Chapter 5

Eligible Expenditure

Introduction

5.1 In their 2007 report, the Productivity Commission identified three types of R&D when they reviewed the role of public support for innovation:

- basic research – basic research is the experimental or theoretical work undertaken primarily to acquire new knowledge of the underlying foundation of phenomena and observable facts, without any particular application or use in view although it is this type of research that is likely to have large spillover benefits;
- applied research – applied research is original investigation undertaken in order to acquire new knowledge, it is however directed primarily towards a specific practical aim or objective; and
- experimental development – experimental development is 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.[1]

5.2 Under the new R&D tax incentive, eligible entities will be entitled to a tax offset for expenditure on eligible R&D activities and for the decline in the value of depreciating assets used for eligible R&D activities.[2] The rules governing the tax incentive will be set out in new Division 355 of the ITAA 1997.

5.3 The operation of the new provisions relies on the concepts of 'R&D entities' and 'R&D activities' – it being R&D entities that qualify for a tax offset in respect of their R&D activities.[3]

What are 'R&D entities'?

5.4 'R&D entities' continue to be defined as being:

- a body corporate (ie a company) incorporated under an Australian law;
- a body corporate incorporated under a foreign law that is an Australian resident; and

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1 Productivity Commission, *Public Support for Science and Innovation*, 9 March 2007, p. 8.

2 Explanatory Memorandum, Tax Laws Amendment (Research and Development) Bill 2010, para 1.1, p. 11.

3 Proposed sections 355-1, 355-20 and 355-35, Tax Laws Amendment (Research and Development) Bill 2010, pp 4-7.

- a body corporate incorporated under a foreign law that is a resident of a foreign country[4] but carries on business in Australia through a permanent establishment.

5.5 Companies that meet the definition of an R&D entity will, in principle, be eligible to claim the new tax offset. They will however need to have notional deductions[5] for R&D expenditure of at least $20,000.[6] This requirement of a minimum threshold is also a feature of the existing R&D tax concession. It does not apply however in circumstances involving R&D expenditure of a Research Service Provider or contributions to a Cooperative Research Centre.[7]

5.6 The definition of 'R&D entity' did not attract attention or comment throughout the course of the Committee's inquiry.

What are 'R&D activities'?

5.7 R&D activities are defined in section 355-20 of the bill as being 'core' R&D activities or 'supporting' R&D activities. These concepts are further clarified in sections 355-25 and 355-30, yet, according to the explanatory memorandum are not new:

> The new R&D tax incentive retains some elements of the framework for R&D activities that currently applies… (For example, the distinction between core and supporting R&D activities continues.) However, these elements have been refined so that the new scheme better aligns with the rationale for providing a general subsidy for business R&D…[8]

5.8 Although the explanatory memorandum suggests that the concepts of 'core' and 'supporting' R&D activities are not new, the redrafting of the definitions received the majority of attention in submissions received and at the public hearings held. The general consensus was that the re-written definitions will reduce the number of firms eligible for the tax incentive as they amount to a 'wholesale re-write' of the provisions.

> When the Cutler report came out, we were very receptive to what was in it. Basically it said that there are some areas where there was a case of misuse

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4 And that foreign country has a double tax agreement with Australia.

5 Notional deductions — a notional deduction is an amount that an R&D entity would otherwise deduct for business expenditure if they were not eligible for the R&D tax offset.

6 Explanatory Memorandum, para 3.10, p. 51.

7 Explanatory Memorandum, para 1.28, p. 15. An R&D entity can obtain an offset regardless of the level of its R&D deductions for expenditure incurred to a Research Service Provider or for expenditure incurred as a monetary contribution to a Cooperative Research Centre. An RSP provides services in one or more specified research fields to registered R&D entities. A CRC is an organisation formed through medium to long term collaborative partnerships between publicly funded researchers and end users. Source: Explanatory Memorandum, pp 59 and 98. RSPs and CRCs are not covered in detail in the Committee's report.

