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SUBMISSION IN RELATION TO PROPOSED CHANGES TO THE RESEARCH AND DEVELOPMENT TAX INCENTIVE

Issues of principle

1. At the outset, let me declare a personal interest in the proposed changes. Back in 1986, together with people from the then Department of Industry, Technology and Commerce and Parliamentary Counsel, I was intrinsic to the development of the policy and legislation which resulted in Section 73B of the Income Tax Assessment Act 1936. I have always regarded that legislation as the most important of the taxation legislation, with which I was involved during my time as an officer of the then Policy and Legislation Division of the Australian Taxation Office. The package of legislation had a purpose beneficial to the future of Australia, and not merely related to revenue raising.

2. That having been said, I also wish to draw strong attention to the fact that the proposal will result in a different package of assistance. By this I don't mean just that the benefit will occur in a different way, but that there will be activities that, quite properly, have been eligible in the past, that will no longer be eligible. Certain items of expenditure may finish up being treated in a lesser way that at present. Decisions made may increase the administrative burden.

3. Over the journey, Treasury has always had a blind spot in that the comment is often expressed that the tax incentive rewards companies for carrying out R&D that they would have carried out anyway. In doing so, they have ignored that, for multinationals in particular, the location of the R&D can hinge on the availability of incentive programs. I have vivid memories of a seminar in Sydney, organized by AusIndustry, and timed to take place shortly after the 1996 reduction in the rate of the concession. AusIndustry had lined up the head of Kodak in Melbourne as a speaker in relation to the assistance that the concession had provided to that company. Government officials, including a senior officer from Treasury, were gob-smacked when the Kodak man reported that Eastman Kodak, his head office in the USA, had advised him in the previous 48 hours that the research facility in Coburg, Melbourne, was to be closed and that Kodak's future R&D would be carried out in Malaysia. The man from Kodak related how he had to advise highly regarded researchers that their services were no longer required in Australia.

4. Concomitant with the location of R&D is the ability of Australian brains to remain in Australia. Opportunity to carry out their work which may have its origin in the retention of R&D activities in Australia through government incentives, is to be defended strongly. To the extent that the new R&D incentive program has the effect of reducing R&D, not increasing it, that is not an outcome that should occur.

5. A second blind spot that Treasury seems to have had over the journey has been to underestimate the impact of the R&D tax concession in the decision making process, particularly in large corporations. From my practical experience over 20 years in advising companies, I have seen a large amount of evidence that *"Capital expenditure requests"* put to Finance Directors seeking funding for R&D programs routinely adopt cost accounting principles to determine the after-tax cost of the program and hence the "payback period". In a world where corporate spending can be governed by how soon a profit will be generated from that spending, the reduction in the payback period because the project is R&D concession supported, compared to other proposals for investment of funds, can be pivotal.

Responses to question raised in the Consultation Paper

1. **Should there be any exceptions to the general rule that eligible R&D activity must be carried out in Australia?**
   In my view, the current arrangements – that some activities may be granted advance approval, or that the off-shore activities be incidental or ancillary to Australian R&D activities – are working successfully and would not adversely affect the integrity of the concession if left alone. The latter exception which relies on a "less than 10%" rule is fairly self-regulating and the overall requirement that the overseas activities be unable to be conducted locally also ensures to a high degree that the eligible R&D activities be confined for the most part to Australian sourced activities.

2. **How should the new R&D tax incentive treat R&D expenditure that is currently deductible at 100 per cent?**
   In my view, the treatment of interest directly related to the funding of R&D activities at a different rate to other expenditure was never justified, but it is there and is not likely to be changed under the new proposals. But the interest expenditure and expenditure on "core technology" should not be further discriminated against by excluding it from the Refundable R&D Tax Credit.

3. **Should expenditure incurred to associate entities only be eligible for the new R&D tax incentive where paid in cash?**
   I don't quite understand the thinking behind this question. Expenditure incurred between associates, to be eligible for the extra 25%, cannot exceed the actual outgoings of the associates *(subsections 73B(14AB) to (14AD).* In addition, the amount incurred by the claimant must reduce the expenditure claimable by the associate for its amounts actually spent. Thus, although there may not have been a cash outlay by the claimant, there must have been a cash outlay by the associate in carrying on the part of the eligible activities, or providing other goods or services attributable to the eligible activities.

   To require an actual cash outlay in lieu of bona fides accrual accounting entries need produce little benefit. In many cases there is no revenue stream from the R&D activities in the early years of a project. Therefore, it seems that, in order to provide funds for the actual cash outlay, the associate may well have to provide loan funding to the claimant. In both cases, there will be an unpaid debt by the claimant to the associate until a revenue stream is activated.

   At the end of the day, it does not seem that there would be any great benefit to the revenue from including this requirement.

4. Administration

I concur with the view that more efficiency in administration is always desirable. From the consumers' point of view more and better guidance material is essential in a largely self-assessment regime. In the past, both the Taxation Office and AusIndustry have co-operated in the production of the ***Guide to the R&D Tax Concession.*** The last revision of this guide was made in 2007. I was astonished, at the recent Melbourne Consultation Session, to discover how many of the participants who were unaware of the existence of the ***Guide***. This is attributable, I believe, to the ***Guide*** being a document available on-line rather than as a hard publication like the well-loved "Billiard Book".

