

Comments in response to the Government's consultation paper of September 2009: 'The new research and development tax incentive'

Due date for submissions: Monday 26 October 2009

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I welcome this opportunity to provide comments and feedback on the questions and principles set out in the consultation paper.

I have provided submissions on all questions and principles set out in the consultation paper, other than Question 6 (which currently falls outside my area of expertise and knowledge).

I have sought to relate my comments and suggestions to the government's goals with respect to the new R&D tax incentive, as identified in the consultation paper and set out below.

My experience stems from several years' involvement (1991 to 2008²) preparing claims for the R&D tax concession. I have worked for 4 different consultancies³, 3 of which specialised almost exclusively in preparing claims for the R&D tax concession.

I now work at Monash University and am currently preparing a proposal to undertake my PhD on the R&D tax concession and the proposed new R&D tax credit.

The consultation paper states the **goals** of the government to be:

1. To increase the level of R&D currently being undertaken so that firms undertake R&D in addition to what otherwise would have occurred⁴ and to stimulate greater collaboration on business R&D with universities⁵.
2. To provide more effective support for R&D in Australia⁶ by designing a more streamlined approach to delivering support for business R&D⁷ and to redistribute support to small and medium sized businesses⁸.

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² Intermittent due to periods of maternity leave and an interstate move.

³ Michael Johnson & Associates (NSW), The Fourth Wave (NSW), PriceWaterhouseCoopers (Vic) and Compliancegroup (Vic).

⁴ Cl 12, Principle 5.

⁵ Cl 22.

⁶ Cl 78.

⁷ Cl 1.

⁸ Cl 10.

3. To subsidise R&D that provides spillover benefits to the wider community⁹.
4. To tighten the definition of R&D¹⁰ in order to target support where it is most likely to produce net benefits for the Australian community¹¹ while at the same time be revenue neutral over its first 4 years¹²; also to provide a definition of R&D that is the same for Australian owned and foreign owned companies¹³.
5. To provide a more robust self assessment framework¹⁴.

QUESTION 1- *Should there be any exceptions to the general rule that eligible R&D activity must be carried out in Australia?*

Under the new R&D tax incentive, the general rule will be that eligible R&D activity must be conducted in Australia. The consultation paper seeks comments on whether there should be limited exceptions to this rule.

I am of the opinion that where some supporting R&D activity can be conducted outside Australia for less cost, this should be encouraged as it is a more efficient use of limited funds and should allow greater funds to be applied to the core R&D activity (which MUST be carried out in Australia). It is of course necessary to have appropriate safeguards in place to ensure that Australian based R&D is not negatively impacted by such an allowance.

One possibility, in line with other suggestions made in the consultation paper, is:

1. That all *core* R&D activity must occur in Australia; AND
2. Where a claimant wishes to claim costs associated with *supporting* R&D activity carried out outside Australia, it must shown that such activity could only have been carried out in Australia at considerably greater cost; AND
3. That the overseas supporting R&D activity was carried out solely for the purpose of supporting the Australian core R&D.

The existing rules on 'adequate Australian content' and 'exploitation for the benefit of Australia' provide further safeguards to address concerns about Australian R&D moving offshore.

Such an approach would be consistent with the government's overall goals in relation to the new incentive, as well as the suggestions made by the NIS Review regarding sharing and movement of knowledge and skills.

⁹ Principle 5.

¹⁰ CI 2.

¹¹ CI 8.

¹² CI 14.

¹³ CI 30

¹⁴ Consultation paper-Fn 1.

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.*

I support the proposal to make the incentive available only to companies incorporated in Australia rather than extend it to other business structures.

In relation to the issue of ownership of IP, the consultation paper does not make it clear whether or not a further consequence of this proposal will be that the identity of the IP owner (as well as the location of ownership) continues to be a determining factor in assessing eligibility of claims.

It is not clear what impact this will have on the existing 'on own behalf' rules. The existing rules require a weighing up of three key criteria, the third criteria being who 'effectively owns the project results'. Clarification is also needed to understand the impact of this change on other aspects of the incentive, including the requirement to exploit R&D for the benefit of Australia.

