Response to the R&D Tax Credit Scheme Legislation

Submission prepared by the
Australian Industry Group

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Executive Summary

The legislation for the New Research and Development Tax Incentive introduced to Federal Parliament on May 13 is due to take effect from 1 July 2010.

Ai Group believes the proposed legislation overall to be deeply flawed and which, if implemented, would significantly reduce the innovation efforts of Australian industry.

There are, however, a number of elements of the proposed changes to the R&D tax incentive that Ai Group fully supports. These include the change to the form of the incentive from an augmented deduction to a tax credit. This, together with the slightly higher effective rate of the general incentive and the more substantial increase in the rate of the refundable credit for a broader range of small to medium businesses, was warmly received by Ai Group over a year ago and we retain this support.

Ai Group also supports the proposal to extend eligibility for the tax incentive in cases where the intellectual property is owned offshore and the proposal to partially remove the anomalous treatment of software under the tax incentive.

We supported these changes despite the Government's proposal to remove the Premium 175% concession for certain incremental R&D expenditure. Our reasoning was that, given the Government's unwillingness to expand its support for business R&D, funds needed to come from somewhere. It was not our preferred position but one arising from the conditions imposed by the Government for the new policy to be revenue neutral.

These changes are positive changes that will improve the tax incentive for business R&D. They are measures aimed at improving productivity and competiveness and Ai Group maintains they should take effect from 1 July 2010.

However, we very firmly oppose the fundamentally new approach to defining business R&D expenditure that is embodied in the legislation before the Committee. It is embodied in the objects clause, the changed definitions of eligible expenditure and the restrictions relating to the treatment of core and supporting expenditure.

Our opposition has three elements: the timetable the Government has imposed; the restrictive nature of the definition of eligible business R&D expenditure and the heavy compliance requirements that we anticipate would arise from the structure of the new approach.

Firstly, the Government has given itself an absurdly short timetable for community consultation and examination by the Parliament of what is a fundamentally new approach to the definition of eligible expenditure. The new approach would apply to all business R&D expenditure undertaken from 1 July 2010 and, under the timetable presented to us, business will have about two weeks to examine the new Act before R&D spending will come under the new regime.

Putting aside the particular features of the proposed changes, this timetable for introducing a fundamentally new approach will increase the range of grey areas

surrounding the tax incentive and the resulting uncertainty will see businesses scale back their expenditure. This outcome sits in stark contrast to the purpose of the R&D tax incentive – which is to encourage additional R&D expenditure by business.

The second and central basis for our strong opposition to the new approach to defining eligible business R&D expenditure is that it is highly restrictive. For around 25 years our R&D tax incentive has been based on what is known as the Frascati model that has been developed under the auspices of the OECD over a number of decades.

The narrow coverage of the objects clause suggests to us that the Government intends to pare back the role of the R&D tax incentive to fund, almost exclusively, research. It does not intend to include much of what business R&D is about, namely the development of exiting knowledge to "devise new applications". Instead the Government intends that the R&D tax incentive will apply to activities conducted for the purpose of producing new knowledge. This formulation would exclude from eligibility for the tax incentive a large proportion of business spending on R&D.

The third element of our opposition to the proposed approach is that it will increase compliance costs. Under the proposed approach business will need to split its R&D activities into core R&D activities; directly related supporting R&D activities; and supporting R&D activities subject to the new dominant purpose test.

This would be a permanent feature of the new approach and will add substantially to business compliance costs of the program. As is generally the case, the extra compliance costs will fall disproportionally on smaller businesses.

In summary therefore, Ai Group proposes that, except in relation to R&D where the intellectual property is held offshore and in relation to the removal of the anomalous treatment of R&D relating to software, there should be no changes to the eligibility rules for expenditure for R&D until there has been adequate scrutiny of the proposed approach in close and effective consultation with industry. Any other changes to eligibility could take effect from 1 July 2011.

We nevertheless propose that the new form of the tax incentive including the changed arrangements for the refundable tax credit for smaller businesses should be adopted as announced in the 2009-10 Budget.

About Ai Group

The Australian Industry Group (Ai Group) is a leading industry association in Australia. Ai Group member businesses employ around 750,000 staff in an expanding range of industry sectors including: manufacturing; engineering; construction; automotive; food; transport; information technology; telecommunications; call centres; labour hire; printing; defence; mining equipment and supplies; airlines; and other related service industries.

