Business Strategies International

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Department of the Senate
PO Box 6100
Parliament House
Canberra ACT 2600

SUBMISSION IN RELATION TO TAX LAWS AMENDMENT (RESEARCH AND DEVELOPMENT) BILL 2010 - THE NEW RESEARCH AND DEVELOPMENT TAX CREDIT PROGRAM

BSI Innovation Pty Ltd (BSI) is pleased to provide this submission to the Senate Economics Legislation Committee (the Committee) outlining our significant and serious concerns with elements of the *Tax Laws Amendment (Research and Development) Bill* 2010 (the Bill), and the accompanying Explanatory Memorandum (the EM).

BSI is a leading Research and Development (R&D) Tax Concession advisory firm, and a member of the R&D Tax Concession Administration Consultative Group (ACG) which meets bi-annually to review the operation of the current incentive. BSI has provided claim preparation, R&D planning and assessment, and strategic review services to around 180 companies annually during the past 19 years (formerly as The Fallon Group). Our team of experienced senior advisors to industry are well placed to comment on the likely ramifications of the implementation of the new incentive as drafted in the Bill.

EXECUTIVE SUMMARY

BSI supports an increase to the effective rate of support for investment in private sector R&D as contained in the Bill, and the delivery of those benefits as a refundable/non-refundable tax credit.

However, we strongly believe that the Bill in its current form not only threatens the achievement of the core program objectives of incentivising and encouraging additional investment in R&D by Australia's private sector, but also risks undermining increases in Australia's level of Business Expenditure on Research and Development (BERD) achieved since 1985 under the existing R&D Tax Concession (the Concession).

The principal flaw in the Bill relates to the "dominant purpose" restriction on the eligibility of supporting R&D activities conducted in a production environment (Subdivision 355-30(2)(b) and (c)). This element of the Bill, outlined in detail below, acts to exclude otherwise valid and important R&D activities purely on the basis that they are conducted in, or with some relation to a production setting. Contrary to advice before the Committee in the Joint Submission of Treasury and the Department, the extent to which an R&D activity is related to production activities should *not* be a relevant factor in determining that activity's categorisation as either a core or supporting R&D activity. Australian companies (and in particular SMEs) routinely undertake extensive R&D activities within or in parallel with routine production – this does not mean the activities are any less innovative, ambitious or exposed to the risk of failure. To penalise firms for this practice, as this Bill currently does,

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not only overlooks or ignores this reality, but will in our view result in the exclusion of legitimate R&D activities from the incentive without any consideration of the role of those activities within an R&D project. Furthermore, the discretional interpretation of determining this "degree of proximity" (refer worked examples Matryoshkoala and Hayk Hockey Stix in the EM) creates a high level of uncertainty both in self-assessment and administration of the legislation.

The achievement of revenue neutrality, and associated limitations on the scope of claimable expenditure should not, in our view, be attempted through the drafting of technical eligibility criteria (such as these definitions of Core and Supporting R&D). Where an activity can be shown to be directly related to the progress of an eligible R&D project, that activity should be classed as an eligible R&D activity under the incentive, and its cost eligible in full as is currently the case under the Concession. Where the intention of Government is to limit the quantum of claims to achieve a predetermined cost to revenue for the program, we would suggest this should instead be achieved via an explicit cap on the level of benefits available to any one entity, or group accessing the program.

A second major flaw is the retention of an effective compound requirement for both innovation <u>and</u> technical risk in the definition of Core R&D Activities (s.355-25) in the Bill, which significantly limits the scope of activities (and hence projects) that would be able to qualify.

It is the breadth and generality of the existing R&D Tax Concession program which have underpinned its success in generating increased BERD levels across the Australian economy during the past two decades. To abandon that success, and now replace this program with the narrow and short-sighted incentive currently contained in the Bill will, in our view, send a clear message to many Australian firms that Government support for private sector investment in R&D has in effect been withdrawn.

The following discussion further details the various flaws we see in the Bill and EM, and comprises elements of BSI's previous submissions to Treasury (in response to the first and second exposure drafts) which we feel are central to the Committee's inquiry.

We would be happy to brief the Committee further on any aspect of this submission.

<u>ISSUES WITH THE BILL</u>

Core R&D

The new definition of Core R&D (s.355-25(1)) abandons the existing stable and well-understood definitions of SIE activities (used in the Concession) entirely - and with it some 25 years of precedential case law, tax rulings, and corporate knowledge. While the EM claims that the new definition uses "clearer language" instead of relying on the established concepts used in the Concession, it is our view that instead, it imposes a highly complex and prescriptive series of compound tests that an applicant taxpayer is expected to self-assess before seeking to access the incentive.

The tests are prescriptive in that they define eligible activities on the basis of their <u>form (requiring them to be in the form of an experiment)</u>, rather than their <u>content (innovation and technical risk)</u>.

