Level 2
95 Pitt Street Sydney, NSW 2000
Telephone 02 8223 0000
Facsimile 02 8223 0077
Email tia@taxinstitute.com.au
Website www.taxinstitute.com.au
ABN 45 008 392 372

28 October 2009

General Manager
Business Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

Email: rdtaxcredit@treasury.gov.au

Dear Sir

Research and Development Tax Incentive Consultation Paper

The Taxation Institute of Australia (**Taxation Institute**) appreciates the opportunity to comment on the Consultation Paper of September 2009 concerning the new Research and Development (**R&D**) tax incentive.

The Taxation Institute supports the reform objectives of making the new R&D tax incentive more effective in delivering support for business R&D and in targeting that support to where it is most likely to produce benefits for Australia.

In particular, the Taxation Institute welcomes the introduction of a refundable tax credit available to small to medium-sized enterprises.

However, the Taxation Institute also has some concerns with the practical application of some of the principles and design features of the new R&D tax incentive as outlined in the Consultation Paper. These include:

- the practical application of the policy objectives of “additionality” and/or “spillover”;
- the proposed changes to the definition of R&D activities which will restrict the incentive in respect of what would otherwise be genuine R&D activities; and
- the practical and policy issues surrounding restriction of eligibility for expenditure incurred in supporting activities.

Summary of Recommendations

The key point of our submission is that, notwithstanding the recent ongoing consultative process convened by AusIndustry, considerable uncertainty remains as to the extent to which R&D tax claims will be available pursuant to the proposed amendments. Further our recommendations are as follows:

- There be no change to the definition of eligible R&D activities until an independent inquiry/study has been undertaken to more fully investigate the potential implications of the proposed definition.
- R&D activities in respect of software development are assessed under the same definitional criteria as other R&D activities, i.e. that no additional criteria is applied to software development activities.
- There be no limitations or caps on the level of expenditure which will be eligible for the R&D tax incentive in respect of supporting activities.
- More extensive guidance material, as proposed in the Consultation Paper, be provided, and regularly updated, as to the type of activities which the Government considers to be eligible to provide clarity to companies undertaking R&D activities and to assist in remedying any deficiencies in claims.

Detailed comments

The Taxation Institute would like to also provide more detailed comment on the following concerns and issues.

Policy - Additionality and spillovers

The Consultation Paper states that "…an effective R&D incentive needs to result in businesses conducting R&D that they would not otherwise perform…"

The Taxation Institute submits that the principle, referred to as "additionality", is erroneous and that companies do not make a decision to proceed with an R&D project solely as a result of a tax incentive.

The Taxation Institute does not necessarily disagree with 'additionality and spillover' being adopted as general and overarching design objectives for the new system but only from a macro economic and social perspective. Incorporating "additionality and spillovers" in the legislation, even within an objects clause, will lead to confusion as to its application at a company level. Spillover benefits are extremely difficult to quantify, particularly at the commencement of R&D activities.

Finally, the Taxation Institute strongly believes that a cornerstone objective of Australia's R&D incentive should be to encourage R&D activities within Australia in order to, amongst other things, make eligible enterprises internationally competitive. Having said that, the Taxation Institute also agrees that the definition of R&D should still conform to generally accepted international norms and conventions. However, the Taxation Institute does not accept the further rationalization that the proposed changes to the definition will bring the Australian definition more in line with International definition.

Reporting - "Above the line"

Reporting of the R&D Credit "above the line" is absolutely critical if the Government's ambition is that the R&D Credit is to be a driving factor in a company's decision to undertake specific R&D projects. A company makes a decision on a pre-tax basis. As proposed in the Venturous Australia Report, consideration must be given to the design of the tax credit program so as to enable companies to treat the credit received as "above the line".

Proposed changes to definition of Eligible R&D activities

Following the release of the Consultation Paper, many companies have advised the Taxation Institute that they are concerned that the proposed amendments will adversely affect their existing legitimate R&D tax concession entitlements.

This perception has the potential to deter companies from appropriately utilising the R&D tax incentive as a real incentive to drive further investment in innovative or technically risky projects.

This contention is supported by the Taxation Institute's analysis of corporate Australia's reaction to the 1996 cut backs to the R&D tax concession.

