Response to the Second Exposure Draft R&D Tax Incentive

Submission prepared by the Australian Industry Group

April 2010

AUSTRALIAN INDUSTRY GROUP

Executive Summary

The Second Exposure Draft legislation for the New Research and Development Tax Incentive released just prior to Easter is proposed to take effect from the year beginning 1 July 2010.

This schedule presents business with inadequate time to examine and comment on what amounts to a fundamentally new approach to the R&D tax incentive.

Further, our investigation of the proposed changes exposes very significant risks that the approach taken will severely limit the range of expenditure that will qualify for the tax incentive.

We expect these restrictions will substantially reduce the total tax benefit to business from the R&D tax incentive. The Government has not released any information relating to the costing of its proposals that gives us reason to question this expectation.

Ai Group therefore proposes that, except in relation to R&D where the intellectual property is held offshore and in relation to the removal of the anomalous treatment of R&D relating to software, there should be no changes to the eligibility for the R&D tax incentive until there has been adequate scrutiny of the proposed approach. Such changes should take effect from 1 July 2011.

We nevertheless propose that the new form of the tax incentive and the changed arrangements for small businesses should be adopted as announced in the 2009-10 Budget.

We note that the 175% incremental tax incentive has already been removed and we do not therefore expect a substantial loss of revenue relative to the R&D tax regime that operated prior to the 2009-10 Budget. As previously put to the Government, if the Government argues that there is a material risk of a cost blow out, Ai Group is ready to discuss alternative ways to address this concern.

In listing our concerns with the Second Exposure Draft, our point of reference is the R&D tax incentive as it existed before the announcements in the 2009-10 Budget. While in the meantime a First Exposure Draft has been released and now retracted, this, and the improvements that the Second Exposure Draft makes on the First Exposure Draft, is now not relevant to considerations.

The new draft clearly indicates a significant change in the policy mindset of the Federal Government as it relates to stimulating research and development in the economy. Contrary to its stated position in recent policy documents, such as the *Powering Ideas*, it is now apparent that the Government intends to pare back its role to fund, almost exclusively, research.

In fact, as it stands, the draft legislation would be better referred to as a Research Tax Credit given the narrow definition proposed for core R&D and the likelihood that most supporting developmental activity would be discounted under the new rules.

This shift in approach fails to credit the importance of the development of research for commercial application.

Moreover, we are concerned by the eleventh hour introduction of a new and modified range of concepts for which it is simply impractical to test in the time available. Specifically, Ai Group believes the following significant flaws exist in the scheme:

- The introduction of a new Objects clause which narrows the scope of the legislation to support research which has additionality and spillover for the economy but which makes no mention of activities that aid in the further development and commercial application of that research. This is a serious flaw and forms the cornerstone of our strong opposition to the draft legislation.

- The compliance cost imposition likely to be experienced by business in separating out the core, 'directly related supporting' and supporting activities excluded by the new dominant purpose test. This will particularly inhibit smaller businesses from participating in the scheme.

- The potential for differing treatment of sectors likely to arise from the publication of sector guidelines for defining core activities. We see no valid reason to give preference to any particular sector in the economy. In so doing the extremely valuable innovation undertaken in sectors where Australia has proven track record of being able to compete globally may be discounted.

- The 'Expenditure not at risk' provisions contrast with the stated goal of the Federal Government to incentivise and stimulate greater levels of R&D. In Ai Group's view the R&D tax credit scheme should not simply be an insurance policy for R&D of no commercial value.

- The augmented feedstock provisions – remain surrounded by uncertainty so that detailed analysis is not possible.

- The administrative powers for AusIndustry are inappropriately strengthened and will give rise to unnecessary dispute.

- The introduction of the dominant purpose test for some supporting expenditure will negatively impact on much of the important incremental R&D occurring in the economy, especially 'green' R&D in the manufacturing and construction industries.

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.

The Importance of R&D and Innovation to the Australian Economy

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, the higher domestic currency and the upwards pressure on interest rates that are 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. Research and development undertaken in the private sector is a critical element in this.

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.

Change the Objects Clause

The second exposure draft legislation for the R&D tax credit scheme represents a backward step for Australia in terms of defining the scope of activities the Federal Government is willing to recognise and support as research and development. Indeed, the Objects clause omits any reference to development.

In this way it not only conflicts with Ai Group's view that any Government intervention in relation to R&D must deal with all aspects of such activity, but also runs contrary to the OECD definition (the Frascati model).

Any remedy to the existing draft legislation must deal with this inconsistency and recognize that 'experimental development' (i.e. "systematic work, drawing on existing knowledge gained from research and/or practical experience, which is directed to producing new materials, products or devices, to installing new processes, systems and services, or to improving substantially those already produced or installed") must be captured in the Objects clause and therefore recognised as worthy of public funding.

The challenge for Australia in 'experimental development' is, in fact, more pronounced than in many other OECD nations. Historically, we have a relatively weak record in developing research for commercial gain and in developing collaborations between the research and business communities that would improve the realisation of commercial value in the economy. The Second Exposure Draft legislation unnecessarily retires from this challenge.

