

# Remedies for the proposed R&D Tax Credit Scheme

Australian Industry Group Submission

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## Executive Summary

The draft legislation for the new research & development (R&D) tax credit scheme is a major concern to Australian industry and puts at risk the important advances made in lifting Business Expenditure on Research & Development (BERD) in recent decades. The Australian Industry Group (Ai Group) believes that, if enacted, the changed approach to support for business R&D would narrow, removing much of the incentive for industrial R&D. In so doing, it would slow business-led productivity improvements and future economic growth.

Reversing the positive trend that has occurred in BERD in Australia over the past twenty years would be a most unfortunate outcome. Australia continues to lag the OECD average on this important indicator and should be making every effort to close this gap.

The significant flaws in the scheme, as it is currently drafted into legislation, include:

- The augmented feedstock provisions that will unnecessarily exclude a substantial proportion of business expenditure on industrial R&D from eligibility for the tax incentive;
- Other changes to the criteria for eligibility will also significantly erode incentives for industrial R&D. These include:
  - Replacing the current concept of “innovation” with the proposed, narrower concept of “considerable novelty”;
  - Introduction of a dominant purpose test for supporting activities;
  - Replacing the “innovation *or* technical risk” test with a necessarily more restrictive “considerable novelty *and* technical risk” test;
  - The substantial expansion of the exclusions list; and
  - A major claw-back in the range R&D on software that would qualify for the tax credit.

These restrictive measures would reduce support for overall industrial research and development expenditure by business. This will occur both in relation to the specific areas of expenditure that would be excluded and in relation to other areas of expenditure on R&D that will not be undertaken because of the removal of support for closely-associated, excluded expenditure.

In addition the much more restrictive approach will very substantially add to the ongoing complexity of the scheme and add to compliance costs borne by business and administration costs incurred by public agencies. This is in stark contrast to the unsupported claims made by the Government that the new scheme will remove complexity.

Additional complexity and higher costs of compliance and administration will be experienced in the short and medium terms as new definitions and concepts are refined and given operational meaning.

Finally, on the basis of the feedback we have received from our members, the much more restrictive approach will reduce the range of expenditure eligible for the tax credit and result in very large reductions in total support for business R&D. Together with the removal of the 175% premium concession, the proposed restrictive approach will go well beyond the Government's proposed revenue neutral objective.

There are, however, aspects of the new credit scheme that Ai Group continues to support. These include:

- The proposal to extend eligibility to R&D undertaken in Australia regardless of where the associated IP is owned;
- The change in the form of incentive from enhanced deductions to a tax credit as a means of decoupling the tax incentive from the company tax rate;
- The increased incentive and the relaxation of restrictions on the availability of the refundable tax credit;
- The proposed change in eligibility for the refundable credit for companies part-owned by exempt entities so that companies up to 50% owned by exempt entities will qualify (compared with the current 25%); and,
- The proposal to increase the incentive for eligible expenditure that currently attracts the 125% enhanced deduction (the proposed 40% credit is equivalent to a 133% deduction at the current company tax rate of 30%).

Ai Group submits the following as a way to resolve the current flawed approach:

- The proposed restrictions on eligibility should be put aside in favour of the already established and well-understood definitions of eligible R&D;
- The government should more closely examine and make available its modeling of impact of removing the 175% tax concession;
- To meet the revenue neutral constraint, any shortfall net of the real impact of the removal of the 175% tax concession, Ai Group proposes measures more precisely targeted at areas of inappropriate claims.

On this basis, the Government could continue to implement the scheme according to the existing timeframe of 1 July, 2010.

If, the Government chose to pursue a wholesale change in the definitions of eligibility along the lines based on the current draft legislation, Ai Group proposes that a period of much more considered consultation be undertaken to develop a workable approach and to reduce the substantial costs of adjustment. This could only be done if the timeframe for implementation was extended to 1 July, 2011.