In particular, the decision, at that time, to tighten the definition of R&D activities from 'innovation' or 'technical risk' to 'innovation' or 'high levels of technical risk' caused many companies to conclude that their existing genuine R&D projects were no longer claimable.

The Taxation Institute is concerned that the prevailing uncertainty in industry will cause a repetition of the behaviour of Australian industry during the years subsequent to 1996 when the level of R&D spending by businesses in Australia dropped significantly. The Taxation Institute is also concerned as to the long-term impact on our ability to maintain internationally competitive industries in Australia if reduction in investment in R&D activity occurs.

Such a result would not be in the best interests of Australian industry policy and would be clearly detrimental to the commendable efforts of those participants from Government, academia, the research community and industry throughout the various consultations which have taken place, particularly during the past two years.

In the circumstances, the Taxation Institute believes that this is a unique opportunity for the stability of the R&D tax concession and it is absolutely critical that any substantial amendments to the fundamental issue of 'what is R&D' be fully and comprehensively understood by all stakeholders.

Innovation and high levels of technical risk

The proposed changes to the definition of core R&D activities will now require those activities to exhibit both innovation and high levels of technical risk where the threshold is currently for the activities to exhibit only one of these characteristics.

The proposed definition also changes from "activities" to "activity" and "for the purpose of producing new knowledge or improvements" instead of "new or improved materials, products, devices, processes or services" or "new knowledge". There is no discussion in the Consultation Paper as to the rationale for these changes, nor to their potential impact on what may be considered eligible R&D activities.

The Taxation Institute will provide further comment on these aspects when more detail is provided or in response to the Exposure Draft of the proposed legislation, in the meantime the following points are tabled.

The Consultation Paper states that:

> *"A definition which requires that core R&D activities involve both innovation and high levels of technical risk means that the new scheme will better align with the Frascati Manual and international practice. Currently Australia has one of the broadest definitions of R&D (when compared to the Frascati Manual). Many countries including the United Kingdom and the United States, take a narrower approach."*

In this regard, the Taxation Institute notes that the Frascati Manual does not make reference to any requirement for R&D activities to exhibit characteristics of both innovation **and** high levels of technical risk and, that the breadth of its definition of R&D is notably broader than that of the current Australian system.

Further, the Taxation Institute notes that for the purposes of R&D expenditure qualifying for their respective systems' tax relief, the United Kingdom, Canada and Ireland all have sole requirements of characteristics of technical risk or technological advancement. The focus in these locations is on the end result **or** objective of the R&D activities, not on the requirement for innovation in the individual activity itself.

As such, it would seem that the proposed scheme, if enacted, would serve to distance Australia from international norms of R&D treatment. This would create a threat to Australia receiving its future share of global R&D spending in addition to placing Australian companies at a competitive disadvantage with their international counterparts.

The Taxation Institute believes that, whilst, of itself, such a requirement for satisfaction of dual criteria should not necessarily preclude the appropriate characterisation of the activities in question, in practice, this will largely depend on the definition of "innovation", and how that definition is interpreted in practice by the Government authorities.

The Taxation Institute would therefore like to stress the importance of the definition of innovation being commercially practicable with regard to the stated policy intention. Were "innovation" to be defined too narrowly, this could restrict the eligibility of the tax incentive beyond that intended by Government policy.

In particular, regard should be had to the nature of the practicality of commercial R&D activities, with the definition containing an appropriate level of tolerance for elements of existing technology through and upon which nevertheless eligible innovative R&D activities result in the creation of new technologies.

It has not been demonstrated in the Consultation Paper as to how the change from "innovation or high levels of technical risk" to "innovation **and** high levels of technical risk" in the definition will impact on the three examples given. From the information provided in the Consultation Paper, the requirement for both innovation and high levels of technical risk would not change the determination of whether R&D activities were being undertaken in each of the three examples. It would appear that the examples are more concerned with claims for "supporting" activities, extending beyond "genuine" R&D, than with whether the activities would satisfy the new definition of R&D activities.

Software

The Taxation Institute notes that the paper has also expressed concern with respect to the application of the R&D definition to the development of software and welcomes the invitation to provide specific comment as to alternative approaches in this regard.

The Taxation Institute concurs with the view expressed in the Consultation Paper as to both the multiple sale test's irrelevance in today's R&D context and the almost ubiquitous presence of software development in current economic endeavour given the world wide web.