It is noted that 'effective ownership' can extend beyond IP ownership and there is considerable merit in formally recognising that benefits flowing from the R&D are far broader than the issue of IP ownership. Nonetheless, the impact of such changes must be understood in relation to other requirements of the proposed scheme.

(Note: The NIS review noted that the existing IP rules had a detrimental impact on innovation in Australia and such a change may assist in overcoming this detrimental impact).

PRINCIPLE 2- *The standard R&D Tax Credit will be available at a rate of 40% for eligible R&D expenditure and can be carried forward where a company's income tax liability is zero.*

PRINCIPLE 3- *The refundable R&D Tax credit will be available to companies with a turnover of less than \$20m at a rate of 45% for eligible R&D expenditure.*

Principles 2 and 3 make it clear that the government intends to increase the level of financial support for eligible business R&D.

It is also clear that the government intends to redistribute support in favour of small to medium sized businesses¹⁵. It can be predicted that big businesses will still receive a greater amount of actual support than small to medium businesses due to the likelihood that such businesses will carry out R&D activities on a much larger cost scale.

I am in favour of increased support for all business R&D.

My discussions with claimants made it clear to me that an R&D incentive at 125% is not in fact a sufficient 'incentive' to encourage firms to engage in increased levels of R&D - claimants were merely happy to get the tax benefit on projects that were going to be undertaken regardless.

I am not convinced that small to medium sized businesses should have greater proportional support than other businesses. The consultation paper suggests that the justification for this is that such firms are more responsive to fiscal incentives. While this may be the case, such businesses may not

¹⁵ CI 10

have the capability to undertake R&D opportunities that provide the greatest benefit to the Australian community. In addition there are question marks over the efficiency of many such businesses.

I observed in practice that in many cases (regardless of the size of the firm involved) there was a lack of communication between the personnel wanting to carry out the R&D (ie scientists, engineers etc) and the financial personnel giving the go ahead.

R&D needs to be a prominent item on the agendas of firms to encourage a true increase in innovation in Australia. It is hoped that the proposed changes to the new R&D tax incentive, will stimulate a culture changes in Australian firms that facilitates greater communication on R&D between financial and technical personnel. Arguably this culture change *may* occur more rapidly in smaller firms but that is yet to be seen.

Further research is needed to consider whether additional support to small and medium sized businesses is in fact warranted. The additional support needs to be considered in terms of the government's goals as identified above.

QUESTION 2- *How should the new R&D tax incentive treat R&D expenditure that is currently deductible at 100%?*

It would be interesting to understand how claimants themselves have been treating such expenditure. In my experience, such expenditure was generally ignored for the purpose of the R&D claim and deducted under the normal tax rules. I suggest R&D expenditure that is otherwise deductible at 100% should therefore be dealt with under the normal tax rules.

The capital allowance scheme under the normal tax rules could be adjusted to allow accelerated write-offs of R&D capital items if such items are used for the sole purpose of carrying out R&D.

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

Currently accrual payments can result in tax benefits years before taxable receipts are reported. It is my view that it is appropriate for the government to mandate that expenditure to associates can only be claimed where paid in cash. It seems to be a more equitable method of sharing the government's limited resources amongst stakeholders.

Once the new incentive has been operating for a couple of years it would be interesting to carry out further research into whether this has a negative impact on decisions to undertake R&D.

PRINCIPLE 4- *Legislation for the new R&D tax incentive will provide support for the scheme's efficient and effective administration*

I applaud the planned rewriting of the current legislation dealing with the R&D tax concession. Over the period that I have been working in this area, the legislation has become increasingly complex and changes have generally lead to increased difficulties in preparing claims.

In my experience the system of joint administration between AusIndustry and the ATO has worked well and it is pleasing to note that this will be continued. The proposed increasingly active role of Innovation Australia and AusIndustry is to be commended. In particular, upfront compliance checks in certain circumstances would be very helpful to claimants and their advisors.

It is hoped that this will be accompanied by increased staffing to facilitate such plans.

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**

I note that the proposed ‘additionality and spillovers’ test applies broadly to the new incentive rather than individual R&D activities. It is very difficult to assess such potential benefits and the tax incentive has steered away from aiming to prejudge ‘winners’ – unlike grant schemes. Nonetheless it may be helpful to require applicants to provide information to AusIndustry that focuses attention on this goal, via the ‘Application for Registration of R&D Activities’.

