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TAXATION INSTITUTE of AUSTRALIA
IT'S ESSENTIAL

5 February 2010

General Manager
Business Tax Division
The Treasury
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PARKES ACT 2600

Email: rdtaxcredit@treasury.gov.au

Dear James

The New Research and Development Tax Incentive - Exposure Draft Legislation and Explanatory Materials

Please find enclosed the Taxation Institute of Australia's (**Taxation Institute**) response to the Research and Development (**R&D**) Tax Incentive - Exposure Draft Legislation and Explanatory Materials released on 18 December 2009.

The Taxation Institute welcomes the opportunity to comment on the proposed legislation and endorse the policy vision announced with the release of the exposure draft that the R&D tax credit "is about boosting investment in research and development, supporting jobs and strengthening Australian companies as they continue to seize new opportunities during the economic recovery".

- In particular our submission considers the cumulative impact of the following key issues:
- Significant restrictions to the definition of R&D activities.
- The wholesale exclusion of computer software development activities and other activities
- The penalising of successful R&D with the introduction of new 'feedstock' rules and the expenditure 'not at risk' provision.
- The inability of Australian companies to access the R&D credit in respect of R&D activities undertaken for related foreign companies.

If you require any further information or assistance in respect of our submission, pleas contact David Williams on 02 9958 3332 or the Taxation Institute's Tax Counsel, Angie Ananda on 02 8223 0011

Yours sincerely

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David Williams
President

Research and Development (R&D) Tax Credit Exposure Draft Legislation

The Taxation Institute of Australia (**Taxation Institute**) welcomed the Government's proposed package of measures as its innovation agenda for Australia over the next decade in *Powering Ideas: An Innovation Agenda for the 21st Century*, acknowledging that R&D is needed to facilitate growth in the economy and promote an increased skilled workforce.

The Taxation Institute would like to thank Treasury for welcoming submissions in respect of the Tax Laws Amendment (Research and Development) Bill 2010 and associated Explanatory Materials pertaining to the proposed R&D tax credit.

On review of the Exposure Draft (**ED**) legislation and Explanatory Materials (**EM**), the Taxation Institute is disappointed that the net impact of the proposed package of new measures represents a quantum reduction in the promotion of, and assistance to, the nation's commercial and industrial R&D effort, where the greatest "spill-over" benefits from technological innovation have been and would have continued to emerge. It is the Taxation Institute's view that the R&D measures proposed in the ED do not promote the same level of support as the current regime, and it will dramatically impact on Australia's international competitiveness, as it starts to lag behind most countries in the developed and rapidly emerging markets of our region and globally.

In making this submission, the Taxation Institute wishes to articulate concerns in respect of the proposed legislative changes introducing the R&D tax credit, which contain a range of outcomes that were not anticipated to flow from the changes foreshadowed in the release of the *Venturous Australia Report*. The draft R&D Tax Credit provisions effect an outcome by directing support away from commercial innovation and development towards narrow theoretical research, and unfairly impact specific industries, such as those focussed upon information and communication technology (**ICT**) innovation and development.

Definition changes

Core R&D activities

The tightening of the definition to require *considerable novelty* <u>*and*</u> *high levels of technical risk* is taking a more academic rather than realistic approach. The choice of words used in the ED definition, such as "*considerable*", creates uncertainty in the definition and the ongoing interpretation. The fact that novelty is required from the onset of the output rather than the experimental activity will exclude any operational R&D and only focus on risky isolated R&D. The result of which, by adherence to the definition, is the reward of failed R&D. It is, however, the success of the activity that will contribute to Australian industry and the economy.

The Taxation Institute believes that the proposed definition changes do not focus on industrial, experimental development but on academic research, which is not analogous to accepted international definitions of R&D. Whilst the rate of benefit available has been increased, the level of genuine R&D activities which satisfy the new definitions of core or supporting activities has been substantially reduced.

The change to a cumulative test of *considerable novelty* <u>*and*</u> *high levels of technical risk* will create substantial practical uncertainty for innovative taxpayers in determining what activities will qualify for the credit, and will leave Australia at odds with international practice and at a marked disadvantage at a time of increasing tax competition for highly mobile global R&D expenditure.

Taxpayer uncertainty from definitional change to underlying rules may result in real challenges for using the credit as a mechanism to directly incentivise specific R&D projects, also contributing to increased administration and procedural costs (and the cost of consulting support), further eroding the value of the incentive to business.

The Taxation Institute believes that Australia's R&D incentive should seek to encourage R&D activities within Australia in order to, amongst other things, make eligible enterprises internationally competitive.

It was anticipated that the ED would bring the Australian definition in line with international norms. Instead there appears a further divergence from the generally accepted OECD definition. This is likely to have an adverse impact of discouraging R&D investment in Australia, particularly in today's global economy, where companies can choose to undertake R&D under more advantageous regimes elsewhere.

