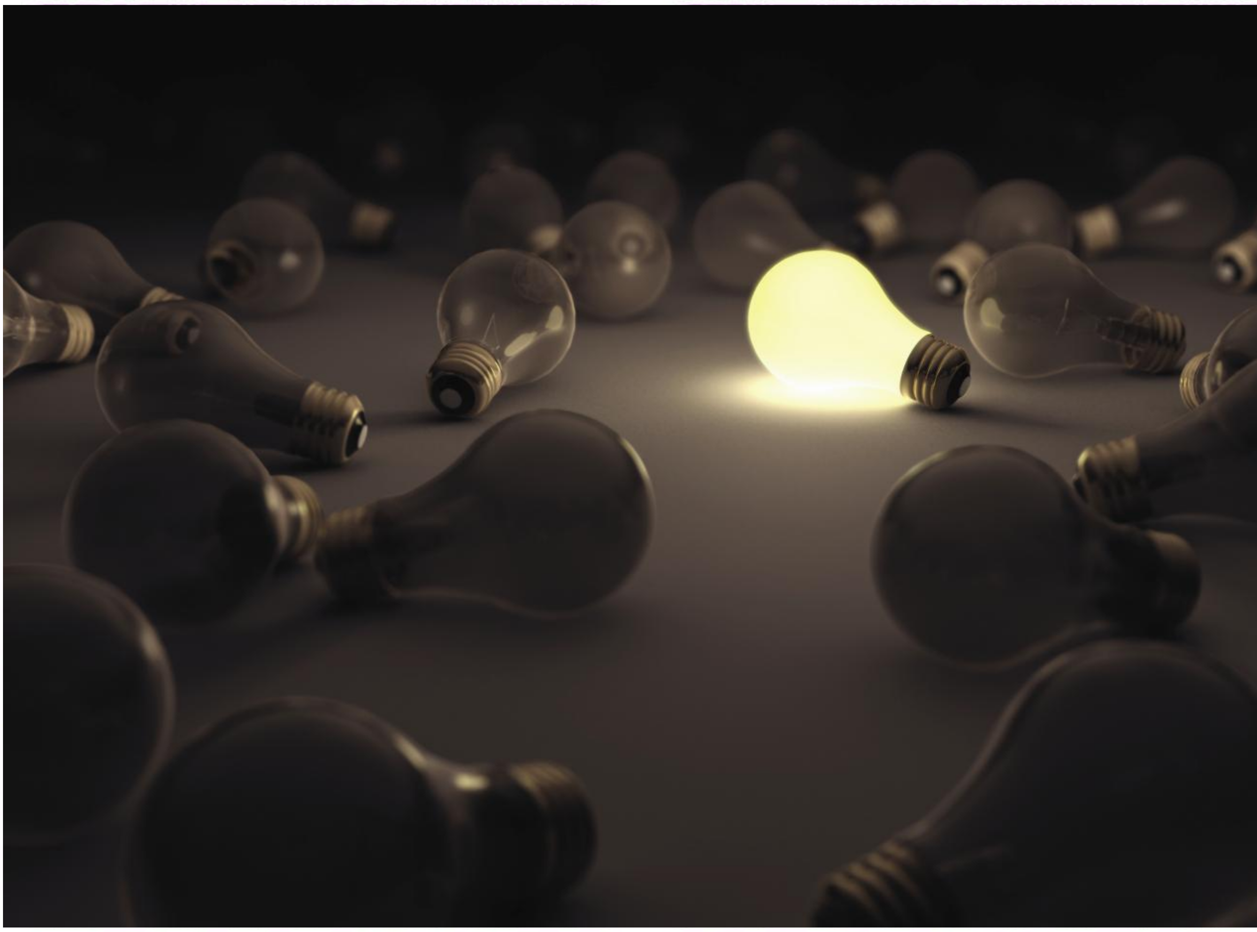
The new R&D tax incentive

Submission to Treasury 5 February 2010



Invigorating Business Representation

Call > 13 26 96

nswbusinesschamber.com.au

Executive Summary

NSW Business Chamber welcomes this opportunity to make a submission regarding the exposure draft legislation and explanatory materials for the Federal Government's new research and development tax incentive. The NSW Business Chamber represents the interests of around 30,000 companies across NSW and the ACT, ranging from owner-operators to corporations, and from manufacturers to service providers.

