

The new R&D tax incentive

Submission to the Senate Economics Committee 26 May 2010

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representation



Invigorating Business Representation

Executive Summary

NSW Business Chamber welcomes this opportunity to make a submission regarding the Tax Laws Amendment (Research and Development) Bill 2010 and the Income Tax Rates Amendment (Research and Development) Bill 2010. 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.

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. Unfortunately, the proposed scheme (as detailed in the Bills) appears unlikely to achieve these objectives. In particular, we note the following concerns:

- **The objects clause:** The new object clause (s355-5), when taken in conjunction with the new definition for core R&D, seems to reflect an intention to limit support to research and exclude development. This is despite the fact that development represents the largest and most important aspect of BERD.
- **Definition of core R&D:** The Bill includes a completely new definition for core R&D. While Treasury's consultation guide states that the revised definition "uses clear language instead of ambiguous concepts," we would note that the introduction of a new test with new wordings and interpretations is likely to create significant uncertainty.
- **Dominant purpose test:** The requirement for businesses to differentiate between core and supporting R&D, and then identify the dominant purpose of supporting R&D, will increase both complexity and uncertainty. The dominant purpose test inherently involves a subjective assessment in determining what the "dominant" purpose of a particular activity was. In addition, the requirement that supporting R&D activities be separately identified and costed will significantly increase compliance costs for businesses.

The Government has been very clear in stating its intention that the package of R&D changes be revenue neutral. However, a number of stakeholders have expressed concerns that in aggregate, the changes to eligibility proposed in the legislation would result in a significant reduction in levels of R&D expenditure. Treasury has also undertaken modelling to understand the impact of these legislative changes on R&D, and found that the legislative changes are revenue neutral over the forward estimates.

Modelling the costs and benefits of the various legislative changes proposed is critical to understanding whether or not they will lead to increased levels of R&D activity. It is clear that Treasury and industry stakeholders have reached significantly different conclusions in modelling the legislative changes. In the interests of transparency and informed decision making, it would be beneficial if the Treasury modelling, including the assumptions underpinning it, was publicly released.

Recommendation 1: Treasury should release their modelling and underpinning assumptions regarding the costs of the proposed legislative changes and their impact on levels of R&D.

The desire to achieve budget neutrality has driven the tightening of eligibility criteria. One of the main areas where concerns about "excessive" claims arise is in relation to "whole-of-mine" claims. We would question whether a blanket application of a more complicated and restrictive set of eligibility criteria is the best way to address this issue. Other stakeholders have suggested that a "group cap" on claims would be a more effective solution. NSW Business Chamber believes that options such as this warrant further consideration.

Recommendation 2: The Senate Committee should consider whether direct caps placed on "whole-of-mine" claims would be more effective at achieving budget neutrality than tightening eligibility.

Since the initial announcement of its policy position on Budget night in 2009, the Government has been firmly committed to achieving an implementation date of 1 July 2010. While the desire to move quickly is admirable, rushing to achieve this artificial deadline has compromised aspects of the consultative process.

With the legislation introduced into Parliament on 13 May, the timeframes have once again been very tight. Hearings commenced on 20 May, giving stakeholders less than a week to review the Bill and supporting materials. Submissions are due by 26 May, the Committee must report by 15 June, and the legislation is scheduled to

commence from 1 July. This is a very limited timeframe within which to constructively comment on the proposed legislative changes.

According to the Government, the proposed legislative amendments represent “the biggest reform to business innovation policy in over a decade.” Given the significance of the changes proposed, it is critically important that the Government gets it right. In this context, a careful and considered approach is essential - seeking to rush the legislation through without proper consideration is unlikely to lead to high quality policy outcomes. As such, NSW Business Chamber supports the calls of other stakeholders in recommending that the implementation of this legislation be delayed to provide adequate time for proper consultation.

Recommendation 3: The legislation should be delayed until 2011 to provide adequate time for comprehensive stakeholder consultation.

Background

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

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.² 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.³ Productivity growth requires finding more efficient and effective ways to use existing resources, and it is through innovation that these efficiencies can be developed and implemented.

Recognising this relationship, the Rudd 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.

Public consultation around the form of the new legislation commenced following the release of a consultation paper by Treasury in September 2009. Unfortunately, the consultation paper introduced a number of concepts that were inconsistent with the ideas put forward in the Cutler review and Powering Ideas. Almost 200 submissions were received on the consultation paper, the vast majority of which were critical of the apparent change in focus.

