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Senator Annette Hurley
Chair
Senate Economics Legislation Committee
Parliament House
Canberra ACT 2600

Dear Senator

Response to further questions regarding Tax Laws Amendment (Research and Development) Bill 2020 and Income Tax Rates Amendment (Research and Development) Bill 2010

Following the public hearings on Thursday 20 May and Friday 21 May, you requested in a letter to the Secretary of the Department of Innovation, Mr Paterson, further clarification on some themes that emerged from witnesses the Committee took evidence from.

Please find attached responses to your questions. In addition, we have provided advice on the proposed changes to intellectual property beneficial ownership provisions which have been raised by some Senators.

The Department is available to provide the Committee with any further assistance it may require.

Yours sincerely

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1. 'Research' taking precedence over 'Development'

There was a view that the legislation favours a more pure research focus rather than development or commercialisation of a product, process or service. This is a widely held view that Australia does relatively well in research but relatively poorly in the commercial development of that research, so this is a matter of critical importance in promoting innovation in Australian businesses.

Response

The R&D tax incentive is intended to provide support to both research and development activities. The policy intent is to encourage R&D activities for the purpose of generating new knowledge in either a general or applied form. The 'development' aspect of R&D is captured by the application of knowledge recognised in the object clause and also in the definition of *core* R&D. *Core* R&D activities are experimental activities that include activities conducted for the purpose of generating new knowledge (including about the creation of new or improved materials, products, devices or processes).

- The expression 'improved' within 'new' or 'improved' means experimental development activities. These experimental development activities can occur in any environment, including a production or commercial environment.

2. Dominant purpose

In a related matter, there was criticism of the use of the word 'dominant' in describing activity related to R&D. You would be aware of the discussion around the use of this word. I am specifically seeking your responses to the suggestion that;

- (a) The word 'dominant' could be replaced with 'substantial'
- (b) Rather than 'the dominant purpose, 'a dominant purpose' would resolve the perceived problems.

I am seeking advice on the legal significance and the practical effects of these words.

Response

The dominant purpose test ensures that taxpayers do not claim their 'business as usual' activities. The R&D tax incentive is not intended to support these activities, as normal business deductions are available for such activities.

- (a) Replacing the word 'dominant' with the word 'substantial' will not achieve the policy intent.
 - The word 'substantial' should be avoided because in other contexts the courts have found the word to be imprecise and potentially ambiguous. For example, in the 1979 Federal Court case of *Tillmanns Butcheries*

Pty Ltd v Australasian Meat Industry Employees' Union Justice Deane said:

- The word “substantial” is not only susceptible to ambiguity: it is a word calculated to conceal a lack of precision. In the phrase “substantial loss or damage”, it can, in an appropriate context, mean real or of substance as distinct from ephemeral or nominal. It can also mean large, weighty or big. It can be used in a relative sense or can indicate an absolute significance, quantity or size.
- If ‘substantial’ were used to mean ‘not insignificant or de minimis’, the existing low bar for supporting R&D activities would be retained.
 - This would be fundamentally inconsistent with the object that the R&D tax incentive should not support activities that would clearly be undertaken in the absence of the incentive.

(b) ‘A dominant purpose’ implies that activities can serve more than one dominant purpose. ‘Dominant purpose’ means the prevailing or most influential purpose. So an activity cannot be conducted for more than one dominant purpose.

- This will be inconsistent with the meaning of the term ‘dominant’ and will not solve the problem of claims related to ‘business as usual activities’.

3. Effect of current legislation

Can you provide any examples of where the current legislation results in large payments to some firms carrying out activities that may qualify under the current definition but are not effectively innovative activities? Naturally I do not expect specifics that will identify companies, but would be interested in identifying the nature of payments that might be wound back in order to make available further funds to more innovative work.

It has been suggested that unduly large R&D claims be dealt with by a cap or ratio mechanisms and I would appreciate some advice on the practicality of this suggestion.

Response

There has been a trend for claims to include more and more activities which would seem to be normal commercial business activities. In some cases, these ‘directly related’ supporting activities, which are not R&D in nature, amount to 90% of the tax concession claim. Weaknesses in the current legislation in relation to claims are illustrated by the following examples. These examples are derived from real claims.

- **Resource sector:** A mining company registers an R&D project for the tax concession which is concerned with improving extraction techniques. The cost of this core R&D is \$20 million. Nonetheless given the current weaknesses in the definition around supporting activities it claims \$500 million, the bulk of which is for normal mine operations and mineral extraction to test the R&D.
- **Construction sector:** A construction company has registered a project that involves the construction of a new building that has a stated design goal of meeting newly emergent accreditation standards. The core R&D centres on improved air-conditioning, yet the company has registered around \$100 million for the R&D project of which 85% is the cost of constructing the building which

the company regards as a 'prototype' to test the R&D. The actual core R&D activities probably represent less than 10% of the company's claim.