The Importance of R&D and Innovation to the Australian Economy

The Research and Development tax incentive provides critical support to industrial research and development expenditure. The period since the introduction of the incentive has seen very strong growth in Australia's Business Expenditure on Research and Development (BERD).

The significant demographic, environmental and competitive challenges facing Australia call for continued efforts to raise our rate of productivity improvement.

The importance of R&D in raising productivity and improving competeviness is of course relevant across the economy. It is doubly valuable for businesses on the slower side of Australia's two-speed economy. The pressures on key sectors, such as manufacturing, agriculture and tourism, to adjust to the greater call on internal resources, the higher domestic currency and the upwards pressure on interest rates that are associated with the ongoing strength of demand for Australia's mineral commodities put a premium on improvements to productivity and competitiveness improvements.

Moreover, for the manufacturing sector in particular, the same forces driving demand for our mineral commodities – that is the rapid industrialisation of China and other emerging economies – are also driving unprecedented levels of global competition for manufactured products, pulling down prices and challenging Australian producers both in export markets and in our domestic economy.

Notwithstanding the significant contributions that can be made by Governments to improve productivity, the larger share of improvements stem from measures undertaken in the private sector to improve products, services, organisations and production and distribution processes. Research and development undertaken in the private sector is a critical element in this.

Ai Group agrees that the case for public support of business research and development activity arises because of the direct and indirect spillovers that arise when the full value that flows from this expenditure is not captured by the businesses making the expenditures but part of which flow to other parties.

Without public support, the total quantity of business expenditure undertaken would be less than the socially optimum level. An incentive such as Australia's tax incentive that provides benefits to the company undertaking R&D expenditure is an appropriate intervention to boost the level of private expenditure towards the socially

optimum level. Ai Group notes that the R&D tax incentive is far and away the predominant form of public support for private sector R&D in Australia. This is unlike most other countries where direct expenditures also play much more important roles.

For these reasons Ai Group has long been a supporter of business R&D and of the tax incentive for business R&D. We regard it as a critical element in the relative success of Australia over the past couple of decades and we regard the role it has to play over coming decades to be of even greater importance.

The Central Problem with the Proposed Eligibility Rules for R&D Expenditure

For around 25 years Australia's R&D tax incentive has been based on the Frascati definition of R&D that has been developed under the auspices of the OECD over a number of decades.

Under the Frascati model R&D is defined as:

> *creative work undertaken on a systematic basis in order to increase the stock of knowledge, including knowledge of humanity, culture and society, and the use of this stock of knowledge to devise new applications*.

The second part of the definition "*the use of this stock of knowledge to devise new applications*" is central to our objections to the new approach proposed by the Government.

Core R&D

Subdivision 355-A—Object (s355-5) of the Tax Laws Amendment (Research and Development) Bill 2010 states that:

> *(1) The object of this Division is to encourage industry to conduct research and development activities that might otherwise not be conducted because of an uncertain return from the activities, in cases where the knowledge gained is likely to benefit the wider Australian economy.*
>
> *(2) This object is to be achieved by providing a tax incentive for industry to conduct, in a scientific way, experimental activities for the purpose of generating new knowledge or information in either a general or applied form.*

Critically this clause omits the second critical element in the Frascati approach – "the use of this knowledge to devise new applications."

The narrow coverage of the objects clause, despite repeated feedback from business, suggests that the Government intends to pare back the role of the R&D tax incentive to fund, almost exclusively, research. It does not intend to include much of what business R&D is actually about, namely the development of exiting knowledge to "devise new applications". Instead the Government intends that the

R&D tax incentive will apply to activities conducted for the purpose of producing new knowledge.

If this is the Government's intention it would be more straightforward to refer to it as the Research Tax Credit.

The definition of Core R&D activities in s355-25(b) confirms the research focus of the new approach to business R&D. Core R&D activities are defined as:

> *experimental activities:*
>
> *(a) whose outcome cannot be known or determined in advance on the basis of current knowledge, information or experience, but can only be determined by applying a systematic progression of work that:*
> *(i) is based on principles of established science; and*
> *(ii) proceeds from hypothesis to experiment, observation and evaluation, and leads to logical conclusions; and*
> *(b) that are conducted for the purpose of generating new knowledge (including about the creation of new or improved materials, products, devices, processes or services).*

Note that *both* a) and b) need to be satisfied before activities would qualify as core R&D. This approach leaves little room for the majority of what business R&D is actually about – what, in the Frascati model, is called "experimental development". Experimental development is defined as

