# The New Research and Development Tax Incentive

## Consultation Paper

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## About Flavour South Australia, the food industry association inc.

Flavour South Australia (Flavour SA) is an Industry Association, which is industry driven and plays a significant role in the development of the South Australian Food Industry. Flavour SA is an

- Information Source
- Innovation Enabler
- Industry Voice

The Association aims to provide services and information which assist members to achieve development objectives whilst contributing to the State Food Plan objectives.

**Flavour South Australia is focussed on the State's food industry, specifically to increase the economic benefits of food, total value to the economy whether it be domestically or internationally, from the current $6.9b to $15b by 2010.**

These goals can be achieved by adopting a value added, market driven focus which will enable the food industry to compete effectively in the global market place.

South Australia's Food Industry comprises of dynamic sectors with exciting development opportunities. The people involved in these industries are already contributing over 60 per cent of the State's export revenue. It is crucial that these people are both inspired and supported in their quest to achieve a significant presence in their global markets.

Industry growth will be realised largely through a commitment to producing quality value added products and by delivering consistent, reliable supply to targeted markets.

Flavour SA represents approximately 100 small to medium food manufacturers in South Australia.

## VISION

Flavour SA's vision is to be the peak food industry representative organisation playing a significant role in the development of the Food Industry.

## OBJECTIVES

- To be the recognised voice of the South Australian Food Industry
- To provide networking opportunities and information
- Development of interstate markets
- To positively influence policy and regulation regarding food
- To play a significant support role in assisting member companies to become competitive in regional and national markets
- To have a growing, broad, active and appreciative membership base throughout the state
- To facilitate the recognition of South Australian food producers throughout Australia
- To be the key provider of relevant information in the food industry

# Key Recommendations

**FLAVOUR SA**;

- recommends the Government adopt the Refundable R&D Tax Credit at a rate of 145% for companies with a turnover of less than $20 million

- recommends the Government retain the current arrangement for expenditures incurred to associate entities, particularly for participating companies with a turnover of less than $20 million

- recommends the Government considers an "additionality and spillover" element as a potential selection criterion, but ***not*** as a broad-based test applied to define what activities will be deemed eligible for the new R&D tax incentive

- recommends the Government ***retain*** the existing definition of R&D as described at Part B3-2 of the current "Guide to the R&D Tax Concession" in favour of the more restrictive definition proposed at Principle 6

- ***STRONGLY*** recommends the Government differentiates between the requirements of companies with a turnover of less than $20 million and larger companies when developing the new limitations for claiming supporting (non-core) activities under the new R&D tax incentive

- ***STRONGLY*** recommends supporting activities be eligible where they are ***predominantly*** for the purpose of supporting a core R&D activity ***and/or enable the commercial feasibility of the R&D outcomes to be established***

- ***STRONGLY*** recommends the current list of activities excluded from being considered core R&D ***NOT*** be extended to ***exclude*** certain activities from being considered supporting activities

- recommends retaining the capacity to claim R&D conducted overseas provided it does not exceed 10% of the claimed expenditure

# Specific Comments – Priority Areas Identified by Flavour SA

## Refundable R&D Tax Credit

- ***Principle 3***

  *The refundable R&D Tax Credit will be available to companies with a turnover of less than $20 million at a rate of 45 per cent for eligible R&D expenditure.*

Given that the majority of Flavour SA's members are SME's with a group turnover of less than $20 million, Flavour SA strongly endorses this proposal. We confirm that the increase to 145% from the current 125% incentive will be more favourable to our membership and provide a greater inducement to them participating in the scheme. The capacity to apply unused refundable tax offset amounts to reduce other tax liabilities (such as GST) if the income tax liability is reduced to zero, as well as the cash refund of residual unused amounts, also makes the scheme attractive to our members in the food sector.

**Recommendation**

Flavour SA recommends the Government adopt the Refundable R&D Tax Credit at a rate of 145% for companies with a turnover of less than $20 million.

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

Flavour SA supports the current arrangements whereby expenditure on R&D to associate entities is incurred under accrual accounting principles. The potential for cash refunds being paid on amounts for which the taxpayer is yet to make an actual cash outlay provides an additional incentive for SME's in the food sector to consider participating in the scheme, particularly as it relates to their cash-flow management.

**Recommendation**

Flavour SA recommends the Government retain the current arrangement for expenditures incurred to associate entities, particularly for participating companies with a turnover of less than $20 million.