Given its involvement across all industry sectors and the direct and indirect nexus to economic spillovers, the Taxation Institute submits that software development should be afforded the same treatment as other core R&D activities. Accordingly, the Taxation Institute submits that the optimal approach would be to avoid prescriptive rules for software-associated R&D activity wherever possible.

The Taxation Institute also notes that software development by its nature can be transformational, creating new industries without need for national expenditure on new infrastructure.

With regard to the international treatment of software development in R&D, the Taxation Institute notes that whilst the Consultation Paper suggests that the United Kingdom system might be a useful starting point, it (in addition to the majority of OECD member states) does not differ in its treatment of software from that afforded to any other form of R&D activity.

For completeness, the Taxation Institute also notes that the definition of software in R&D at paragraphs 135-142 of the Frascati Manual are notable for both their breadth and lack of reference to any motive or purpose test as to future commercial exploitation.

Supporting activities

As an overarching comment, the Taxation Institute's view is that, from a policy perspective, the distinction between core and supporting activities is essentially artificial. That is, provided the activity is necessary for the successful pursuit of the R&D project and achievement of the objective of acquiring new knowledge and improvements, it should be supported by the tax concession.

This principle is recognised internationally by there being no differential treatment of expenditure incurred in core or supporting activities. As with the current Australian system, where there is no differential treatment, there is no tension as to characterisation of activities.

In practice, it appears that the changes proposed as options in the Consultation Paper do not represent the embodiment of any principle as to which activities should receive government support. Instead it appears to be a variety of means for the revenue cost of that support to be restricted.

However, the mere fact that the cost of these activities is high does not make their contribution to the R&D activity any less valuable than "core" activities. Indeed, they are likely to be fundamental to success or failure of the R&D project.

The Taxation Institute comments below on each of the methodologies proposed in the Consultation Paper for the restriction of claims for supporting activities, from a practical legal and operational perspective. As a general point it is noted that, of its nature, any such restriction places significant stress on the definitions of core and supporting activities with a characterisation of activities as core being preferable since there would be no such restriction.

Capped as a proportion of Core R&D

The Taxation Institute notes that the Consultation Paper suggests that capping eligible supporting activity at a percentage of core R&D expenditure would address concerns regarding the relative size of claims for supporting and core R&D activity.

However, as varying industries, R&D projects and indeed taxpayers will have differing ratios of expenditure with regard to core and supporting activities. This form of fixed cap would create an arbitrarily fixed relationship between core and supporting R&D claims, we consider it is likely to be inequitable in the majority of cases.

Sole purpose

The Taxation Institute submits that a “sole purpose” test would not be practical, given that almost all bona fide supporting activities will have some element of incidental benefit for the claimant taxpayer. Accordingly, such an approach is likely to lead to the ineligibility of the majority of otherwise eligible expenditure incurred in supporting activities.

The suggested variation that the activity be “predominantly” for the purpose of supporting a core R&D activity may be a workable compromise. However, this option would require that practical guidelines are given to both assessors and taxpayers to enable self assessment and equitable evaluation.

Exclude production / dual purpose activities

With regard to the potential exclusion of activities with a purpose other than R&D, the Taxation Institute would suggest that the key issue is that of whether the activities support or are needed to support the core R&D activities.

An approach based on exclusion of activities with a purpose other than R&D would seem to simply be a negative phrasing of the same question as that of sole purpose. However, the Taxation Institute would submit that the key question should not be one of phrasing negative or positive limbs to the criteria but rather the recognition in legislation and practice of industry-specific norms as to at least some element of “dual purpose” or incidental benefit.

However, it should be noted that trials to prove whether a process or product is viable should continue to be eligible.

Net expenditure only

Under the current rules, any proceeds received arising from the results of R&D are included in the claimant’s assessable income under section 73B(27A) ITAA 1936. Where those proceeds to be netted off against associated R&D expenditure, this would of itself, reduce the effective tax concession available to “successful” R&D projects where proceeds exceeded costs. Furthermore, the effective tax concession would also be reduced where the claimant’s project made a net economic loss.

Under this approach, net qualifying expenditure (and therefore, any effective tax concession) would only arise where, and to the extent that, the R&D was “unsuccessful”.