8 Explanatory Memorandum, para 2.2, p. 19.

> and that the definition of R&D should be refined to address those areas of misuse. We think that is a sensible thing to do as ongoing maintenance of the tax act. But they did not recommend a wholesale rewrite of the definition of expenditure eligible for R&D, nor was there an indication in the government's media release and announcements in the budget last year, when it indicated that it was proceeding with some changes, that it was going to redefine eligible R&D.[9]
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> The changes to the definitions of R&D are genuinely problematic in terms of various industries—for example, in manufacturing, the importance of the development side versus the research side in manufacturing. You end up with unintended consequences, such as the consequences of complexity and the like from the dominant purpose test, and I am not sure why.[10]
>
> The proposals stem from the Cutler Report which seemed to recommend the support of the iconic R&D Tax Concession with increased support levels for SMEs. It also proposed to change from a tax deduction to a tax credit and cut out the 175% premium…nevertheless, those aims could surely be achieved in a much simpler manner than by a wholesale change to the R&D Tax Concession and without the major increase in complexity currently proposed.[11]

5.9 As indicated, those who commented on the changes, mostly beneficiaries of the existing scheme, were generally critical of the redrafted definitions contending that the existing definitions did not require amendment.[12]

5.10 There was general consensus around some aspects of the bill. For example, there was broad support for abolishing the complex 175 per cent premium concession, which perversely rewards volatile R&D and is of no assistance to new firms:

> The removal of the 175 per cent concession, which was complex to model, and almost impossible to model in advance for large corporate groups, is also welcome; I think it is good policy.[13]
>
> The 175 per cent incremental did not make sense to them and, beyond the simple case, it was a complicated after-the-fact tax calculation where windfalls occurred because of corporate merger and acquisition activity. We think it was underpowered at 7½ cents under the 125 and overcomplicated because of the premium. We have got a high base rate regime and that is great. We have got rid of the premium and we think that is excellent as well… We have consulted every day in their 175 per cent

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9 Dr Peter Burn, Director, Public Policy, Australian Industry Group, *Proof Committee Hansard*, 21 May 2010, p. 7.

10 Dr Chris Roberts, Chief Executive Officer, Cochlear, *Proof Committee Hansard*, 21 May 2010, p. 11.

11 Mr Geoff Stearn, GSM Consulting, *Submission 7*, p. 1.

12 NOAH Consulting, *Submission 8*, p. 2.

13 Mr Serge Duchini, Partner and Research and Development and Tax Incentives Practice Leader, Deloitte, *Proof Committee Hansard*, 21 May 2010, p. 32.

> incremental premium. We generate fees help for companies every day, and we have advocated for its closure since before it began.[14]

5.11 Some concerns were raised, however, in relation to the operation of the objects clause together with the redrafted definitions of core and supporting activities.

The objects clause

5.12 The object of Division 355 will be set out in section 355-5 and will state:

> (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.[15]

5.13 Numerous submitters to the inquiry raised concern with the new objects clause on the basis that its reference to activities that 'might not otherwise be conducted' and the requirement to 'generate new knowledge or information' limit the definitions of core and supporting R&D and will therefore affect their ability to access tax incentives for R&D expenditure.

> The objects clause of the bill…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 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 existing 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.[16]
>
> The objects clause in the draft legislation definitely narrows the definition and has a much greater emphasis on the R rather than the D, compared to the existing situation.[17]
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> A number of tests need to be satisfied by all claimants and they are cumulative in nature. Let us start, firstly, with my opening comments

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14 Mr Kris Gale, Managing Director, Michael Johnson and Associates Pty Ltd, *Proof Committee Hansard*, 20 May 2010, pp 32 and 35.

15 Tax Laws Amendment (Research and Development) Bill 2010, lines 12–21, p. 5.

16 Dr Peter Burn, Director, Public Policy, Australian Industry Group, *Proof Committee Hansard*, 21 May 2010, p. 3.

17 Dr Chris Roberts, Chief Executive Officer, Cochlear, *Proof Committee Hansard*, 21 May 2010, p. 14.

> around the definition of core R&D...I think there is a conflict between this definition and the objects clause.[18]

5.14 Treasury, however, disagreed with the criticisms raised and suggested to the Committee that:

> An issue raised in some submissions is the wording of the objects clause. The objects clause in the current law provides a general statement of the intent of the law to provide a tax incentive in the form of a deduction to encourage R&D activities in Australia that increase commercial competitiveness. The bill's objects clause describes the essence of R&D, namely to encourage industry to conduct research and development that might otherwise not be conducted because of an uncertain return from the activities in cases where the knowledge gain is likely to benefit the wider Australian economy. This object is stated 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. In this way, the object and the operating provisions are aligned and entirely consistent.[19]

Committee view

5.15 The Committee acknowledges the concern of some submitters that by its express reference to the scientific process and new knowledge the objects clause tends to focus on research rather than development. The Committee does, however, note that the objects clause clearly identifies that those research and development activities can be carried out in an experimental way for the purpose of 'generating new knowledge or information' in an **applied form**.

