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SUBMISSION ON R&D CONSULTATION PAPER

The Corporate Tax Association (CTA), which represents the taxation interests of about 125 of Australia's largest companies, is pleased to comment on the R&D Consultation Paper (the paper) that was released last month. This submission should be read in the context of the CTA's response to "Venturous Australia" dated 3 October 2008, which was the outcome of the Review of the National Innovation System. A copy of that submission is also attached.

As we indicated in our earlier submission, the CTA remains far from convinced about the "smaller is better" philosophy that underpins the proposed re-orientation of the R&D tax concession from larger firms to smaller firms. This policy direction appears to be largely based on anecdotal evidence gleaned from the 2007 work of the Productivity Commission. Further, in response to the suggestion at paragraph 8 of the paper that supporting small business R&D rather than large business R&D would produce more net benefits for the Australian community, the CTA would like to emphasise that in the past large business has demonstrated its ability to commercialise successful R&D projects, which has led to further job creation and other spill-over effects such as knowledge transfer.

Nevertheless, we recognise the government has decided that the R&D tax concession needs to be redesigned in a revenue neutral way and this will involve some cost to large firms. Having said that, we are concerned about the lack of economic modelling (at least to the extent that any such modelling is publicly available) demonstrating that any policy design changes beyond the removal of the 175 per cent premium concession will actually be needed in order to achieve revenue neutrality.

We are also concerned about the proposed changes to the definition of eligible R&D activities - particularly the inclusive innovation and high level of technical risk tests, the impact of which appears to be highly uncertain. In our view, this change would result in one of the most restrictive definitions in the world and would in fact be out of step with the OECD Frascati Manual.

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As we have indicated in the course of the consultation process, the CTA strongly considers that any proposal that requires firms to separate core R&D activities from supporting activities would be an extremely retrograde step. This is not so much because of any possible reduction of the tax concession as the increased compliance costs and the almost unlimited scope for uncertainty and disputes that such a distinction would bring about.

From the perspective of many larger firms, the proposed package of measures is unlikely to be seen as representing an improvement over the existing arrangements, and in fact could make the tax concession less relevant to many firms when the increased compliance costs and uncertainty around supporting activities are taken into account. And we make this comment in the context of having heard from many large firms that they currently under claim the R&D tax concession because of its low level relative to the associated compliance costs.

If the government is serious about making the R&D tax incentive less complex, consideration should be given to a broader definition of "activity" as companies monitor and track "projects" rather than "activities". For example, a project that seeks to develop a new product should fall within the definition. This would take away some of the uncertainty and the additional compliance burden of determining whether each and every small identifiable activity within a project will meet the onerous criteria.

If the government is determined to introduce revenue saving measures over and above the removal of the premium scheme, there may be other options available that would produce more certain outcomes for both firms and the agencies administering the incentive.

We provide the following comments in relation to some of the specific questions put in the paper:

Question 1: Should there be any exceptions to the general rule that eligible R&D activity must be conducted in Australia?

CTA response: Given that it will remain a reality that certain R&D activities cannot be undertaken in Australia, we consider that the limited exceptions to the "conducted in Australia" rule should be retained under the new scheme. By and large, the exceptions under the current scheme appear to be working well and we believe they should be broadly replicated under the new arrangements.

Regarding the location of IP, we agree with the proposition that it is where and on whose behalf the R&D is conducted that should determine eligibility for the R&D tax incentive.

Question 2 How should the new R&D tax incentive treat R&D expenditure that is currently deductible at 100 per cent?

CTA response: Given that large firms will not be entitled to a refundable R&D tax credit, the CTA considers that R&D expenditure which currently receives a non-enhanced deduction should be given normal tax treatment.

Question 3 Should expenditure incurred to associate entities only be eligible for the new R&D tax incentive where paid in cash?

CTA response: Large firms record expenditure (including R&D expenditure) on an accruals basis, which is also the basis under which the general tax deductibility provisions permit deductions to be claimed. The CTA would not be in favour of a system that requires firms to make adjustments for expenditure that has accrued but has not yet been paid in cash. We are not aware of any evidence suggesting normal accrual accounting presents a material integrity risk.