Lower rate of assistance

The Taxation Institute submits that the level of assistance granted to supporting activities should remain the same as that granted to core activities. As the supporting activity is required to properly enable the core activity, to the extent support was withdrawn from the former, it must of necessity indirectly reduce support for the latter.

In addition, as noted in our general comments above with regard to the introduction of differing treatment between supporting and core activities, such a differential will place significant stress on the interpretation of the associated definitions leading to greater uncertainty and complexity for taxpayers.

.

There are a number of further options below however should any of these options be adopted consideration will also need to be given to the tax treatment of expenditure above the relevant cap or otherwise excluded.

Exclusion of nominated activities

The current legislation contains some express exclusions from the definition of R&D activities contained in subsection 73B(2C) of the *Income Tax Assessment Act 1936* that the Taxation Institute submits should be reconsidered from a policy viewpoint.

Pre-production

The Taxation Institute submits that activities such as demonstration of commercial viability, tooling up and trial runs are often 'core' R&D activities and not merely remote. Most often, they are integral and essential activities for successfully carrying out a broader R&D project. The greatest commercial risk is not laboratory R&D but rather, achieving a commercially viable outcome from the development of technology.

Accordingly, their exclusion appears to be arbitrary and would not seem to promote the policy intent of the new tax incentive and we would suggest that paragraph 73B(2C)(H) be repealed.

Compliance with statutory requirements

The Taxation Institute notes that the full scope of this exclusion is as follows:

> "Activities associated with complying with statutory requirements or standards, such as the maintenance of national standards, the calibration of secondary standards and routine testing and analysis of materials, components, products, processes, soils, atmospheres and other things."

The Taxation Institute submits that exclusion of these activities is difficult to rationalise, firstly, for most of the same reasons as outlined for pre-production activities above. In addition, the challenges being faced globally in respect of sustainability and the environment and the inherent need to develop green technologies predominantly against emerging and untested standards would make this exclusion a notable shortcoming of proposed incentive program.

As noted above, with regard to other currently excluded activities such as quality control and data collection, the Taxation Institute submits that these activities are often necessary to the successful prosecution of the project in question and to the extent that they are, should be afforded the same level of support as other R&D activities.

"On own behalf", IP ownership and financial risk

As the Consultation Paper notes, the purpose of the "on own behalf'" rule was to prevent the duplication of claims where R&D was contracted out. The Consultation Paper, also states that the location of Intellectual Property (IP) will not be relevant in the R&D tax credit program.

The Taxation Institute is unclear as to how the proposed system would operate in practice but would seek clarification as to our understanding that the "on own behalf" rule would still apply, albeit that a foreign resident grouped-company would satisfy this requirement.

Section 73CA was introduced in 1990 specifically to deal with R&D claims made by companies taking advantage of the extension of the concession to "R&D syndicated arrangements" in a particular way to effectively remove all or most of the commercial risk to investors by guaranteeing them a minimum return on their expenditure.

The relevant syndicated R&D provisions giving rise to the measure have since been repealed and therefore, as it is now redundant, the Taxation Institute suggests that section 73CA should be repealed.

Eligible entities

Based on the premise that innovative enterprises will benefit the Australian economy, it is difficult to rationalise a restriction of the R&D incentive to corporate entities only. Value-adding R&D is undertaken by all forms of the usual unincorporated business structures, from joint ventures to partnerships to trusts to branches.

The Taxation Institute welcomes the extension of the 25% ownership threshold to 50% for tax-exempt entities. This will be particularly beneficial in assisting university and other non-profit organisations' spin-off opportunities that are limited by the current ownership caps.

Other recommendations

Overseas activities

The present legislation, which extends the concession to 10% of project expenditure on overseas R&D activities, in our view, is soundly based in policy and is worthwhile retaining. That policy is to assist and encourage Australian enterprises to continue to invest in innovation for the benefit of the Australian economy, even if that investment has to be outside Australia, but only where the R&D cannot otherwise be accessed from within Australia.

However, having regard to that policy objective, we do not see that it is necessarily appropriate to limit the eligibility to overseas R&D only when forming part of a larger Australian R&D project, if the activities meet the other eligibility criteria.

