Chapter 12

Schedule 11—Research and development tax concession

12.1 Schedule 11 to the bill amends the *Income Tax Assessment Act 1936* (ITAA 1936) to extend the premium 175 per cent research and development (R&D) tax concession to companies belonging to a multinational enterprise group for additional R&D expenditure on behalf of a grouped foreign company above a rolling three-year average of expenditure. Companies will also receive a specific base deduction for all expenditure that contributes to a company's calculation of additional R&D expenditure in that income year.

12.2 The bill also amends the *Industry Research and Development Act 1986* to deliver the policy intent of the measure. These amendments will give the Industry Research and Development Board additional functions and powers relating to foreign-owned R&D activities.

Background

12.3 The ITAA 1936 allows a tax concession for companies that incur expenditure on R&D activities. For a claimant to receive the R&D tax concession, that R&D must be undertaken on behalf of the company, not have guaranteed financial returns to the company and be exploited for Australian benefit. These rules currently disqualify Australian companies who conduct R&D on behalf of a foreign company, from claiming the R&D tax concession.

12.4 The R&D tax concession comprises three main elements:

- a base R&D tax concession that provides a higher rate of deduction of 125 per cent for all eligible expenditure on R&D activities;
- a refundable R&D tax offset that provides a cash refund to the value of the deduction for small companies in a tax loss situation; and
- a premium R&D tax concession that provides an additional deduction of 50 per cent to a total deduction for that expenditure of 175 per cent for all additional expenditure above the average of the three previous years of expenditure.

12.5 On 1 May 2007, the Prime Minister and the Minister for Industry, Tourism and Resources jointly announced that the Government would extend the premium 175 per cent R&D tax concession to multinational subsidiaries that choose to hold resulting intellectual property offshore and are currently unable to claim the R&D tax concession.

12.6 The extension of the premium 175 per cent R&D tax concession is intended to encourage additional R&D expenditure in Australia by multinational enterprise subsidiaries. An immediate 100 per cent deduction for expenditure on eligible R&D

activities and an additional 75 per cent immediate tax deduction on expenditure above the average of the previous three years of expenditure on R&D, will be provided.

12.7 The amendments to the provisions for the premium 175 per cent R&D tax concession are intended to have minimal changes to the eligibility or entitlements of current claimants for the premium 175 per cent R&D tax concession under the existing rules if they do not conduct any R&D on behalf of a grouped foreign company.

12.8 Eligibility for the concession is determined by claims history provisions. According to the EM, companies will be eligible for the additional deduction for the increase in expenditure on foreign-owned R&D in the premium 175 per cent R&D tax concession if they could deduct, or an eligible group member could deduct, under the base 100 per cent specific deduction in the current claim year and each of the previous three R&D expenditure history years.[1]

12.9 Transitional arrangements apply. These arrangements will deem companies to have deducted under the base 100 per cent specific deduction in each of the three income years prior to the particular company's first full income year commencing after 1 July 2007. This does not preclude a company from qualifying with three previous nil expenditure years. Foreign companies that establish a new presence in Australia will have immediate access to the 175 per cent concession. However the nil expenditure year will only be available if neither the eligible company nor any grouped eligible companies existed in that year or the preceding 10 years.[2]

Evidence on the Schedule

12.10 The committee received evidence on this schedule from Deloitte Touche Tohmatsu Ltd (Deloitte), the Minerals Council, the Australian Chamber of Commerce and Industry (ACCI) and from Medicines Australia.

12.11 The Minerals Council welcomed the new R&D provisions in the legislation,[3] as did the ACCI, which said that 'we strongly support that'.[4] Deloitte, for its part, was critical of a number of aspects of the Schedule, arguing that it did not go far enough and would benefit only a small number of claimants. The Deloitte submission also pointed to what the organisation considered to be a number of shortcomings, which are described below.

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1 EM, p. 247.

2 EM, pp 247–8.

3 Minerals Council of Australia, *Submission 7.*

4 Mr Michael Potter, Chief Economist, Australian Chamber of Commerce and Industry, *Proof Committee Hansard*, 28 August 2007, p. 5.

12.12 Medicines Australia was equivocal in its support, telling the committee that while it 'appreciated the policy initiative' and wanted to see the legislation pass, there were some outstanding concerns, specifically in relation to:

- how the legislation would be interpreted and implemented;
- the process of establishing a claim history (see paragraph 12.8); and
- written agreements.

