Sub no: 26.1
- SCIM, R&D Inquiry

R+D INQUIRY
Submission No. 26.1

Research & development tax concession

Objectives:

1985
The Government's principal incentive to increase the amount of R&D being conducted by Australian companies.

2002
R&D plans introduced to reinforce the need for companies to think strategically about R&D as a critical part of business.

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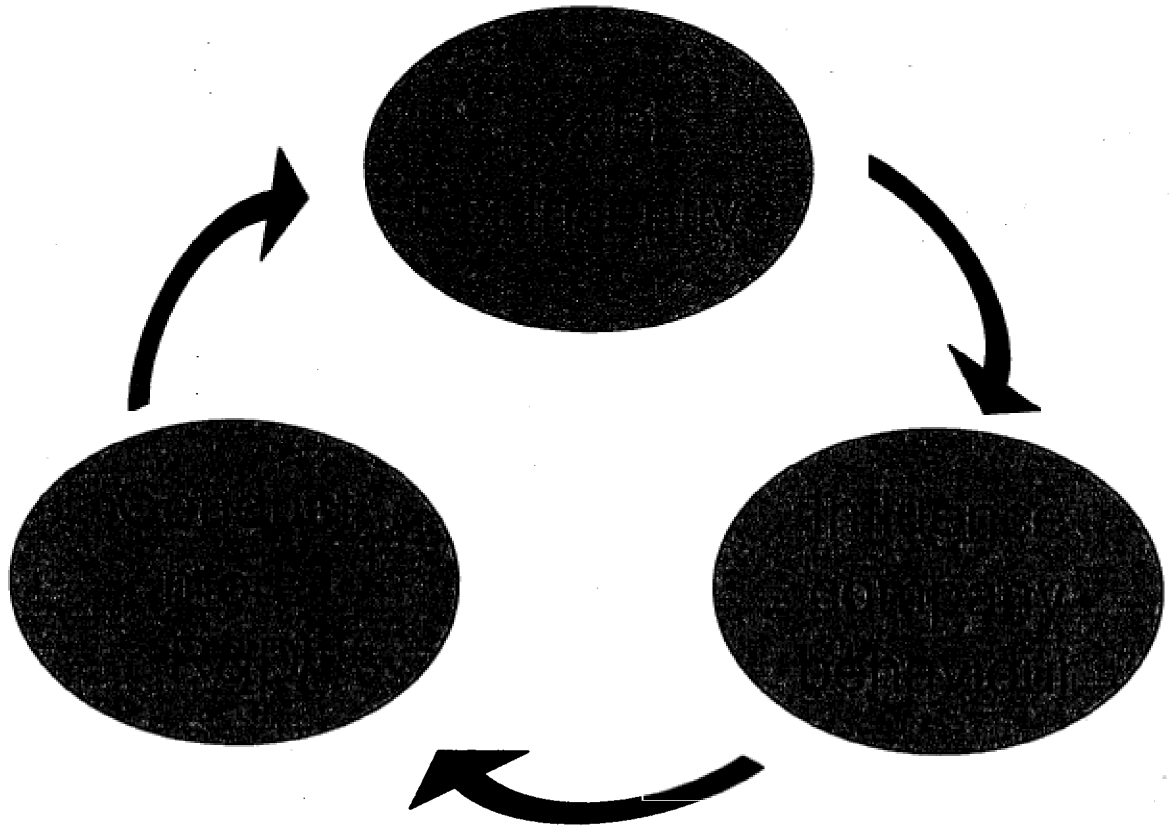
How are these objectives achieved through a tax concession?



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How effective is the tax concession in influencing company behaviour?

- How do you influence a company's behaviour?
  By influencing key decision makers

- Who are the key R&D decision makers within companies?
  The people who control and manage R&D funding

- What influences or motivates these people?
  Key performance indicators (KPIs) eg:
  - Financial measures – EBIT, EPS etc
  - Cost centre/budget management

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How effective is the tax concession in influencing company behaviour?