Also, accessing this concession is unnecessarily difficult and complex and is inconsistent with principles of self-assessment, involving pre-certifying expenditure and potentially having to pre-determine total final "project" expenditure in order to ascertain that the overseas expenditure incurred will be within 10 percent of that ultimate total project cost.

Transitional period

The Taxation Institute notes that, under the present system, the treatment of core technology, plant and equipment and government grants is spread over more than one income year. Accordingly, with the advent of the new system, we also seek clarification as to transitional rules for treatment of these items.

Core technology

With respect to "core technology" expenditure, we submit that the existing unduly complex rules should be scrapped and deductibility provided under the current capital allowance provisions, over the lesser of the "effective life" of that technology or, say, 3 or 5 years.

Clawback of grants

With respect to "**clawback**" of R&D expenditures, we believe that expenditure equal to the amount of any grant or subsidy should be subject to normal deductibility rules (the grant or subsidy being assessable income) and any excess be subject to the normal concessionary tax credit.

Plant and equipment deductions

The Taxation Institute assume that plant and equipment will continue to be entitled to concessional treatment under the new tax credit rules but would seek clarification in this regard.

The Taxation Institute recommends that a company be able to elect whether the concessional treatment is to apply to its depreciable assets. An election was in place under the previous "exclusive use" concessional deductions for plant and equipment. A similar election should be incorporated into the design of the new R&D credit program.

Non-enhanced deductions

The Taxation Institute submits that, where taxpayers have a turnover in excess of $20m and are therefore ineligible for the refundable tax credit, such expenditure should be deductible under the general deduction provision. Where taxpayers are eligible for the refundable tax credit, relief could be given as a 30% tax credit.

The Consultation Paper states that it may be simpler to treat these expenditure items under normal tax rules. It should be noted that many of these items may not be elsewhere deductible because of their connection with R&D activities. As a result, companies will be adversely impacted as a result of incurring this expenditure. A specific provision should be included to ensure that these items will be deductible at 100%.

Amendment period

The Australian Tax Office (**ATO**) has currently an unlimited time, under subsection 170(10A) of the *Income Tax Assessment Act 1936,* to amend R&D tax concession claims.

This is at odds with the standard four year limitation for most other potential tax adjustments excepting for situations involving fraud or evasion or where Part IVA (the general anti-avoidance provision) applies.

There appears to be no justification for such an anomaly. Further, it imposes an unwarranted and onerous record-keeping compliance burden and increases the perceived risks for claimants, particularly with any substantial effluxion of time before a claim is reviewed. As such the Taxation Institute would recommend that subsection 170(10A) be repealed.

Impact on Franking Accounts

The impact of the R&D Tax Credits on a company's franking account should also be incorporated into the design of the program. Under the current tax concession program, whilst a company receives a tax saving, when dividends are paid to individual shareholders that shareholder must make up the shortfall of tax resulting from the concessional treatment received by the company.
The R&D tax credit should provide a permanent benefit to Australia and encourage investment in Australia. Franking accounts should, therefore, reflect the notional tax paid prior to application of the R&D tax credit for both refundable and non-refundable categories. This would ensure that the cost of the benefit received by the company is not ultimately borne by shareholders on any future distributions paid by the company.

Consolidation

As far as possible, we consider that compliance with the concessionary tax system should operate on the basis of self-assessment, consistently with the rest of the tax system. Compliance should be based upon sound risk management principles with a view to minimising unwarranted compliance costs for taxpayers.

Accordingly, we suggest that, in the context of tax consolidated groups, group companies should be able to register as a single consolidated entity, since the tax consolidation regime will account for the apportionment of claims through stub returns for periods within an income year spent inside/outside a tax consolidated group.

Conclusion

The Taxation Institute supports the initiatives of the Government in their attempts to develop a robust platform for enhancing Australia's R&D performance.

The Taxation Institute also appreciates the need for the program's integrity to be maintained in both the short and long term.

However, the Taxation Institute is concerned that the present uncertainty is not conducive to attaining the Government's stated industry policy objectives.

As such, it is critical in the Taxation Institute's view that these issues be resolved as a matter of priority.

If you would like to meet with representatives from the Taxation Institute or require any further information or assistance in respect of our submission, please contact Joan Roberts on 03 9611 0178 or the Taxation Institute's Tax Counsel, Angie Ananda, on 02 8223 0011.

Yours faithfully

Joan Roberts
President