# ADITUS CONSULTING

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General Manager
Business Tax Division
The Treasury
Langton Crescent
PARKER ACT 2600

Dear Sir/Madam

**The New R & D Tax Incentive**

We are pleased to submit our comments in relation to the design of the new R&D tax incentive. We are looking forward to actively reviewing the Exposure Draft legislation when it becomes available.

Aditus Consulting Pty Ltd is a small consulting firm specialising in the provision of R&D tax advice to a wide range of clients ranging from small clients accessing the R&D offset scheme to larger clients accessing the 125% R&D tax concession. We have been continuously advising clients for more years than I care to remember. I have seen the current R&D tax concession evolve from an immature position where everything was a potential R&D project to a more refined understanding of the nature and scope of what constitutes eligible R&D activities. This is ably supported by a body of case law, Guidelines, Tax Rulings, Interpretative Decisions and the recently consolidated 125% R&D Tax Guide to Benefits. The scheme works effectively in actively supporting R&D across all sectors of the economy and the various stakeholders generally work within the well accepted and understood rules of the system.

Generally, we support the broad aim of the introduction of a more streamlined tax incentive and the Refundable and Standard R&D tax credit seems a good delivery mechanism for this policy objective. The current R&D offset is of significant benefit to a number of our smaller clients. Large companies also embrace the tax concession as an incentive to focus their operating divisions to reduce the after tax cost of conducting necessary R&D.

However, after discussions with a number of our clients, there are a number of fundamental design issues proposed in the new scheme that are at direct odds with delivering the objectives of stimulating greater R&D spend, having more claimants, offering a more streamlined and effective scheme and being revenue neutral.

The design principles of the new scheme we have concerns with are detailed below. Where warranted, we have provided additional analysis in the attached document.

**Principle 1** Aditus is of the view that continued support needs to be maintained for development activities conducted offshore where it can be demonstrated that the resulting R&D will be of benefit to the Australian economy. The 10% statutory cap is outmoded and reflects a time when Australian companies operated in a vacuum and not as part of a global economy. This restriction specifically impacts a number of biotechnology companies conducting critical clinical trials both offshore and in Australia. This will be further impacted if the restrictions in claiming supporting activities outlined in Principle 7 are implemented. We recommend that the cap be lifted.

**Principle 3** Core technology acquisitions and interest on R&D financing should be supported in the new scheme as both aspects are critical in diffusing new technologies in large and small companies alike. Interest costs should be included as part of the R&D tax credit.

**Principle 4** Both AusIndustry and the ATO have statutory powers to review, query and reject or confine the R&D claims made by taxpayers. The majority of companies respect the established R&D boundaries. These companies should not be penalised by a new scheme

that will seriously impact the number of claimant companies and the size of the claims made. All that is required is a more targeted audit approach on an industry basis by both Government agencies to stop any perceived abuses to the system and re-establish what is accepted.

**Principle 5** The proposal to incorporate an "additionality" and "spillovers" test within the legislation is flawed. Arguably, every R&D project undertaken has spillover benefits ranging from job retention to simply staying in business. Why therefore is there a need to draft a specific provision to this effect? "Additionality" is economic jargon that should not form any part of the new tax incentive. It lacks the ability to be precisely defined, is highly subjective and will cause practical difficulties in assessing whether R&D would have occurred in the absence of support.

It is further *highly likely* that significant effort will be required to assess the principle of additionality in relation to all future claims under the new incentive. This is likely to increase compliance and regulatory costs for both the taxpayer and the Government.

**Principle 6** A conjunctive test for R&D projects to contain both "innovation and high levels of technical risk" has a serious risk of contracting the numbers of claimant companies who will struggle to meet the test. A conjunctive test is restrictive enough but when coupled with a contraction in the scope of claiming supporting activities, many SMEs and some large companies, will not bother with the additional administrative compliance and costs required to effectively administer the scheme once implemented. This will reduce the target market to a small handful of companies in the SME space and reduce significantly the size of the claims made by larger companies.

**Principle 7** Supporting activities are integrally linked to the carriage of a successful R&D project. The current legislation specifies that the supporting activities need to be directly related to the carrying on of the "core" R&D. This is an extremely clear test. The expenditure incurred on supporting activities adheres to the same test. Any limitations on the proportion of claimable supporting activities should be carefully considered as it places artificial constraints on all companies and will seriously undermine R&D in Australia.

Please don't sacrifice a well oiled, broad based industrial R&D scheme for a scheme that is narrowly defined and contains vagaries such as "additionality" and "spillover" tests. The new R&D tax incentive in my view will have the unintended consequence of reducing the number of claimant companies particularly in the SME manufacturing sectors. For a large number of companies, the compliance costs will outstrip the cost benefit of the incentive offered and many will not bother to make a claim. At a time when investment in Australian industry is critical for economic survival in a competitive world economy, it is not the time to wind the policy clock back to 1987 in the name of fiscal restraint..

l welcome the opportunity of discussing my concerns in more detail and can be contacted on 02 9969 3913 or 0407 898 493.