- Tax expense is not a KPI
- No annual growth measurement
- Tax expense is not measured against the R&D budget
- Tax expense is managed by Finance/Tax Managers
- Tax is complex and difficult to understand
- Tax benefits accrue in following years

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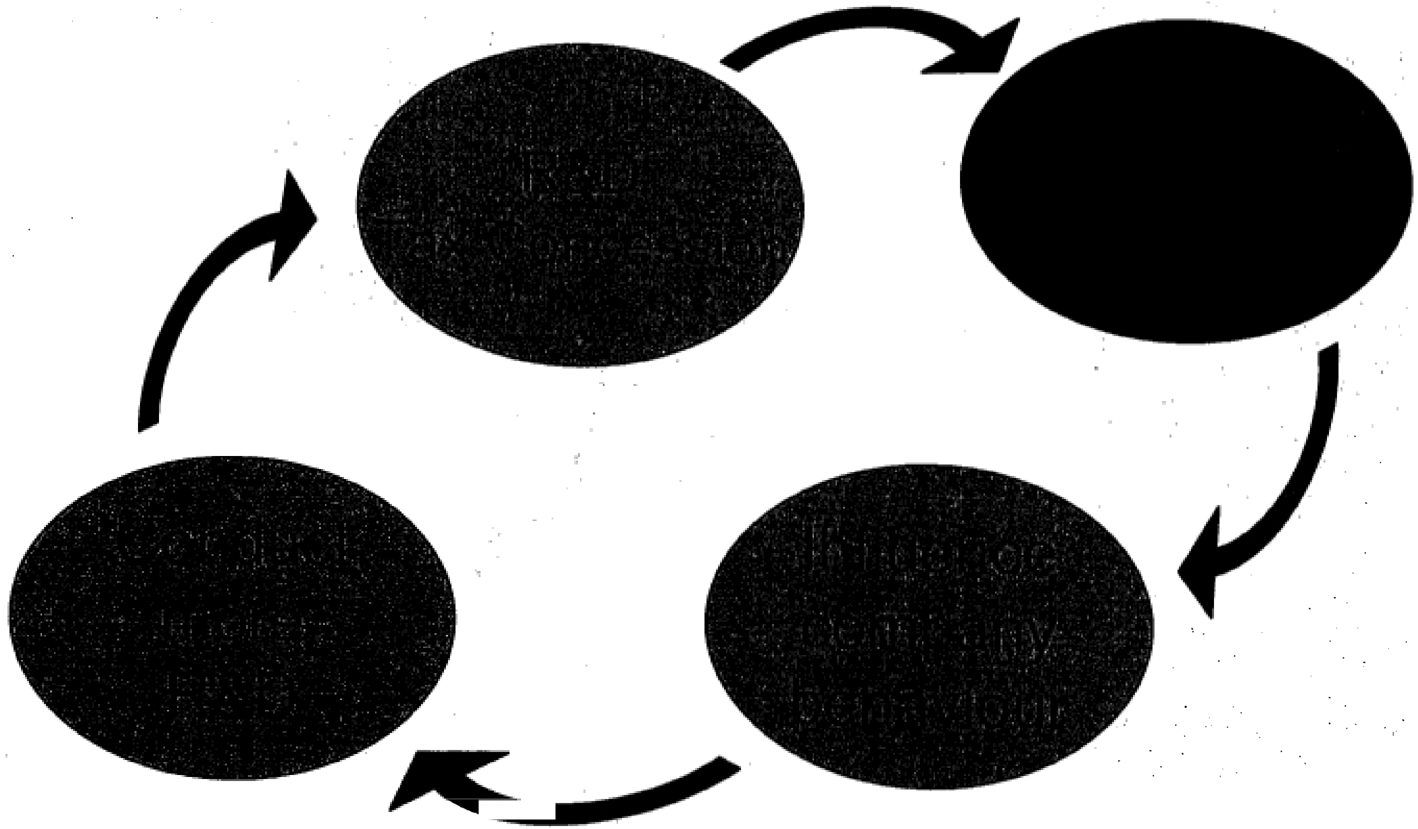
Research & Development Incentive