> *systematic work, drawing on existing knowledge gained from research and/or practical experience, which is directed to producing new materials, products or devices, to installing new processes, systems and services, or to improving substantially those already produced or installed.*

In its 2007 report *Public Support for Science and Innovation* (at page 31), the Productivity Commission broke down the proportion of business expenditure on R&D into four categories: pure basic research, strategic basic research, applied research and experimental development. Based on 2004-05 data it estimated that the total business expenditure on R&D was allocated as follows:

Pure basic research	1.8%
Strategic pure research	5.0%
Applied research	31.6%
Experimental development	61.6%

Critically, the Productivity Commission (at page 8) used exactly the same definition of experimental development as quoted above. The central point about that definition is that it covers systematic work, *drawing on existing knowledge gained from research and/or practical experience*.

Supporting R&D

It may be contended that while experimental development is excluded from the definition of "core R&D", it is adequately covered in the definition of "supporting R&D". Unfortunately, this is not the case. It is not the case for two reasons.

Firstly, supporting R&D expenditure is only eligible if it is ether "directly related to" core R&D activities or if it is "undertaken for the dominant purpose of supporting" core R&D activities. This means that businesses would have to be undertaking core R&D before *any* of its R&D expenditure could qualify as supporting R&D expenditure. If a business has no expenditure that qualifies as core R&D, it will have no eligible R&D expenditure.

Secondly, in any case much experimental development is neglected by the dominant purpose test in the definition of supporting R&D activities. In the Bill (s355-30), a supporting R&D activity is defined as an activity directly related to core R&D activities except if it is an activity that is: explicitly excluded, *or* if it is an activity that "produces goods or services", *or* if it is an activity "is directly related to producing goods or services". In any of these cases the expenditure needs to be undertaken for "the dominant purpose of" supporting core R&D activities.

One of our advisors put it this way: "it is difficult to think of many supporting activities that don't fall into one of the three dominant purpose categories given that any activity directly related to production is captured."

Put simply, there are simply too many ways that supporting R&D activities will be excluded from eligibility for the proposed new R&D incentive for business to have any confidence that experimental development will continue to attract a tax incentive.

Specific member commentary on the impact is direct. To quote one member:

> *"The effect of these changes would see the exclusion of vital development activity from eligibility, in favour of 'pure' research that in the absence of an associated development phase, has no commercial application.*
>
> *"In a manufacturing environment, research and development is necessarily heavily biased towards development in a live production environment – whether that be to commercialise research into new marketable products, to improve existing products, or to improve the efficiency of manufacturing processes. All of these activities are essential in order to remain competitive in a mature global industry, continue to export, and compete against imports."*

Another larger member identified the following impact to their R&D activities:

> *"We believe that more than 60 per cent of our current activities would not be eligible. Importantly, SMEs can expect a flow-on impact from the reduction in R&D activities across larger companies. The legislation clearly favours white coat research rather than development. On this basis alone the bill is flawed."*

Our strong opposition to the changes to eligibility for business R&D can be summarised in this way: it excludes a large proportion of business spending on R&D.

Why Compliance Costs will Rise if the Legislation is Enacted

It is the view of the Australian Industry Group that the legislation for the new R&D tax credit scheme will increase compliance costs. Under the proposed approach business will need to split its R&D activities into core R&D activities; directly related supporting R&D activities; and supporting R&D activities subject to the new dominant purpose test.

This would be a permanent feature of the new approach and will add substantially to business compliance costs of the program. As is generally the case, the extra compliance costs will fall disproportionally on smaller businesses.

This claim is very different to the claim made by the Government in the Explanatory Memorandum (p.9).

> *Overall, once the new R&D tax incentive matures, the compliance costs should … be lower than the comparative costs of obtaining the current benefit of the R&D Tax Concession.*

We think this is wrong and it appears to rest on a view of the relative complexity of the 175% premium concession. It is true that the premium concession is complex and has a high compliance cost. However, only 26% of the 7,754 companies who were registered for the tax incentive in the 2007-08 year used the 175% Premium. The other 74% used the 125% concession[1].

Certainly for these businesses the compliance costs under the new arrangements would be higher and our assessment is that for the remaining 26% of businesses, the jury is out on whether the complexity of the Premium concession would match the complexity of the proposed approach.