5.16 Based on the evidence provided to the Committee explaining that the 'D' of R&D refers to the application of existing knowledge in new ways, which is referred to by the Frascati model[20] as 'experimental development',[21] the Committee considers that the objects clause should not operate to restrict unduly development activities.

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18 Mr Serge Duchini, Partner and Research and Development and Tax Incentives Practice Leader, Deloitte, *Proof Committee Hansard*, 21 May 2010, p. 34.

19 Mr Paul McCullough, General Manager, Business Tax Division, Treasury, *Proof Committee Hansard*, 20 May 2010, p. 48.

20 The *Frascati Manual*, a publication developed by the OECD in Frascati, Italy in 1963, is a technical document that is viewed as the 'cornerstone' of OECD efforts to increase the understanding of the role played by science and technology by analysing national systems of innovation. As it provides internationally accepted definitions of R&D and classifications of its component activities, it contributes to intergovernmental discussions on best practice for science and technology policies. Source: *Frascati Manual – Proposed Standard Practice for Surveys on Research and Experimental Development*, OECD, 2002, p. 3.

5.17 The Committee does, however, take the view that the opportunity should be taken to clarify the law prior to its enactment and therefore where the words in the bill can be made clear, that approach should be preferred above reliance on extrinsic material.

Recommendation 1

5.18 The Committee recommends that subsection 355-5(2) of the objects clause be amended to clarify the reference to 'new knowledge or information in either a general or applied form' by adding 'new knowledge in an applied form includes new or improved materials, products, devices, processes or services'.

Core activities

5.19 The existing definition of R&D activities in section 73B(1) provides that research and development activities are:

> (a) systematic, investigative and experimental activities that involve innovation or high levels of technical risk and are carried on for the purposes of:
>
> (i) acquiring new knowledge (whether or not that knowledge will have a specific practical application); or
>
> (ii) creating new or improved materials, products, devices, processes or services; or
>
> (b) other activities that are carried on for a purpose directly related to the carrying on of activities of the kind referred to in paragraph (a).[22]

5.20 Section 73B(2B) provides further guidance explaining that, for the purposes of the definition of research and development activities:

> activities are not taken to involve innovation unless they involve an appreciable element of novelty; and
>
> activities are not taken to involve high levels of technical risk unless the probability of obtaining the technical or scientific outcome of the activities cannot be known or determined in advance on the basis of current knowledge or experience; and the uncertainty of obtaining the outcome can be removed only through a program of systematic, investigative and experimental activities in which scientific method has been applied, in a systematic progression of work…from hypothesis to experiment, observation and evaluation, followed by logical conclusions.[23]

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21 Experimental development is defined by the Frascati model 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. Source: Dr Peter Burn, Australian Industry Group, *Proof Committee Hansard*, 21 May 2010, p. 2.

22 Section 73B(1) Definitions, ITAA 1936.

23 Section 73B(2B), ITAA 1936.

5.21 This is contrast with the proposed definition of core R&D activities that will be set out in section 355-25. It will provide that:

> (1) 355-25 Core R&D activities are 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).
>
> (2)… [excluded activities]

5.22 Treasury submit that the definition in the bill improves certainty by removing contradictions, focusing clearly on underlying experimental activities and using plainer language.[24] They are of the view that the current definition of core R&D activities[25] is 'problematic' as it involves 'multiple overlapping tests and qualifications applied to the basic concept…'[26]

5.23 The Australian Industry Group however takes a different view and contends that the proposed definition will reduce support for development.

> What we are concerned about is the experimental development—that is, the application of existing knowledge in new ways. Clearly it does not fall into the definition of core R&D and, because one way or another it is excluded under the supporting R&D tests, it will not be eligible to be claimed as supporting R&D either. That is our concern and that is not really research related; that is more experimental development—this process of developing things on the run, if you like, in the production process, which is, as the Productivity Commission notes, where 61.6 per cent of 2004-05 R&D expenditure undertaken by business actually occurred.[27]

5.24 Cochlear, also raised some concerns with the proposed new definition of core activities, explaining that:

> It is the importance of the D as well as the R, and a company like Cochlear is doing more D than R. It is capital D and little r. We call it R&D. It is the recognition that it is an ongoing step-by-step-by step building on what has

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24 Mr Paul McCullough, General Manager, Business Tax Division, Department of the Treasury, *Proof Committee Hansard*, 20 May 2010, p. 47.