Treasury subsequently released two drafts of the legislation for public comment, with the first exposure draft released on 18 December and the second exposure draft on 31 March. Both of these drafts substantially tightened the eligibility criteria for R&D, and appeared to go significantly further in restricting eligibility than was ever envisioned in the Cutler review. In total, the Government received more than 180 submissions on the draft legislation, and again, the vast majority of submissions expressed significant concern with the proposed approach.

It was in this context that the R&D Bill was subsequently introduced into parliament on 13 May. The NSW Business Chamber supports the Government's objective to introduce legislation which "will make Australian companies more innovative, productive and prosperous and position them to create jobs for the future."⁴ In particular, we are supportive of the move from a tax concession to a tax credit, and applaud the Government for its efforts to encourage R&D amongst SMEs through increased rates of support for this sector. We also acknowledge that some efforts have been made to address a limited number of concerns raised by stakeholders through revisions to the draft legislation.

However, it is equally true that many concerns about the proposed legislation remain. These concerns have been raised on a number of occasions by a diverse range of stakeholders in the sector, and cannot simply be discounted as vested interests. We would urge the Senate Committee to give serious consideration to delaying the passage of the legislation, to provide time for the legislation to be redrafted in a manner which properly addresses universal stakeholder concerns. In its current form, the legislation is unlikely to achieve the Government's publicly stated policy objectives.

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

² Australian Treasury, *Australia to 2050: future challenges*, January 2010 IGR, p. xii.

³ *ibid.*

⁴ The Hon. Kim Carr, *Increasing Support for Business Research and Development – media release*, 13 May 2010.

The legislation

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*.⁵ 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).⁶

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.⁷ Further, BERD as a percentage of GDP is only half the OECD average.⁸ 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.

In previous submissions to Treasury, NSW Business Chamber has expressed concern with elements of the proposed legislation. NSW Business Chamber is not alone in holding these reservations. The vast majority of submissions made to Treasury regarding both its September consultation paper and exposure drafts of the legislation expressed concerns over the proposed changes to eligibility.

Budget Neutrality

On a number of occasions, the Government has been very clear in stating its intention that the package of R&D changes be revenue neutral. In its September consultation paper, the Government reaffirmed its earlier statements that "implementation of the new R&D tax incentive is to be revenue neutral over its first four years of operation."⁹

However, it appears that the proposed restrictions on eligibility go much further than would be necessary to achieve Budget neutrality. In their previous submissions to Treasury, a number of stakeholders have expressed concerns that in aggregate, the changes to eligibility proposed in the legislation would result in a significant reduction in levels of R&D expenditure. Some submissions were accompanied by modelling supporting these assertions, with stakeholders estimating that the reduction in overall levels of R&D expenditure could be as high as 50 per cent.

The Government and Treasury do not appear to have attempted to refute the findings of this modelling. Instead, Treasury has also undertaken modelling to understand the impact of these legislative changes on R&D, and found that the legislative changes are revenue neutral over the forward estimates.

Modelling the costs and benefits of the various legislative changes proposed is critical to understanding whether or not the changes will result in increased levels of R&D activity. Without a sound understanding of this, it is impossible to assess whether or not the legislative changes are likely to achieve the underlying policy objective.

It is clear that Treasury and industry stakeholders have reached significantly different conclusions in modelling the legislative changes. In the interests of transparency and informed decision making, it would be beneficial if the Treasury modelling, including the assumptions underpinning it, was publicly released.

Recommendation 1: Treasury should release their modelling and underpinning assumptions regarding the costs of the proposed legislative changes and their impact on levels of R&D.

The desire to achieve budget neutrality has driven the tightening of eligibility criteria. One of the main areas where concerns about "excessive" claims arise is in relation to "whole-of-mine" claims. We would question whether a blanket application of a more complicated and restrictive set of eligibility criteria is the best way to address this

⁵ The Hon Wayne Swan, Media release: *New R&D Tax Credit – Exposure Draft Legislation*, 18 December 2009

⁶ Department of Innovation, Industry, Science and Research, *Powering Ideas – An Innovation Agenda for the 21st Century*, 2009, p. 43.

⁷ *ibid.*, p. 20.

⁸ Cutler, *Venturous Australia: Building Strength in Innovation*, 2008, p. 7.

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

issue. Other stakeholders have suggested that a “group cap” on claims would be a more effective solution. NSW Business Chamber believes that options such as this warrant further consideration.

Recommendation 2: The Senate Committee should consider whether direct caps placed on “whole-of-mine” claims would be more effective at achieving budget neutrality than tightening eligibility.

