The Institute of Chartered Accountants in Australia

26 October 2009

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By email: rdtaxcredit@treasury.gov.au

Dear Paul

The new Research and Development (R&D) Tax Incentive

The Institute of Chartered Accountants in Australia (the Institute) welcomes the opportunity to comment on *the new Research and Development tax incentive* consultation paper (the paper) and provide our input into the design and implementation of the new tax credit proposed to commence on 1 July 2010.

The Institute is the leading tax and accounting professional body in Australia. Our reach extends to more than 62,000 of today's and tomorrow's business leaders, representing over 50,000 Chartered Accountants (CAs) and 12,000 of Australia's best accounting graduates who are currently enrolled in our world class Chartered Accountants postgraduate program.

Overall, the Institute welcomes the Government's initiative to replace the existing R&D tax concession with a more streamlined and better targeted R&D tax incentive. In particular, we are very supportive of a number of aspects, including:

- the introduction of a refundable tax credit for small to medium-sized companies (under $20 million turnover);
- an increase in the effective rate of tax savings from 7.5 cents in the dollar to 10 cents in the dollar for large companies ($20 million turnover or more) and 15 cents in the dollar for small to medium-sized companies; and
- streamlining of the incentive by removing layers and complexities, such as the 175% Incremental Concession.

In redefining the scope of the R&D tax incentive, the Institute is hopeful that the Government will seize the opportunity to simplify the incentive by adopting a broad-based, principled approach so as to minimise complexities and increase certainty and efficiency in the system for claimants.

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We applaud the Government for its commitment to undertaking a full consultation process with industry and the profession on the new R&D tax credit. We believe that it is most productive to have the opportunity to contribute to the design of the incentive at this stage, prior to the release of the Exposure draft legislation later this year. In the attached Appendix, we outline our key comments and recommendations in response to the paper.

Overall comments

The Institute notes a desire that the new R&D tax incentive be revenue neutral over its first four years of operation (assuming the level of underlying R&D is constant). From a policy perspective, revenue neutrality should not be an objective in the design of legislation for an R&D incentive intended to have a life of at least one (preferably two) decades, given that was the duration of the outgoing R&D tax concession. Whilst anecdotal evidence, contained in the Cutler report and Innovation Australia commentary during consultation processes, indicates that current scope of the eligible R&D activities will need to be tightened, this is no substitute for good design of the new incentive. An incentive that encourages Australian companies to innovate through development of new products, processes and services should achieve the Government's desired outcomes of "additionality" and "spillover" benefits.

The manner in which the definition of "eligible R&D activities" is tightened is critical. It is important to ensure that much of the traditional R&D activity that has formed the mainstay of industrial innovation in Australia continues to be incentivised for the benefit of the Australian economy. Much tighter legislation would most likely make it easier for AusIndustry and the Australian Taxation Office (ATO) to administer because a significant level of currently claimable R&D would not be allowable.

In our view, the definition of "eligible R&D activities" must be crafted in a way that appropriately targets subsidised activities, without altering the essence of the current concession. That is, we see it as central to the success of the new R&D tax credit that it continues to support not just the 'research' aspect of R&D, but also the vital 'development' side if it is to deliver maximised additionality and spillover benefits to the public.

As the Cutler Review panel observed in its report on innovation[1] to the Government last year, the R&D incentive forms part of a broader set of objectives which seek to encourage, through the Government's industry and technology policies, the development in Australia of internationally competitive, export oriented, innovative industries.[2] If the incentive is cast too narrowly in its scope or is overly restrictive in the 'developmental' activities that it supports, it could discourage take up of the incentive and risk rendering the credit effectively redundant as an industrial incentive.

The Government's stated intention is to achieve greater 'bang for the buck', that is, to actually increase the overall uptake of R&D, while maintaining the R&D budgetary spend. The Institute is eager to work with the Government and Treasury in designing and implementing the new R&D tax credit to ensure that these outcomes are achieved.

We would appreciate the opportunity to meet with you to discuss our ideas in this submission in further detail. **The Institute would welcome the opportunity to put forward some substantive alternatives to the Treasury proposals, particularly to assist in the development of principle-based definitions that we believe should deal with perceived concerns relating to large marginal claims, yet encourage Australian industry to adopt innovation as an essential and constant aspect of operating successful, growing businesses.**

1 *Venturous Australia - Building Strength in Innovation*, Review of the National Innovation System., Cutler & Company Pty Ltd, 2008, Chapter 8, p 102

2 House of Representatives, *Income Tax Assessment Amendment (Research and Development) Act 1986*, Second Reading Speech

Should you have any questions in relation to any aspect of this submission, please do not hesitate to contact me on (02) 9290 5623 or Donna Bagnall on (02) 9290 5761.

