Chapter 6

Complexity and changes

Complexity and compliance costs

6.1 This bill will introduce aspects of the recommendations that came out of the Productivity Commission's 2007 review; through these changes the Government is seeking to simplify the operation of the R&D tax incentives and more effectively target funding at small and medium enterprises.

6.2 A recent study in the United Kingdom has illustrated that these benefits can be achieved through simplifying the tax laws that act as an incentive to investment in R&D.

> A recent …paper on the impact of the R&D tax credit in the UK found that 42% of firms surveyed identified the cost and the information obligation for claiming the tax credit on R&D as the main hurdle to filing a request… Canada has simplified its processes…this has…anecdotally…[led] to increases in claims…[1]

6.3 Whether or not these aims will be achieved by this bill received much attention throughout the inquiry. Some submitters are concerned that the new provisions are in fact more complex and as a result will increase compliance costs to such an extent as to act as a disincentive for those at whom the measures are targeted.

> The third element of our opposition to the proposed approach is that it will increase compliance costs. Under the proposed approach, business will need to split its R&D activities into core R&D activities, directly related supporting R&D activities and supporting R&D activities subject to the new dominant purpose test. This…will add substantially to the business compliance costs of the program…the case, the extra compliance costs will fall disproportionately on smaller businesses...Our claim about compliance costs is very different to the claim made by the government in the explanatory memorandum. We think the government's claim is wrong.[2]
>
> As you know, under the current R&D regime, there is a requirement for R&D plans. While that requirement will not exist under the new legislation, there will nonetheless be a significant amount of additional planning required by companies so that they can reassess the eligibility under the new definition, on the one hand, and also, importantly, to predetermine,

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1 Dyson, *Ingenious Britain*, p. 54.

2 Dr Peter Burn, Director, Public Policy, Australian Industry Group, *Proof Committee Hansard*, 21 May 2010, p. 4.

> perhaps throughout the annual life of a project, what activities will now be core and what will be support.[3]
>
> [T]he nature of the activities that are to be supported by the bill; the burden of proof and evidence required to sustain eligibility by all claimants; and the compliance burden that will be imposed on claimants who seek to benefit from these provisions.[4]
>
> The structure of the core and supporting R&D provisions will not only unduly limit corporate R&D claims but will also result in significantly higher compliance costs.[5]

Committee view

6.4 The Committee notes that the Department and the Australian Tax Office have been allocated $38 million in their budget for additional guidance and support for companies applying under the new legislation.

6.5 The Committee also recognises the intention by the Government that these measures be revenue neutral.

6.6 Nevertheless the Committee recognises that some businesses, particularly small businesses, may struggle with planning and compliance and is concerned this might restrict the ability of some to access the R&D incentive.

> The provision introduces a highly subjective component, which will necessarily increase compliance costs and cause confusion and inconsistency in its application.[6]
>
> You may even want to consider whether or not you have a multi-stage purpose test for those organisations that are SME. Maybe they do not have to meet it…[7]

Recommendation 4

6.7 The Committee recommends that companies with revenues under $20 million be exempt from the dominant purpose test.

6.8 In addition to concerns regarding the new application arrangements (discussed in Chapter 7) considerable concern has been raised in respect of the proposed feedstock amendments.

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3 Mr Gregory Oliver, Research and Development Analyst, Cochlear Ltd, *Proof Committee Hansard*, 21 May 2010, p. 12.

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

5 Corporate Tax Association, *Submission 14*, p. 2.

6 Deloitte, *Submission 22*, p. 6.

7 Mr Serge Duchini, Partner and Research and Development and Tax Incentives Practice Leader, Deloitte, *Proof Committee Hansard*, 21 May 2010, p. 35.

