Senate Standing Committee on Economics
ANSWERS TO QUESTIONS ON NOTICE
Innovation, Industry, Science and Research Portfolio
Additional Estimates Hearing 2010-11
23 February 2011

AGENCY/DEPARTMENT: INNOVATION, INDUSTRY, SCIENCE AND RESEARCH

TOPIC: R&D Tax Credit

REFERENCE: Written Question – Senator Colbeck

QUESTION No: AI-74

1. Following the Minister's admission in a Financial Review report of 18 February 2011 (titled 'Business told to pay up for R&D') that he believes the spending on the current R&D Tax Concession system is "unsustainable", can the Department now confirm that thousands of businesses, advisors and consultants and the Opposition were all correct when they said this Bill will legislate for a reduction in BERD?

2. Given the elimination of the 175% concession and the likely contraction in what is recognised as genuine R&D, how much additional R&D would need to occur over the first four years of the new program to keep it revenue neutral?

3. On 21 May 2010, Peter Thomas – the Chair of Innovation Australia – told a Senate Economics Committee hearing that "in the end, it is all judgement" in relation to dominant purpose. Is that a reasonable statement of the application of the dominant purpose test – in other words, there will inevitably have to be some discretion and judgement used and that there will be some grey areas?

4. Has the Department had – or attempted to initiate – any discussions with the Board of Taxation with a view to having the Bill reviewed by them?

5. How much was paid to claimants through the 175% concession for each of the years 2007-08, 2008-09, 2009-10?

6. How much of the expenditure on the R&D Tax Concession for the years 2007-08, 2008-09 and 2009-10 respectively was paid to businesses with an annual turnover of $20 million or less?

7. Does the Department believe the dominant purpose test works against R&D in a production environment where the R&D is based on process developments or environmental projects or projects to improve manufacturing efficiency? If not, why not?

8. There is still no public modelling available of the effect of the new legislation. Has the Department received any documentation from the Treasury modelling the effect of the new legislation – and, if so, when? And what representations has the Department made to Treasury to seek more modelling (including the public release of this modelling) of the effect of the new legislation?

9. A stated benefit of the Bill is that the R&D Tax Credit is not tied to the company tax rate. Yet the feedstock adjustment in Section 355-465(2) assumes that the tax rate is 30% and all companies are eligible for the 40c tax credit. Given this:

(a) Why is this calculation tied to the company tax rate?
(b) Will all R&D research companies always pay 30% company tax given the Government's stated intention to reduce the Company rate for SMEs and later for larger companies?
(c) Do all taxpayers receive the 40c tax credit on their eligible R&D expenditure?
(d) Businesses that earn less than $20 million will receive a 35c credit on feedstock inputs where the feedstock output is sold for a profit. The more such a business spends on materials and goods prior to undertaking the R&D or energy for that R&D, the more they will benefit from this windfall gain. Why has this provision been designed in such a way when this windfall gain cannot occur under the current provisions?

10. The necessity to split R&D activities and costs between core and supporting is a brand new requirement. Under the current program, these activities are registered and costed together. What is the Department's calculation of the size of the increase in complexity and compliance costs that will accrue as a result?

11. The Bill proposes that the feedstock adjustment will need to be made each and every time a product made or partly made during an experiment is sold outside of the group. Where the product has a long maturation process after the experiment then the taxpayer claims the benefit including feedstock inputs in the year they do the experiment. The feedstock inputs are not clawed back until the product has matured and is sold. Is it true that the Bill is framed in such a way that it can provide a zero interest loan for the period of maturation?

ANSWER

1. No. The Minister's statement about the unsustainability of the current Tax Concession referred to the amount of business-as-usual activity that is being claimed, not the overall amount of benefit available. The current Tax Concession is allowing claims for business-as-usual activities that are not R&D. If these claims are left unchecked, in the long-term the current concession would become financially unsustainable. Thus, as part of the total R&D reform package, the Government has sought to tighten the definition around R&D to focus assistance on activities that are likely to deliver economy wide benefits that would not be enjoyed in the absence of public support. A significant part of this package is a doubling of assistance for small and medium businesses and an increase of a third for large firms. This should ultimately lead to more firms engaging in R&D and growth in BERD.

2. The modelling of the R&D Tax Credit is the responsibility of the Treasury portfolio.

3. The R&D Tax Credit Bills make use of a dominant purpose test, which is also used in other areas of the tax law, in relation to supporting R&D activities.

Paragraph 2.24 of the Explanatory Memorandum accompanying the Bills explains the dominant purpose test – 'Dominant purpose means the prevailing or most influential purpose. Implicit in the dominant purpose test is the acknowledgment that activities can serve, or be conducted for, more than one purpose. Accordingly, the fact that an activity serves a commercial objective as well as being directly related to R&D does not preclude it from qualifying as supporting R&D.'