Governments support research and development (R&D) because they recognise the benefits that this investment provides to the broader community. Government support for R&D increases levels of innovation, which in turn leads to greater productivity growth, and therefore higher standards of living.

The R&D Tax Credit is a central element of the Government's long-term agenda to lift Australia's innovation capacity and performance, as set out in *Powering Ideas.* This innovation agenda includes an ambition to increase the proportion of businesses innovating by 25 per cent, and lift the number of businesses undertaking BERD (business expenditure for R&D).

NSW Business Chamber strongly supports these ambitions. Australia spends 2.01 per cent of GDP on R&D, compared to the OECD average of 2.26 per cent. Further, business expenditure on R&D as a percentage of GDP is only half the OECD average. For Australia to improve its performance relative to international peers, a supportive public policy environment is essential.

In their joint media announcement on 18 December 2009, the Treasurer and Minister for Innovation released draft legislation for the new R&D Tax Credit. According to the announcement, the new R&D Tax Credit "*follows through on the Government's commitment to deliver a more generous, more predictable and less complex tax system."* The media release also refers to the legislation cutting red tape, boosting investment in research and development, and lifting Australia's innovation capacity.

NSW Business Chamber holds significant reservations about the capacity of the legislation, as currently drafted, to achieve the Government's stated policy objectives. Instead, the legislation outlines a scheme that is less generous, and in some respects less predictable and more complicated. The legislation is likely to increase red tape, detract from investment in research and development and reduce Australia's innovation capacity.

The most likely outcome of the implementation of this legislation would be a significant reduction in R&D activity in Australia, which will inevitably lead to reduced productivity growth and lower standards of living for all Australians.

In particular, tightening the definition of core activities, narrowing eligibility for supporting R&D, and the introduction of the new augmented feedstock rule are all unnecessary changes that will discourage investment in innovation in Australia.

NSW Business Chamber is not alone in holding these reservations. The vast majority of submissions made to Treasury regarding its September consultation paper expressed concerns over the proposed changes to eligibility. In addition, a feature article recently published in the Australian Financial Review has drawn further attention to the broad range of stakeholders expressing dissatisfaction with the proposed changes.

Senator Carr maintains that his intention is to provide a "better targeted, more generous, more predictable and less complex" tax incentive "for genuine R&D," and that "to the extent that the draft legislation is not delivering this intent it will be changed."

NSW Business Chamber would urge the Government to take this opportunity to review the constructive feedback it has received from stakeholders, and consider how the scheme can be amended to better achieve the Government's policy objectives.

The importance of innovation

Governments support research and development (R&D) because they recognise the benefits that this investment provides to the broader community. Government support for R&D increases levels of innovation, which in turn leads to greater productivity growth, and therefore higher standards of living.

Innovation as a driver of productivity

Innovation is an essential component of productivity growth. The Government's innovation strategy draws particular attention to this relationship, stating that *"Innovation is the key to making Australia more productive and more competitive. It is the key to answering the challenge of climate change, the challenge of national security, the age-old challenges of disease and want. It is the key to creating a future that is better than the past."*[1]

Productivity growth requires finding more efficient and effective ways to use existing resources. It is through innovation that these efficiencies can be developed and implemented. Innovation has been recognised by the Government as one of the key elements in its commitment to lifting productivity growth.[2] As the Prime Minister said, "it's about working smarter."[3]

Productivity growth as a driver of economic prosperity

The relationship between productivity growth and economic prosperity is well recognised. In its latest Intergenerational Report, Treasury stated that "productivity growth will be the major contributor to real GDP per person growth in Australia over the next 40 years."[4] The Report identifies enhancing productivity as the key to increasing economic growth, improving living standards and offsetting the fiscal pressures of ageing.[5]

Australia's productivity growth has slowed in recent years, averaging 1.4 per cent over the past decade, substantially lower than the 2.1 per cent annual growth realised during the 1990s.[6] Treasury calculates that if productivity growth could be maintained at 2 per cent per annum over the next 40 years, the economy would be 15 per cent larger than if productivity growth averaged 1.6 per cent.[7]

These findings and recommendations have been embraced by Government, and formed a key pillar in a range of presentations given by the Prime Minister in the lead up to Australia Day this year.