The feedstock provisions

6.9 The explanatory memorandum explains at paragraph 3.134 that feedstock adjustments apply in relation to good or materials that are transformed or processed during R&D activities that produce one or more tangible products (feedstock outputs). An adjustment also applies to energy that is input directly into processing or transformation.[8]

6.10 This 'adjustment' claws back the incentive component of the R&D tax offset that is enjoyed on recouped feedstock expenditure.[9] The 'incentive component' is the excess of the tax offset over the company tax rate[10] – for example, for companies with a turnover of more than $20 million who are eligible for the 40 per cent non-refundable offset, the 'incentive component' is 10 per cent. Feedstock expenditure is considered to be recouped in circumstances where the product(s) produced (the feedstock output) is sold or supplied to another entity.[11] The following example of the application of the feedstock provisions is provided in the explanatory memorandum:

> Example 3.14: Feedstock output a marketable product
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> Lisowski Crushing Pty Ltd acquires granite boulders from an adjacent quarry and crushes them into small stones for sale to landscapers. Lisowski identifies a significant potential market for ‘mock dirt’ that will not blow away. Lisowski engages consultants to research and design a diorite stamping head that will crush the granite to fine grains, and has a set of the heads fabricated and fitted to a stamping machine that has been suitably modified. It conducts experiments on 10 tonnes of granite to test the effectiveness of the diorite heads. The resulting granulised granite is sold shortly after to the trade at a special introductory price.
>
> Feedstock expenditure of $10,000 is included in the $22,000 of notional deductions claimed by Lisowski for the R&D activities. Lisowski Crushing has a turnover of $100 million per annum and receives a non-refundable tax offset of $8,800 (40 per cent × $22,000). The potential for the granite granules to be sold in either that or a subsequent income year has no bearing on the size of this tax offset.
>
> The 10 tonnes of granite granules are sold for $900 per tonne. As this is an arm’s length price the feedstock revenue is $9,000. Because the feedstock revenue of $9,000 is less than the feedstock expenditure of $10,000, the feedstock adjustment is based on the $9,000 feedstock revenue figure. In addition to the $9,000 received from the sale, a feedstock adjustment of $3,000 ($9,000 / 3) is included in Lisowski Crushing’s assessable income. This feedstock adjustment is made for the income year in which the granite

8 Explanatory Memorandum, paras 3.134–3.136, p. 86.

9 Explanatory Memorandum, p. 86.

10 Explanatory Memorandum, p. 87.

11 Explanatory Memorandum, pp 86–87.

> granules are sold, which might be the same year as the R&D activities that produce them, or a later year.
>
> The sale occurs in the same income year as the R&D activities. Allowing for the $10,000 tax deduction forgone in order to receive a 40 per cent tax offset on the feedstock expenditure, the incentive component of the tax offset was $1,000 ((40 per cent – 30 per cent) × 10,000), which reduces Lisowski Crushing's income tax liability by that amount. Including the feedstock adjustment in taxable income increases Lisowski Crushing's income tax liability by $900 (30 per cent × $3,000). The net 'tax benefit' of $100 (1,000 – 900) is equivalent to only allowing the 10 per cent incentive on the $1,000 (10,000 – 9,000) 'net' feedstock expenditure.[12]

6.11 Feedstock adjustments apply to both core and supporting R&D activities and the adjustment is required to be included in the company's assessable income.[13]

6.12 In providing evidence to the Committee, Treasury explained that the feedstock provisions within the bill retain the effect of the existing provisions.[14] Treasury also advised that:

> [the] feedstock provisions in the bill have the same scope as under the existing law. For ease-of-use, the bill consolidates all the existing feedstock rules in one subdivision and changes the form of the new feedstock adjustment to that of an increase in accessible income rather than a reduction in the R&D offset. The new mechanism overcomes several technical flaws in the existing rule that can disadvantage taxpayers and avoids the need to put a value on outputs at the end of each year that are not yet in a marketable state.[15]

6.13 Their claim that the proposed provisions retain the same scope and effect of the existing provisions has however been dismissed by numerous submitters to the inquiry.

> There are some feedstock provisions in this bill. They are different from the old bill and they would appear to be more of a tightening position than the old bill. … these current feedstock provisions are a tightening and, if that is the government's intent, all well and good, but I would not characterise them in any other way.[16]

6.14 There has also been much criticism of the fact that the 'augmented feedstock provisions' that featured in the first exposure draft which were redrafted to their

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12 Explanatory Memorandum, para 3.148, p. 89.

13 Explanatory Memorandum, pp 88–89.

14 Mr Paul McCullough, Treasury, *Proof Committee Hansard*, 20 May 2010, p. 48.

15 Mr Paul McCullough, Treasury, *Proof Committee Hansard*, 20 May 2010, p. 48.

16 Mr Robin Parsons, Partner – Indirect Tax, Ernst & Young, *Proof Committee Hansard*, 20 May 2010, p. 14.

current form were not exposed for public consultation until the bill was introduced into the parliament.