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Research & Development Incentive

Objectives: to increase R&D activity by effecting positive change in company behaviour

Solution: make the benefit of the concession attractive to: strategic business managers; decision makers; and innovators

How?: by redirecting the benefit so that it is recorded/recognised by business managers <u>NOT</u> tax or finance people

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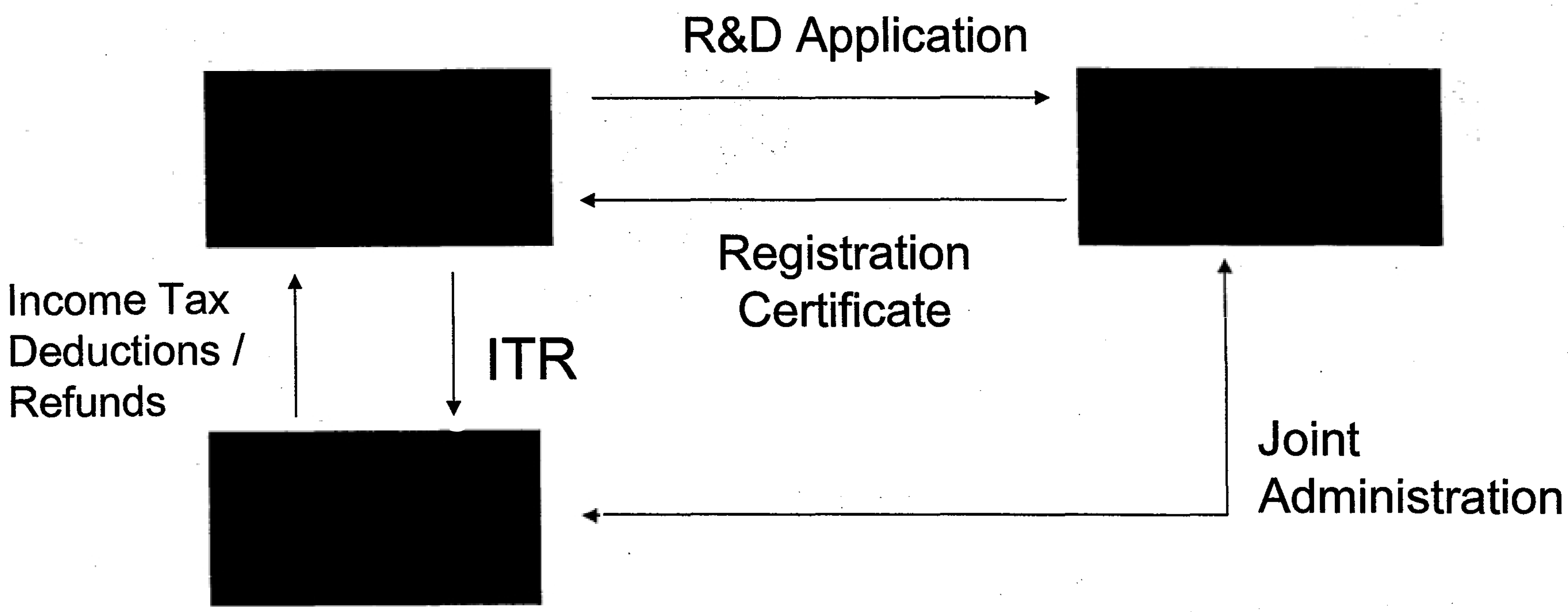
Current Tax Concession



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Proposed Research & Development Incentive

[redacted]

R&D Application

[redacted]

Grant Certificate

Grant offset against tax liability

Grant certificate

[redacted]

Joint Administration

[redacted]

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Delivery of R&D Incentive

- Grant Income
  - Pre-tax equivalent of the additional benefit provided by the existing R&D tax concession.
- Offset Arrangement with ATO
  - Offset agreement between ATO and AusIndustry allows grant to be offset against tax liability
  - Tax offset carried forward in the same way as tax losses.
- Accounting Standards
  - permit grant offset against tax liability to be recorded as operating income