Government support for R&D

Recognising the relationship between investment in R&D and economic prosperity, the Government made innovation policy an early priority. On 22 January 2008, it commissioned a review of the National Innovation System (the Cutler review). The Government's response to the Cutler review was released on budget night in 2009, as the document *"Powering Ideas – An Innovation Agenda for the 21st Century."*

Powering Ideas committed to the introduction of an R&D tax credit, alongside a tightening of the definition of R&D to ensure that only genuine R&D qualified for the tax incentive. Both of these propositions were consistent with the recommendations of the Cutler review.

The Government subsequently released a consultation paper in September 2009, and draft legislation in December 2009, with the intention of the new scheme taking effect from 1 July 2010.

---

[1] Department of Innovation, Industry, Science and Research, *Powering Ideas – An Innovation Agenda for the 21st Century*, 2009, p. 1.

[2] The Hon. Kevin Rudd, Speech: *Building workforce participation and tackling social exclusion*, 22 January 2010

[3] The Hon. Kevin Rudd, Speech: *Tackling Australia's long-term challenges*, 23 January 2010

[4] Australian Treasury, *Australia to 2050: future challenges*, January 2010 IGR, p. xii.

[5] ibid., p. vii.

[6] ibid., p. xii.

[7] ibid., p. xii.

The new R&D Tax Credit

In their joint media announcement on 18 December 2009, the Treasurer and Minister for Innovation released draft legislation for the new R&D Tax Credit. According to the announcement, the new R&D Tax Credit "*follows through on the Government's commitment to deliver a more generous, more predictable and less complex tax system."* The media release also refers to the legislation cutting red tape, boosting investment in research and development, and lifting Australia's innovation capacity.

Broadly speaking, there are three main elements to the draft legislation:

- Measures which introduce the new 40 per cent and 45 per cent R&D Tax Credit;
- Measures designed to tighten the eligibility criteria; and
- Measures to enable joint administration by both the Australian Tax Office (ATO) and AusIndustry.

NSW Business Chamber holds significant reservations about the capacity of the legislation, as currently drafted, to achieve the Government's stated policy objectives. Instead, the legislation outlines a scheme that is less generous, and in some respects less predictable and more complicated. The legislation is likely to increase red tape, detract from investment in research and development and reduce Australia's innovation capacity.

The most likely outcome of the implementation of this legislation would be a significant reduction in R&D activity in Australia, which will inevitably lead to reduced productivity growth and lower standards of living for all Australians.

NSW Business Chamber is not alone in holding these reservations. The vast majority of submissions made to Treasury regarding its September consultation paper expressed concerns over the proposed changes to eligibility. In addition, a feature article recently published in the Australian Financial Review[8] has drawn further attention to the broad range of stakeholders expressing dissatisfaction with the proposed changes.

Generosity

In its September consultation paper, the Government reaffirmed their earlier statements that "implementation of the new R&D tax incentive is to be revenue neutral over its first four years of operation."[9] It is difficult to reconcile a commitment not to increase funding against public statements that the new scheme is more generous.

Leaving this observation aside, it appears that the proposed restrictions on eligibility go much further than would be necessary to achieve Budget neutrality. Treasury has not released any modelling of the costs to Government of implementing the various changes associated with the R&D Tax Credit. It would be prudent for the Government to undertake such modelling if it has not done so already, particularly given the Government's need to determine the impact of each of the scheme's elements on its own fiscal position.

Changes which will tighten eligibility, and therefore reduce Government outlays, include:

- Changing the definition of core activities, to require both novelty *and* high levels of technical risk;
- Restricting eligibility of supporting R&D activities through introduction of the dominant purpose test; and
- Dramatically limiting support for successful R&D through introduction of the augmented feedstock rule.

Independent and conservative costing carried out by Michael Johnson Associates as part of its September submission to Treasury indicated that the scheme would achieve revenue neutrality in the absence of any definitional changes, and that "there appears to be no case for any reform to the definition of R&D based on the need for maintenance of budget neutrality."[10]

The introduction of the proposed eligibility restrictions will reduce levels of R&D support and by definition reduce the generosity of the scheme.