Yours sincerely

Yasser El-Ansary
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The Institute of Chartered Accountants in Australia

Key comments and recommendations

Our key high-level comments and recommendations in response to the paper are as follows:

1. Eligible R&D activities

The Institute supports the Government's desire to ensure that the new R&D tax credit only subsidises appropriate activities. In particular, we acknowledge the stated policy intent to redistribute the $1.4 billion program budget, with a view to achieving the maximum additionality and spillover benefits over time in return for the public R&D spend.

When tightening the scope of "eligible R&D activities", however, the Institute reiterates our comments to the Cutler panel last year that we caution against making significant changes to the definition which has been long-standing and is based on the international norms established by the Frascati Manual. In this regard, we understand that the new R&D tax credit is to be re-written in plain English language and included in the *Income Tax Assessment Act 1997*. In doing so, it should be borne in mind that there is a large body of established precedent and administrative interpretation existing in relation to the current definition and terminology in section 73B of the *Income Tax Assessment Act 1936* which provides certainty to taxpayers on the scope of the incentive. Overall, we consider that the removal of this certainty by introducing new terminology would outweigh any perceived advantages which could be gained.

In this vein, the Institute is pleased that the Government has signalled both in the paper and its recent public consultation sessions that the wording of the definition of "eligible R&D activities" will not be completely re-written with a new structure or new terminology.

We note however that the following two significant changes are proposed:

1. the definition of core R&D will require activities to involve *both* innovation *and* high levels of technical risk, i.e. the current "or" in the definition will be changed to "and";

2. supporting R&D activities will continue to be recognised, but claims will be subject to new limitations.

As a general statement, the Institute's preferred approach is to fine-tune the existing definition of "eligible R&D activities" by limiting the scope or extent of 'supporting' activities, as opposed to altering the essence and established industry understanding of 'core' activities. We now discuss this in greater detail, offering some examples to illustrate our view.

1.1 Core R&D activities

The Institute has long held the view that the definition of 'core R&D' should be maintained as one requiring activities which involve either "innovation *or* high levels of technical risk". Our current opinion on this issue remains unchanged.

In our view, altering the requirements for core activities such that they must involve *both* innovation *and* high levels of technical risk would represent a departure from the Frascati model and would likely make Australia's R&D definition among the most onerous in the world. We consider that such a change could potentially eliminate many of the traditional R&D activities that are currently supported by the R&D concession, particularly if the narrow view of "innovation" taken by many AusIndustry assessors is to prevail under the new tax credit.

Many of the arguments against requiring core activities to involve both innovation and high levels of technical risk were raised before the Senate in 2001[3] in relation to a proposed amendment to introduce a dual test at that time. Some of the reasons for which the proposal was rejected included:

- the definition of R&D in the Frascati Manual, the generally accepted norm by OECD member states, requires activities to be evaluated "in combination";
- since increasing the threshold test to require "high levels" of technical risk in 1996, the evidence indicated that the amended definition had proved sufficient to exclude ineligible activities from the benefit of the tax concession; and
- the impact of a requirement for activities to satisfy both criteria was not understood in a context where there were widely-differing interpretations of the definition of "innovation" between government and industry.

The Institute believes that these arguments remain equally valid in the context of the current proposal to change the "or" to an "and" in the definition of 'core' R&D activities. The only challenge present today that was not evident in 2001 relates to the Government's desire to restrict the cost of the concession to $1.4 billion per annum.

If the Government determines that it is desirable to go down the path of changing the requirements of R&D to involve both innovation *and* high levels of technical risk, in our opinion this should only be instituted at the project level, not the activity level. That is, an overall project would be required to contain elements of both innovation and high levels of technical risk, for example, as specified in its objectives and as between its core activities. We consider that this would address the Government's policy that the incentive should be directed towards subsidising endeavours that are both innovative and technically risky.

In this respect, projects that only contain one of the dual requirements would be excluded. As such, projects that currently qualify for support, but which can only demonstrate that one of the two requirements are present in their technical objectives and overall core activities would no longer be able to access the incentive.

An example of a project that would not qualify under the requirement for satisfying both innovation and risk requirements would be in a mining project where traditional drilling methods are used to extract ore that is to be the subject of traditional mineral processing methods. Whilst such a project may have technical risk (because of unknown ore characteristics), unless a new technique was being applied, the project would not be likely to qualify. We note in passing that such scenario should not in our view be eligible under the current definition in any event, as a person experienced in the field could predict the outcome.

