AUSTRALIAN INDUSTRY

GROUP

Ai Group Submission on the Treasury Consultation Paper

The new research and development tax incentive.

October 2009

Executive Summary

The Australian Industry Group (Ai Group) welcomes the opportunity to comment on the Treasury Consultation Paper *The new research and development tax incentive.*

The Consultation Paper initiates the consultative process the Government announced in May 2009 when responding to the August 2008 report of the Review of the National Innovation System (the NIS Review).

Ai Group supports:

- the stated intention of making the R&D tax incentive "less complex and more predictable";
- the proposal to introduce a compliance framework that is "transparent, consistent and ensure[s] timely service delivery";
- the proposal to extend eligibility to R&D undertaken in Australia regardless of where the associated IP is owned;
- the change in the form of incentive from enhanced deductions to a tax credit as a means of decoupling the tax incentive from the company tax rate;
- the increased incentive and the relaxation of restrictions on the availability of the refundable tax credit;
- The proposed change in eligibility for the refundable credit for companies part-owned by exempt entities so that companies up to 50% owned by exempt entities will qualify (compared with the current 25%); and,
- the proposal to increase the incentive for eligible expenditure that currently attracts the 125% enhanced deduction (the proposed 40% credit is equivalent to a 133% deduction at the current company tax rate of 30%).

While Ai Group did not support the Government's decision to remove the 175% incremental incentive, we note that the removal of this incentive will raise considerable revenue and will go a long way to satisfying the revenue neutrality constraint after the measures above are put in place.

Ai Group strongly opposes:

- the proposal to introduce a new definition of eligible R&D activity as activity that is systematic, investigative and experimental involving both innovation and high levels of technical risk (from the current requirement that activities involve innovation or high levels of risk); and

- o the proposal to limit the degree to which supporting activities are eligible for the tax incentive.

On the basis of feedback from members, Ai Group expects these changes would significantly undermine the attractiveness and effectiveness of the tax incentive.

The tax incentive would become more costly to comply with and to administer and new levels of uncertainty would be introduced into the program.

We expect these restrictions in combination would substantially reduce the aggregate amount of tax incentive and, would take the overall revenue impact of the changes canvassed in the Consultation Paper well beyond the stated revenue neutral benchmark.

Ai Group welcomes the opportunity to comment on the treatment of research and development expenditure in relation to software. Ai Group proposes that software-related R&D should be treated like other R&D and that the multiple sales test should be removed.

In light of the views developed in this Submission, Ai Group proposes a substantial re-think of the approach set out in the Consultation Paper around eligibility and supporting activities. While we are of the view that the removal of the 175% incremental concession will at least substantially cover the costs involved in the changes supported in this submission, we acknowledge that some additional measures may need to be developed.

We suggest that the existing timetable be adhered to in relation to the points that we support (and we believe have the overwhelming support of other members of the business community), but that a more considered and less disruptive approach to any additional savings be developed in consultation with the business community in time to take effect from 1 July 2011.

About Ai Group

The Australian Industry Group (Ai Group) is a leading industry association in Australia. Ai Group member businesses employ around 750,000 staff in an expanding range of industry sectors including: manufacturing; engineering; construction; automotive; food; transport; information technology; telecommunications; call centres; labour hire; printing; defence; mining equipment and supplies; airlines; and other related service industries.

General

The Research and Development tax incentive provides critical support to industrial research and development expenditure. The period since the introduction of the incentive has seen very strong growth in Australia’s Business Expenditure on Research and Development (BERD).

The significant demographic, environmental and competitive challenges facing Australia call for continued efforts to raise our rate of productivity improvement. This imperative is compounded by the pressures on key sectors, notably manufacturing, to adjust to the greater call on internal resources and the higher domestic currency that is expected to be associated with the ongoing strength of demand for Australia’s mineral commodities.

Notwithstanding the significant contributions that can be made by Governments to improve productivity, the larger share of improvements will stem from measures undertaken in the private sector to improve products, services, organisations and production and distribution processes. While far from the only area of innovation, research and development undertaken in the private sector is a critical element in the total innovation mosaic.

Ai Group agrees that the case for public support of business research and development activity arises because of the direct and indirect spillovers that arise when the full value that flows from this expenditure is not captured by the businesses making the expenditures but part of which flow to other parties. Without public support, the total quantity of business expenditure undertaken would be less than the socially optimum level. An incentive such as Australia’s tax incentive that provides benefits to the company undertaking R&D expenditure is an appropriate intervention to boost the level of private expenditure towards the socially optimum level.

Ai Group notes that the R&D tax incentive is far and away the predominant form of public support for private sector R&D in Australia. This is unlike most other countries where direct expenditures also play much more important roles.

We also note that smaller businesses occupy a very important role in business innovation more generally and research and development in particular. Smaller businesses undertaking R&D tend to be much more R&D intensive than larger businesses undertaking R&D. An important consequence of this is that the proposed changes to eligibility and treatment of supporting R&D are very likely to impact with disproportionate severity on small businesses undertaking R&D.

Proposed Design Principles

Design Principles 1 to 4

Ai Group supports the proposed Design Principles 1 to 4.