Committee view

6.15 The Committee notes some concerns about the complexity of the feedstock provisions set out in the bill but does not believe this will be a problem for large companies. The Committee expects that some of the additional $38 million in funding being provided to the Australian Taxation Office and the Department of Innovation, Industry, Science and Research will be used to help small businesses comply with the provisions.

Recommendation 5

6.16 The Committee recommends that a broad-based working group including small business and union representatives be established to advise Innovation Australia and the Department of Innovation, Industry, Science and Research about any unforeseen circumstances that emerge as the bill is implemented. This working group would also inform the two year review of the bill (Recommendation 7).

Calls for delay

6.17 Throughout the inquiry submitters agreed that several aspects of the bill were positive and should be passed without delay. However, there were calls by some to delay passage of the bill for a further 12 months to provide more time for consultation and further modelling.

> One of the biggest issues that we have had with this whole process—and this was borne out yesterday—is that there has been no modelling with which we can engage or comment on in relation to the likely impacts of these changes at a macro level, an industry level or a sectoral level, so it is hard for us to make these assessments.[17]
>
> We believe the eligibility rules are flawed and the implementation timetable is unreasonable…Caltex proposes the following changes to the legislation:
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> - Delay the implementation of the legislation until 1 July 2011 or later
> - Amend both the core and supporting R&D activities definitions [to adopt the OECD definition for R&D].[18]
>
> Generally we support the broad aim of the introduction of a more streamlined tax incentive however, after a review of the bill and explanatory memorandum; the proposed changes are in direct opposition to

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17 Mr Serge Duchini, Partner and Research and Development and Tax Incentives Practice Leader, Deloitte, *Proof Committee Hansard*, 21 May 2010, p. 39.

18 Caltex, *Submission 3*, pp 3–5.

> the stated policy objectives…more time is needed to introduce effective legislation that can deliver on the stated policy objectives. From the limited modelling I have seen, by simply repealing the 175% incremental deduction should go a long way to making the current scheme more revenue neutral.[19]

> MJA fully supports the introduction of the Credit as a replacement for the Concession…MJA submits that more time is needed to properly absorb and analyse the new concepts and allow …stakeholders adequate time to plan and prepare for the changes. Time is now so short that the prudent thing for the Government to do is to announce a delay in the introduction of the Credit for one year.[20]

6.18 The question of adequate time for consultation was raised with the Minister during Senate Estimates on 31 May 2010, when he was asked why there was such a rush for the legislation to be passed.

> This is a budget measure. It starts on 1 July this year. It is doubling the benefit to small firms and increasing their level of support for large firms by one-third…the question you would be asking is not 'Why has there been so little consultation?' because that is patently untrue, but, 'Why is there such a campaign by such a small number of consultancy firms…that control claims that are well in excess of $1 billion per annum?' The question is: should we cave in to vested interests? I say we should not.[21]

6.19 The Minister further noted that:

> It is not unusual with tax legislation; it is certainly not unusual in this area of R&D policy. A good change does not necessarily mean that every single person has to agree with it. That is not a measure of success of government policy; a measure of success is whether it stands up to the weight of evidence.[22]

Committee view

6.20 From the evidence it has collated throughout the course of its inquiry the Committee takes the view that on balance, most stakeholders are in favour of the new R&D tax incentive that will provide a refundable or non-refundable tax offset to eligible entities.

6.21 The Committee considers that the calls for the delay of the bill's passage relate to matters which it has sought to address throughout its recommendations.

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19 Aditus Consulting, *Submission 16*, pp 1–2.

20 Michael Johnson Associates, *Submission 5*, pp 5–6.

21 Senator the Hon Kim Carr, Minister for Innovation, Industry, Science and Research, *Senate Economics Committee Hansard*, 31 May 2010, p. 53.

22 Senator the Hon Kim Carr, Minister for Innovation, Industry, Science and Research, *Senate Economics Committee Hansard*, 31 May 2010, p. 54.

6.22 The Committee takes the view that the remaining opposition to the bill appears to be an opposition to the Government's policy objective to target R&D expenditure to small and medium enterprises and to do this through changes to the eligibility criteria. The Committee supports this policy objective of the Government and notes that the recommendations it has made will operate to ensure that the objective is achieved.