Regardless of whether the test is dual or alternate, but particularly if both concepts are required to be met, we consider that it is important that the definition of "innovation" be amended in line with the OECD definition in the Frascati Manual. In this way, the current fuzzy concept of "appreciable element of novelty" would be replaced with a more certain and meaningful definition specifying that "innovation" encompasses the following:

- patentable results
- new processes
- existing technology applied in a new way
- new knowledge; and
- integration of two or more different technologies (synergies).

As R&D is rationed expenditure, if Australia has an overly narrow definition for accessing the incentive, it will become uncompetitive. The current definition has lead to R&D assessors interpreting "novelty" very narrowly, requiring the subject matter to be a world first or the only one in the world.

3 Senate Economics Legislation Committee, Report on the Taxation Laws Amendment (Research and Development) Bill 2001, September 2001

We see this as especially detrimental to SMEs who often gain their competitive edge by being an adaptor of existing technologies. In our view, the OECD definition is the most appropriate, and reflects the fact that innovation can be seen to exist in many ways that do not involve world firsts. It is often through many small steps that paradigm shifts in performance are achieved. Resolving high levels of technical risk also creates new knowledge and is therefore an innovative activity, even if the end result is not itself innovative. The Oslo Manual[4] definition also illustrates that "new" ought to include new to the company.

So that the meaning of "innovation" provides the necessary certainty for claimants and administrators, we consider that the definition needs to be enshrined in legislation, not just proffered administratively in sectoral guidance.

By contrast, we believe the definition of "high levels of technical risk" should be retained as it stands. It is appropriate and clear, and consequently is well understood and accepted by scientists, engineers and assessors.

1.2 Supporting R&D activities

The Institute recognises that there is a need to limit expenditure on activities that are not directly related to the experimental development aspects of a group of activities or project.

The Institute notes that the Government has identified instances under the current definition of 'eligible R&D activities' where large amounts of supporting activities can attract subsidies that are considered to be out of proportion to the public benefit. We understand that principal areas of concern include "whole of mine" claims, production trials and localisation/integration of large software projects.

In this respect, Question 4 of the paper raises five possible options for establishing a limitation on supporting activities, namely:

(a) capping them as a proportion of expenditure on core R&D;
(b) making them eligible where they are for the sole purpose of supporting core R&D;
(c) excluding production activities or dual role activities;
(d) only allowing eligibility on a net expenditure basis; or
(e) allowing a lower rate of assistance than core R&D.

As they are currently presented, the Institute does not favour any of the five approaches above. Indeed, many of the proposed solutions do not go to the heart of addressing the mischief identified. As a principle, seeking to plug perceived loopholes and definitional inadequacies through legislation is in our view vastly inferior to defining allowable activities having regard to internationally recognised and workable principles.

We note that Treasury has not modelled the potential impact of any of the changes. The paucity of evidence, due in part because current claims do not isolate the nature of claimed activities, makes it difficult to predict the impact of any or all of the changes. As a starting point, the saving that will be delivered through removing the 175 per cent Incremental Concession should be factored into the equation. This is not an ideal starting point for developing definitions with a desired 'decade plus' longevity.

Capping

Broadly, the Institute has a preference against approaches involving recoupment (option d) or capping (option a), as this tends to fail to deliver certainty to taxpayers, in terms of the level of after-tax benefit they can anticipate deriving from particular strategic expenditure.

4 Chapter 3, paragraph 148

We see the proportionate capping approach (option a) as creating inequities since different sectors have a different standard mix of core and supporting activities, with the effect that a single rule would impact different sectors to differing degrees. Caps also lead to complexities in the law as can be seen from the 175 per cent Incremental Concession. We believe we should learn from those experiences and aim for simplicity in designing the new tax credit. Complexities include calculation issues, i.e. whether the ratio is calculated on an annual basis or project life basis, and whether adjustments would need to be made since expenditure on core and supporting activities for a project may not be uniform throughout the life of a project.

Net expenditure basis

Similarly, the net expenditure option (d) is uncertain and places a level of contingency on the entitlement that is unquantifiable indefinitely until it becomes known whether proceeds are derived in connection with the R&D activities. The Institute does not support the philosophy underlying this approach which appears to be that only unsuccessful projects warrant subsidising. We consider that this runs contrary to the object of the incentive to develop productive, globally competitive industries in Australia.