12.13 Medicines Australia's major concerns revolved around how the legislation would be interpreted and implemented, once passed. Representatives told the committee that legislative interpretation had been a problem previously:

> We certainly do want to see the legislation passed, but that will necessarily flow on to some interpretative guidelines through the IR&D Board. In the past, as a result of interpretative guidelines, companies have been excluded from being able to access the tax concession, and we obviously would like to overcome those hurdles to maximise the ability of our member companies to access a tax concession. [5]
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> …
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> But it is the way the legislation is interpreted. … if the interpretation of other parts of 'eligibility' are not corrected then they still will not be able to access the tax concession and the incentive will not be there.[6]

12.14 Medicines Australia indicated that unless the legislation is interpreted in such a way as to allow companies to access it, it would not prove to be a significant incentive to greater R&D investment:

> …but my overall concern is that it will not be a very large incentive and that we will not see as big a rise in R&D as we would wish. So, the better it is interpreted to allow companies to access it, obviously the more incentive there is and you will get the greater investment.[7]

12.15 Medicines Australia representatives also questioned the process in the Schedule for establishing a claim history (the transitional claims history provisions).[8] They argued that the approach may disadvantage companies who are coming off a low R&D investment base, and sought an amendment that would allow an eligible entity to use its historical R&D spend as an alternative to the formula-based method.[9]

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5 Ms Deborah Monk, Director, Innovation and Industry Policy, Medicines Australia, *Proof Committee Hansard*, 28 August 2007, p. 15.

6 Ms Monk, *Proof Committee Hansard*, 28 August 2007, p. 16.

7 Ms Monk, *Proof Committee Hansard*, 28 August 2007, p. 16.

8 See EM, paras 11.36-7, 28 August 2007, pp 247–8.

9 *Proof Committee Hansard*, 28 August 2007, p. 15.

12.16 Finally, Medicines Australia questioned the requirement for a written agreement[10] between the Australian entity and the foreign company:

> While it is appropriate that the company has an internal agreement to cover foreign owned R&D, we are concerned that this could be used to exclude R&D covered by another multiparty agreement. For example, an Australian subsidiary could be undertaking R&D as part of an agreement between itself, its parent company and other companies. The existence of this type of agreement should not cause the activity in Australia to become ineligible for the tax concession.[11]

12.17 Deloitte, while commending the Government's initiative to increase business expenditure on research and development, submitted that the amendments do not go far enough in encouraging a broader increase in such expenditure. The Deloitte submission was critical of the provisions in the Schedule, arguing that the concession will only benefit a small number of claimants and not the R&D claimant community generally. The submission stated that even for those entities that qualify, there are a number of operative concerns and administrative complexities that must be measured from a cost/benefit perspective.

12.18 Deloitte did identify one aspect of the Schedule as 'positive', namely the ability to sub-contract the foreign–owned R&D activities down one level from the eligible company and that eligible company retaining the eligibility to include this sub-contract expenditure as 'foreign–owned'.

Departmental response

12.19 Treasury and Department of Industry Tourism and Resources witnesses (departmental witnesses) did not agree with Medicines Australia's concerns about the transitional claims history provisions. Mr Davis, Principal Adviser, Business Tax Division, Department of the Treasury explained that in developing the provisions, the position that had been put by industry in the initial consultation process was that it would be very difficult for most companies to go back and build a three-year history, and even harder to have that as a verifiable history. He said that 'the administrative difficulties with doing that caused us to want to move to something that could work for everybody.'[12]

> The complexity in getting those histories out and verifying them would make that—I think the word 'nightmare' was mentioned by a few people—impossible for many. In order to find a way through that, we went with transitional histories.[13]

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10 See EM, paragraph 11.8, p. 242.

11 Ms Monk, *Proof Committee Hansard*, 28 August 2007, p. 15.

12 *Proof Committee Hansard*, 28 August 2007, p. 18.

13 *Proof Committee Hansard*, 28 August 2007, p. 18.

12.20 Mr Davis also disputed the disincentive effects referred to by Medicines Australia:

> … I am somewhat confused by the argument I just heard that it would cause companies to not want to increase their R&D activities. Certainly, after the first year of implementation I cannot see how that works at all. In effect, they are given a transitional history that applies off the first year of spending then they have the same incentive to increase after that first year as they will at any time in the operation of this bill or act.[14]

12.21 In relation to the written agreement provisions, departmental witnesses confirmed that this is an integrity measure.[15]

12.22 Departmental witnesses did not address Deloitte's comments in their evidence. However, witnesses did advise the committee that the consultation process on the Schedule had been extensive. Industry forums had been held in Sydney, Brisbane and Melbourne, and about 60 industry representatives attended the forums. Questioned by committee members about industry groups who were expressing concern about the legislation, Mr Davis of Treasury responded that:

> You would expect that there would be a number of people who thought they might be able to do better. I have not been knocked down in the rush of complaints. That might be a nice way to put it.[16]

Committee view

12.23 The committee notes that this legislation extends the R&D provisions to groups that have not previously accessed them. While some concerns have been raised that the provisions are excessively restrictive or complex, it remains to be seen if these concerns will be borne out by experience. The committee suggests that the government review the effects of the Schedule in twelve months with a view to determining whether the amendments have been sufficiently stimulatory of R&D. The committee does not consider that any amendments to the Schedule are required before passage of the bill.

14 *Proof Committee Hansard*, 28 August 2007, p. 18.

15 *Proof Committee Hansard*, 28 August 2007, p. 18.

16 *Proof Committee Hansard*, 28 August 2007, p. 20.