Model the Changes and Delay the Introduction

A cornerstone of the Federal Government's position on the introduction of the new R&D tax credit scheme has been that any changes would be revenue neutral in terms of their impact on the Government expenditure. Ai Group contests that this would be the impact of the proposed changes, a position which mirrors the overwhelming majority of submissions in this consultation process.

Despite repeated requests the Government has not yet released any modeling of the proposed changes. A thorough cost-benefit analysis of the changes needs to occur if we are to have informed debate and consultation. More importantly, it will help in ensuring that the legislation will not have negative unintended consequences for BERD in Australia. As it stands, there is a growing consensus across industry that this would be the impact of the proposed changes.

Notwithstanding the uncovering less than three weeks ago of fundamentally new concepts, the timetable for consultation is now truncated by the preference of the Government for a hurried introduction of the legislation to meet original timeframes for implementation. A delay to July 1, 2011 is required if we are to ensure the legislation has a positive impact on research and development in Australia.

Our position on the delay is given further weight because a number of important documents that relate to the scheme's administration have not yet been published.

In particular, the sectoral guidelines for determining core activities are not available. Neither have the feedstock provisions for the exposure draft legislation been included. The absence of such important detail is unacceptable given the intended timeframes for implementation.

Remove the Unnecessary Compliance Burden

A key feature of the 2009-10 Budget announcement and the literature accompanying the initial consultation period was a commitment to reducing the compliance burden for business and thereby making the scheme more accessible to business, especially small business.

Ai Group believes that, if implemented in its current form, the opposite would be true. The separation of core activities, ‘directly related supporting’ activities and supporting activities excluded by the new dominant purpose test poses a significant compliance headache for business.

Another area of increased compliance cost will emanate from the considerable number of changes to concepts and definitions included in the draft legislation. Such a profound change to the scheme will give rise to a prolonged period of uncertainty across the business community as to how it will be administered.

Additionally, the increased powers of AusIndustry to administer the scheme raise real concerns. The Federal Government should be committed to greater levels of self assessment that reflect that businesses using the tax concession scheme did so with high levels of compliance.

Ensure scheme provides incentive not just insurance

Government can play a very useful role in incentivising research and development. While much innovation will occur in competitive markets, there is a well-recognised role for Government to stimulate private sector expenditure on research and development.

In its current form, however, the Second Exposure Draft legislation does little to incentivise spending on R&D. Indeed, the expenditure not at risk provisions that are a feature of the new legislation recast the scheme as an insurance scheme, structured to provide a safety net for R&D expenditure that fails to pay off rather than a springboard for those that generate commercial value.

Ironically, there will be very few, if any, spillovers arising from widespread commercial adoption generated by the classes of expenditure that appears to be favoured by the new approach to R&D.

Sort the Feedstock Provisions

One of the more significant uncertainties yet to be resolved in relation to the second exposure draft is the area of feedstock provisions. While the Federal Government has agreed to make concessions in this area, the nature of these is difficult to ascertain as no amendments have been made as yet. Given the short timetable for introduction this is unacceptable policy process.

On reading of the Explanatory Memorandum it is expected that the new provisions will extend inappropriately to any goods, materials or energy used in the R&D activity rather than might more commonly be regarded as "feedstock".

Remove the Dominant Purpose Test

The dominant purpose test discounts the importance and value of much of the process innovation that occurs in Australia. By eliminating production activities as a valid part of R&D there is a risk of creating an R&D scheme with inherent sectoral biases that are not in the best interests of the Australian economy.

Its inclusion very much supports Ai Group's view that the scheme is being recast as a Research Tax Credit Scheme. Also importantly, its inclusion conflicts with other areas of government policy, especially in the area of environmental sustainability.

The Path Ahead

If introduced in its current form the Second Exposure Draft legislation for the R&D Tax Incentive would have negative consequences for the level of business expenditure on research and development and therefore puts at risk future productivity improvements and economic growth.

While many of the headline aspects of the scheme, as it was originally announced, remain attractive to Ai Group, its detail gives rise for concern.

For the past decade Australia has been playing a game of catch-up with our OECD counterparts when it comes to R&D. The existing tax concession scheme has played a fundamental role in helping improve our relative standing . While we accept that it can be improved, Ai Group does not accept that the proposed tax credit scheme, in its current form, is a step in the right direction.

The emerging bias to 'research only' activities is inappropriate. The compliance burden for businesses wanting to use the scheme is too high. The administration of the program is too heavy handed. The likelihood is that the scheme will heavily reduce funding for business R&D. There is an absence of appropriate modeling of the scheme.

Ai Group therefore proposes that, except in relation to R&D where the intellectual property is held offshore and in relation to the removal of the anomalous treatment of R&D relating to software, there should be no changes to the eligibility for the R&D

tax incentive until there has been adequate scrutiny of the proposed approach. Such changes should take effect from 1 July 2011.

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