25 Which requires activities to be systematic and investigative, involve appreciable novelty or high levels of technical risk or be conducted for the purpose of acquiring new knowledge or information or for creating new or improved materials, products, devices, processes or services.

26 Mr Paul McCullough, General Manager, Business Tax Division, Department of the Treasury, *Proof Committee Hansard*, 20 May 2010, p. 47.

27 Dr Peter Burn, Australian Industry Group, *Proof Committee Hansard*, 21 May 2010, p. 6.

> gone on before. To give you an example, 30 years after the first implant of our cochlear implant, we are still spending 13 per cent of our revenues on technological innovation…We are doing that because it is a step-by-step journey, and it is development. I guess that is the difference between, say, devices and drugs. A drug either works or it does not, but with a device you hit it with a hammer or paint it green or make it blue and add a little widget or whatever, and you develop it. It is a development process. It is the successful development of that over the long term that creates substantial competitive advantage and keeps you in business, and that is why the development side is really important. Even if you come up with an emphasis on the R that might help the SME when it starts up, unless it gets in its head that ongoing development it will not be there. It is a really important point.[28]

5.25 It is this process of demonstration, leading and following that results in spillover benefits that provide the rationale for public sector support for R&D activities.[29] Indeed, Professor Roy Green highlighted the importance of both elements of R&D when he told the committee that:

> [I]n experimentation prototyping the D element of R&D is an important aspect of the definition. I would be surprised and concerned if that were not to be part of a final scheme…I am looking at it from the broader issue of public policy and the application of principles…if it does narrow R&D in an illegitimate way— and that excludes legitimate R&D, including the D part of experimentation and other forms of development—I would be concerned… The point is that, if they are doing R&D that is risky and innovative, it should be covered by the terms of the new scheme...provided that companies are undertaking R&D within what I hope will be a broad definition, they ought to be eligible for such return, but it may not be simply return for business as usual…[30]

5.26 Mr Serge Duchini of Deloitte also highlighted the importance of ensuring development is supported.

> The definition of core R&D…does not explicitly and sufficiently cover application R&D in my opinion, and this was referred to in earlier submissions. This stems from the policy belief that greater benefits flow to the broader community from generating knowledge rather than from the application of the knowledge that is the product of the R&D. No evidence has been presented throughout this entire policy debate that the public subsidy for new knowledge creation will yield greater economic benefit than the subsidy of the application of that new knowledge to the creation of new products, processes, services and devices…There is significant public benefit and wealth creation occurring, with the focus of the R&D as its

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28 Dr Chris Roberts, Cochlear, *Proof Committee Hansard*, 21 May 2010, p. 16.

29 Mr Innes Willox, Australian Industry Group, *Proof Committee Hansard*, 21 May 2010, p. 2.

30 Professor Roy Green, Dean, Faculty of Business, University of Technology Sydney, *Proof Committee Hansard*, 21 May 2010, pp 19 and 22.

> practical application. This is where the rubber really does hit the road, where tangible commercial outcomes are achieved…It is where corporates take on a significant risk and where technical failures are also common.[31]

5.27 Treasury advised the Committee that they disagree with claims of stakeholders that the proposed definition will 'skew public financial support towards theoretical research and away from the development of new products and services'.

> This is not the case [and] [a]lthough the rewording highlights the purpose of new knowledge, it is clear that the knowledge can be in the practical form of developing new or improved products, processes or services. It has also been put that, if an Australian company could not access knowledge about a product owned by another company and it sought to bridge that knowledge gap through its own R&D, it may be denied the tax incentive since it might be argued that its own R&D is not generating new knowledge… Such an interpretation is not warranted. It ignores the fact that knowledge that is not accessible cannot logically form the benchmark from which the generation of new knowledge can be measured…In any case, under the current law, the concept of new knowledge already exists and, moreover, the particular activities may need to involve appreciable novelty, a concept that overlays a further element of degree and subjectivity. The effect of the knowledge test is to avoid subsidising activities that merely amount to reinventing the wheel or that merely address routine uncertainty.[32]

5.28 The Department of Innovation, Industry, Science and Research (DIISR) has also sought to allay the concerns that have been raised advising that:

> The development aspect of R&D is captured by the application of knowledge recognised in the object clause and also in the definition of *core* R&D. *Core* R&D activities are experimental activities conducted for the purpose of generating new knowledge (including about the creation of new or improved materials, products, devices or processes). The expression 'improved' within 'new' or 'improved' means experimental development activities. These experimental development activities can occur in any environment, including a production or commercial environment.[33]

5.29 As Professor Green put it:

> The point is that, if they are doing R&D that is risky and innovative, it should be covered by the terms of the new scheme...provided that companies are undertaking R&D within what I hope will be a broad

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31 Mr Serge Duchini, Partner and Research and Development and Tax Incentives Practice Leader, Deloitte, *Proof Committee Hansard*, 21 May 2010, p. 33.