Lower rate of assistance

In our view, option (e) is also philosophically counterintuitive when viewed in light of the policy to subsidise core activities at a certain level of assistance. Reducing the level of assistance to supporting activities naturally reduces the level of support for core R&D activities. On this basis, the Institute believes that the rate of assistance for all eligible R&D activities should be the same. On a practical level, we also see that introducing two separate rates of assistance creates an undesirable compliance burden and administrative complexities in terms of capturing the time spent on activities after classifying them as supporting activities and isolating such time in the case of blended activities, so that a different tax credit rate can be applied.

Sole purpose test

In relation to option (b), the Institute considers that this approach is undesirably restrictive and in practice is such a high threshold that very few developmental-end supporting activities would qualify. This is because the test invites such a narrow interpretation that any non-R&D purpose (or intention) could exclude a supporting activity from eligibility. As acknowledged in the paper, all production trials would appear to be excluded under this test, which the Institute could not support due to their important role in the developmental R&D phase. This is discussed in greater detail below.

If the purpose test were varied to a “substantial purpose” test, in our view, this may provide a more appropriate threshold test as it would allow some production trials to be eligible, while filtering and excluding those that have gone beyond a substantially R&D phase. We consider that a “substantial” purpose test is to be preferred over a “predominant” purpose test as this is a more suitable threshold for establishing the desired nexus to warrant subsidising the activity as part of R&D. We believe that the relevant inquiry is whether the R&D would be impaired if the activity was not conducted, i.e. if it is necessary. If it is necessary, then a sufficient R&D purpose can be demonstrated. On this basis, we consider that a “substantial” purpose would be an appropriate threshold level for establishing that an activity is for the purpose of R&D.

Production trials or dual purpose activities excluded

Option (c), which involves specifically excluding production trials or dual purpose activities, appears to be similar to option (b) but is framed as a negative test. As mentioned above, the Institute does not support the complete exclusion of production trials, nor do we consider that eligibility should be restricted where any dual purpose can be identified, regardless of how minor.

We do recognise however, that the area of production activities, in particular very large and extended production trials, is one of the perceived revenue 'leakage' areas which the Government is seeking to tighten. Accordingly, the Institute considers that the limitation to the definition of supporting activities should focus on how best to restrict the eligibility of production trials so as to achieve the appropriate balance in the extent to which they are subsidised.

International approach for production activities

As a broad principle, we contend that the eligibility of production activities should be assessed by reference to and commensurate with the needs of the R&D. That is, for example, if the production activity is in a phase where it requires additional line operators and supervisors to monitor and resolve technical issues, such needs indicate that the production activity is still in an experimental R&D phase. This proposition is also consistent with the principles in the *Mobil* case[5].

In this regard, the Institute notes that several other R&D jurisdictions have the concept of "experimental development" incorporated into their schemes, such as Canada and the UK. In the UK, guidance issued on the eligibility of activities in an engineering context notes that "R&D generally includes the development of a piece of fundamental research up to the production stage". In the guidance, it is recognised that "there may be difficulties in distinguishing experimental development from pre-production development", but that "the basic rule here is to look at the primary objective of the work undertaken. If the primary objective is to make further technical improvements on the product or process, then the work comes within the definition of R&D." The guidance then observes that the treatment of prototypes and pilot plant provides an example of this experimental development phase of R&D work.

Similarly, Canada grants eligibility for experimental production and experimental development occurring with commercial production. These concepts again recognise that activities are still in an R&D phase where an experimental production trial is required predominantly to verify whether the technical objectives have been met or a technical advancement is achievable. We understand that this approach has worked well in Canada and the "experimental" criterion has provided an appropriate filter for distinguishing between R&D and production activities.

Interestingly, we note that the Canadian economy is similar to Australia's in several key respects in that it has significant mining and financial services sectors. For this reason, the Canadian approach may provide an instructive precedent as to how workable limitations for eligible supporting activities might be designed to strike the appropriate balance for subsidising R&D in these key industries.

Preferred approach for production activities

The Institute therefore recommends that the Government consider introducing a definition of supporting activities which incorporates terminology similar to the Canadian model, whereby all production environment activities must be experimental or directly related to the experimental process to be eligible, and supporting the core R&D must be the substantial purpose.

Clear administrative guidance, such as that in Canada Revenue Agency Policy No. 2002 - 02R, would also be required to clearly outline the accepted methodology for determining allowable expenditure.

We submit that development of prototypes and pilot plant should continue to be eligible as originally intended.

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5 *Re Mobil Oil Australia Ltd & Industry Research & Development Board* 95 ATC 2042

2. Excluded activities

We consider that certain activities could be removed from being 'core' R&D, where they are regarded as falling outside the intended policy scope for support, by including those additional activities in the list of excluded 'core' activities (the current ss73B(2C)). In addition, certain supporting activities could be expressly excluded from eligibility under this provision.