Supporting R&D activities

It appears that the substitution of *'directly related'* with *'dominant purpose'* seeks to further narrow the definition of R&D activities. This tightened definition of 'support' activities reflects a narrow and uncommercial view of a 'spill-over' benefit. There appears to be little understanding that, in the commercial sector, innovation and R&D is interlinked with operational developments, prototyping, production et al. As Australian R&D is often undertaken as part of operational or production facilities, the drafting of the proposed provisions appears to embrace a particularly narrow view that that support costs can only be those costs that are distinct to these activities, and in our view reflects a genuine misunderstanding of current trends in commercial R&D and innovation. The dominant purpose test will necessarily place a heavy burden of proof on the claimant, and the determination of dominant purpose further adds to the uncertainty of claims, and to an increased cost of compliance.

The need to distinguish between core and supporting activities adds an unnecessary layer of complexity to the R&D tax credit. Where an activity is undertaken for both R&D and another purpose it will be difficult to differentiate. However, it is reasonably straightforward to determine if the activity was necessary for the conduct of the R&D, e.g. if it was required to enable testing activities to be conducted.

Software

The ED specifically excludes all computer software development except for that which is developed for 'multisale' (supply) to two or more non-associates of the claimant for direct consideration only.

The ED appears to show a lack of understanding as to the variety of ways in which businesses realise value from software development in R&D. Many businesses invest heavily in software development which would otherwise be eligible for R&D, but, as a result of the nature of their market, provide access to the resulting intellectual property via means other than a direct licence to customers.

The proposed 'multisale' and associated software provisions have the effect of significantly reducing access to the concession for organisations involved in developing and innovating in ICT for the purpose of supporting the core business operations. In our opinion, these provisions are unnecessary and also fail to recognise the significance of innovation and R&D in ICT as a critical aspect of various businesses.

The new 'multisale' provisions appear to have the arbitrary outcome that, for exactly the same work, a specialist ICT consulting firm may be able to access the tax credit in circumstances when an in-house development team may not. In-house ICT teams are an important part of the ICT R&D and innovation area, and the provisions, as drafted, do not give effect to a fair application of the R&D tax credit.

Given the intertwined nature of software development in virtually all aspects of global scientific, technological, industrial and commercial endeavour, the fact that it is one of the single most important contributors to achieving competitive advantage in today's open and global marketplace, and the fact that capital support for R&D in this strategically critical area is so internationally mobile, the Taxation Institute believes that these specific legislative proposals counterproductive to Australia's national interest.

In this regard, we would submit that the government cannot afford to simply exclude software from core or supporting activities as the very quantum of software-related (core or supporting) R&D

activity combined with Australia's divergence from international treatment would simply drive global R&D spend (and the associated benefits flowing to the Australian economy) elsewhere.

Other excluded activities

The Taxation Institute submits that the specific statutory exclusions in subsection 355-35(2) of the ED are unnecessary, given the proposed definitional changes of core and supporting R&D activities.

If any of the specified activities in that subsection strictly qualified as core or support R&D activities in the circumstances of any given case, there would be very compelling policy grounds for them qualifying for the credit, in the absence of any overriding or overarching policy considerations to the contrary.

If any or all of the listed activities were to fail in meeting the strict definitional requirements of R&D activities, they will not qualify for the credit and the list is rendered entirely redundant. However, whether any or all of those activities do in fact meet those definitional requirements, should properly be left to be determined on the facts of any individual case, and not pre-empted in any arbitrary statutory list of exclusions.

If the change to the definition of R&D to include innovation *and* high levels of technical risk represents the original policy intent of the tax credit, then this change alone should be sufficient to restrict government support to those eligible R&D activities. If so, any and all activities necessary to pursue those projects – supporting or core – should receive equal support.

Augmented Feedstock rules

In review of the proposed *'augmented feedstock rule',* the Taxation Institute believes that this has the potential to undermine the effectiveness of the credit for all applied research and development.

There exists significant uncertainty in the ED as to the full extent to which the new feedstock rule will operate, depending upon key aspects of non-finalised legislation, including the scope of included "quarantined expenditures", and its application to R&D undertaken in order to enable the completion of contractual obligations.

The augmented feedstock rule will effectively only allow the credit to apply to unsuccessful or loss making R&D activities. The dominant purpose test will effectively preclude most R&D claims because the vast majority of R&D is carried on within a commercial context, i.e. the dominant purpose of any good business activity, including industrial R&D, is always to increase profitability. Even if a claimant can prove that this test is satisfied, the augmented feedstock rules will in most cases prevent a claim except for the quarantined activities.