## Eligible R&D

- ***Principle 5***

  *The new R&D tax incentive should target R&D that:*

  *a) is in addition to what otherwise would have occurred; and*

  *b) provides spillovers – benefits that are shared by other firms and the community – that are large relative to the subsidy.*

Flavour SA agrees with Part (A), that the new R&D tax incentive should target new R&D that otherwise would not occur without the incentive.
Flavour SA is concerned with Part (B), that applying an 'additionality and spillovers' test to the new R&D tax incentive as a whole will expressly ***limit*** the type of activity or project that will be eligible for the new incentive. Flavour SA agrees with the principle of public subsidies generating, as a flow-on outcome, additional benefits to the community. However, Flavour SA recommends this be recognised as a "value added" component of the scheme, rather than a test ***applied*** to each project. The key aspects of this argument are;

- ensuring projects produce outcomes that are accessible to ***other*** firms will undoubtedly promote R&D projects submitted to the scheme residing within the "pre-competitive space" or utilising knowledge and/or technologies that are in the public domain. The extension of what is already "known" is inherently ***less*** innovative and ***less*** risky than acquiring ***new*** knowledge or creating ***new*** technologies. As such, an "additionality and spillovers" rule will counteract the overall intent of the program to promote "experimental activities that involve innovation or high levels of technical risk".

- specifically as it relates to the South Australian food sector, an "additionality and spillovers" rule would promote the eligibility of certain activities but preclude others.

  - Examples of activities that would be amenable to an "additionality and spillovers" rule are those providing outcomes loosely categorised as;
    - food safety practices
    - food integrity practices
    - waste management and other business sustainability practices

  - Activities that would not be amenable to an "additionality and spillovers" rule are "activities undertaken for the modification of the organoleptic qualities of particular food items" defined in Part B 4-7 of the current "Guide to the R&D Tax Concession" as potential eligible activities. Thus R&D projects undertaken to develop ***new*** food products would largely be ***excluded*** by an "additionality and spillovers" rule.

**Recommendation**

Flavour SA recommends the Government considers an "additionality and spillover" element as a potential selection criterion, but ***not*** as a broad-based test applied to define what activities will be deemed eligible for the new R&D tax incentive.

## Core R&D

- ***Principle 6***

  *Eligible R&D activity will be defined as systematic, investigative and experimental activity that:*

  *a) involves both innovation and high levels of technical risk; and*

  *b) is for the purpose of producing new knowledge or improvements.*

Flavour SA contends "The detailed definition of R&D" at section B 3-2 of the current "Guide to the R&D Tax Concession" provides greater scope for inclusion in the scheme of the SME's it represents, than the proposed change enunciated in Principle 6. Flavour SA supports the current definition whereby "Systemic, investigative and experimental activities involve innovation ***or*** high levels of technical risk…". Simply embarking on a project that involves "innovation" is a "high risk" undertaking for a SME in the food sector. As a stated aim of the case for reform "intentionally redistributes support in favour of small and medium sized businesses…", the Government should be cognisant of changes that will limit SME's, more so than larger companies, from adopting the scheme to support the development of their business R&D. This is one such change.

Flavour SA is concerned that one of the rationale's for adopting this change in definition of core R&D activity is to better align with the Frascati Manual and international practice. Given that the Frascati Manual was "written by and for the national experts in member countries ***who collect and issue*** national R&D ***data***…", Flavour SA encourages the Government to retain the breadth of its current definition to better align with the stakeholders it is trying to attract to the scheme.

**Recommendation**

Flavour SA recommends the Government ***retain*** the existing definition of R&D as described at Part B3-2 of the current "Guide to the R&D Tax Concession" in favour of the more restrictive definition proposed at Principle 6.

## Supporting R&D

- ***Principle 7***
  *Supporting R&D will continue to be recognised under the new R&D tax incentive but claims will be subject to new limitations.*

Fundamental to the likelihood an SME in the food sector will utilise the new R&D tax incentive scheme is their ability to claim activities that enable the research outcomes to be translated into a commercially viable format, whether that is a product or process. In essence, this relates to establishing the feasibility of the R&D outcomes prior to implementation. If the Frascati Manual is to be used as a benchmark, then it should be noted that it accepts "feasibility studies on research projects are part of R&D" at paragraph 73, section 2.2.2. At present, a number of the activities currently excluded as being considered "core R&D" activities, but allowable as "supporting activities" are activities food sector companies would undertake as part of establishing feasibility.

