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26 October 2009

The General Manager
Business Tax Division
Australia Treasury
Langton Crescent
PARKES ACT 2600

Dear Sirs,

**Submission to Treasury's Consultation Paper on the New R&D Tax Incentive Scheme**

Cochlear Ltd ("Cochlear") supports the Federal Government's 2020 innovation policy agenda to reform the R&D Tax Concession through the current review of the National Innovation System. Cochlear supports the thrust of the findings and recommendations from the Cutler's report *Venturous Australia* and is now responding to the request for public submissions in relation to the policy matters raised in the consultation paper *The New Research and Development Tax Incentive Scheme*.

We acknowledge that the following submission will be a public document.

Cochlear Limited Profile

- Top 100 ASX listed company focusing on research, development, manufacturing and distribution of implantable hearing devices, established in 1983;
- Group turnover approximately AUD $700 million per annum, with over 90% of sales being exports outside of Australia;
- Employs approximately 2,000 employees worldwide, of which more than 1,000 are based in Australia.
- International leader with approximately 65-70% global market share;
- Over 120,000 recipients world wide;
- Annually re-invests 12% to 14% of gross revenue into continuing R&D activities;
- The vast majority of the R&D activities are conducted in Australia;
- Employs more than 200 scientists and engineers engaged in R&D in Australia.

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## The Case for Reform and its impact to Corporate Australia

Cochlear recognises that the new R&D tax incentive will be more effective in delivering support to Small to Medium Enterprises (SMEs), by "intentionally" redistributing support from Corporate Australia (i.e. large businesses who annually reinvest their profits into R&D). The removal of the incremental 50% premium has meant that many larger organisations which have planned their R&D several years in advance will be adversely impacted under the Government's proposed changes effective from 01 July 2010 and may not be able to adjust their business or project plans accordingly.

Currently, under the prevailing R&D Tax Concession regime, a company with over $20 million dollars turnover would be eligible R&D expenditure over their 3 year rolling average is able to receive support to the extent of 52.5c (175% @ 30%) for every $1 invested into R&D.

In the proposed new tax incentive scheme, the same company would be only entitled to 40c support for every dollar invested in R&D. The decrease in support has meant that the Government has effectively withdrawn up to 24% support (between the current regime and the proposed new system scheme) for larger Corporate Australia to continue their R&D programs with **no transitional period** for organisations to plan their R&D programs.

*Recommendation*

Cochlear recommends the Federal Government considers a transitional period of where the taxpayer would elect to stay under the current existing R&D Tax Concession regime for a specified number of years (but not permanently) until the projects which were planned under the existing R&D tax concession regime have been completed.

## R&D to be Conducted in Australia

Whilst the majority of Cochlear's R&D activities are conducted in Australia in relation to our products, there are several exceptions to this case where **Australia does not have the necessary skills set or qualifications**. On several occasions Cochlear has either had to procure international services to ensure that the organisation maintain its technologic leadership or recruit staff from abroad to bring their expertise to Australia.

The report prepared from the review into the National Innovation System advocated that it was the location of R&D activities that would create "spill over" benefits to the economy and not the location of where IP was finally created. Cochlear supports this view, however with the exception that it strongly believes that Australia's talent pool for work conducted in many fields (including the implantable hearing field) is limited.

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*Recommendation*

Cochlear recommends that there should be a general carve out for *high value technical services* which **can not** be conducted in Australia due to the lack of expertise or qualification. Under the current R&D Tax Concession regime, these expenses are administered under section 39ED of the Industrial R&D Act 1986.

Cochlear recommends that the current **10% cap be abolished**, as this creates distortions in the purpose of why companies are forced to conduct R&D overseas.

**Non Enhanced Deductions**

We understand from the consultation paper issued, that the Government is yet to decide on how the new R&D tax incentive will treat expenditure on R&D that currently receives a 100% or non enhanced deduction. Cochlear is concerned that the Government has not considered the impact this will have for current projects where claimants have invested large amounts of money into R&D projects with the assumption that funds invested (especially in core technology acquisitions) may be eligible for non enhanced deductions.

Cochlear's activities as a company include not only R&D, but manufacturing and distribution and sale of implantable hearing devices. This means that the organisation must maintain its technologic leadership position to stay ahead of its international competition. Cochlear utilises the core technology provisions to acquire and integrate technologies to support our current technology leadership.

*Recommendation*

Cochlear recommends the government should continue to provide corporations with support to non enhanced deductions, subject to some qualification testing (e.g. the previous core technology provisions under ss 73B(1) ITAA 1997).

If the Government does decide to make corporations deduct these expenditures under the normal provisions of both the Income Tax Assessment Act 1936 or 1997, corporations should be entitled to **transitional relief**.

Where projects have been initiated and expenses incurred in relation to non enhanced deductions, the Government should allow the company to continue to access these provisions for a number of transitional years to take into effect that these transactions have been entered into prior to the date of the royal ascension of the proposed new tax incentive.