In doing so however, care needs to be taken, as emphasised above, to ensure that the R&D tax credit adequately supports the process of bringing new ideas to a state where they can be commercialised. The main impediment to the realisation of benefits from R&D is in having commercially viable technology. Therefore, simply excluding from R&D claims all together some of the supporting activities listed in ss73B(2C) would mean that the R&D credit excludes some of the more commercially risky and crucial activities in bringing new ideas to market (e.g. clinical trials, factory trialling).

In principle, as discussed above, experimental production and experimental development occurring with commercial production should be distinguished and specifically allowed. As outlined above, this could be achieved by incorporating these limited 'experimental' R&D activities into the definition of eligible supporting activities.

If the Government considers it appropriate to go down the path of special sectoral rules to address concerns that there is an increasing trend of extensive projects, large claims and disproportionate assistance in certain industries (for example mining, infrastructure and software) then the Institute's comments are:

- The claims in these sectors are large because the scale of expenditure in these sectors is large, as is the scale of the taxable income contributed by these sectors to the Australian revenue and the Australian economy; and
- We would caution that any special sectoral rules should give due recognition to the Australian risk-taking spirit and Australia's established track record of developing world first innovations in these key sectors. The R&D policy should ensure that appropriate ongoing support is provided to these ventures.

3. Software

The paper observes that the R&D treatment of software is a complex area and invites comment on suggested alternative approaches. The Government states that it considers that the current multiple sale test under section 73B(2A) has become outdated as it no longer represents the policy intent in relation to software.

In Example 3 (Attachment A), an "internal software development and integration" project is provided as an illustration of the weakness the current multiple sale test on the basis that it allows large claims largely in relation to existing systems.

The Institute agrees with the Government that the 'multiple sale' test is no longer a relevant or appropriate test in today's world and needs to be updated, for example in light of the fast growing e-commerce economy. However, given the rate of innovation in software, industry should be closely consulted on any proposed changes to the multiple sale test to ensure that the impact of such changes is fully understood and appropriately calibrated to commercial activities.

Factors such as protecting the revenue, productivity gains and development of new service offerings will need to be carefully balanced. Software has been recognised as a key enabler and 'change agent', through which much innovation can take place in other traditional industries and across the economy. Given the role that software plays in supporting other innovation and as an enabler for innovative industries, the Institute would prefer an approach whereby:

- software development has the same generic test for eligible R&D activities as all other industries, as opposed to a specific sectoral rule for software R&D; and
- specific exclusions are used in a limited way, eg drafted appropriately to exclude low value-add in-house software development.

4. 'On own behalf' test – IP ownership and financial risk

The Institute welcomes the Governments intention to move away from the requirement to have intellectual property ("IP") ownership in Australia in order for R&D expenditure to be eligible. We consider that this shift accords with the change in trends towards global ownership of R&D results.

The IP ownership requirement is one of the three limbs of the "on own behalf" test in subsection 73B(9) of the ITAA 1936 which precludes an entity from claiming the R&D conducted "on behalf of any other person". The purpose of this provision was to prevent duplicate claims of R&D expenditure in respect of the same R&D activities.

The ATO's interpretation of the "on own behalf" test has to date required that three criteria be met, namely the claimant must:

- bear the financial risks associated with the R&D activities;
- have control over the activities; and
- effectively own the IP arising out of those activities.

The paper notes that the Government intends to retain the "on own behalf" test. The Institute considers that there is a significant amount of uncertainty around the application of these three tests, particularly where different types or degrees of ownership exist in respect of the IP, such as one entity legally holding the patent and another entity owning a right to use the patent. Ambiguities also arise as to how to apply the test where, for example, financial risks are shared.

Such uncertainty in relation to a fundamental threshold question as to whether an entity can claim the concession is undesirable and does not promote the objective of the tax credit to incentivise expenditure on R&D activities.

Another undesirable disincentive in the "on own behalf" test resides in the 'financial risk' requirement for foreign-owned companies. If a company in a corporate group carries on R&D activities in Australia, but its expenditure is reimbursed by another group company, such as its parent company, then subsection 73B(9) would preclude the company conducting the R&D activities from claiming the section 73B deductions in respect of its expenditure.

The Institute believes that this runs counter to the stated policy objectives of the Government (in introducing the 175 per cent International Premium) "to increase expenditure on R&D in Australia by multinational enterprises and to improve Australia's integration into global R&D value chains".

