Business Strategies International

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SUBMISSION IN RELATION TO SECOND EXPOSURE DRAFT OF TAX LAWS AMENDMENT (RESEARCH AND DEVELOPMENT) BILL 2010 - THE NEW RESEARCH AND DEVELOPMENT TAX INCENTIVE

BSI Innovation Pty Ltd (BSI) is pleased to provide the following further comments in relation to the revised exposure draft legislation (the revised Bill) and accompanying explanatory memorandum (the new EM) for the new R&D tax incentive.

Objects Clause

While changes to the Objects clause in the revised Bill may be a slight improvement on that in the original Bill, the attempt to narrow the incentive to situations where "knowledge gained is likely to benefit the wider Australian economy" – effectively legislating a test for "spill over" benefits – regrettably remains.

As noted by BSI and other stakeholders during consultations and in submissions, the danger with either version of the Objects clause proposed to date is the potential for elements requiring additionality, or spillovers, to evolve into a further additional eligibility requirement. Whether a particular development "is likely" to result in knowledge of the kind prescribed in the clause, would be an extremely subjective argument, and in most cases superfluous to the ultimate success or failure of the R&D activities.

It is therefore our view that the Government should consider an Objects clause which closely approximates that used for the current R&D Tax Concession (the Concession) – a program shown to achieve these outcomes of additionality and spillovers to the wider Australian economy.

Core R&D

The complete revision of the definition of Core R&D activities, and the removal of terms such as "innovation" or "high levels of technical risk" in favour of new language remains the area of most significant concern in the revised Bill, together with the revisions to the criteria for supporting R&D.

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The new definition of Core R&D abandons the existing stable and well-understood definitions of SIE activities (used in the Concession) entirely, and with it some 25 years of precedential case law, tax rulings, and corporate knowledge as to the operation of the incentive program. While the new definition claims to use "clearer language" instead of relying on the established concepts used in the Concession, it is our view that instead a highly complex series of compound tests results, against which an applicant taxpayer is expected to self-assess before seeking to access the incentive.

A brief application of the revised definition using the text from the new EM reveals the complexities introduced as a result. We believe a situation where an applicant must answer at least the following questions to determine whether a given activity was a core activity is not unrealistic:

- *Is the activity an "experimental activity" entailing investigation of causal relationships among relevant variables to test a hypothesis or determine efficacy of something previously untried? (Para. 2.11 of the EM).*
- *If so, in what setting did the activity take place? (Para. 2.11)*
- *Was the activity part of a systematic progression of work based on scientific principles? (Para. 2.12)*
- *Did the experimental activities follow the prescribed path from hypothesis to experiment, observation and evaluation, and lead to logical conclusions? (Para. 2.12)*
- *Does the "eligible experiment" exceed the threshold knowledge gap, and degree of uncertainty, such that knowledge of whether it is scientifically or technologically possible, or how to achieve it, is not deducible by a competent professional in the field on the basis of current knowledge information or experience? (Para. 2.13)*
- *Is there a risk that the desired outcome of the "eligible experiment" will not be the desired one? (Para. 2.14)*
- *Is the uncertainty being resolved "significant enough" to warrant application of scientific method, rather than other problem solving techniques when considering how long the experiment takes, and how often it is repeated? (Para. 2.15)*
- *Is the "experimental activity" carried on for the dominant or sole purpose of acquiring new knowledge, in the form of new knowledge in the practical form of knowledge or information about the creation of new or improved materials, products, devices, processes or services? (Para. 2.16 & 2.17)*
- *Does the "experimental activity" occur in the context of normal production activities? (Para. 2.17)*
- *Does the need to employ the scientific method reflect a threshold degree of novelty in the ideas being tested which is significant enough to require application of the scientific method? (Para. 2.18)*

As is evident from this brief example, the new and unfamiliar concepts underlying the new definition of Core R&D in the revised Bill not only dramatically narrow the scope of eligible activities, but due to their complexity and subjectivity will largely preclude most applicant companies from confidently self-assessing their eligibility for the R&D incentive.

Given all of the above, we are unable to support the definition of Core R&D as revised. We therefore urge the Government to return to the established definition of core and supporting R&D activities (using an innovation **or** high levels of technical risk test) as exists today under the Concession.

Supporting R&D

The change to the definition of supporting activities, and the resultant inclusion of activities in subsection 355-35(1) in the revised Bill is generally welcome. The directly related criteria is currently used in the Concession, and in our experience operates efficiently and is a concept well understood by industry, consultants and departmental staff alike.

However, the retention of the "dominant purpose" requirement for eligibility of supporting activities, which are also Section 355-35(2) activities, undermines the otherwise positive aspects of this change. This revision creates a new requirement to classify at least four (4) separate types of supporting activities, and, to set out the dominant purpose of each where they fall within subsection 355-35(2). It is relatively easy to envisage significant challenges as the question of the dominant purpose of particular supporting activities is resolved between applicants and the ATO/Innovation Australia via potentially extended and expensive legal argument.