32 Mr Paul McCullough, General Manager, Business Tax Division, Department of the Treasury, *Proof Committee Hansard,* 20 May 2010, p. 47.

33 Mr Ken Pettifer, Head of Division, Innovation Division, Department of Innovation, Industry, Science and Research, *Letter to Committee*, 8 June 2010, p. 1.

> definition, they ought to be eligible for such return, but it may not be simply return for business as usual…[34]

Committee view

5.30 While the Committee recognises the apprehension of stakeholders and their concern that application of the new rules will favour research over development, it notes the evidence provided by the Treasury and DIISR.

5.31 The advice provided to the Committee confirms that it is not the intention of the amendments to curtail D but rather to ensure that 'business as usual' activities are not subsidised by taxpayers.

5.32 It is the Committee's preference that the definition of core activities should be sufficiently clear that it does capture both R and substantial D where it is clear that the D is not business as usual activity and will result in spillover benefits. In forming this view the Committee refers to the Productivity Commission's 2007 research report – *Public Support for Science and Innovation*, which identified that:

> R&D should not just be judged on its immediate promise of improvements in products, services or processes, but also on its ability to provide the capacity for better decision making in the future…[35]

> A large part of economic growth reflects the steady application and adaptation by firms of knowledge and innovations that are quite dated from an international perspective but are new to their own productive processes.[36]

5.33 Bearing these observations of the Productivity Commission in mind and having regard to the rationale for public support of R&D, the Committee regards the passage of this bill as the ideal opportunity to remove doubt and ambiguity from operation of the law to provide certainty for those affected by the changes.

Recommendation 2

5.34 The Committee notes that many of the concerns were raised by organisations who want to maintain the status quo. Nevertheless, given the concerns raised, but acknowledging the need to ensure that public support is targeted appropriately, the committee recommends that the definition of 'core R&D activities' in section 355-25 be amended to remove the word 'about' from paragraph 355-25(1)(b) so that the paragraph reads as:

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34 Professor Roy Green, Dean, Faculty of Business, University of Technology Sydney, *Proof Committee Hansard*, 21 May 2010, p. 19.

35 Productivity Commission, *Public Support for Science and Innovation*, 9 March 2007, p. 10.

36 Productivity Commission, *Public Support for Science and Innovation*, 9 March 2007, p. 11.

> **[talking about experimental activities] that are conducted for the purpose of generating new knowledge (including ~~about~~ the creation of new or improved materials, products, devices, processes or services).**

5.35 Removing 'about' from the parentheses after the word 'including' would clarify that the creation of new knowledge includes the creation of new or improved materials, products, devices, processes or services. It was suggested to the Committee that as the paragraph currently reads the placement of the word 'about' may be interpreted as a qualifier limiting what the generation of new knowledge includes:

> …the test now focuses on new knowledge, which can be construed as emphasising research but largely ignoring the development side of the equation. In practical terms, there is a question as to whether a building development that involves on-site R&D can even be considered as an R&D cost under the incentive. For instance, in order to test a green retrofit for insulation or structural reinforcing for a new and innovative type of building, it is necessary to conduct part of the R&D within the building itself to take account of all variables. However, the costs associated with that test may not strictly fit the definition of core R&D, as it is currently defined. That would be a very unusual outcome, I would have thought. It really depends on how you interpret 'new knowledge' regarding improving materials, products, et cetera. That is fairly easily fixed, in fact, by ensuring that the R&D definition indicates that the actual creation of new and improved materials, products, devices et cetera is a part of core R&D. That is actually a very simple change because it involves removing two words from section 355-25, being 'about' and 'the' in parentheses.[37]
>
> I have always advocated that we should just get rid of the word 'about'. To me it connotes that it is the development of knowledge around the process of creation rather than the hard, fast creation activity that includes eligible R&D activities. I think that should be amended and I think it is a quick fix. Overall, when I as a professional read the definition I believe that it is easier to read, and I think an engineer reading it would get it, as it talks about 'experimental' and 'experimentation'. Where is the knowledge gap? On the surface, it is a simpler definition than the clunky one that we now have. I accept that, and it is good.[38]

Supporting R&D

5.36 The proposed definition of supporting R&D also attracted criticism throughout the inquiry.

5.37 The definition, that will be set out in section 355–30, will specify that:

> 355–30 Supporting R&D activities

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37 Mr Andrew Mihno, Deputy Executive Officer, International and Capital Markets Division, Property Council of Australia, *Proof Committee Hansard*, 21 May 2010, p. 41.