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Calculation of R&D Grant

Existing Tax Concession

R&D Expenditure	$4,000,000
Additional Deduction @ 25%	$1,000,000
Additional Net Cash Benefit	**$300,000**

Proposed R&D Incentive

Additional Net Cash Benefit	$300,000
Pre-tax equivalent income	
($300,000/(1- 0.30*))	$428,571

**** Assumes income tax rate of 30%***

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Impact on Management Accounts

	R&D Tax Concession	R&D Incentive
R&D Budget	$4m	$4m
R&D Grant	-	$.428m
R&D Spend	$4m	$4.428m
Income Tax Benefit	$300K*	Nil*

** Not recognised in management accounts – so where does the money go?*

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Impact on Management Accounts

The R&D Grant effectively moves the tax benefit “above the line.”

Probable outcomes:

- Improved awareness of R&D concession
- Strategic recognition of R&D by senior management
- Benefit used to do more R&D and take greater risk
- Improved record keeping and accountability
- Contemporaneous recognition and use of benefit
- Harmony with R&D plan regulations

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Impact on Statutory Accounts

Current R&D Concession		Proposed Grant Incentive	
		Trading Profit	5,000,000
		Grant Income	428,571
Operating Profit	5,000,000	Operating Profit	5,428,571
Tax Expense:		***Tax Expense:***	
Operating Profit	5,000,000	Operating Profit	5,428,571
Less R&D Claim	(1,000,000)	Less R&D Claim	Nil
Profit adjusted for R&D:	4,000,000	Profit adjusted for R&D:	5,428,571
TAX EXPENSE @ 30%	1,200,000	TAX EXPENSE @ 30%	1,628,571
PROFIT AFTER TAX	3,800,000	PROFIT AFTER TAX	3,800,000

[redacted]

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Research & Development Incentive

What's New:

- Timely and direct nexus between R&D activity and the resulting incentive
- Highly visible to key decision makers
- Supports strategic thinking
- Easy to understand

What Stays The Same:

- No additional cost to revenue
- After tax benefit is the same as under the R&D tax concession
- Existing ATO/AusIndustry powers remain unchanged
- Dispute resolution process unchanged
- Available to companies in tax paying position

What Changes:

- Powers to effect offset by ATO/AusIndustry
- Simple changes to income tax law / other law