We recommend that the criteria to be satisfied for the "on own behalf" test be clearly codified in the new law, rather than rely on administrative interpretation. The outcome of the revised test should be to limit the restriction on claiming to situations of actual duplication. In addition, reimbursement by a foreign group company should not preclude a company from claiming R&D expenditure which is conducted in Australia.

5. Overseas R&D

In the Institute's view, the present rules that allow taxpayers to only claim a very limited deduction in respect of overseas R&D (capped at ten per cent of total project expenditure) are uncommercial and unnecessarily restrictive.

Those rules were introduced more than ten years ago and are outdated in the current global economy and comparative R&D regimes.

It is recommended that consideration be given to amending the rule for overseas R&D by:

- granting AusIndustry a discretion to allow more than ten per cent of the project expenditure, at least where the IP is owned in Australia; and
- calculating the ten per cent cap (or other percentage) by reference to a claimant's total annual eligible R&D expenditure, rather than project expenditure, with any undisclosed amount to be available for a three year carry forward.

6. Core technology expenditure

We consider that the present "core technology" expenditure rules should be reviewed and amended as they currently give rise to permanent 'blackhole' expenditure. For example, if the project is successful in the first income year and there is no R&D expenditure in the following year, any undeducted expenditure that is carried forward will never become deductible.

The Institute proposes that the rule should be changed so that undeducted expenditure becomes deductible at 100 per cent once the project is completed.

7. Clawback R&D expenditure

The Institute believes there is a need to move away from the retrospective clawback of grants. A company's net expenditure on R&D should be the subject of the tax credit. Given that the commercial ready grant program has been eliminated, the tax credit remains the cornerstone of innovation subsidisation. The level of grant support could be moderated to take into account R&D tax credit benefits (enabling the Government more options in targeted grants funding).

With regard to the quantum of the clawback, we consider that expenditure equal to the amount of any grant or subsidy should be subject to normal deductibility rules, since the grant or subsidy is assessable income. Any excess should then be eligible for the R&D tax credit incentive.

8. Non-enhanced deductions

The Institute is of the view that R&D expenditure which is currently treated as deductible at 100 per cent, such as interest and residual feedstock expenditure, should continue to be deductible under the general deductibility rules for large companies.

For small to medium-sized companies, we would agree with the proposal to provide an equivalent level of support as a refundable tax credit at the prevailing corporate tax rate, i.e. 30 per cent.

Core technology expenditure should be allowable as an ordinary deduction to taxpayers. The one-third of R&D spend rule (designed to counter R&D syndication) should be abolished. Consideration should be given for refundable offsets to be allowable for SMEs acquisition of core technology.

9. Eligible entities

The paper states that the incentive will be available to companies incorporated in Australia for R&D undertaken in Australia. As such, it proposes that only companies (or those treated as companies for tax law purposes) will be eligible for the new R&D tax credit.

The Institute considers that there is no reason from a policy perspective to draw a distinction between companies and other business structures in determining eligibility for access to the R&D incentive. We note that this approach was adopted for the New Zealand R&D tax credit.

All enterprises that innovate or engage in technological advancement activities for the benefit of the Australian economy should be entitled to participate in the benefits of the R&D regime.

The nature of R&D is highly collaborative, and as such often involves a variety of structures being adopted to undertake the R&D, such as partnerships, joint ventures, trusts and other forms of unincorporated body.

Therefore, the scope of entities eligible for the R&D tax credit should be considered further, and as appropriate, extended to include to all types of 'enterprise' structure. For example, enterprises such as listed property and infrastructure trusts should be able to access the incentive to reward innovative "greening" activities, such as the development and integration of energy-saving devices or materials in buildings.

10. Climate change mitigation and adaptation

Following from the point above, the Institute considers that the Government should ensure that the design and implementation of the new R&D tax credit is consistent with promoting and achieving Australia's National Priorities for Innovation, such as climate change mitigation and adaptation, as identified by the Cutler review panel.

Given the national and global imperative to achieve emissions reductions, the Institute recommends that the Government carefully consider the potential positive or negative impacts of the proposed design of the new tax credit on activities involving:

- development, demonstration and commercialisation of new or improved low-emissions technologies, and
- technologies to reduce or sequester emissions or achieve energy efficiencies or other demand-side abatement.

As the new R&D tax credit will be the single broad-based industry incentive offered to encourage innovative development, it is vital that the R&D policy encourage this type of desirable development. Therefore, care should be taken in designing any sectoral limitations on the eligibility of certain activities, for example mining sector or software development projects, to ensure that the rules do not unduly inhibit or curtail the overarching policy objective of promoting projects in the interest of one or more of Australia's national innovation priorities, such as climate change mitigation and adaptation.