One member summarised the impact concisely:

> *"It would be more administratively complex and burdensome than the current incentive, particularly in relation to record keeping and the itemising of our activities."*

To this end, we think that most businesses that would claim the R&D tax incentive under the new approach would experience an increase in their compliance costs.

[1] (See *R&D Tax Concession Fact Sheet* at http://www.innovation.gov.au/Section/AboutDIISR/FactSheets/Pages/RDTaxConcessionBERDFactSheet.aspx.)

Other Problems with the Bill

One of the most significant flaws with the proposed legislation has been the inadequate time provided to the business community to examine and comment on what amounts to a fundamentally new approach to the R&D tax incentive.

While the first exposure draft was released before Christmas, there has been a wholesale rewrite of some parts of the legislation since this time. Entire concepts have either been introduced or withdrawn in this time. Modelling has also been produced, the methodology and assumptions for which has to be questioned as it departs from the commonly held view of industry that the new scheme could as much as halve Federal Government support for R&D in Australia.

This schedule presents business with about two weeks to examine the new Act before R&D spending will come under the new regime. Further, being a new approach, legal experts and practitioners would undoubtedly discover anomalies and unintended consequences over the coming months.

For instance, our view is that Section 355-225 of the Bill, which details expenditure that can not be notionally deducted, will have significant negative impact on the building industry in relation to important environmental innovation related to areas such as water courses, water management and many other activities undertaken to achieve green star ratings. This decision seems inconsistent with other areas of government policy and certainly counterproductive to the significant efforts being made to create a greener, lower carbon emitting economy in Australia.

These will require amendment and will require convincing the Government that amendments should be made. Assuming the Government is receptive, the new approach to business R&D will be adjusted on the run. This would be unfortunate and time consuming for the remaining businesses that are applicants to the scheme.

Putting aside the particular features of the proposed changes, this timetable for introducing a fundamentally new approach will increase the range of grey areas surrounding the tax incentive and the resulting uncertainty will see businesses scale back their expenditure. This outcome sits in stark contrast to the purpose of the R&D tax incentive – which is to encourage additional R&D expenditure by business.

Further, it should be noted that business has already completed or is in the final stages of agreeing budgets for the new financial year. These changes are the cause for significant uncertainty that is unhelpful, especially in the already uncertain economic circumstances which currently prevail in the global economy.

Other areas which concern Ai Group include:

- The potential for differing treatment of sectors likely to arise from the publication of sector guidelines for defining core activities. We see no valid reason to give preference to any particular sector in the economy. In so doing the extremely valuable innovation undertaken in sectors where Australia has proven track record of being able to compete globally may be discounted.

- The ‘expenditure not at risk’ provisions (s355-405) appear to have a wider application than contrast with the stated goal of the Federal Government to incentivise and stimulate greater levels of R&D. In Ai Group’s view the R&D tax credit scheme should not simply be an insurance policy for R&D of no commercial value.

- The feedstock provisions (Subdivision 355-H) which, while amended from the first exposure draft, are still very complex and will have a significant and negative impact on the manufacturing/engineering sectors in particular or any sector that creates successful products from their R&D.

The Path Ahead

If introduced in its current form the legislation for the R&D Tax Incentive would have negative consequences for the level of business expenditure on research and development and therefore puts at risk future productivity improvements and economic growth.

While some aspects of the new approach remain attractive to Ai Group, the new restrictions on eligibility of expenditure presents a major threat to business R&D.

For the past twenty or so years Australia has been playing a game of catch-up with our OECD counterparts when it comes to R&D. The existing tax incentive scheme has played a fundamental role in helping improve our relative standing. While we accept that it can be improved, Ai Group does not accept that the proposed tax credit scheme, in its current form, is a step in the right direction.

The clear bias to ‘research only’ activities is inappropriate. The compliance burden for businesses wanting to use the scheme is too high. The administration of the program is too heavy handed. The likelihood is that the scheme will heavily reduce funding for business R&D.

Ai Group therefore proposes that:

- Except in relation to R&D where the intellectual property is held offshore and in relation to the removal of the anomalous treatment of R&D relating to software (both of which should take effect from 1 July 2010), there should be no other changes to the eligibility for the R&D tax incentive until there has been adequate scrutiny of alternative approaches.

- Any changes to eligibility that withstand appropriate scrutiny could take effect from 1 July 2011.

- We also propose that new form of the tax incentive (tax credit), the new rates of incentive and the changed arrangements for smaller businesses should be adopted with effect from 1 July 2010.