AusIndustry, the program delivery agency, will be working with industry and other stakeholders to provide guidance and advice on the dominant purpose test, with information clarifying factors that will be taken into consideration in applying the dominant purpose test.

4. No.

5. The Science, Research and Innovation Budget Tables published by the Department show that the amount paid to claimants for the 175 per cent concession element of the R&D Tax Concession was: $330 million in 2007-08, $380 million in 2008-09 and $350 million in 2009-10 (this figure was the Estimated Actual for the year). These numbers are provided by the Treasury portfolio.

6. The Department of Innovation, Industry, Science and Research does not have access to this data.

7. No. The above examples are likely to fall within the definition of core R&D activities and consequently the dominant purpose test would not be activated. The dominant purpose test is only applied to supporting R&D activities.

The dominant purpose test does not work against supporting activities in a production environment that involves process developments or environmental projects or improving manufacturing efficiency. Any activities undertaken to support core R&D activities in a production environment will be supported if the supporting activities are undertaken for the dominant purpose of experiments (core R&D). The fact that an activity serves a commercial objective as well as being directly related to R&D does not preclude it from qualifying as a supporting R&D activity. Chapter 2 of the Explanatory Memorandum accompanying the R&D Tax Credit Bills contains a number of examples demonstrating the application of the dominant purpose test where a commercial objective is also present.

8. The General outline and financial impact section of the Explanatory Memorandum accompanying the R&D Tax Credit Bills shows the fiscal impact of the proposed R&D Tax Credit.

The Department of Innovation, Industry, Science and Research acknowledges the Treasury's role in modelling the fiscal impact of the R&D Tax Credit. The Department has liaised with the Treasury on an ongoing basis discussing various aspects of the design of the new R&D Tax Credit.

9.

(a) The calculation is not tied to the company tax rate. The feedstock adjustment in the Bill (subsection 355-465(2)) is explicitly 1/3 of the lesser of feedstock revenue and feedstock expenditure, without reference to the company tax rate.
(b) No. A company's tax rate will not be affected by whether or not they claim the R&D tax incentive.
(c) No. The R&D tax incentive is only available to R&D entities, which are defined at section 355-35 of the Bill. R&D entities with an aggregated turnover for the income year of less than $20 million receive a 45 per cent tax offset.
(d) It is not accurate to say that businesses that earn less than $20 million will receive a 35c credit on feedstock inputs where the feedstock output is sold for a profit. Such companies will receive a 45 per cent offset for their feedstock expenditure in the year it is employed, with a feedstock adjustment equivalent to 10 percentage points occurring when the feedstock revenue is enjoyed — which could be in a later year.

The assertion that this reflects a windfall gain does not take into account that the equivalent of 30 percentage points would ordinarily be deductible (under the prevailing company tax rate). Therefore the ‘extra compensation’ amounts to only five percentage points and reflects a judgment to err in the direction of supporting companies that seek to commercialise their R&D so that they are not out of pocket where the feedstock revenue is not enjoyed until a later year. By contrast, the current feedstock provisions are flawed in how they operate in cases where feedstock revenue in enjoyed in a later year to the year in which the feedstock expenditure is incurred.

10. The requirement to identity both core and supporting activities is not new. The only difference is that the Bill will expressly require the two types of activities to be clearly separated in the registration form. The separation has been introduced to ensure that the R&D tax offsets support core R&D activity in the first instance. By having supporting activities identified separately, the Government will be able to ensure that their dominant purpose is to support the core activity.

There could be some transitional compliance costs associated with the separate reporting of supporting from core R&D activities in the early stages of the new tax incentive regime. However, this will eventually dissipate as companies adjust their practices.

The Government has made changes to reduce compliance costs under the new tax incentive. These include removing the current requirement for companies to develop, maintain and submit a formal R&D plan and simplifying the benefits available to companies.

AusIndustry will provide guidance material to assist companies in identifying core and supporting R&D activities. In addition, it will organise information and education forums for companies and other stakeholders to provide information and clarify issues.

11. No, in the situation described it is not true that an amount equivalent to the ultimate feedstock adjustment is akin to a zero interest loan for the period of maturation. The Bill recognises that development of new products and processes involves feedstock expenditure that was ‘at risk’ at the time it was incurred and therefore it is appropriate to allow the full amount of the feedstock expenditure be initially eligible for the tax offset. The feedstock adjustment is, appropriately, triggered only when the feedstock revenue is obtained at the end of the maturation process. In this way the new tax incentive seeks to provide better and more generous recognition of risks involved in commercialising R&D.