## About Ai Group

The Australian Industry Group (Ai Group) is a leading industry association in Australia. Ai Group member businesses employ around 750,000 staff in an expanding range of industry sectors including: manufacturing; engineering; construction; automotive; food; transport; information technology; telecommunications; call centres; labour hire; printing; defence; mining equipment and supplies; airlines; and other related service industries.

## The Importance of R&D and Innovation to the Australian Economy

The Research and Development tax incentive provides critical support to industrial research and development expenditure. The period since the introduction of the incentive has seen very strong growth in Australia's Business Expenditure on Research and Development (BERD).

The significant demographic, environmental and competitive challenges facing Australia call for continued efforts to raise our rate of productivity improvement. This imperative is compounded by the pressures on key sectors, notably manufacturing, to adjust to the greater call on internal resources and the higher domestic currency that is expected to be associated with the ongoing strength of demand for Australia's mineral commodities.

Notwithstanding the significant contributions that can be made by Governments to improve productivity, the larger share of improvements will stem from measures undertaken in the private sector to improve products, services, organisations and production and distribution processes. Research and development undertaken in the private sector is a critical element in this.

Ai Group agrees that the case for public support of business research and development activity arises because of the direct and indirect spillovers that arise when the full value that flows from this expenditure is not captured by the businesses making the expenditures but part of which flow to other parties.

Without public support, the total quantity of business expenditure undertaken would be less than the socially optimum level. An incentive such as Australia's tax incentive that provides benefits to the company undertaking R&D expenditure is an appropriate intervention to boost the level of private expenditure towards the socially optimum level. Ai Group notes that the R&D tax incentive is far and away the predominant form of public support for private sector R&D in Australia. This is unlike most other countries where direct expenditures also play much more important roles.

## **Revert to Previous Position on Feedstock Provisions**

The augmented feedstock rule and related provisions proposed in the draft legislation fundamentally alter the nature of the tax benefit such that it no longer resembles the policy espoused by the Federal Government.

The proposed changes will deliver a system which concentrates foremost on providing a safety net for R&D that fails partially or totally. It will favour the narrow and esoteric, rather than provide up front agitation for commercially viable R&D. The R&D tax credit therefore becomes little more than an insurance policy for commercially unviable R&D.

Because benefits can only be calculated on the after market value of R&D, the administration of a company's R&D affairs takes on an altogether different level of complexity. This is especially the case for claimants where the pay back period on the R&D is lengthy. The accounting of projects will become unnecessarily variable and complex given that the value of the output may be clawed back at a future date. The assessment of potential liability will be extremely difficult to gauge and cause serious internal contention, requiring more art than science. For significant proponents of R&D, the requirement to amend prior year's tax returns will become omnipresent, adding a significant burden of red tape.

Additionally, the inclusion of labor and plant depreciation in the 'output's cost' is inappropriate. The existing provisions which deal only with material inputs and energy are more than appropriate in achieving the goal of recouping incentives on profitable activities.

## **Maintain Existing Eligibility Requirements**

The draft legislation for the new R&D tax credit scheme proposes the strictest and most complex definitions of R&D for tax purposes anywhere in the world. It is concerning not only in relation to its impact in terms of excessively narrowing the field of candidates for the tax credit (and the consequent impact this would have on levels of innovation in the Australian business community), but also in relation to its administration.

It is our view that the proposed changes in definitions should be rejected in their entirety and that the Federal Government keep in place the existing set of definitions that are more reasonably interpreted and understood by business and which much better align with most other global definitions.

The problems with the proposed approach include:

- The removal of the widely understood term of 'innovation' is a significant error. Its replacement 'considerable novelty' is inadequate in that it gives rise to uncertainty stemming from error in interpretation and, most likely, applies too strict a definition as to what constitutes R&D. For instance, the capacity and capability of the Government to determine issues such as whether 'knowledge of

[a] technology...is publicly available on a reasonably accessible worldwide basis' should be questioned. Further the likelihood of subjective interpretation to be applied in determining novelty as 'considerable' or as a mere 'logical progression' is extremely high. This has the potential to lead to highly contentious interpretations not prevalent in the current scheme. Importantly, it is more likely to narrow the field of potential claimants and result in a reduction in the total value of overall public funding to stimulate private R&D.