We initially interpreted this "dominant purpose" requirement to be limited to R&D activities or trials conducted on a production or process line. However, given that this appears not to be the case, our concern is the potential breadth of the term "production of goods or services" used in subsection 355-25(2)(b) and (c), which directly determines which supporting activities are caught by this "dominant purpose" requirement. The examples provided in the new EM suggest that this section will be interpreted very broadly so as to effectively capture any R&D activity which is conducted in proximity to normal production activities. For the revised Bill to take this approach to the issue of supporting R&D activities conducted in a production context is extremely regrettable. Not only does this appear to be a thinly veiled attempt to vastly reduce the scope and net benefit of the incentive, but it again confirms that Government is somewhat disconnected from the reality of the very R&D activities it seeks to encourage. As would be expected in a private sector setting, the great majority of valuable Australian private sector R&D is undertaken on the back of activities whose dominant purpose is commercial – such is the nature of our remote, and relatively small Australian economy. For Government or Treasury to overlook this fact in the design of the new incentive is, in our view, to impair its capacity for success from the outset.

As we advised during meetings with Treasury officials in February 2010, it is our view that these attempts to limit the cost of the incentive through an approach of narrowing technical eligibility provisions (be they core or supporting) will both *gut* the value of the incentive to applicants, and undermine any potential for encouraging *greater* investment in private sector R&D. We therefore urge the Government to review the changes to both Core and Supporting R&D definitions with the aim of at least maintaining a similar scope of eligible activity as that currently set out within the Concession.

Treatment of software-related R&D

The revised treatment of software-related R&D projects is a significant improvement on that contained in the first Bill. While supporting these changes, we would urge the Government to go further and fully remove any industry-specific eligibility criteria beyond that contained in the definition of Core R&D activities.

The revised Bill continues to penalise R&D undertaken for the purposes of developing computer software for improved business administration, relative to similar activities undertaken in other industries. We would instead argue that the spillover benefits sought by the Government as an objective of the program, are in fact more likely to be derived from the innovative (internal) technologies firms develop which enable them to compete more effectively in global markets – thereby placing them on a firmer footing to conduct still further

R&D in the future. Where such activities also meet the statutory definition of Core R&D, they should be eligible for support under the R&D incentive.

We stress again - it is the generality and breadth of eligibility for the tax-based R&D incentive, and its lack of prescription, which in our experience delivers the very additionality and spillover benefits pursued as a successful policy outcome. However, to adopt a narrower technical eligibility in attempting to limit the potential cost of the program not only introduces unnecessary complexity, but also frustrates the real-world achievement of the policy objectives that such provisions ultimately seek to promote.

We therefore suggest that in finalising the Bill for introduction to the Parliament, the Government reconsider the current exclusion of R&D for the purpose of creating new software applications for internal business administration purposes at subsection 355-30(1)(o).

R&D Expenditure

Feedstock

The removal of the "augmented" feedstock rules, in favour of a revised feedstock provision which approximates that in operation under the Concession, is the major positive change contained in the revised Bill. However, without further detail as to the exact form that the new feedstock provisions will take it is not possible to provide any further comment on this issue.

As such, BSI recommends that the Government revert to a feedstock rule which is as close to a direct copy of the existing provisions for feedstock which currently operate within the Concession program for materials or goods that are subject to processing or transformation.

Core Technology

As we set out in our submission on the first Bill, the removal of accelerated deductions for core technology acquisitions in the draft legislation appears counter-intuitive when considering the overarching objectives and justifications for a tax-based R&D incentive.

In our experience companies seek to license available technology to reach a point from which they can commence or continue an experimental R&D program of their own. To date, this has been encouraged and facilitated by the core technology provisions operable within the Concession, and their eligibility for the R&D Tax Offset election.

The importance of the current treatment within the Concession of core technology expenditure, and its eligibility for a 100% refundable tax offset, for small, early-stage technology companies who are severely constrained in terms of working capital while undertaking an R&D program should not be underestimated. These benefits allow these firms to draw down on their future profitability (via the R&D Tax Offset) to assist in financing both the acquisition of precursor core technology, and further R&D activities based on that technology. To isolate expenditure of this kind as ineligible for the new R&D incentive, seems to suggest that it is preferable for researchers to "reinvent the wheel" rather than seek to identify appropriate licensable technology which may comprise the crucial "jumping off" point for new research and inquiry. Relative to the oft quoted program objectives it would seem illogical were this in fact the view of Government in relation to core technology acquisitions.

The decision to retain an exclusion for core technology expenditure in the revised Bill in our view ignores the longer-term economy wide benefits that are to be obtained through

encouraging the acquisition of technology which is "core" to a proposed or ongoing R&D program. In global markets, it is this very trade in new intellectual property which allows firms to innovate at the pace demanded of them by customers and competitors alike. To do anything less than extend the incentive (perhaps with limitations for acquisitions between associate entities) is to undermine a key capability of the program to produce the benefits sought by Government.

