



**Business Strategies International**

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**SUBMISSION IN RELATION TO TAX LAWS AMENDMENT (RESEARCH AND DEVELOPMENT) BILL 2010 - THE NEW RESEARCH AND DEVELOPMENT TAX CREDIT PROGRAM**

In response to the invitation to comment on the exposure draft legislation (the Bill) and associated explanatory materials (the EM) BSI Innovation Pty Ltd (BSI) is pleased to provide this submission outlining our significant and serious concerns with several elements of the Bill as drafted.

BSI is a leading Research and Development (R&D) Tax Concession advisory firm which has provided claim preparation, R&D planning and assessment, and strategic review services to around 190 companies annually during the past 19 years (formerly as The Fallon Group). As such we believe our team of senior advisors to industry are well placed to comment on the likely ramifications of the implementation of the new incentive as drafted in the Bill.

**Introduction**

We strongly support the decoupling of the benefit from the prevailing company tax rate as this provides certainty into the future of the level of benefit, whereas the company tax rate is subject to change. We also support the new benefit structure that provides a higher level of benefit to SMEs.

However, we are very disappointed with the details of this new legislation that will significantly reduce both the scope and level of assistance and encouragement to innovative Australian companies.

The existing R&D Tax Concession (the Concession) has a 23 year history, is well understood by business and is arguably the most successful of all government programs in promoting innovation in industry. The Concession and its structure, operation and cost-effectiveness was found to be very successful, according to the 2007 DITR report "How R&D Assistance Influences Company Behaviour (A survey investigating behavioural additionality effects of the R&D Tax Concession program)" in producing increases in the level of private sector R&D.

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This new legislation introduces significant complexities into both the identification and substantiation of eligible R&D activities and the calculation of eligible expenditure. Far from streamlining the process, this new approach will require a great deal of additional time, effort and resources from applicants to ultimately receive a much lesser benefit.

This will not encourage Australian companies to take on the financial and business challenges of pursuing additional R&D.

### **Intent of the Legislation**

The Government has on many previous occasions stated that the intent of the legislation is to encourage industry to undertake R&D activities in Australia. The argument for changing from the existing Concession to the R&D Tax Credit was that the new program would increase certainty for claimants in regards to the value of their R&D deductions, redistribute the benefits of the program in favour of SMEs and reduce the associated compliance burden. During the consultation process, it was stated the implementation of the new R&D Tax Credit would be revenue neutral when compared with the Concession and that increased level of benefits and would be offset by only minor changes to the existing definitions.

Instead, the legislation in its current form effectively renders ineligible a very large proportion of previously eligible R&D activities and/or excludes their associated expenditure. Analysis of the effect of this change from various industry groups and advisors indicates that this will affect all industries and most companies will find that they will lose approximately 50-80% of their previous benefit. This is supported by our own internal analysis of our clients' historical claims.

Further, the compliance load of the new program is inherently more complex. There is a considerable increase in complexity in analysing expenditure and its dominant purpose within a project. The preparation of applications and their substantiation must become more complex with the definition combining considerable novelty and high levels of technical risk and the requirement to justify all Supporting Activities and substantiate their dominant purpose to a specific Core Activity.

It is difficult to see how the intent to encourage Australian companies to undertake an increasing level R&D activities is achieved with this additional complexity, narrowing of eligible activities and reduction in actual benefit.

The new program will not be revenue neutral, rather it will be a major cost saving to the Government compared to the current program. We believe that this is a case of the Government being “penny wise, pound foolish”, as the initial loss to revenue from the Concession has been recouped in future income tax payments from the company profits generated from the R&D projects as well as the personal income tax paid by the staff and contractors employed to work on the projects. In the future, if companies no longer undertake their R&D in Australia, then the associated tax revenue will also no longer be generated in Australia. Associated with this will be the broader loss of innovation and skills in industry, which will further reduce productivity and impair Australia's economic development.