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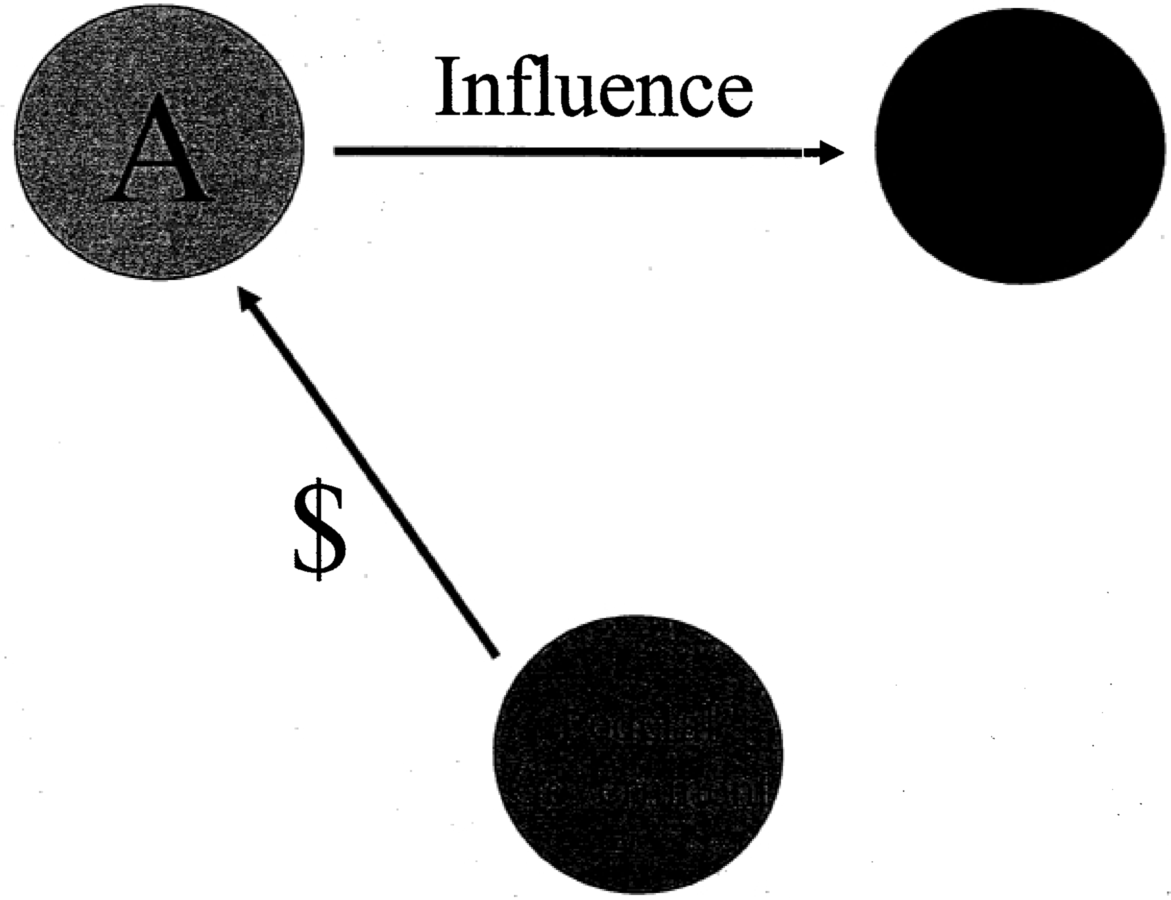
In a Nut Shell



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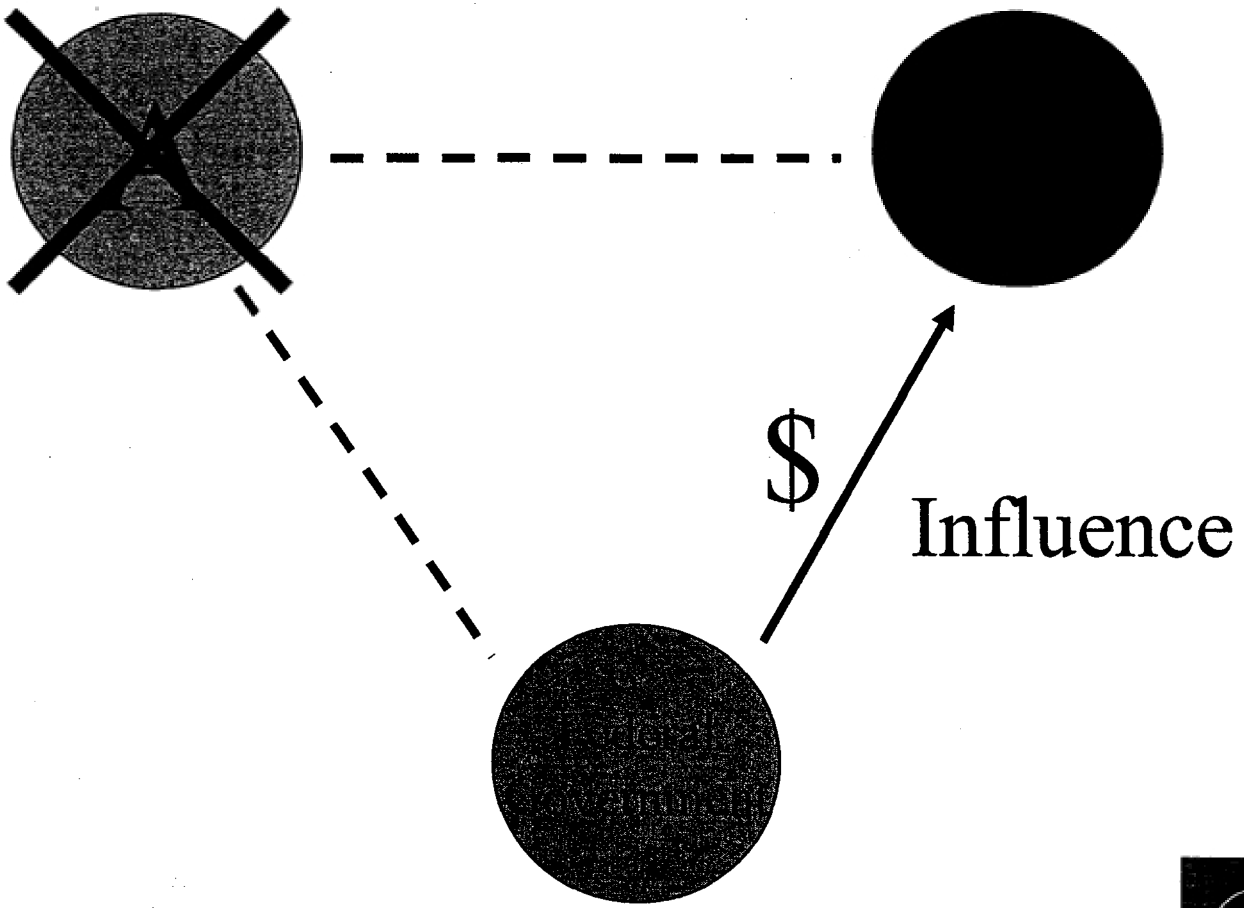
In a Nut Shell