11. Removal of unintended provision

11.1 'Guaranteed returns to investors' - Section 73CA

By way of background, this provision was not part of the original R&D legislation and was enacted in the early 1990s to specifically address syndicated R&D arrangements. Given that those arrangements have terminated, the provisions are now redundant and have no operation.

Despite this, legitimate R&D tax concession claimants have been advised by the ATO for some years now, including in recent times, that the provision may also apply to 'traditional' R&D tax claims. The Explanatory Memorandum accompanying the original legislation clearly indicates that "normal commercial transactions" should not be considered "not at risk" for the purposes of applying this section.

The effect of the ATO's position is, essentially, that a company which expects to reap a financial return from exploiting R&D would be disqualified from making an R&D claim. Given the legislative intent of the scheme to encourage the commercialisation of R&D, this outcome would arguably render the R&D tax incentive ineffectual.

As this provision relies on a determination by the Commissioner, the Institute notes that it is also contrary to the Review of Self-Assessment (ROSA) recommendations which were aimed at providing more certainty in a self-assessment environment.

We submit that s73CA should be repealed.

11.2 'Income tax amendment limitation period' - Section 170(10A)

The Institute urges the Government to remove the unlimited amendment period that the ATO currently enjoys under section 170(10A) in respect of R&D claims. This would be consistent with, and could be undertaken as part of, the broader review of unlimited amendment periods currently underway.

This rule detracts considerably from the R&D tax incentive for potential investment into Australia, represents an unlimited and unquantifiable business risk for taxpayers, and reflects a significant inequity (as between the Commissioner and the taxpayer). By contrast, taxpayers are limited to going back four years, however in addition, they must also have registered their R&D activities within ten months of the end of each financial year in order to qualify for the R&D tax incentive.

12. Tax and accounting matters

12. 1 Carry forward losses

In our opinion, the Government should consider allowing the carry back and/or carry forward of R&D tax losses, as occurs in other jurisdictions such as the UK, US and France. By limiting the period for which losses can be carried back or forward, e.g. one or two years, certainty to the revenue and taxpayers can be achieved.

12.2 'Above or below the line'

The Institute also encourages the Government to explore ways in which the R&D tax credit could be designed so as to recognise the tax benefit "above the line" for accounting purposes, subject to overarching International Accounting Standards (which may require the benefit to be recognised below the line). In this respect, the Institute is currently working with Innovation Australia and AusIndustry, the Australian Accounting Standards Board (AASB), and other accounting bodies to examine the design factors likely to impact the accounting treatment.

12.3 Impact on franking accounts

Furthermore, we note that the Government should consider and clarify the impact of the new R&D tax credit on company franking accounts and foreign tax credits. The Institute recommends that the R&D tax credit have a neutral impact so that it operates as a true additional benefit.

12.4 Uncertainty and provisions

For completeness, we note that the proposed distinction between 'core' and 'supporting' activities under the new incentive is likely to create an uncertainty issue regarding the quantum of the eligible R&D expenditure. This would mean that the income tax expense line in the statutory accounts is subject to change. The degree of uncertainty will likely depend upon which rules are ultimately adopted to limit the extent to which supporting activities can be claimed. It will need to be considered how this uncertainty or contingency should be reported for accounting purposes, i.e. whether there is a need for a provision.

13. Administration

It is important that the administration of the new R&D incentive strikes a balance between facilitating self-assessment (efficiency) and implementing effective compliance arrangements (integrity).

The Institute recommends that the administration of the new incentive be designed in line with best practice models, such as the Fuel Tax Rebate, which has clear, well written administrative laws, and a robust risk management framework. Importantly, the new definition needs to be administered with the overriding objective of encouraging innovation without requiring 'world exclusive' technology being developed so that innovative close to market companies continue to be incentivised to apply the tax credit to help fund their product development activities.

This would involve greater guidance being issued by the joint administrators, Innovation Australia and AusIndustry, and the ATO, including:

- release of guidance on what is no longer claimable under the new incentive compared to the R&D tax concession. This should be issued at the same time as the draft legislation;
- preparation of sectoral guidance, prepared in consultation and conjunction with key industries;
- development of an 'Assessor's guidebook' that is published and binding on the joint administrators; and
- issue administrative statements (similar to Decision Impact Statements issued by the ATO) to clearly communicate to practitioners the joint administrators' view of the implications of judicial decisions. This should address concerns that some consultants have read propositions into cases that go beyond the *ratio decidendi* of the case.

14. R&D registration

To streamline and improve the efficiency of the registration process, the Institute recommends that tax consolidated groups be able to register as a single consolidated entity for R&D purposes.