- **Manufacturing sector:** A company has registered an R&D project to upgrade a processing plant and claimed supporting activities include extensive time periods (years) to trial the impacts of claimed core R&D activities. In this case directly related supporting activities are in excess of 80% of total claim value.
- **Shipbuilding sector:** A boat manufacturer claims an R&D project that involves the design and construction of a new marine vessel for sale. The core R&D centres on improved hull design yet the R&D claim is around \$30 million with the bulk of the expenditure being in the directly related activities of the cost of hull construction, engines, luxury fitting out, sea trials and new design.

The introduction of a cap or ratio (instead of the dominant purpose test) in relation to supporting R&D claims is not practical for the following reasons.

- The cap or ratio will be arbitrary and there is no basis for determining the appropriate cap or ratio to apply.
- A cap or ratio will be inequitable to claims with a large amount of legitimate supporting R&D activity. There are also likely to be inequities between sectors, with some sectors by their nature having higher levels of legitimate supporting activity and others less.
- Setting a cap or ratio portrays the notion that "business as usual activities" can be claimed up to the point where the cap or ratio starts to apply. This is counter to the policy intent and will encourage strategic behaviour to maximise the benefit. If the activity is not genuine R&D it should not be supported even if it happens to be under the cap.
- A basic policy principle in designing an effective incentive scheme is simplicity and ease of understanding by potential investors in R&D. Caps and ratios create complexity and uncertainty and will diminish effectiveness in leveraging more R&D.
- Ratio's over multiple years of R&D are difficult to administer.

4 Feedstock provisions

Although it was held by government officials that the new feedstock provisions are consistent with the existing law, several submitters saw the Bill as broadening the concept of feedstock output. This was perhaps most concisely put in the Deloitte's submission which included a suggested remedy. Can you provide me with comments on this view?

Response

The Treasury's letter of 3 June 2010 to you on several issues they took on notice at the public hearing in Canberra on 20 May 2010 included clarifications on feedstock provisions. Our view corresponds with the Treasury's clarifications.

5 Changes to the treatment of Intellectual Property

The draft Bill before the Parliament proposes a liberalisation of the rules associated with the intellectual property ownership of research and development supported by the tax credit. This issue has been raised in a number of forums including the Senate Economics Committee.

Recent OECD work on the globalisation of R&D by multinational enterprises (MNEs) indicates that there are significant national benefits from having local investments in R&D. These investments are likely to anchor local R&D activities and attract further R&D investment by other MNEs. Multinational R&D investments greatly increase the flow of global expertise into the country, they provide the conduit for global commercialisation of local discoveries, and they facilitate exports by local suppliers. There are clear advantages for firms in co-locating process R&D with production, so investment in this type of R&D can also act as an anchor for manufacturing jobs.

The majority of R&D investment is in people, and this provides a national benefit that firms cannot easily move offshore. These skilled people are also significant assets for many other firms in the industry.

Under the current R&D Tax Concession many of these MNEs have not been encouraged to locate their R&D operations within Australia due to the requirement of ownership of intellectual property being held in Australia. Overseas R&D tax programs, such as in the United States, United Kingdom, Ireland and Canada don't discriminate on this issue. It is now established that what matters is where the R&D is performed, not where the intellectual property resides.

This was something that was recognised strongly in the Review of the National Innovation System. The Review stated:

“The Panel has adopted the principle that all R&D expenditure undertaken in Australia should be supported by the non-refundable tax credit. ... The Panel does not consider the focus on IP ownership is appropriate given the global nature of R&D and the movement of global enterprises across continents dependent on where the best environment exists, and in particular to gain access to capability, skills, and markets. Firms undertaking foreign-owned R&D expenditure in Australia would be able to access the non-refundable tax credit”.

The R&D Tax Credit deliberately applies to all R&D performed in Australia because it is now recognised that the majority of the benefits from R&D come from where the R&D is performed and not from IP ownership. The goal is to increase the amount of foreign investment in R&D in Australia and thus the spillover benefits to the Australian economy.

The Australian arms of multinational enterprises account for a disproportionate share of manufacturing exports, jobs and R&D. The change to the IP ownership rules will give those businesses a strong reason to expand their operations in Australia. Their investment creates jobs, brings the latest technology to Australia and enhances the skills of our workforce.

The fact that R&D is not Australian owned does not mean that it will not be exploited or commercialised in Australia. This depends on whether Australia offers a competitive business environment for such activities to be undertaken. In the same way, Australian owned IP will be commercially exploited where the environment is most attractive.