38 Mr Serge Duchini, Partner and Research and Development and Tax Incentives Practice Leader, Deloitte, *Proof Committee Hansard*, 21 May 2010, pp 33–34.

> (1) Supporting R&D activities are activities directly related to core R&D activities.
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> (2) However, if an activity:
>
> (a) is an activity referred to in subsection 355–25(2) [ie an excluded activity]; or
>
> (b) produces goods or services; or
>
> (c) is directly related to producing goods or services;
>
> the [excluded] activity is a supporting R&D activity only if it is undertaken for the dominant purpose of supporting core R&D activities.[39]

5.38 Concerns have arisen predominantly in relation to the introduction of the 'dominant purpose' test that must be met where a claimant is seeking to access the R&D incentive in respect of an otherwise excluded activity.

5.39 Excluded activities are identified in subsection 355-25(2) and include:

> (a) market research, market testing or market development, or sales promotion (including consumer surveys);
>
> (b) prospecting, exploring or drilling for minerals or petroleum for the purposes of one or more of the following:
>
> (i) discovering deposits;
>
> (ii) determining more precisely the location of deposits;
>
> (iii) determining the size or quality of deposits;
>
> (c) management studies or efficiency surveys;
>
> (d) research in social sciences, arts or humanities;
>
> (e) commercial, legal and administrative aspects of patenting, licensing or other activities;
>
> (f) activities associated with complying with statutory requirements or standards, including one or more of the following:
>
> (i) maintaining national standards;
>
> (ii) calibrating secondary standards;
>
> (iii) routine testing and analysis of materials, components, products, processes, soils, atmospheres and other things;
>
> (g) any activity related to the reproduction of a commercial product or process:
>
> (i) by a physical examination of an existing system; or
>
> (ii) from plans, blueprints, detailed specifications or publicly available information;

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39 Sections 355-25 and 355-30 of Tax Laws Amendment (Research and Development) Bill 2010, pp 6–7.

> (h) developing, modifying or customising computer software for the dominant purpose of use by any of the following entities for their internal administration (including the internal administration of their business functions):
>
> (i) the entity (the developer) for which the software is developed, modified or customised;
>
> (ii) an entity connected with the developer;
>
> (iii) an affiliate of the developer, or an entity of which the developer is an affiliate.[40]

5.40 Although the redrafted definition has caused considerable concern, Treasury explain that the tightening of the provisions application is intentional:

> An important policy change in this bill is that supporting R&D is connected more tightly to core R&D… The key task of the dominant purpose test for any supporting and excluded activities is to prevent activities that would be conducted regardless of core activities being leveraged off them so as to qualify for the tax incentive—that is, the R&D tax incentive should not cross-subsidise production activities that the experiment is merely piggybacking on.[41]

5.41 The potential application and operation of the dominant purpose test is causing particular concern to those companies that undertake R&D in a production environment given that it will require claimants to show that the activities in the production environment are for the dominant purpose of supporting their core R&D activities.

> …the dominant purpose test will severely restrict genuine manufacturing R&D carried out in a production environment…[42]

5.42 Throughout the inquiry, the introduction of the dominant purpose test was related to the matter of 'whole of project' claims; situations where companies are claiming as R&D normal business activity or claiming the whole of a large project when only part of it is innovative (such as claiming the whole of a building as an expense when only the air conditioning was experimental). The Department identified the need to address this issue noting that in some cases directly related supporting activities amount to 90 per cent of tax concession claims.[43]

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40 Subsection 355-25(2), Tax Laws Amendment (Research and Development) Bill 2010, p. 6.

41 Mr Paul McCullough, General Manager, Business Tax Division, Department of the Treasury, *Proof Committee Hansard,* 20 May 2010, p. 47.