Hear now. And always

Cochlear™

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**Payments to Associates**

Cochlear recommends that expenditures incurred to associate entities should be eligible for the new R&D tax incentive regardless whether it is paid in cash or some other means.

**Administration**

We are encouraged that the joint administration model implemented between Innovation Australia (AusIndustry) and the ATO will continue. This model has separated the technical issues from the numerical aspects of the R&D claim.

*Recommendation*

Cochlear recommends that AusIndustry should have the capability to provide advance registrations and rulings in relation to large projects or uncertain transactions which may be out of the norm.

As a part of the Government's consideration from the consultation process regarding the continuation of the enhanced deduction and the overseas R&D expenditures, further thought must also be provided to whether AusIndustry would still govern the approvals process for certificates. Cochlear recommends that AusIndustry does continue to perform this function.

**Definition of Core R&D**

The current proposed changes in the consultation paper outline that the new R&D tax incentive scheme would only be available to Core R&D that is **both** innovative and technically risky. Whilst Cochlear recognises the Government wishes to create a "spill over" effect into the economy through other beneficiaries undertaking innovative and technically risky activities, the narrowing of the criteria will only discourage future R&D activities if companies perceive they may not meet the be eligibility criteria for both innovative and technically risky activities.

*Recommendation*

Cochlear recommends that the definition for Core R&D is maintained as **either** innovative or technically risky. A change to the definition would exclude many ancillary, but potentially highly lucrative activities. This change would hurt Australia's future potential to become an R&D centre of excellence.

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If the Government does decide to make this amendment, then corporations who previously undertook R&D activities based on the assumption that the definition of Core R&D would not change should be entitled to **transitional relief** over the remaining life of their project.

**Supporting R&D**

The consultation paper outlines that the Government proposes that the implementation of the new R&D tax incentive scheme is to be revenue neutral. One of the options which the Government has considered to limit the amount of R&D support going forward is to introduce a new measure to reduce the amount of supporting activities a claimant can make in relation to their Core R&D activities.

*Recommendation*

The consultation paper has provided five options which the Government considers to be able to limit supporting activities going forward in line with best practice approach. Cochlear strongly supports that the Government considers the **capping of supporting activities as a proportion to the total Core R&D based on a 1:1 ratio** as its first preference.

Based on industry experience and evidence in our market, Cochlear's experience in the international market it operates in is that where a highly technical product does become internationally successful through continued R&D into the product's lifecycle and future advances, a company's Core R&D activities and its supporting activities need continued Government investment to support the product until its final stages of production and manufacturing. Only then will "spill over" effects be felt in the economy including the Company's key vendors and suppliers and technology partners.

Government investment into supporting activities in the interim period should not diminish immediately , as several companies have begun large scale projects, which may have factored into their business case or project plan the benefits from the current R&D tax concession. Again, Cochlear would like to propose that the Government does introduce a **transitional period** where projects can move from the current regime to the new proposed R&D Tax Incentive Scheme.

The proposed **transitional period** would also allow many corporations time to adjust their systems in order to cope with the new requirement to split R&D activities and costs between Core and Supporting. When considering the extent of the proposed changes, they would likely require an overhaul of:

(i) Project Accounting Systems;
(ii) Timesheeting and Record Keeping Systems;
(iii) Vendor and Supplier Invoicing Systems; and
(iv) Manufacturing Systems.

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These changes would mean that corporations would potentially need to invest millions of dollars into changing their current Business Systems and Business Intelligence applications to comply with the new proposed R&D Tax Incentive Scheme.

Furthermore, during the initial stages of identifying and treating activities and costs between Core and Supporting, there may be occasions where a company may incorrectly define these as eligible Core R&D expenses for the new R&D Tax Incentive Scheme, but upon audit and investigation AusIndustry may determine that these expenses are only supporting costs. A **tolerance** level should be generally granted to taxpayers to familiarise themselves with the new rules and requirements.

## Excluded Activities

Whilst Cochlear recognises that the current exclusions from the definition of R&D activity under ss 73B(2C) of ITAA 1936 is broad in its application, under the current regime some of these activities may fall under supporting activities and attract concessional tax benefits.

*Recommendation*

Cochlear recommends that the Government abandons its position on Excluded Activities to be non-eligible for supporting activities. This approach under Cochlear's view may be **detrimental to the overall industry**.

Cochlear recommends that the Government continues to allow corporations to determine that the excluded activities may be treated as supporting activities and as such be available for support in the new R&D Tax Incentive Scheme.

Cochlear would like to thank the Treasury and Innovation Australia for their continued support during the review into Australia's National Innovation System.

Please do not hesitate to contact me if you wish to discuss any of these points further.

Yours sincerely

N Mitchell

NEVILLE MITCHELL
CHIEF FINANCIAL OFFICER &
COMPANY SECRETARY