The ED states that *The feedstock rule applies in relation to both core and supporting activities*, in essence operating as an extension of the current "feedstock" legislation.

However, the current "feedstock" legislation negates the concession only in relation to and to the extent of the costs of any raw material inputs, which are processed or transformed by R&D activities and are embodied in any processed or transformed outputs of value. The current rules are limited to experimental/trial activities.

The fundamental difference is that the current feedstock rule does not apply to the non-material costs of the actual *R&D activities*, themselves nor to the costs of laboratory development (if, for example, the output value happened to exceed the cost of those materials inputs).

The effect of the new feedstock rule (based on this proposed new policy of qualifying "net" expenditure) would be to deny the tax credit, not only for materials input costs but also for the costs of the actual qualifying R&D activities, themselves – core or supporting – potentially negating any assistance for that R&D entirely, depending on the commercial value of the outputs (materials, products devices or services).

The augmented feedstock rule will effectively “penalise” successful R&D activities and “reward” failed / unsuccessful R&D activities.

The net result of this far more complex regime is increased time and cost investment, by the average claimant, in determining eligible costs and maintaining the cumbersome and voluminous requirements, to make a claim. As the benefit is significantly diluted, it is likely many potential claimants will not justify the cost-benefit of submission to such a complex regime.

Expenditure not at risk

The Taxation Institute holds significant concerns with respect to the inclusion of section 355-405 of the ED, which in reading appears to operate in the same fashion as section 73CA “guaranteed returns” in the current legislation.

As the intent of section 73CA was to mitigate syndicated R&D claims (removing all or most of the commercial risk to investors by guaranteeing them a minimum return on their expenditure), and *not* intended to apply to the exploitation of the results of R&D activities on normal commercial terms, the Taxation Institute submits that the proposed S355-405 should be entirely removed from the final legislation, so as not to render the credit unworkable in most cases where R&D activities are undertaken in a commercial context.

R&D activities undertaken for a related foreign company

Activities undertaken in Australia for a related foreign company will be eligible R&D activities. The criteria to qualify for this incentive essentially remain the same as those currently required for the International Premium Tax Concession.

However, unlike the current concession, if the Australian company is reimbursed for the R&D expenditure it incurs for the foreign related company, it may not be entitled to the R&D tax offset, due to the operation of the anti-commercialisation provisions mentioned, as the expenditure may be considered not at risk or clawed back under the augmented feedstock rule. As financial risk is a key criterion to determine if an R&D activity is undertaken for a particular company, it may be difficult to establish that the work is being undertaken for (or on behalf of) the foreign resident if that foreign resident is not bearing the cost of the R&D activities. It is not clear whether this is an intentional change or an error in drafting.

Furthermore, there may be other income tax consequences (such as transfer pricing) for Australian companies who do not price their R&D work for a related foreign party on normal commercial terms, so we cannot readily envisage circumstances where an Australian company undertaking R&D activities on behalf of a foreign related party will receive any meaningful benefit from this.

Unknowns

The Taxation Institute holds significant concerns with respect to a number of aspects which are still to be clarified either in the final legislation or by way of guidelines or regulations. These uncertainties include:

- Registration of the claimant company is still required; however the extent of information to be provided is not yet clear.
- Clarification on the continual requirement for the R&D plans, and whether the R&D plans will be reintroduced in another format, e.g. as part of the registration process.
- How the additional administrative requirement of specifically identifying ‘core’ and ‘supporting’ R&D activities will impact preparation time of the registration and also the eligibility of the claim in the long run. Adding yet more uncertainty to the new tax credit and its viability.
- How the receipt of Government grants will be treated.
- Whether expenditure incurred overseas will be subject to a cap (such as the current 10% rule).

- Whether the R&D taxation credit can be treated as ‘above the line’ for accounting purposes, as initially foreshadowed.

Conclusion

The ED as it stands provides the claimant a greater cash-back / credit on a much smaller amount and on a much smaller number of activities. It does not acknowledge that nearly all R&D in the world is undertaken in a commercial environment and that business R&D underpins the greatest majority of R&D in Australia.

The ED will also outcome in a shift of R&D support from profitable established businesses to small ‘start-up’ enterprises focused on pure research orientated activities.

The incentive as it stands will only provide assistance to core R&D that fits a very restrictive definition and is *carried on for the purpose of acquiring new knowledge or information*, and other R&D activities that have a dominant purpose of supporting activities carried on for the purpose of acquiring new knowledge or information.

Furthermore, the proposed changes to the definition of R&D activities, as well as the credit reduction provisions and some of the integrity rules, will create new complexity and uncertainty.

This outcome does not reflect the intent of the Venturous Australia Report, but rather significantly reduces the R&D support for all businesses.