I recommend that more publicity – through the vehicle of AusIndustry's periodical *"R&D Tax Concession Information Bulletin"* – of the existence of the future ***Guide to the R&D Tax Incentive*** should occur.

5. Principle 6: That the definition be changed to require both Innovation and High Levels of Technical Risk

The fact that this is the 3rd attempt to require both elements, following 2 failures to convince the Parliament of the necessity to do so, should indicate the general industry opposition to such a measure. Indeed, I would expect that opposition to continue.

Most projects which have relied on the Innovation arm of the definition would be able to substantiate some levels of technical risk, but may not be able to substantiate high levels of technical risk. As a well publicized example, I would offer the development of the Cochlea Bionic Ear. The first versions of that invention would clearly have met both tests, but the development of the Mark 3 and later versions would have met increasing difficulties in meeting a high levels of technical risk, given the great store of technical knowledge acquired in the earlier versions and the consummate skills of the inventors.

Companies active on the international market, such as Cochlea, in the absence of continued eligibility for Government incentives, may choose to migrate their R&D activities. This has happened in the past (see above Kodak example) and will happen again if opportunities are restricted in Australia.

A compromise that may meet the concerns expressed in paragraph 54, but not closing off eligibility to companies with activities that are innovative but include only lower, but actual, technical risk might be to define Eligible Activities as involving both innovation (as presently defined in *subsection 73B(2B)*) and substituting "appreciable" for "high" in the definition of technical risk in that subsection.

A further concern that I hold with the requirement for both innovation and high technical risk would emerge from an experience that I had with an AusIndustry assessor. That assessor, in assessing the eligibility of a software development, attempted to de-rail the eligibility by alleging that the development was not innovative because there was a vaguely similar product that he had identified from trawling the internet, discovering its existence in Phoenix Arizona. This was notwithstanding the high levels of technical risk that were there to be proven. If projects containing very high levels of technical risk can be invalidated because an assessor's internet searching skills are superior to an Australian engineer's, then the incentive will soon gain a bad reputation.

5. **Limitations on the deductibility of supporting activities**
   I recognize the concern that some claims may involve very extensive expenditure on "supporting activities" arising from a much smaller level of "core activities". The examples given in Attachment A give a clear basis for that concern and I acknowledge that the Government might want to limit the occasions where the perceived imbalance might occur. Five options are presented for discussion. I now address these.

   Options (a) and (e): Lesser deductibility for all or part of expenditure on Supporting Activities
   I would oppose any dichotomy of deductibility which options (a) and (e) would present. This would create problems of accounting for a start and of pressuring claimants towards the margin of core eligibility in order to maximize the benefits. The likelihood of disputation would increase, and where there is disputation the risks of ill-judged remedial legislation increases.

   Option (d): Deductibility on a "net expenditure" basis
   Similarly, the concept of "net expenditure" in option (d) would cause complicated legislation and the arguments expressed in paragraphs 66 e.s. fly contrary to the concepts of technical and financial risk that underlie the legislation.

   Options (b) and (c): A "sole purpose" test
   Both of these options are, in my view, viable alternatives. I would favour a test that requires that production activities be undertaken solely to prove the practicability of the theoretical conclusions reached as a result of the "core activities".

   The effect of a change along the lines of options (b) and (c) should be examined against the circumstances of the Australian Submarine Project. Had the supporting activities of the major claimants in producing a saleable prototype not been eligible, the increased after-tax costs of the production of that prototype would certainly have meant a higher contract cost to the Australian taxpayer. You could even mount an argument that the project may not have gotten off the ground in Australia; the submarines built overseas; and a large increase in technical knowledge flow into Australia lost. I raise this not as a reason for not introducing a "sole purpose test", but merely to highlight the possible ramifications of such a change.

6. **Changes to the treatment of the current list of excluded activities**
   In my experience, there has rarely been a case for inclusion of any of these activities as a supporting activity, with the possible exception of the item (c) activities in certain conditions in proving the efficacy of "core activities" in the development of innovative and technically risky techniques of exploration. If changes are made to the general deductibility of "supporting activities" as discussed under part 5 above, this eligibility would be removed. Accordingly, I would suggest that no change be made to the current list.

7. **Changes to the Treatment of Software R&D**
   I am not equipped to provide meaningful input to the technical discussion of the elements of innovation and/or technical risk as it applies to considering whether Software R&D should qualify as "core activities". I am, however, concerned to ensure that software developed internally should not be denied eligibility as a "supporting activity" where its purpose is directly related to the conduct of "core" R&D activities.

Conclusion

I commend the Government for the aspects of the new research and development tax incentive that will add to reasons for Australian companies to conduct R&D. I caution that changes made in "tightening" the incentive should not have the reverse result. Accordingly, I recommend to the drafters of the implementing legislation that they ask themselves that question in reaching each decision.

Graham Carew