# Submission

The New Research and Development Tax Incentive

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Our client base has historically been privately owned businesses, and their owners, although we now have a substantial share of large corporations. Many of the views we express are on behalf of privately held businesses, being a very significant part of the Australian taxpayer base.

# Introduction

We appreciate the opportunity to provide our comments and input into the design of the new R&D tax incentive.

Our comments are in relation to the Treasury Consultation Paper released for comment on September 2009.

We acknowledge that the Consultation Paper is intended as a forum for comment and discussion and does not necessarily represent settled Treasury policy on the issues raised.

The key message in our submission is to ensure that the measures taken to ensure a cash basis revenue neutrality over the first four years is carefully considered against imposing a system that is overly restrictive and may act as a disincentive to desired R&D activity.

# 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."

### Companies incorporated in Australia

We support the principle that access to the R&D tax incentive should be limited to companies with a presence in Australia. This supports the need for Australian R&D tax incentive to support and reward R&D activities that benefit the Australian economy.

### Tax exempt entities

An issue with the current R&D tax concession is the restrictions it places on companies, who would otherwise have satisfied the criteria for the tax-offset. The restriction currently imposes a 25% ownership cap by tax exempt entities.

The imposition of the 25% cap can be a disincentive for smaller companies to collaborate with tax exempt entities such as universities and hospitals.

The proposed lifting of the cap to 50% will provide greater flexibility to smaller companies in establishing collaborative relationships with larger tax exempt entities. All things being equal, this measure should encourage greater participation by smaller private companies.

We note that the Consultation Paper sees the lifting of the cap to 50% as a way to "…encourage collaboration between those entities and small firms while still providing some protection against the R&D Tax Credit being used to fund non-business R&D (that receive public support through other programs)"[1].

The collaboration between business and tax exempt institutions is a critical step for assisting the development of valuable R&D. The value of the contribution of resources and skills provided by private companies to tax exempt institutions must not be underestimated.

The purpose of the R&D tax offset, which is to be replaced with the refundable tax credit, is to assist smaller companies with the funding of their eligible R&D activities. This is in recognition of

[1] Consultation Paper, paragraph 22

the funding and capitalisation issues associated with smaller companies and a desire to encourage smaller companies to participate in R&D.

A restriction which affects a smaller company's access to tax exempt collaborators will not only affect the company in question, it also restricts the tax exempt entities ability to source external collaborators.

Although the proposed measure will not legally prevent smaller companies from forming collaborative arrangements with tax exempt entities, economically, it puts them at a disadvantage if they exceed the 50% ownership cap. This is due to the 45% refundable tax credit being disallowed and instead, the 40% non refundable tax credit would be available.

Therefore, all else being equal, the R&D entity would have a funding gap. In this case there would be a disincentive for smaller companies to participate with tax exempt entities compared with other options available.

Ideally, the ownership cap should be removed. However, in recognition of the need to provide a protection against the tax credit funding "non-business R&D"[2], we suggest that the cap test be modified to a reducing refundable tax credit.

For example, retain the 50% cap as proposed, and when the 50% cap is exceeded, the entitlement to the refundable tax credit reduces in proportion to the excess over the 50%. This will ensure that, to the extent of the tax exempt ownership above the 50% cap, the R&D entities entitlement to the refundable tax credit reduces in proportion.

## R&D to be conducted in Australia

### Location of IP ownership not relevant

"Question 1

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

The issue of IP ownership overseas has proven to be restrictive for groups that operate in multiple jurisdictions. There are many reasons why IP is held overseas. Reasons can include, overseas parent company location, government regulations on IP ownership and asset protection.

For example, it is common for IP to be held centrally with other group entities being granted usage rights or a limited license for operating in their relevant jurisdiction.

Given Australia's recent demonstration of relative financial stability, along with its stable political environment and highly educated workforce, interest in Australia has grown.

In our discussions with clients and other interested parties, it is evident that Australia is recognised as a desirable location for undertaking R&D activities.

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[2] Consultation Paper, paragraph 22

Given the growing interest in Australia as an R&D destination for global groups, we encourage the move to R&D being based on where the activity is being conducted, rather than only where the IP ownership resides.

This will encourage overseas funding of R&D research in Australia with the spillover benefit of further educating an Australian workforce.

## The 'on own behalf' rules

The so called 'on own behalf' rule is a critical integrity component of the R&D tax incentive. It ensures that the criteria is set to identify which entity is entitled to make a claim for the eligible R&D activity and therefore reduces the likelihood for more than one entity being eligible to claim the same R&D expenditure (ie prevents multiple claiming).

In principle, it is recognised and accepted that protections need to be in place to prevent multiple claiming of the same eligible R&D, however the 'on own behalf' rules can be difficult to apply in practice.

Although the complexity of this rule has been recognised in the past by all the relevant administration parties (ie ATO, Innovation Australia and AusIndustry), little guidance has been released to assist R&D tax concession claimants.