Furthermore, the new definition, by way of its construction, implicitly requires the simultaneous presence of both innovation <u>and</u> technical risk in order for a Core R&D activity to exist. As argued many times over during the last two decades, and more recently by the

majority of respondents in this consultation process, many innovative and financially (and fiscally) rewarding private sector R&D outcomes may quite reasonably rely on only one of those conditions. It appears therefore to be counter-productive and restrictive to the overall economic objective of the R&D incentive to impose such a compound test for eligibility of Core R&D.

The new and unfamiliar concepts underlying the new definition of Core R&D in the revised Bill not only narrow the scope of eligible activities, but also introduce a degree of legislative uncertainty which we feel will largely preclude or discourage many applicant companies from confidently self-assessing their eligibility.

We would therefore suggest that this new definition be abandoned in favour of a return to the established definition of core and supporting R&D activities (using an innovation **or** high levels of technical risk test) as exists today under the Concession.

Supporting R&D

The change (between the first and second Exposure Drafts) to the definition of supporting activities to a "directly related" criteria similar to that contained in the Concession was a welcome change to the first exposure draft of the Bill. In our experience this method of determining the nature and magnitude of supporting R&D activity operates efficiently and is a concept well understood by industry, consultants and departmental staff alike.

However, the retention of the "dominant purpose" requirement for supporting R&D activities, which are also activities which produce, or are related to the production of, goods or services (s.355-30(2)(b) and (c)), undermines the otherwise positive aspects of this change. Subsection 355-30 of the Bill creates a new requirement to classify at least four (4) types of supporting activities and, where they fall within s.355-30(2), to also establish the dominant purpose of each activity. This introduced complexity not only limits the scope of eligible activity, but also results in a program whose operation is far removed from any ideal of self-assessment.

The breadth of the term "production of goods or services" used in s.355-30(2)(b) and (c), should not be underestimated, especially as there is no accompanying definition of the term in the Bill, nor any qualification regarding the normal business activities of the taxpayer. An activity which is *directly related* to the carrying on of a core R&D activity, but which is also an activity which *produces goods or services* will be excluded from support under the incentive except in those rare cases where it can be shown that the production of goods and services is a subordinate purpose to that of supporting core R&D.

As noted above, the examples provided in the EM are ambiguous in their application of the dominant purpose test and in Eco Startup I and II, appear to import a qualification in relation to testing activities which is simply not present in the Bill as drafted. We are deeply concerned that this section will in practice be interpreted extremely broadly so as to effectively capture any R&D activity which is conducted in proximity to normal production activities. For a new, flagship R&D incentive program to adopt this approach to supporting R&D activities conducted in a production context is extremely regrettable. Not only does this appear to be a thinly veiled attempt to vastly reduce the scope and net benefit of the incentive, but it again confirms a Bill which is disconnected from the realities of undertaking the very R&D activities it seeks to encourage.

As would be expected in a private sector setting, the great majority of valuable Australian private sector R&D is undertaken on the back of activities whose dominant purpose is commercial. Most companies, and especially Australian SMEs, do not have the available

resources or spare working capital to isolate their R&D activities from their production activities to the extent required to maintain eligibility under the Bill. Indeed, it is often the case that supporting R&D activities (i.e. testing) conducted in a full-scale production environment, while failing the dominant purpose test in the Bill, are a vital factor in the ultimate success of Core R&D being undertaken, and thus warrant support under the incentive. For the Bill to overlook, or perhaps purposefully ignore this fact in the design of the new incentive is, in our view, to impair the capacity for success of the incentive from the outset.

As we advised during meetings with Treasury officials in February 2010, it is our view that these attempts to limit the cost of the incentive through an approach of narrowing technical eligibility provisions (be they core or supporting) will both *gut* the value of the incentive to applicants, and undermine any potential for encouraging *greater* investment in private sector R&D. The existing net benefit from the base 125% R&D Tax Concession, which contains no such "dominant purpose" restriction on the inclusion of supporting R&D activities, is 7.5%. To increase this to 10% or 15%, as the Bill nominally does, but also legislate to exclude production-related R&D from the incentive risks a real level of benefit considerably less than 7.5% of the full cost of the R&D activities. We believe that such an outcome would structurally undermine any ability the incentive may have to act as a true motivator of additional investment in R&D. We therefore urge the Committee to recognise the need for a further review the changes to both Core and Supporting R&D definitions with the goal of at least maintaining a similar scope of eligible activity as that currently set out within the Concession.

As we have stated above, concerns regarding the alleged "rorting" of the Concession are not best dealt with through changes to the legislative definitions of eligible R&D which penalise the entire Australian R&D community as a result. Instead, we would propose a different limitation on the eligibility of the *costs* of the supporting R&D activity, and an overall cap on total benefits under the program as follows:

(a) The definitions of Core and Supporting R&D could be changed to mirror those in operation within the existing Concession;

(b) A further legislative test could be included which limits the cost of any R&D activity (core or supporting) to expenditure (as set out in the withdrawn taxation ruling IT2552 at para. 14) which is incurred "directly in respect of R&D activities":

- where the carrying on of eligible R & D activities contributed to the incurring of all or an identifiable part of the expenditure; OR

- where the conduct of eligible R & D activities by the company would be materially impaired if the expenditure were not incurred.