We would also suggest that the Government consider whether it is necessary under the new tax credit for claimants to register all of their projects. We understand that precedent for this exists in other R&D programs, for example claimants may only be required to register their top 20 per cent of R&D projects.

15. R&D Plan Guidelines

The Institute recommends that the requirement for R&D claimants to have approved R&D Plans in place prior to undertaking R&D activities should be relaxed for claimants entering the system for the first time under the new R&D tax credit. This is particularly pertinent in light of the increased stringency of the revised Draft R&D Guidelines which are proposed to be released following consultation and prior to the introduction of the new R&D tax credit.

We expect that new entrants will be primarily SMEs and are likely to require transitional R&D Plan measures so that they are able to benefit from the new R&D tax credit as intended from 1 July 2010. Transitional measures may, for instance, be a 'de minimus' rule applying to SMEs with R&D claims under a certain level, eg $500,000, for which R&D plans are waived in the first year. For claims over this level, R&D plans would be required.

Appendix

Summary of recommendations

- Retain the current definition of 'core' R&D activities as requiring innovation *or* high levels of technical risk.

- Amend the definition of 'supporting' R&D activities to require that they be experimental or directly related to the experimental process, and are "substantially" for the purpose of supporting the core R&D.

- Issue clear administrative guidance on the accepted methodology for determining allowable expenditure on supporting activities under the new rules, eg experimental production trials and experimental development occurring during commercial production.

- Amend the definition of "innovation" so that it is in line with the globally accepted OECD definition of "innovation" and Oslo Manual meaning of 'new'.

- Retain the current definition of "high levels of technical risk".

- Avoid or limit as far as possible the use of sectoral specific rules to define eligibility of activities so as to maximise simplicity and broad-based coverage, and minimise distortions/inequities.

- Apply the same generic test for "eligible R&D activities" to software as all other industries, and use specific exclusions in a limited way to exclude low value-add in-house software development.

- Codify the three criteria to be satisfied under "on own behalf" test, clarify the operation of the criteria, and ensure that the overall effect of the test only places restrictions on claims in cases of actual duplication.

- Amend the eligible overseas expenditure rule to:

  - grant AusIndustry a discretion to allow more than ten per cent of the total expenditure, at least where the IP is owned in Australia;
  - calculate the ten per cent cap by reference to the total annual expenditure, not project expenditure.

- Amend the rule for core technology expenditure so that undeducted expenditure becomes deductible when the project is completed (remove the current blackhole).

- Amend the clawback rule so that expenditure equal to the amount of any grant or subsidy is subject to normal deductibility rules (as the grant or subsidy is assessable income), so that any excess is eligible for the tax credit.

- Continue to treat non-enhanced deductions in relation to R&D as 100 per cent deductible for large companies, and allow small to medium-sized companies relief as a 30 per cent refundable tax credit.

- Review and extend the scope of entities eligible for the R&D tax credit to include to all types of 'enterprise' structure, e.g. trusts, partnerships and joint ventures.

- Ensure that any sectoral rules introduced to limit the scope of the new incentive do not inhibit or curtail advancement of Australia's national innovation priorities, such as climate change mitigation and adaptation.

- Repeal section 73CA as it creates uncertainty and is no longer relevant, and remove the unlimited amendment period under section 170(10A).
- Consider allowing the carry back and/or carry forward of R&D tax losses for a limited period, e.g. one or two years.
- Ensure that the R&D tax credit is designed in such a way as to allow the tax benefit to be recognised as “above the line” for accounting purposes.
- Consider the impact of the new R&D tax credit on franking accounts and foreign tax credits, and ensure it has a neutral impact.
- Consider how any ‘uncertainty’ regarding the income tax expense line in the statutory accounts should be reported for accounting purposes, i.e. whether there is a need for a provision.
- Design and implement a best practice administration model for the new tax incentive, including clear administrative laws and a robust risk management framework.
- Release guidance on what is no longer claimable under the new incentive compared to the R&D tax concession, and issue it at the same time as the draft legislation.
- Prepare sectoral guidance, in consultation and conjunction with key industry groups.
- Develop an ‘Assessor’s guidebook’ that is published and binding on the joint administrators.
- Issue administrative statements, similar to Decision Impact Statements issued by the ATO, to clearly communicate the joint administrator’s view of the implications of judicial decisions.
- Consider streamlining the R&D registration process to allow tax consolidated groups to register as a single entity and enable registration of a selection of a claimant’s projects.
- Waive / relax the R&D plan requirements during a transitional period for first time claimants, eg SMEs with claims less than $500,000.