### **Changes to the definition of R&D activities**

The new definition of R&D activities contained in the draft legislation creates significant limitations on what will be eligible under the new R&D Tax Credit program. The

requirements that Core Activities contain both considerable novelty and high levels of technical risk, and that Supporting Activities be undertaken for the *dominant* purpose of supporting Core R&D, dramatically narrows the level of support provided by the program.

The research & development undertaken by industry covers a very broad range of activities. While many projects do indeed involve both innovation and high levels of technical risk, there are many occasions when valuable R&D, worthy of the assistance intended by this program, involve only one or the other of these characteristics.

Innovation would indeed be present in the creation (discovery or acquisition) of new knowledge but this could quite possibly not involve high levels of technical risk. For example, the discovery of a new chemical relationship, determining a new mathematical function or the process of synthesising new molecules is creating new knowledge, it does not necessarily involve what is accepted as high levels of technical risk but it is surely R&D worthy of support.

High levels of technical risk are certain to be present in attempting improve the productivity of a manufacturing process. There is sure to be uncertainty whether changing the handling techniques, unit routing, operational speed of the process, material changes etc could achieve the technical objective of improved productivity. However, it would be likely that very little if anything in this R&D progression could be considered to involve considerable novelty.

The “*and*” requirement in the new legislation creates the situation where an otherwise innovative project must in-effect seek to take on a high level of technical risk in order to be eligible. Most R&D projects seek to rely, to the greatest extent possible, on the best technologies and knowledge available to the researcher at the time. To mandate that a project is only eligible where it involves a high level of technical risk shows seems determined to support only that R&D with the highest chance of failure rather than success.

R&D by its very nature involves activities and projects of extremely variable form and substance. It is impossible to determine with any certainty the specific elements of experimental R&D which later lead to the spillover effects and knowledge transfers desired by Government. As such, to introduce a compound definition risks being little more than an attempt to “*pick winners*” which is arguably doomed to fail as it has when attempted in other Government R&D programs.

When combined with the Augmented Feedstock adjustments (s.355-450), the revised definitions of Core and Supporting R&D activities contained in the draft legislation will, in our view, narrow the application of the R&D incentive to such a degree as to represent the effective removal of Government support for private sector R&D for many Australian companies.

BSI would therefore urge the Government to reconsider the changes appearing in the current draft:

- a. Change the definition of Core Activities to require only innovation **or** high levels of technical risk; and
- b. Change the definition of Supporting Activities to require that they be *directly related* to the carrying on of Core Activities.

The requirement for Core Activities to satisfy the four tests (ESI, Considerable Novelty, High Levels of Technical Risk and PKI) has not only significantly increased the threshold of eligibility, it has also significantly reduced the scope of what can be defined as an eligible activity. In addition, the scope of eligible activities is further narrowed by the changes to the definitions of Supporting Activities and Excluded Activities.

For instance, a company could be granted a patent for a new product that it has developed. Most people would consider that a patent is the highest test for innovation, yet under the new legislation Innovation Australia could deem that the R&D activities that led to the invention:

- a. Fail the considerable novelty test as the new product is the “next logical step”;
- b. Fail the PKI test as the purpose for undertaking the R&D is to create a new product rather than acquire new knowledge.

The R&D activities could also fall under the excluded list or not meet the very narrow commercialisation criteria, be it the software multiple sale test or the augmented feedstock test, which could also preclude the company from claiming the R&D Tax Credit.

The wording of the new definition not only constrains the scope of eligible activities, it is also a surreptitious way of ensuring that existing case law, and tax rulings and more than 20 years of accepted practice cannot be relied upon in the future. The vague and ill defined wording of the definition, e.g. what is considerable novelty, opens up the possibility that Innovation Australia can make an arbitrary assessment determining that a company’s R&D activities do not meet the definition of Core Activities because the assessor’s interpretation of considerable novelty (more than “the next logical step”) differs from the company’s interpretation (granting of a patent). How does one, in hindsight, argue that the patentable invention was not “the logical next step”?