We therefore again strongly urge a review of these provisions to ensure that core technology purchases are also eligible for the tax offset, and if necessary, with restrictions on the transfer of core technology between associate entities.

Building Expenditure

As discussed with Treasury representatives, we feel that it is necessary to clarify the operation of certain provisions in the new legislation, which currently exclude all expenditure incurred in the acquisition or construction of a building, or an extension or alteration or improvement to a building, from classification as R&D expenditure.

The intent of the existing exclusion, in the Concession, can be traced back to deny accelerated depreciation of building expenditure (incurred after 20 November 1987) on structures used as R&D facilities. This exclusion, as presented in the new legislation, and without clarification of this intent, would be taken to preclude expenditure on all R&D activities conducted in the development of building technologies and processes and any associated prototyping and testing.

Given the program is intended to be broad based and there is no stated intention to exclude the building industry from making claims, we would recommend that this provision is clarified before it is included in the finalised Bill.

We understand from recent email correspondence that Michael Bradshaw of Treasury is currently reviewing this matter.

Other Issues

Clawback

An opportunity exists within the Bill to clarify the meaning of the phrase "receives or becomes entitled to receive" as it is used in the clawback provisions. It is our experience that in practice this phrase is interpreted as meaning when a grant is in fact paid to a recipient as confirmed by ATO ID 2004/568. In the interest of simplifying the legislation wherever possible, and reflecting the realities for most grant recipients, we would ask that the Government further review the language in the clawback provisions in the Bill as it is finalised for introduction to the Parliament. This could be achieved by replicating the language used in the decision of ATO ID 2004/568.

The methodology for dealing with grant repayments under the proposed clawback provisions is unnecessarily complex as it requires applicants to recalculate their clawback amounts by deducting any repayment amounts from the grant amounts received. In most cases, these repayments would occur in later income years, which would require the applicant to amend prior year income tax returns, possibly several times. This would seriously affect the accuracy and integrity of the clawback calculations and could also prevent applicants from recouping the additional 20% tax paid on the grant amount. This could easily be addressed by excluding repayable grant programs from the clawback provisions, or, by providing a mechanism in the tax return to enable the clawback adjustment to be made in the current year tax return, rather than amending the original tax return.

Associate entities

The retention of a limitation on notional deductions for R&D expenditure validly incurred, but not yet paid, to an associate introduces unnecessary complexity to the calculation of notional deductions, and the value of the R&D Tax Offset.

As we set out in our original submission to the first consultation paper, expenditure incurred to associate entities on R&D activities should continue to be eligible where both the applicant taxpayer and their associate account for their income and expenses on the same basis (ie. cash or accruals). This would avoid the situation, created by the provisions in the Bill, which will require companies of all sizes to isolate individual items of R&D expenditure which are incurred (but not yet paid) to the associate, and exclude them from the claim.

Surely it is an oversight that the normal trade credit arrangements existing between two associates dealing at arm's length will result in an adjustment to R&D tax offset claims for amounts invoiced but yet to be paid, when payment is in all but a very small minority of cases made in accordance with those commercial terms.

We support the principles in TR 97/7 and the ATO guidance in ATO ID 2006/238 in relation to accrued expenses claims, and taking these views into account, where the applicant company validly incurs an expense (to an associate entity) which results in the required liability to which it is definitively committed, that expense should be eligible for support under the R&D tax incentive program.

We therefore request that in finalising the Bill the Government revise the provisions relating to expenditure incurred to associates such that the restriction on deductibility is only operative where the taxpayer is accounting for income and expenditure on a different basis to that used by the associate entity.

Summary

The revisions to the Bill are to be applauded insofar as they show that Government is willing to listen and respond to the significant concerns of industry in the development of the new R&D tax incentive. However, the significant narrowing of the Objects clause, Core and Supporting R&D eligibility criteria, and the complexity and overall reductions in net benefit to applicants which would result were the Bill enacted in its current form, all combine to make it impossible for BSI to support.

Again as noted in our earlier submission, the R&D Tax Concession has successfully taken Australia's Business Expenditure on Research and Development (BERD) from near the bottom of the OECD ladder to about 14th place over the past 25 years. Despite that success however, in terms of BERD to GDP, Australia still only spends about half that of the international leaders in business R&D.

This improvement has been achieved with all the benefits, and the attendant stability, of the current Concession program. If support for private sector investment in R&D is reduced, as it will be under either version of the Bill for the new R&D tax incentive, Australian BERD measures will quickly descend toward the bottom of the OECD ladder once again.

Higher levels of business innovation are widely regarded as one of the critical factors in achieving Australian productivity growth targets. In finalising the new R&D tax incentive therefore, we believe the Government must ensure that the net benefit available under the Concession is maintained, and preferably increased, to truly support and encourage Australian companies to undertake increasing levels of research and development. In its

present form however, the Bill will not in our view result in the achievement of such an outcome.

If you have any questions, please give me a call on 02 9212 5505 or 0418 236 179 at any time.

Yours sincerely
BSI Innovation Pty Limited

Marcus Webb
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