- This problem is exacerbated by the insistence on introducing the 'and' test for eligibility to include 'high levels' of technical risk. Once again, the likelihood of subjective interpretation is high. For instance, how is it likely to be determined 'when knowledge of whether something is scientifically possible or technologically feasible, or how to achieve it in practice, is not readily available or deducible by a 'competent' professional working in the field'? This would require a significant increase in current resource allocations to Innovation Australia, including access to a cadre of global leading scientists and innovators. The result, therefore, is likely to be that many genuine R&D activities will be excluded on the basis of incomplete knowledge and understanding of a given endeavour. The confluence of both tests will significantly reduce the number of successful R&D claimants as a result of poor decision making in relation to applications and the increased cost and risk associated with making an application.
- Additionally, the introduction of the 'dominant purpose' test for supporting activities will also add to the burden of business in terms of the resource it will have to apply to proving a direct relation to core activities. For instance, proving that activities can 'serve, or be conducted for, more than one purpose' is likely to be a highly contested space with claimants. The uncertainty inherent to this test is obvious in the explanatory memorandum. It gives rise to more questions than are answered.

Due to the level of subjective analysis and interpretation likely to stem from the introduction of the proposed scheme, Ai Group believes there will be a long and costly transitional period involved in its implementation. In the short term it will create significant levels of indecision in the investment plans of many Australian companies. It also has the potential to derail significant long term investment plans. Both outcomes will stem the growth of BERD.

At least as importantly, the restrictive and overly complex definitions are likely to detract from essential efforts in many important commercial areas relevant to the achievement of broader public policy goals of the Federal Government. For example, submissions from a number of companies in manufacturing and construction during the initial consultation phase reveal that much of the incremental R&D undertaken in the area of green product development and process engineering will be put at risk. This would be an unwelcome development given the critical nature of this innovation in respect of improving Australia's efforts in addressing climate change.

## Review the Exclusions

The problems associated with the new 'headline' definitions are further exacerbated by the decision to exclude such a significant number of activities from being either core or supporting activities.

The handling of software development is especially out of step with policy intentions in other portfolios such as Communications and the Digital Economy.

- If enacted, it will undermine investments in innovation in a range of areas that are vital to the success of the National Broadband Network (NBN).
- It is also out of step with the significantly more progressive and favourable R&D tax treatment regimes being implemented elsewhere in the world. It places Australia in a disadvantaged position in relation to attracting the skills and investment required to expand the sector.
- More generally, it fails to recognise the primacy of information communication technology in driving productivity gains in the Australian economy in recent past.

Contrary to the intended tightening of the multiple sale test, Ai Group has and will continue to argue for the removal of this test. Australia suffers as a result of this restriction. Software development is not unique and should be treated commensurate with any other form of R&D.

The contentious nature of the exclusions list is not only in relation to the treatment of the software development industry however. For instance, part 2 (h) of section 355-35, regarding pre-production activities and demonstrations of commercial viability, will significantly restrict R&D effort in the manufacturing industry. Further, part 2 (l), which disallows activities associated with statutory requirements, could mean that clinical trials in the pharmaceutical industry are ineligible due to regulatory requirements of the Therapeutic Goods Administration (TGA).

## Remedies

The proposed legislation represents an unacceptable over-adjustment in attempting to narrow the field of claimants for the R&D tax credit and will go well beyond the revenue neutrality position that has been set as a condition of the refashioning of the policy. Moreover, it contrasts markedly to the stated position of the Federal Government in terms of incentivising private research & development in Australia.

Ai Group submits the following as a way to resolve the current flawed approach:

- The proposed restrictions on eligibility should be put aside in favour of the already established and well-understood definitions of eligible R&D;
- The government should more closely examine and make available its modeling of impact of removing the 175% tax concession;

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