beyond the control of a company as such costs are primarily attributable to movements in global FX rates, increases in Reserve Bank lending rates or the fluctuation in commodity prices.

It would seem inappropriate that such expenses should adversely, or alternatively positively, impact a taxpayer's ability to claim the R&D tax incentive for projects which drive genuine new knowledge and innovation in the digital technological industry.

Recommendation:

Ensure a company's ability to claim and reasonably quantify R&D tax incentive amounts is not impacted by unrealised or notional expenses which are beyond the operational control of a company.

Question 3.

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

Aggregating expenditure across a broader economic group poses the risk of 'grouping' companies for R&D purposes where pragmatically the individual entities may have little or no interdependence or interaction at a business level. This could result in an increase in compliance difficulties and costs where taxpayers are required to source information from companies that are merely linked by virtue of a common ownership.

Grouping total expenditure in accordance with an entity's tax consolidated group appears to be the most appropriate basis for calculating 'expenditure' for the purposes of section 355- 115(2), which is currently in alignment with existing R&D rules.

Additional Recommendations / Alternatives for consideration

The proposed R&D rules raise several questions on both the practical implementation of the new regime and whether the R&D Incentive Bill will effect the policy intent for which it is drafted. REA recommends a longer consultation period be undertaken before any new legislation is enacted, to ensure clarity for all stakeholders.

Further, REA recommends that any changes to R&D rules do not have retrospective effect and commence only in tax years following commencement of the legislation. This will avoid the real risk of projects being indefinitely postponed, due to the material impact the proposed R&D Incentive Bill could have on the funding of planned expenditure for R&D activities.