(c) Were it deemed necessary given (b), a group cap of a significant size could also be incorporated to limit claims above a certain magnitude without necessarily questioning the technical validity of the activities undertaken.

Other issues with the Bill

Building Expenditure

As discussed with Treasury representatives, we feel that it is necessary to clarify the operation of certain provisions in the new legislation, which currently exclude all expenditure incurred in the acquisition or construction of a building, or an extension or alteration or improvement to a building, from classification as R&D expenditure.

The intent of the existing exclusion, in the current 125% R&D Tax Concession, can be traced back to the decision to deny accelerated depreciation of building expenditure (incurred after 20 November 1987) on structures used as R&D premises or facilities, such as R&D laboratories. This exclusion, as presented in the new legislation, and without clarification of this intent, would be taken to preclude expenditure on all R&D activities conducted in the development of building technologies and processes involving any associated prototyping and testing.

Subdivision *355-225 Expenditure that cannot be notionally deducted*, does not clarify this situation. There is still the inference that this exclusion is intended for expenditure on R&D facilities, by the instruction in Note 1 that "Expenditure covered by paragraph (a) may be deductible under Division 43 (capital works). However this still leaves considerable uncertainty regarding the eligibility of expenditure where construction, extension, alteration or improvement to a building is the actual subject of the research and development rather than a facility to conduct R&D.

The Australian building industry leads the world in the development of advances in sustainable development technologies and given that the program is intended to be broad based and there is no stated intention to exclude the building industry from accessing this program, we would recommend that this provision is clarified.

We suggest that a change to the wording of subsection 355-225 (1)(a) to include the words, "where the building is used as premises or a facility for conducting research and development", would achieve this result.

Core Technology

As we set out in our submission on the first Bill, the removal of accelerated deductions for core technology acquisitions appears counter-intuitive when considering the overarching policy objectives and justifications for a tax-based R&D incentive.

In our experience companies seek to license available technology to reach a point from which they can commence or continue an experimental R&D program of their own. To date, this has been encouraged and facilitated by the core technology provisions operable within the Concession, and their further eligibility for the R&D Tax Offset election.

The importance of the current treatment within the Concession of core technology expenditure, and its eligibility for a 100% refundable tax offset, for small, early-stage technology companies who are severely constrained in terms of working capital while undertaking an R&D program should not be underestimated. These benefits allow these firms to draw down on their future profitability (via the R&D Tax Offset) to assist in financing both the acquisition of precursor core technology, and further R&D activities based on that technology. To isolate expenditure of this kind as ineligible for the new R&D incentive, seems to suggest that it is preferable for researchers to "reinvent the wheel" rather than seek to identify appropriate licensable technology which may comprise the crucial starting point

for new research and inquiry. Relative to the stated program objectives it would seem illogical were the Bill to in fact produce such a result in relation to core technology acquisitions.

The decision to exclude core technology expenditure in the revised Bill in our view ignores the longer-term economy wide benefits to be obtained through encouraging the acquisition or licensing of technology which is “core” to a proposed or ongoing R&D program. In modern global markets, it is the trade in new intellectual property which in many cases allows firms to innovate at the pace demanded of them by customers and competitors alike. For the Bill to exclude core technology acquisitions (rather than perhaps introduce limitations for acquisitions between associated entities) in our view serves only to frustrate the ability of the program to produce the benefits sought by Government.

We would therefore again strongly urge a further amendment of these provisions to ensure that core technology purchases are also eligible for the incentive, and if necessary, with restrictions on the transfer of core technology between associate entities.

CONCLUSION

The Bill as drafted is fundamentally flawed when considered with reference to the level of benefit it will deliver to Australian firms conducting R&D in contrast to the existing Concession.

As we have stated above, there a small number of significant changes which could be made to the Bill to address these issues, and at the same time address the concerns of Government in relation to the overall cost and integrity of the program.

Over more than 20 years the R&D Tax Concession has successfully taken Australia's Business Expenditure on Research and Development (BERD) from near the bottom of the OECD ladder to about 13th place. However, in terms of BERD to GDP, we still only spend about half that of the international leaders.

This improvement has been achieved with all the benefits of the current Concession program. If the R&D support is slashed, as it will be under the proposed Bill, Australian BERD will quickly head back to the bottom of the ladder.

If the Government wants to encourage an "Innovation Revolution" it must, at the very least, maintain the current level of support for innovative Australian companies to undertake increasing levels of research and development.

We would be happy to further brief the Committee on the contents of our submission at any time. Please call either Mr Michael Lynch or Mr Marcus Webb on (02) 9212 5505 should you require any further information.

Yours sincerely
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