Flavour SA can see the dilemma for the Government. On the one hand, large companies can leverage large amounts of supporting activities that are out of proportion to the core R&D activities underpinning their relevance, thus the subsidies are out of proportion to the perceived public benefit and the subsequent level of claim liability could make the scheme untenable. On the other hand, small SME's such as those represented by Flavour SA, will be unlikely to utilise the scheme if the new approach to supporting R&D is too stringent. There may be a case for developing one set of rules for companies with a turnover of less than $20 million, and another set of rules for larger companies around this principle.

**Recommendation**

Flavour SA ***STRONGLY*** recommends the Government differentiates between the requirements of companies with a turnover of less than $20 million and larger companies when developing the new limitations for claiming supporting (non-core) activities under the new R&D tax incentive.

- ***Question 4***

  Should supporting activities:

  a) be capped as proportion of expenditure on core R&D?
     i. If so, what would be the appropriate proportion?
  b) only be eligible where they are for the sole purpose of supporting core R&D activity?
  c) exclude production activities or dual role activities?
  d) only be eligible on a net expenditure basis?
  e) attract a lower rate of assistance than core R&D?
     i. If so, what would be the appropriate rate

**Recommendation**

Flavour SA ***STONGLY*** recommends supporting activities be eligible where they are ***predominantly*** for the purpose of supporting a core R&D activity ***and/or enable the commercial feasibility of the R&D outcomes to be established***.

- ***Question 5***

  *Should the current list of activities excluded from being considered core R&D be:*

  *a) amended in any way?*

  *b) Extended to exclude certain activities from being considered supporting activities?*

Flavour SA ***STRONGLY*** disagrees with the proposal by Government that it extends the application of the current list so that no R&D tax incentive will be available for any activity included on the exclusion list either as core or supporting expenditure. Flavour SA ***STRONGLY*** reiterates that a number of the activities on the core R&D exclusion list are fundamentally important to either core R&D activities or feasibility studies likely to be undertaken by SME's in the food industry. Without the capacity to claim these activities, Flavour SA ***seriously doubts*** any of its constituents would consider applying to the new R&D tax incentive scheme.

Activities on the current exclusions list of particular importance for food companies represented by Flavour SA are:

*a)* *market testing*
- as it applies to sensory evaluation of new products (by example)

*b)* *quality control*
- as it applies to meeting food safety regulations (by example)

*d)* *the making of cosmetic modifications or stylistic changes to products, processes or production methods*
- as it applies to the modification of the organoleptic qualities of particular food items (by example, and as detailed in part B4-7 of the current "Guide to the R&D Tax Concession")

*e)* *efficiency surveys*
- as they apply to food processing practices (by example)

*h)* *pre-production activities such as demonstration of commercial viability, tooling-up and trial runs*
- as they apply to feasibility studies for products and/or processes (by example)

*l)* *activities associated with complying with statutory requirements or standards*
- as they apply to food safety and food fortification regulations (by example)

**Recommendation**

Flavour SA ***STRONGLY*** recommends the current current list of activities excluded from being considered core R&D ***NOT*** be extended to ***exclude*** certain activities from being considered supporting activities.

## Access to the New Incentive

- ***Principle 1***

  *The new R&D tax incentive will be available to companies incorporated in Australia for R&D conducted in Australia. Location of ownership of the resulting IP will not be relevant.*

Flavour SA agrees with the intent of the R&D tax incentive that it should primarily support eligible R&D activities undertaken in Australia exclusively by Australian incorporated firms. Flavour SA generally supports points 15-22 and 28-34 as outlined in the Consultation paper.

- ***Question 1***

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

Flavour SA favours the retention of the current rules for the R&D tax concession as they relate to the ability of a claim for Australian-owned R&D to include R&D conducted overseas where the activities cannot by conducted domestically and provided it does not exceed 10% of the claimed expenditure. Undertaking a sensory evaluation for a new food product, developed as part of a core R&D project but with export potential, in the target international market provides an example of where it would be beneficial for a food company to claim R&D performed overseas. Whilst sensory evaluation to determine product suitability is achievable within Australia for the Australian market, it is not commercially viable to assess the sensory characteristics of a product in anything other than the intended market.

**Recommendation**

Flavour SA recommends retaining the capacity to claim R&D conducted overseas provided it does not exceed 10% of the claimed expenditure.

## Administration

- ***Principle 4***

  *Legislation for the new R&D tax incentive will provide support for the scheme's efficient and effective administration.*

Flavour SA supports the development of an administrative framework enabling the ability of claimants to self-assess their eligibility and entitlements. Flavour SA supports a streamlined approach to administering the new R&D tax incentive by the ATO, Innovation Australia and AusIndustry.