---

[8] The Australian Financial Review, *It's a double-cross for R&D,* 1 February 2010, p. 53.

[9] Australian Treasury, *Consultation paper: The new research and development tax incentive,* September 2009, p. 2.

[10] Michael Johnson Associates, *The Treasury Consultation Paper: The New Research and Development Tax Incentive,* October 2009, p. 16.

Predictability and certainty

A number of the proposed changes included in the draft legislation will reduce the schemes certainty and predictability, making it more difficult for businesses to assess eligibility in advance of undertaking R&D activities. For example:

- Changing the requirement from “appreciable novelty” to “considerable novelty” removes existing well understood definitions and legal precedent for the term “appreciable.” The lack of guidance surrounding what is meant by “considerable” undermines existing certainty in this area.
- The augmented feedstock rule has been broadened to clawback commercial returns. As businesses do not know up-front whether their R&D investments will be successful, they can no longer be sure whether their expenditure will be eligible for R&D support.
- The dominant purpose test inherently involves a subjective assessment in determining what the “dominant” purpose of a particular activity was. The subjective nature of this assessment introduces additional uncertainty into the process.

Complexity and red tape

The new scheme will increase complexity and red tape. In particular, the requirement that supporting R&D activities be separately identified and costed will significantly increase compliance costs for businesses. Distinguishing between the two classes of activity will be time consuming and complicated. There is currently no need for businesses to separately identify these elements because they are all part of eligible R&D activities.

Complexity and compliance costs are essential considerations in program design. Shifting additional costs onto business undermines the attractiveness of the scheme and reduces utilisation. Compliance costs also reduce the efficiency of the scheme from a whole-of-economy perspective, as resources are reallocated from more productive roles to meet compliance requirements.

Investment in R&D and Australia’s innovation capacity

The R&D Tax Credit is a central element of the Government’s long-term agenda to lift Australia’s innovation capacity and performance, as set out in Powering Ideas.[11] This innovation agenda includes an ambition to increase the proportion of businesses innovating by 25 per cent, and lift the number of businesses undertaking BERD (business expenditure for R&D).[12]

NSW Business Chamber strongly supports these ambitions. Australia spends 2.01 per cent of GDP on R&D, compared to the OECD average of 2.26 per cent.[13] Further, business expenditure on R&D as a percentage of GDP is only half the OECD average.[14] For Australia to improve its performance relative to international peers, a supportive public policy environment is essential.

Unfortunately, the proposed scheme is inconsistent with the Government’s innovation agenda. The combination of reduced predictability and certainty, increased complexity and red tape, and reduced generosity, will collectively reduce the attractiveness of the scheme to businesses.

[11] The Hon Wayne Swan, Media release: *New R&D Tax Credit – Exposure Draft Legislation*, 18 December 2009

[12] Department of Innovation, Industry, Science and Research, *Powering Ideas – An Innovation Agenda for the 21st Century*, 2009, p. 43.

[13] ibid., p. 20.

[14] Cutler, *Venturous Australia: Building Strength in Innovation*, 2008, p. 7.

Senator Carr maintains that his intention is to provide a “better targeted, more generous, more predictable and less complex” tax incentive “for genuine R&D,” and that “to the extent that the draft legislation is not delivering this intent it will be changed.”[15]

NSW Business Chamber would urge the Government to take this opportunity to review the constructive feedback it has received from stakeholders, and consider how the scheme can be amended to better achieve the Government’s policy objectives.

Should you require further information or clarification of our submission, then please do not hesitate to contact Mr Micah Green, Policy Adviser – Tax & Competitiveness on (02) 9458 7259 or via e-mail at micah.green@nswbc.com.au.

[15] The Australian Financial Review, *It’s a double-cross for R&D,* 1 February 2010, p. 53.

Contact:
Mr Micah Green
Policy Adviser – Tax & Competitiveness
(02) 9458 7259
micah.green@nswbc.com.au

NSW Business Chamber
140 Arthur Street
North Sydney NSW 2060

ABN 56 077 016 874

Locked Bag 938
North Sydney NSW 2059

DX 10541 North Sydney

t> 13 26 96

f> 1300 655 277

e> navigation@nswbusinesschamber.com.au