Yours sincerely

Megan Bartlett
Managing Director

**Attachment - The New R&D Tax Incentive**

***Analysis of Principle 6 – The conjunctive Test - Innovation and High Levels of Technical risk***

The current definition of R&D activities has been central to the operation of the R&D tax concession since its inception in 1987. Over the years, there have been a number of court cases that examine the nature of what constitutes eligible R&D activities. There have also been a number of guidelines produced by AusIndustry and more recently, a Guide to Benefits which is a codification of a number of case studies, guidelines and practical insights that have evolved over the years of the schemes operation. We advise a wide variety of companies with the preparation of our R&D claims. We know the accepted boundaries of what constitutes an eligible R&D project. We actively distinguish between routine investigation and those activities containing R&D.

The examples referred to in Annexure A in the Paper, in the absence of more detailed information, clearly look to push the boundaries of what *most* companies would claim as eligible R&D. This is not to say that some R&D is not involved in the projects listed but we query the breadth and duration of the activities indicated. AusIndustry has well defined powers to review technical projects that it views as being in the high risk category. The ATO also has wide powers to audit the expenditure claimed in relation to the activities undertaken. Instead of restricting a well accepted and understood definition, we recommend that more targeted reviews of claims are made to put an end to perceived abuses to the system.

If the Government introduces a conjunctive test such that R&D activities must contain both innovation and high levels of technical risk, we are strongly of the view that a number of projects may not qualify for concessional support. This view however largely depends on how "innovation" will be defined in the draft legislation and more importantly, how it will be implemented at a practical assessment level.

Projects that seek to deliver a new product or a completely new process to the market are more likely to contain both innovation and high levels of technical risk. These types of projects invariably translate to gaining a competitive advantage in a particular market for a particular product.

Projects however where the focus is on delivering a product improvement or process improvement may not necessarily meet the innovation test notwithstanding that the project contains high levels of risk, will lead to processing efficiencies and improvements and create a number of significant spillover benefits to the economy. These projects are necessary for the company to remain competitive.

***Analysis of Principle 7 – Limiting Supporting Activities***

In general, the role of supporting R&D is **fundamental** to the validation of any theoretical or conceptual idea and their progression from the laboratory to production. For years, we have been trying to educate companies to think beyond the traditional notion of "white lab coats and foaming test tubes" and expand the concept of what it actually takes to develop a concept into a product or process. This proposal rolls back Australian R&D to the policy void pre 1987 when it was recognised that Australian companies were slipping behind OECD companies R&D expenditure measures.

Limiting supporting activities limits R&D. This proposed change will impact **every company undertaking R&D**.

Specifically, Question 4 raises the following possibilities. All have flaws:

*(a) Capped as a proportion of expenditure on core R&D*

Supporting R&D activities are integral to realising R&D. A cap imposes an artificial boundary for industries which are capital intensive and rely heavily on the conduct of production based trials to prove their R&D. A cap also impacts biotechnology companies where a comparatively small amount of expenditure is incurred on the "core" R&D and significant sums are incurred in running lengthy and necessary clinical trials. It will also seriously impact software development companies.

The proposed cap also relies on companies distinguishing between core and supporting activities which we strongly disagree with on the grounds of administrative complexity.

(b) *Only eligible where they are for the sole purpose of supporting core R&D activity*

The current R&D tax concession has operated as an industrial R&D based scheme designed to promote business uptake of R&D. The introduction of a sole purpose test fails to recognise the requirement for companies to undertake R&D within a production environment. Very few companies operate separate R&D facilities in order to replicate a full scale operating environment.

The policy decision recognising this is clearly evident in the current R&D tax concession by the relaxing of the tax treatment of R&D plant in 2001 to allow plant to be used for both production and R&D purposes as opposed to the former requirement to be exclusively used for R&D purposes. In 1996, the feedstock rules were introduced allowing companies to claim eligible feedstock expenditure. Both recognise that companies conduct R&D in a production environment. This applies equally to large and small manufacturing clients.

Limiting supporting activities to those which are only eligible where they are for the sole purpose of supporting core R&D activity, will limit the effectiveness of the new R&D tax incentive.

(c) *Exclude production activities or dual purpose activities*

To exclude production activities or dual purpose activities from being eligible supporting R&D activities would adversely a large number of companies within the Australian manufacturing sector both large and SMEs. This seriously impacts all companies operating in the industrial sector such as mining and manufacturing.

(d) *Only be eligible on a net expenditure basis*

A net expenditure basis introduces an additional level of compliance and complexity which detracts from the incentive. The current feedstock provisions are complex and unworkable in many situations and generally speaking, companies only claim those trials were the entire trial has been scrapped and not were there has been a product downgrade.

The inclusion of this option would make the concession unworkable. It also detracts from a policy objective of the new tax incentive which is to be *more effective in delivering support for business R&D.*

(e) *Attract a lower rate of assistance than core R&D*

A lower rate of assistance for supporting activities disregards that supporting activities are integral to the overall success of the R&D project. It will introduce further compliance costs in relation to additional calculations for R&D support, and different record keeping systems to isolate core and supporting expenditure.