42 Mr David Oliver, National Secretary, Australian Manufacturing Workers Union, *Proof Committee Hansard*, 21 May 2010, p. 23.

43 Mr Ken Pettifer, Head of Division Innovation Division, Department of Innovation, Industry, Science and Research, *Letter to Committee*, 8 June 2010, p. 2.

5.43 Witnesses before the Committee also acknowledged the need to address excessive claims.

> There was a need to do something about…'whole-of-mine claims'... Cutler noted that, while these large claims in areas such as mining, civil engineering and the like are currently eligible under the program and are R&D, they are a big cost impost on the system.[44]

> There is whole of project. This is an example whereby people are claiming as R&D stuff that is clearly not R&D; it is normal business activity. The case of a road has been used in examples of that type of major project. There have been cases in the financial system of people claiming their normal IT expenditure as R&D. There are a whole series of activities and some of them have involved hundreds of millions of dollars. But it is not true to say that this involves just one or two isolated cases.[45]

> Senator XENOPHON—Following on from Senator Cameron's line of questioning, you do agree that under the current system it is open to abuse and rorting, in some instances?

> Mr Parsons—Yes, excessive claims are a possibility using the support activity provision in the sense that they become disproportionate. I would express it as 'excessive claims providing a disproportionate outcome which allows for poor outcomes in terms of policy'.

> Senator XENOPHON—Sure. Others might call that rorting, though.[46]

5.44 Although submitters recognise the need to address these excessive claims they contend that the problem could be addressed without the need to re-write the eligibility criteria.

> From my understanding, some of the excessive claims are where the supporting R&D is very, very large relative to the core R&D. You deal with it by a multiple like that. There are other ways of dealing with it, perhaps by pre-approval for the program.[47]

> …We would question whether a blanket application of a more complicated and restrictive set of eligibility criteria is the best way to address this issue.[48]

> Dr Roberts—Those two examples that you mention could very, very easily be addressed by setting some ratio of supporting versus core R&D or a cap.

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44 Mr Kris Gale, Michael Johnson Associates Pty Ltd, Managing Director, *Proof Committee Hansard*, 20 May 2010, p. 27.

45 Minister Carr, *Proof Economics Estimates Hansard*, 31 May 2010, p. 56.

46 Mr Robin Parsons, Partner, Ernst & Young, *Proof Committee Hansard*, 21 May 2010, p. 17.

47 Dr Chris Roberts, Chief Executive Officer, Cochlear, *Proof Committee Hansard*, 21 May 2010, p. 12.

48 NSW Business Chamber, *Submission 10*, p. 1.

> Mr Oliver—Or even a cap on the overall size of the project that then drives the need to have an internal review or advance approval.
>
> Mr Chia—Or when trials are run over a period of time, such as when a trial is run over more six months, you get approval for that to become eligible expenditure under the new incentive.[49]
>
> There has to be a better way than having dominant purpose. When you understand that businesses undertake activities, they try to undertake activities in the most efficient way by piggybacking them together and achieving multiple outcomes that will achieve an R&D end and maybe a commercial objective, which is what you want organisations to do. Maybe the word 'dominant' should be softened to 'substantial', which is not an insignificant or a de minimis purpose; it is still a substantial purpose connected to R&D.[50]

5.45 The main alternative canvassed by some submitters was the suggestion that the 'dominant' purpose test be replaced with a 'substantial' purpose test on the basis that this would address the problem of excessive claims yet ensure that the R&D tax incentive is still available to those companies who rely on their existing production processes to commercialise their R&D.

5.46 Consideration of the use of 'substantial' rather than dominant has however raised the concern that this term is in itself ambiguous and its use would not be consistent with the policy objectives that are sought to be achieved.

5.47 Indeed, use of the term 'substantial' has proven problematic in the *Trade Practice Act 1974* context where the word has been interpreted differently in different contexts: section 46, relating to predatory pricing, refers to a corporation that has a substantial degree of power in a market'. Here, the word 'substantial' has been interpreted to mean 'real or of substance, rather than minimal or trivial'. Another judgement found 'substantial' in the context of section 46 to mean a degree of market power which is considerable or large. Section 50 of the TPA prohibits acquisitions which have the effect or likely effect of substantially lessening competition in a market. Here, the word 'substantial' requires that the acquisition be meaningful or relevant to the competitive process.

5.48 DIISR are also of the view that replacing the word 'dominant' with 'substantial' will not achieve the policy intent and would result in an outcome 'fundamentally inconsistent' with the object of the new incentive.