As noted in the Consultation Paper under the heading 'Administration', the parties empowered to administer the new R&D tax incentive need to be collectively able to 'provide appropriate levels of guidance and certainty to claimants"[3]. In this regard, a critical component must be to provide the appropriate level of guidance and certainty to claimants on the application of the 'on own behalf' test.

### Further clarification of the 'on own behalf' test

Given the complexity of the 'on own behalf' test, particularly where more than one party may be taking the financial and technical risk of an eligible R&D project, perhaps an appropriate way of dealing with this is for all parties to make an express written agreement of which entity is entitled to claim the R&D.

This would be particularly relevant in the case of contracted R&D, where it can be difficult to ascertain whether it is the principle or contractor who is bearing the technical and financial risk.

[3] Consultation Paper, paragraph 46.

# The New R&D Tax Credits

### Standard R&D tax credit

"Principle 2

The Standard R&D Tax Credit will be available at a rate of 40 per cent for eligible R&D expenditure and can be carried forward where a company's income tax liability is zero."

The introduction of a 40% non-refundable tax credit (which equates to a 133% tax deduction) is a welcome change, especially when compared with the current 125% R&D tax deduction. It is an intended consequence of the new R&D tax credit system to replace both the 125% and 175% R&D tax deductions.

As the credit can be carried forward, clarification will need to be provided as to whether the recoupment of the credit against tax payable in future years will be subject to recoupment tests.

If a recoupment test is required, we suggest that it be made to align to the carried forward tax loss recoupment tests to ensure that the claimant is not subject to an additional test beyond the test it would normally have to apply to recoup its tax losses.

### 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."

The 45% refundable tax credit and its linking to a less than $20 million turnover test represents a substantial broadening of the eligibility to a potential cash rebate to a larger number of small companies when compared to the existing R&D tax offset.

As discussed in the following sections, there are concerns as to how, once introduced, certain restrictions are being contemplated to reduce the overall revenue cost. As noted in the introduction to the Consultation Paper "on an underlying cash basis, implementation of the new R&D tax incentive is to be revenue neutral over its first four years of operation."[4]

We understand the need to retain control over the overall cost of the new R&D tax concession package, however in doing so, it needs to be carefully weight up against the intention of the R&D tax incentive and the SME R&D activity it is intending to encourage.

Overall, the integrity measures incorporated in the R&D tax incentive package should not be so complex and restrictive as to act as a disincentive to R&D activity, particularly with the SME sector.

### Non-enhanced deductions

## "Question 2

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

As noted in the Consultation Paper, the current R&D tax incentive allows companies to apply the R&D tax offset to non-enhanced deductions. It is further acknowledged in the Consultation Paper that differential treatment of the non-enhanced deduction may lead to an "…undesirable level of complexity…"[5].

We submit that this area be treated consistently with the existing R&D tax concession, particularly giving regard to the changes proposed to further reduce the eligibility of supporting R&D activities.

### Payments to associates

## "Question 3

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

We do not support the introduction of an R&D tax incentive which distinguishes between associate and non-associate parties.

Where a company accounts for income tax on an accrual basis, any dealings it has with associated parties will also be accounted for on an accrual basis for tax purposes. Therefore, income will be assessable when derived and tax deductions will be claimed when incurred.

If the expenditure under the R&D tax incentive was required to be claimed on a cash basis, this would add to complexity as companies would need to identify and track these transactions. This would also lead to a differential treatment between the company's income tax and R&D tax incentive reporting.

The fact that the other party is an associate should make no difference to the company's eligibility and timing of an R&D claim compared to dealing with a non-associate.

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[4] Consultation Paper, paragraph 14.
[5] Consultation Paper, paragraph 40.

# Administration

“Principle 4

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

One issue with the exiting R&D tax concession is confusion resulting from the shared responsibility of administering the system between the ATO, Innovation Australia and AusIndustry.

The confusion mainly stems from the lack of guidance and clarification on key interpretations and administration (such as the ‘on own half’ rule discussed previously).

Under the existing R&D tax incentive, the ATO and AusIndustry jointly published the “Guide to the R&D Tax Concession”. This document has come a long way in clarifying many of the interpretation and administration issues. We encourage the use of this process into the new R&D tax incentive with a view to further expanding its use.

# Eligible R&D Activity

"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 associated subsidy."

One area of particular concern is the proposed 'additionality and spillovers' test as outlined in the Consultation Paper.

As stated in the above Principle 5, the new R&D tax incentive should target R&D that is in addition to what would have otherwise occurred.

There are three key concerns with the building of the additionality and spillover test into the definition of eligible R&D, they are:

1. How does one practically measure what would have otherwise occurred;
2. The additional compliance and administration required to administer the test; and
3. The impact it will have on specific industries, especially industries that perform R&D activities as part of their normal business activity (ie they need to do the R&D regardless of whether or not there is an R&D tax incentive).