The proposal to removing restrictions relating to the location of the ownership recognises a fundamental reality of the global economy;

The proposal to change the form of the incentive to a non-refundable tax credit and to raise the effective rate of the incentive to 40% is a welcome adjustment that will, at the margin, stimulate additional business research and development;

Introducing a $20 million group turnover threshold for the 45% refundable tax credit will improve access to this important dimension of the incentive for smaller businesses.

Principle 4 that “Legislation for the new R&D tax incentive will provide support for the scheme’s efficient and effective administration” is a very worthy objective and one Ai Group supports. We look forward to some detailed proposals.

Spillovers and Additionality

Principle 5 proposes that the R&D tax incentive should target R&D that is in addition to what would otherwise have occurred and that provides spillovers.

From the discussion in the Consultation Paper it appears that this Principle is more relevant to broad policy design issues than the practical operation of the tax incentive. Thus the paper makes the point that “[t]his ‘additionality and spillovers’ test applies to the new R&D tax incentive as a whole, rather than individual R&D activities.

This is clearly appropriate both from a conceptual point of view and from an operational point of view. R&D activities that did not result in the development of commercial opportunities and did not generate any spillovers should not be excluded from benefits of the tax incentive. The generation of spillovers is more usefully seen in the context of portfolios of R&D activities (and involving so-called “core” and “supporting” activities) rather than any particular activity or type of expenditure.

Similarly additionality is better seen as a program-wide objective rather than relating to any particular activity or type of expenditure. The fact that particular expenditures on R&D that would otherwise have occurred are eligible for the tax incentive cannot be seen as a failure of policy. In fact it is a design feature of the tax incentive.

Eligible R&D Activity

Principle 6 proposes that eligible R&D activity will be defined as systematic, investigative and experimental activity that involves both innovation and high levels of technical risk; and is for the purpose of producing new knowledge or improvements. Currently, activities are eligible if they involve innovation or high levels of technical risk.

The Consultation Paper argues (paragraph 54):

> *Subsidising an activity that is innovative but not risky may, at the margins, lead to additional R&D with benefits extending beyond an individual company. However, it is more likely to do no more than subsidise a company for doing what is already commercially sensible. Similarly, a subsidy for activities that involve high levels of technical risk but are not inherently innovative may lead to additional activity but is unlikely to deliver benefits beyond an individual company.*

To be blunt, these assertions do not provide a compelling case for changing the definition as proposed. The following alternative paragraph will help to illustrate this:

> *Subsidising an activity that is innovative and risky may, at the margins, lead to additional R&D with benefits extending beyond an individual company. However, it is more likely to do no more than subsidise a company for doing what is already commercially sensible. Similarly, a subsidy for activities that involve high levels of technical risk and are inherently innovative may lead to additional activity but is unlikely to deliver benefits beyond an individual company.*

Both paragraphs are equally believable or non-believable depending on one's point of view. Neither progresses the argument.

What is clear is that from a compliance and administration point of view, the requirement that activities be both innovative and risky will compound the uncertainty associated with the tax incentive. This has been illustrated in Ai Group's consultations by the wide range of views about the possible impact of the proposed change. Some businesses take the view that all activities that are currently eligible are both innovative and risky so that all that will change is the degree of difficulty surrounding administration and compliance. Others take the view that as many as 30% of activities that currently qualify would not qualify under the proposed change.

Supporting R&D

Principle 7 proposes that supporting R&D will continue to be recognised under the new R&D tax incentive but claims will be subject to new limitations.

This element of the Consultation Paper has attracted the most concern from Ai Group members. Primarily the concerns relate to the additional complexity, uncertainty and compliance costs that a differential treatment of core and supporting R&D would entail. Several members have pointed out that treating supporting research and development differently would conflict with the Paper's stated intention of making the R&D tax incentive "less complex and more predictable." Notwithstanding this objective, the additional costs associated with complexity, uncertainty and more burdensome compliance are not raised let alone evaluated in the Consultation Paper.

In addition any differential treatment of supporting activities that involved a lesser rate of tax incentive would reduce the overall benefit and effectiveness of the tax incentive in generating additional R&D and therefore spillovers.

Further, the Consultation Paper does not articulate the benefits of treating supporting R&D differently. The points made in paragraphs 56, 57 and 58 amount to little more than bland assertions.

Ai Group maintains that the current restrictions on "supporting activity" are appropriate. Under current arrangements supporting R&D needs to be directly related to the core systematic, investigative and experimental activity to be eligible for the tax incentive. If supporting activity is not directly related, it is not eligible.

Software

Ai Group welcomes the opportunity to suggest a new approach to the treatment of software-related research and development. Ai Group agrees that the multiple sales test is "outdated". Ai Group proposes that the most straightforward, consistent and fair way to treat software-related R&D is to treat it like other R&D. We propose the multiple sales test be removed.

Where to from Here?

In light of the views set out above, Ai Group proposes a substantial re-think of the approach set out in the Consultation Paper around eligibility and supporting activities. While we are of the view that the removal of the 175% incremental concession will at least substantially cover the costs involved in the changes supported in this submission, we acknowledge that some additional measures may need to be developed.

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