Regarding Principle 5, which reflects the additionality/spill-over objective, there was some discussion at the Melbourne consultation meeting on 16 October 2009 about how this might be reflected in the legislation. We understand it is not proposed to legislate directly for this kind of test, but that the tightening of the definition of eligible R&D activities will broadly reflect this objective.

The CTA would have some concerns about these goals being included in an objects clause in the legislation itself, in case the agencies administering the law place undue reliance on it and it becomes a *de facto* administrative test. Also, at the margin, there is some risk that a court might place reliance on such a clause so that there would in effect be an unintended onus on claimants to demonstrate the existence of spill-over benefits. We believe the proper place for expressing this objective would be in the second reading speech introducing the relevant law.

Regarding Principal 6, which changes the definition of eligible R&D activity by moving from an alternative to an inclusive test, we do not agree with the suggestion, made at para 55 of the paper, that such a change would pull Australia back from having one of the broadest definitions of R&D to be more in line with the tests applied by other countries. To the contrary, we believe the use of the word "and" instead of "or" would at a stroke change the Australian definition to one of the narrowest in the world – particularly in view of the fact that in Australia the innovation aspect (new knowledge or improvements) is not restricted to just the firm conducting the R&D activity.

Question 4. Canvasses various approaches to capping supporting activities.

CTA response: As mentioned earlier, the CTA is strongly opposed to any measure that requires firms to differentiate between supporting activities and core R&D. This distinction is not a feature of current law and, in our view, is likely to lead to ongoing uncertainty and disputes about exactly where the boundary lies.

The suggestion at para (d) that supporting activities could be capped on a net expenditure basis would not be an appropriate policy direction to take. Firms should not be penalised for seeking to commercialise and sell the product of their successful R&D activities. The tax concession should be made available at the time the expenditure is incurred and when the outcome of the relevant projects remains uncertain. Recovering the tax concession, in whole or in part, on an *ex poste* basis in effect penalises success.

Question 5 Should the current list of excluded activities be changed?

CTA Response: Before commenting on this question we would need to know which additional activities might be included in a future list of excluded activities.

Question 6 How should the new R&D incentive treat software R&D?

CTA Response: The CTA has no specific comment to make on this question.

One additional issue not canvassed in the paper relates to the unlimited amendment periods that currently apply to the R&D tax concession. The unlimited amendment period was a feature of the original R&D legislation and the CTA understands it was introduced because there were concerns at the time that eligible firms would be likely to under claim their entitlement to what was then a new concession which the government wanted firms to take up. Accordingly, it was felt that firms should be able to amend their claims indefinitely so that the incentive could have its intended effect of encouraging R&D activities.

The 1996 registration requirements largely removed any advantage that firms may have gained from the unlimited amendment rule, but left them exposed to amendments to increase their tax liability in respect of R&D claims going back as far as the start of the current scheme almost 25 years ago. In the CTA's view, this is entirely inappropriate in a self assessment environment. Also, we believe it contributes to the agencies administering the tax incentive not resolving issues as quickly as they might if the normal amendment timing rules applied.

We are aware that a more general review of unlimited amendment periods is taking place as a kind of back end of the Review of Self Assessment project. For reasons that are not entirely clear, however, that project appears to have run out of momentum, and we are not aware of any plans in Treasury to implement changes to amendment periods in the foreseeable future. The current review of the R&D tax concession will bring about significant changes which should not be introduced without at the same time introducing a four-year amendment period as is the case for most other aspects of self assessment.

Thank you for agreeing to accept our submission under a brief extension. This has enabled us to better consult with members and provide appropriate feedback. We accept the assurances given during the consultation process that no specific measures have yet been finalised and that the consultation process is a genuine one. Accordingly, we would be more than happy to engage in further discussion about specific matters raised in this submission.

Best regards,

Frank Drenth
Executive Director
Corporate Tax Association