In the joint media release dated 12 May 2009 of The Hon Wayne Swan MP and Senator the Hon Kim Carr announcing the new R&D tax credit incentive, the stated objective of the new incentive is to introduce "…a simplified R&D Tax Credit which cuts red tape and provides a better incentive for business to invest in research and innovation."

Therefore, in designing an R&D tax incentive system based on an additionality and spillovers principle, care needs to be given to not building a test that's adds to the compliance and administration burden, which has the potential to act as a disincentive to R&D activity.

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."

The inclusion of the 'and' test to the eligibility criteria will prevent R&D projects that qualify under the existing incentive to be eligible under the new incentive.

Although this is a contemplated consequence of making the change to the definition of an eligible R&D activity, it will affect on-going R&D activities. Therefore should the change to the eligibility criteria be made, consideration should be given to the transition of continuing activities that currently qualify under the existing scheme which will cease to qualify under the new incentive.

The rational for requiring both innovation and technical risk is innovation without technical risk will not satisfy the 'additionality' test and technical risk without innovation will not satisfy the 'spillovers' test.

Following from our comment is relation to Principle 5, the imposition of both the additionality and spillovers test needs to be carefully considered against the intent of the R&D tax incentive to simplify the incentive and to encourage companies to invest in research and innovation.

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.

We acknowledge the intent of the Consultation Paper is to introduce a limitation of some kind to supporting R&D.

However, a concern with the introduction of an R&D tax incentive system that seeks to eliminate or reduce its application to supporting activities is the flow on affect it will have on core R&D activity.

In essence, the supporting R&D activity is often a critical element in the success of the core R&D and without it, the Core R&D may fail, or the company may choose not to proceed with the R&D activity.

"Question 4

Should supporting activities:

(a) be capped as a proportion of expenditure on core R&D?

(i) If so, what would be the appropriate proportion (for example, 1:1)?

(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 be?"

### Capped as a proportion to core R&D

Capping as a proportion to core R&D, although simple to apply from an administration/compliance perspective, is arbitrary and does not recognise what level of support R&D is necessary for the success of the relevant R&D project.

Therefore, in this case, a capped expenditure may discourage a company from spending the necessary amount on appropriate supporting R&D.

Furthermore, the actual cost of the core R&D  may not be known until the end of the year, so it could be difficult for a company to manage their core/supporting R&D spending ratio.

### Sole purpose test

A sole purpose test would be more acceptable for an intention to trace non-core R&D that is necessary for the core R&D.

There is a concern that applying a sole purpose test would be overly restrictive and difficult to pass.

As noted in the Consultation Paper, this test would exclude activities that are undertaken partly for non-R&D purposes.

As suggested, a compromise for easier compliance could be to soften the sole to a predominately test.  In the context of this test, we would be supportive of a predominately test compared to the sole purpose requirement.

### Excluding production and dual purpose activities

This would be a difficult test to apply in practice. As noted in the Consultation Paper, this is an element of the UK and Canadian systems.

One of the issues associated with this test, particularly in the UK, is the subjectivity on interpretation of which activities are included and excluded. This is an issue that is causing disputes between taxpayers and the revenue authorities.

Given the other options put forward, we suggest that this option not be considered.

### Net expenditure only

The existing R&D tax concession is built on the basis that the claimant has undertaken an activity which involves a degree of technical and financial risk.

This assessment is made before the commencement of the R&D activity. Whether or not the project ends up commercially feasible and commercially successful is mutually exclusive.

The introduction of a net expenditure or recoupment approach will require a method of measuring what the recoupment is/will be.

As a general principle, the realisation from an R&D activity through sale of the results/bi-product/trading stock or contract would be assessable income and offset the tax benefit gained from claiming the R&D tax concession (although not assessed at the R&D tax credit rate).

The expected revenue generated during or from the R&D activity may be anticipated and never realised, or an opportunity created after commencement of the project. Therefore it would be difficult to predict and be applied against the R&D tax concession claim.

The Consultation Paper also contemplates the complexities of drafting the rules to cover the recoupment approach and whether different industries should be subject to different rules.

Based on the perceived complexities for introducing the recoupment approach, we submit that this option not be considered.

### A lower rate of assistance for supporting activities

Similar to the discussion on capping the amount of supporting R&D that can be claimed, a lower rate of assistance may lead to a disincentive to undertake the necessary supporting R&D that is essential to the success of the overall R&D project.

### Excluded activities

"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?"

The prevention of listed excluded activities from being considered supporting activities may lead to a disincentive to undertake the necessary supporting R&D that is essential to the success of the overall R&D project. Our comments under supporting R&D activities apply.

# Conclusion

**In summary**, we appreciate the opportunity to provide comments and input into the design of the new R&D tax incentive.

We also look forward to contributing in more detail as the design of new R&D tax incentive progresses to draft legislation.