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Where to from here?

- Data to support likely impact of change on behaviour
- Legal structure – offset arrangement
- Agreement of accounting treatment
- Details of joint administration – AusIndustry / ATO

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Research & Development Incentive

The current tax concession for Research and Development (R&D) expenditure was introduced in 1985 to increase the amount of R&D conducted in Australia to make Australian companies more internationally competitive through the development of innovative products, processes and services.

The achievement of this objective is underpinned by the belief that a tax incentive would influence company behaviour by reducing the after tax cost of eligible R&D activities.

In practice, however, the key decision-makers that control and manage the R&D function are generally motivated by key performance indicators (KPIs) not related to income tax expense. KPIs are usually based on pre-tax measures such as operating profit, or cost centre management. In contrast, tax expense tends to be managed independently by the finance function and is rarely factored into the R&D budget or performance measurement process.

GSK and PricewaterhouseCoopers believe that the effectiveness of the R&D tax concession can be significantly improved by delivering it in a form that is more easily understood and readily identified by key decision makers within companies.

This can be achieved, at no additional cost to the Revenue, by transforming the tax concession into a legal form which allows the benefit to be recorded as operating income for Accounting purposes. Moreover, this transformation can be implemented using much of the existing legal frame work, by converting the 'additional net cash benefit' of the existing R&D tax concession into an R&D Incentive or 'grant' which is payable by AusIndustry in favour of the claimant, to the Australian Taxation Office (ATO). A right of offset agreement between the company/taxpayer and the ATO would allow the grant to be netted against any outstanding income tax liabilities.

The effect of this arrangement would be to allow the benefit of the R&D concession to be recorded as 'income' for accounting purposes, without altering the 'substance' of the benefit provided. It would, however, put the benefit directly in the minds of the business managers, instead of tax managers, by directly reducing the cost of R&D to those managers, and by positively impacting before tax KPIs. Initial research into the likely effect of this proposal suggests the benefits could be dramatic.

This proposal would utilise much of the existing legislative framework which supports the existing tax concession and would maintain the joint administration of the concession by the ATO and AusIndustry. In particular, the powers of the ATO and the dispute resolution process would remain intact, as would the current rules for calculating the amount of the benefit.

Importantly, the proposed change to the delivery of the existing tax concession would involve minimal additional cost to the Revenue whilst encouraging and fostering R&D as the concession was intended, by directly targeting business managers, strategic thinkers and innovators across all industries and business sectors.