

AUSTRALIA “CONSULTS” OVER ITS R&D TAX CONCESSIONS

Following on from a 2009-10 Budget announcement in May, the Australian Treasury has issued a “consultation” paper on its proposals for new research and development (R&D) tax incentives¹. The Budget proposed to repeal the existing deduction regime and to replace it with a tax credit regime, similar to that already offered to small business. However, the changes are to be “revenue neutral” and the eligibility criteria are to be tightened in a number of respects.

Under the proposal companies with a group turnover of less than A\$20m will from 1 July 2010 be able to claim a 45% refundable R&D tax credit. With a 30% corporate tax rate this is equivalent to a 150% tax deduction compared with the existing 125% deduction. Other companies will be able to claim a non-refundable 40% R&D tax credit, equivalent to a 133% deduction. Although non-refundable, this credit can be carried forward if the company has no tax liability in the current year. However, the definition of R&D is to be tightened and the claiming of “supporting” R&D restricted. The consultation paper makes it clear that Treasury is looking for agreement on the forms these restrictions might take.

Other changes proposed are unexceptional; the location of the ownership of intellectual property created will not be relevant as long as the work is done in Australia for companies incorporated in Australia, and the refundable 45% credit will be open to companies which are owned up to 50% by income tax exempt institutions such as universities.

The present definition of eligible R&D activity in s 73B(1) Income Tax Assessment Act 1936 (ITAA1936) is activities which are “systematic, investigative and experimental activities that involve innovation or high levels of technical risk and (i) are carried on for the purpose of acquiring new knowledge or (ii) creating new or improved materials, products, devices or services”. The proposed new definition changes the first “or” to “and”, thus requiring both elements, that is activities which involve both innovation and high risk. The explanation given is that the R&D subsidy should only go to risky undertakings which are less likely to

¹ www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=1599

be undertaken in the absence of a subsidy. Clearly, there will be a reduction in the number and value of projects which will attract the tax benefit.

The other change in the definition is that the words “and (i) are carried on for the purpose of acquiring new knowledge or (ii) creating new or improved materials, products, devices or services” are to be deleted and replaced with “[carried on] for the purpose of producing new knowledge or improvements”, a much more general phrase. The consultation paper states that the new definition is more likely to encourage activities that are in addition to what otherwise would have occurred, and to provide “spillovers” that is benefits that are shared by other organisations and the community. In effect, it is said that only R&D which is not likely to produce any benefit should be subsidised, a doctrine eerily similar to that of the Ministry of Silly Walks in the famous 1970s Monty Python sketch. One commentator has observed that the new definition requiring both innovation and high levels of technical risk has been proposed by the Treasury before, only to have its view rejected in the Senate’s review of the Taxation Laws Amendment (Research and Development) Bill 2001.²

It is also suggested in the consultation paper, that in order to achieve “revenue neutrality” it will be necessary to limit the amount of the subsidy for “supporting” R&D. There is also a concern that relatively small expenditure on “core” R&D may be accompanied by large amounts on supporting activities. This may be addressed by a cap on expenditure as a proportion of “core” R&D, the exclusion of production and dual purpose activities, or for supporting R&D to be given a lower rate of subsidy. One sure effect of such measures will be to complicate administration. In the existing provisions “core technology” is defined but “supporting technology” is not, and it will be hard to be precise as to the distinction between them.

The consultation paper also asks if the present list of activities excluded from the definition of “core technology” in s 73B(2C) ITAA 1936 should be amended or extended. In particular, it asks whether the excluded activities should give rise to any tax benefit other than those given to routine business expenses. Most of the present list fall outside the core technology definition but some could be seen as supporting or facilitating core R&D, such as obtaining a patent or standards approval.

² S Duchini & S Heyer, “The new R&D tax incentive-the consultation phase begins” CCH Tax Week, October 8 2009

Some proposals made in the discussion paper are not likely to arouse opposition. A more liberal regime for software, presently subjected to a “multiple sale” requirement, is suggested which will mean development of in house software will be included as eligible R&D. It is also suggested that the UK guidelines for R&D on software (HM Revenue CIRD 81960, issued in 2004) are a starting point. Software projects which involve the application of existing tools to routine tasks (user interaction, encryption, web site creation and the replication of paper procedures) is not likely to be eligible for R&D tax concessions. On the other hand, the development of new operating systems or languages, creating new search engines, resolving conflicts between hardware and software due to unknown causes, creating new algorithms and original security techniques all might qualify. This sort of issue of detail is perhaps best left to the rulings system, as an application of existing statutory definitions.

The administration of the R&D provisions is partly in the hands of a body known as the Innovation Australia Board, an offshoot of Ausindustry (the Department of Innovation, Industry Science and Research), which assesses whether an activity is eligible R&D, a matter the ATO is hardly equipped to judge. Governments are notoriously incapable of picking commercial winners, but of the Board’s eight members seven are from the private sector and together they are likely to be less obsessed by potential abuse than the Treasury or ATO.

Finally, as mentioned above, allowing the intellectual property created by R&D to be located outside Australia will certainly not discourage foreign investors financing Australian R&D.

Treasury’s own “Tax Expenditures Statement 2008”³ issued in January 2009, indicates that the sums involved in the R&D concession are considerable. The regular concession for R&D under s 73B and 73BA in 2008-09 is estimated to have cost \$A580m in foregone tax revenue, and the premium tax concession (the 175% deduction for certain Australian owned and foreign owned R&D) cost a further \$A 390m. It is difficult to predict what effect the proposed measures will have, but tightening eligibility is likely to reduce claims. Whether that is desirable remains to be seen. A quick scan through Taxand’s “Global Guide to R&D

³ www.treasury.gov.au/contentitem.asp?NavId=&ContentID=1465

Tax Incentives”⁴ suggests there is a lot of competition out there (Taxand lists over 40 countries) not all of which are so regulatory minded as Australia.

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www.taxand.com/media/Taxand_launches_new_global_guide_to_RandD_tax_incentives_covering_over_40_jurisdictions_worldwide