Objects clause

The new object clause (s355-5), when taken in conjunction with the new definition for core R&D (discussed below), appears to reflect an intention to limit support to research and exclude development. This is despite the fact that development represents the largest and most important aspect of BERD. Removing support for development would shift commercialisation activity overseas and undermine the capacity of the scheme to secure the benefits of R&D for the Australian economy.

Such an outcome would appear to be completely at odds with the current understanding of the policy objective. A rewording of these sections is essential to explicitly make clear that the R&D tax incentive is aimed at supporting both research *and* development.

Definition of core R&D

The definition of core R&D was completely rewritten in the second exposure draft of the legislation. In explaining the new approach, Treasury’s consultation guide¹⁰ states at paragraph 10 that the revised definition “uses clear language instead of ambiguous concepts.” However, we would note that the introduction of a new test with new wordings and interpretations is likely to create significant uncertainty. Similar concerns were raised by a number of parties in relation to the proposed inclusion of the term “considerable novelty” in the first exposure draft.

The new definition of core R&D appears to recognise the first two components of Frascati (basic and applied research), but is questionable to what extent it incorporates the third component (experimental development). This is in contrast to earlier advice provided in Treasury’s consultation paper, which indicated that the definition would be altered to bring it more in line with Frascati.¹¹

Dominant purpose test

We previously raised concerns about the dominant purpose test, noting that the requirement for businesses to differentiate between core and supporting R&D, and then identify the dominant purpose of supporting R&D, would increase both complexity and uncertainty. While changes since the first exposure draft will reduce the range of circumstances in which the dominant purpose test would be applied, the potential problems associated with the application of this rule remain.

The dominant purpose test inherently involves a subjective assessment in determining what the “dominant” purpose of a particular activity is. Many activities will have multiple purposes, and assessing which purpose is the dominant purpose will often be unclear. The subjective nature of this assessment introduces additional uncertainty into the process.

In addition, 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 needs.

¹⁰ Australian Treasury, *The new research and development tax incentive, consultation guide – 2nd exposure draft*, March 2010.

¹¹ Australian Treasury, *Consultation paper: The new research and development tax incentive*, September 2009, p. 10.

The Process

Since the initial announcement of its policy position on Budget night in 2009, the Government has been firmly committed to achieving an implementation date of 1 July 2010. While the desire to move quickly is admirable, rushing to achieve this artificial deadline has compromised aspects of the consultative process.

Consultation timelines have been highly condensed. The second exposure draft was released by Treasury on 31 March, with submissions from stakeholders due by 19 April, a total of only 10 working days. This is not sufficient time to digest 134 pages of legislation and provide substantive comments, particularly given that the second exposure draft incorporated a number of new concepts, including a completely new definition for core R&D.

In addition, the tight timeframes meant that Treasury had not completed its redrafting in time for the 31 March release. As a result, the second exposure draft did not include redrafted feedstock provisions, and instead merely stated that "a feedstock adjustment rule is under consideration."¹² Stakeholders were not provided with an opportunity to comment on this aspect of the legislation until after it was introduced into Parliament, which is an unfortunate and disappointing outcome.

With the legislation introduced into Parliament on 13 May, the timeframes have once again been very tight. Hearings commenced on 20 May, giving stakeholders less than a week to review the bill and supporting materials. Submissions are due by 26 May, the Committee must report by 15 June, and the legislation is scheduled to commence from 1 July. This is a very limited timeframe within which to constructively comment on the proposed legislative changes.

In addition, documents tabled by Treasury during the public hearings were not made available through the inquiry's website until 25 May, providing no time for stakeholder analysis.

According to the Government, the proposed legislative amendments represent "the biggest reform to business innovation policy in over a decade."¹³ Given the significance of the changes proposed, it is critically important that the Government gets it right. In this context, a careful and considered approach is essential - seeking to rush the legislation through without proper consideration is unlikely to lead to high quality policy outcomes. As such, we support the calls of other stakeholders in recommending that the implementation of this legislation be delayed to provide adequate time for proper consultation.

Recommendation 3: The legislation should be delayed until 2011 to provide adequate time for comprehensive stakeholder consultation.

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.

¹² Australian Treasury, *Tax Laws Amendment (Research and Development) Bill 2010 – 2nd exposure draft*, 31 March 2010, p. 26.

¹³ The Hon Wayne Swan, Media release: *New R&D Tax Credit – Exposure Draft Legislation*, 18 December 2009

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