5.49 They have also raised concerns that the use of the word 'substantial' will result in ambiguity and perpetuate the current problem of excessive claims.

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49 Cochlear, *Proof Committee Hansard*, 21 May 2010, p. 14.

50 Mr Serge Duchini, Partner and Research and Development and Tax Incentives Practice Leader, Deloitte, *Proof Committee Hansard*, 21 May 2010, pp 34-35.

> The dominant purpose test ensures that taxpayers do not claim their 'business as usual' activities. The R&D tax incentive is not intended to support these activities, as normal business deductions are available for such activities… The word 'substantial' should be avoided because in other contexts the courts have found the word to be imprecise and potentially ambiguous. For example, in the 1979 Federal Court case of *Tillmanns Butcheries Pty Ltd v Australasian Meat Industry Employees'* Union Justice Deane said:
>
> > The word "substantial" is not only susceptible to ambiguity: it is a word calculated to conceal a lack of precision. In the phrase "substantial loss or damage", it can, in an appropriate context, mean real or of substance as distinct from ephemeral or nominal. It can also mean large, weighty or big. It can be used in a relative sense or can indicate an absolute significance, quantity or size.
>
> If 'substantial' were used to mean 'not insignificant or de minimis', the existing low bar for supporting R&D activities would be retained. This will be inconsistent with the meaning of the term 'dominant' and will not solve the problem of claims related to 'business as usual activities'.[51]

Committee view

5.50 The Committee acknowledges industry concerns about the unknown impact of the 'dominant purpose' test on R&D activity in Australia. In recognising this concern however, the Committee supports the need for government to target public spending in this industry and in so doing ensure that public funds are not misappropriated. Replacing the 'dominant purpose' test with a 'substantial purpose' test could frustrate the intention of the bill that 'business as usual' activities not attract support.

Recommendation 3

5.51 Given the scope of the changes proposed, the Committee is of the view that the amended provisions, including the effect of the 'dominant purpose' test, be reviewed after two years to ensure that the legislation is operating consistently with the Government's intent.

Intellectual Property and Software

5.52 Two changes that will be introduced by the bill and which are seen as positive amendments are:

51 Mr Ken Pettifer, Head of Innovation Division, Department of Innovation, Industry, Science and Research, *Letter to Committee*, 8 June 2010, pp 1-2.

(a) the proposal to remove the requirement for intellectual property to be owned in Australia; and

(b) the changes to the treatment of software.

Intellectual property

5.53 When discussed during the inquiry, submitters were supportive of removing the requirement that intellectual property be owned in Australia.

> This makes sense and ensures that Australia's R&D incentives are appropriate for a modern, globally integrated economy.[52]

> …it is a fact that globalisation has created a dynamic where intellectual property is very transportable and is protected in jurisdictions outside of Australia. It is an unfortunate reality that we need to work with that reality and recognise that where R&D activity is within Australia, that delivers many good outcomes for the Australian economy and that we need probably to be sympathetic with our legislation to understand that IP can be held anywhere in the world.[53]

> EGGLESTON—So you do not see any issues about the fact that, under this legislation, intellectual property rights for the outcome of any research will be held by foreign nationals in the United States, the UK, Germany and Switzerland? That will not affect you in any way?
>
> Mr Hick—It would not directly affect us…[54]

Software

5.54 Similarly, the proposal to remove the existing exclusion that requires 'in-house' software to include 'multiple sales' and replace it with an exclusion that clarifies that 'activities related to the development, modification or customisation of software are not eligible core R&D where the software is developed for the dominant (sole) purpose of internal business administration by the entity…for which it was developed, modified or customised'[55] has been applauded.

> The general approach of not treating software R&D activity any differently from other R&D activity is welcomed.[56]

> The removal of the attack on software related R&D is welcome.[57]

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52 Dr Brendan Shaw, Chief Executive Officer, Medicines Australia, *Proof Committee Hansard*, 20 May 2010, p. 3.

53 Mr Robin Parsons, Partner – Indirect Tax, Ernst & Young, *Proof Committee Hansard*, 20 May 2010, p. 11.

54 Mr Alastair Hick, Director, Commercialisation, Monash University, *Proof Committee Hansard*, 20 May 2010, p. 21.

55 Explanatory Memorandum, para 2.35, p. 25.

56 Australian Information Industry Association, *Submission 26*, p. 2.

57 Michael Johnson Associates, *Submission 5*, Attachment 2, p. 10.