The proposed new definition of core R&D is discussed in PRINCIPLES 6 and 7 as well as QUESTION 4 addressed below. I would suggest that rather than tightening the definition of eligible core R&D to require **both** innovation and high levels of technical risk, the government should consider a substantial tightening on claims for supporting activities. It seems that at present many ordinary business activities are being re-characterised as supporting R&D activities and consequently inflating R&D claims beyond justifiable levels.

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.**

I am opposed to the definition of core R&D being changed to require activities to involve **both** innovation and high levels of technical risk. I am in favour of retaining the current definition of core R&D that requires core R&D activities to involve **either** innovation or high levels of technical risk.

I recognise that the government is concerned with affordability of the scheme. However it is crucial that it does not lose sight of its goals in relation to the scheme. It is also important that it considers the different elements of the package as a whole rather than individually¹⁶.

Tightening the definition of core R&D will *not* lead to an increase in the levels of R&D being undertaken and will *not* encourage firms to undertake R&D in addition to what otherwise would

¹⁶ CI 14

have occurred¹⁷. This in turn will have a negative impact on spillover benefits to the wider community.

In my experience, most core R&D activity has developed from a desire to conquer high levels of technical uncertainty rather than from desire to be innovative on a grand scale. Such goals still require R&D and create opportunities for substantial spillover benefits to the broader community.

I believe that the answer lies not in tightening the definition of eligible core activities but rather in tightening the definition of eligible supporting activities by introducing a sole purpose test.

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?

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 the appropriate rate be?

It is clear that in order to fund an increase in the level of support for eligible R&D activities above the current 125% R&D tax deduction and so provide a real incentive to firms to carry out R&D that may otherwise not occur, the current scheme requires some changes.

In my opinion the solution does not lie in a tightening of the definition of core R&D activities, but rather in a significant restriction on claims for supporting activities.

Of the proposals suggested in relation to supporting R&D activities, I am most in favour of introducing a sole purpose test (Option (b)).

This approach provides a balance between the need to significantly reduce the current quantum of claims for supporting R&D activities and the need to recognise that there may well be activities that do not meet the criteria for core activities but are an essential requirement to enable core activities to take place. This amendment would more effectively distribute funds to the categories of R&D that provide the greatest benefit to the community as a whole and would most likely result in a marked impact on the current undesirable practice of re-characterising ordinary business activities as R&D supporting activities.

With this change there would be a need for greater transparency in the claim documentation (both the Application for Registration of R&D Activities and the R&D Tax Schedule) requiring the identification of the quantum of expenditure relating to supporting R&D activities. At present

¹⁷ Principle 5

claimants are not required to distinguish between core and supporting R&D and therefore have been able to make claims that are substantially for supporting activities only¹⁸.

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?

I am in support of extending the current list of excluded activities so that claims cannot be made for expenditure relating to excluded activities irrespective of whether the expenditure relates to core activities or supporting activities. The current scheme allows claims to be made on excluded activities if such activities are supporting activities. Such an anomaly leads to confusion and unnecessary complexity and runs the risk of encouraging a culture of rorting the scheme and subsidising ordinary business activities that happen to touch on R&D as well as being necessary for the continuation of the business in any case.

If any amendments are to be made to the list of excluded activities, I would suggest that the costs associated with certain feasibility studies should be allowed. Consistent with my view on the tightening of allowable supporting activities, feasibility studies could be claimable if carried out for the sole purpose of determining whether an R&D project should proceed. If the decision is not to go ahead with the R&D, the claim for the feasibility study could not be made because there would be no core R&D. Encouraging such feasibility studies is consistent with the goal of encouraging firms to undertake an increased level of R&D provided it is prudent to do so. This will reduce the level of government investment in projects that are failures.

QUESTION 6- *How should the new R&D tax incentive treat software R&D?*

I am aware that the current multiple sale test is out of touch with commercial realities in the area of software development. However, I do not have the requisite understanding of this area to add further to the observations in the consultation paper. I suggest however that the proposed changes to the rules relating to IP ownership need to be considered particularly in relation to this area.

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¹⁸ CI 57.