The change in the definition requiring that the R&D activities be undertaken only for the dominant purpose of acquiring new knowledge also makes it difficult to satisfy the high levels of technical risk test. New knowledge is acquired in the concept development stage of a project but largely the high levels of technical risk are involved in applying that new knowledge to the actual development of a new product or process and the dominant purpose of this stage of the project is to create a new working technology not the acquisition of new knowledge. Considerable novelty is also likely to be found only in the concept development stage and not in the later stages of the project.

## **Excluded activities**

The exclusion of activities as supporting R&D activities (s.355-35(2)) represents a further narrowing of the activities to which the new R&D Tax Credit will apply.

Experimental R&D often requires that a variety of activities be undertaken which, while not R&D in their own right, provide critical data and information that in actual fact facilitates the carrying on of Core Activities. For example in the first stages of a project, where an assessment of the existing technology (by an examination of publicly available literature and patents and designs) is undertaken, will be excluded as a supporting activity under 355-35(2)(n)(ii).

The introduction of this exclusion shows a disconnect between the policy objectives underlying the new legislation and the realities of carrying on a modern R&D program in the private sector. As such, BSI would suggest that as part of a comprehensive re-evaluation of the draft legislation such as we have proposed in this submission, items (a), (b), (c), (h), (i), (k), (l), (n), (o), (p), (q) and (r) be removed from the list of activities which may not be Supporting Activities at s. 355-35(2).

## Treatment of software-related R&D

The consultation paper for the R&D Tax Credit contemplated the complete removal of the multiple-sale requirement for software-related R&D project, stating that it was “an outdated articulation of policy intent as it relates to software”.

BSI supported this view, and provided the following in our submission:

*BSI would support the removal of what is in-effect an additional eligibility criterion for software R&D projects. This would bring these R&D activities in line with those of other industries, and limit the test for eligibility to a single generic definition of eligible core and supporting R&D activities. Changes in the software industry and associated technology platforms during the past 20 years serve to make 73B(2A) not only redundant, but also unduly restrictive in an increasingly global market where firm level competitive advantage is critical for commercial success.*

and:

*It is BSI's strongly held view that no sector, be it software or any other, should be subject to additional eligibility criteria in order to obtain support under the R&D Tax Credit program. Any prescription of eligible R&D activity beyond a generic definition seeks to arbitrarily promote or constrain a particular industry over others. The nature of experimental R&D activity is that it is not able to be extensively planned or budgeted for with certainty, nor can it be determined in advance which activities will be successful or valuable.*

*... BSI believes that the rigour of the existing [R&D Tax Concession] definition is, when interpreted and applied correctly, sufficient to ensure that only those activities which are truly R&D are eligible for assistance under the program. We would therefore strongly oppose any additional eligibility provisions seeking to promote or restrain emergent or resurgent industries, on the basis of a government view that a sector may or may not prosper in future as a result of their R&D efforts today.*

In reviewing the draft legislation and its punitive treatment of software R&D, we would strongly reiterate the above arguments.

The global software industry is forecast to grow to US\$457 billion by 2013 – an increase of 50% on 2008 levels. To divert support for R&D away from this industry as the list of excluded activities (s.355.35(2)(o)-(r)) currently does, seems not only counter intuitive from a policy perspective, but also reinstates and strengthens the original multiple-sale requirement which was at issue.

Further, with the Government planning to invest \$43 billion in the National Broadband Network (NBN), the exclusion of software services and other areas of IT development seems contradictory to the stated intent to embrace e-commerce and promote Australian technology and innovation. This exclusion will severely limit the new content and applications that are likely to be developed by Australian companies to exploit the opportunities arising from the NBN and lead to the loss of major commercial opportunities to foreign firms.

Again, it would appear that there is some significant distance between the stated policy objectives, and their articulation in the draft legislation. We would therefore encourage the Government, as part of the comprehensive review of the legislation that we have proposed, to remove items (o)-(r) in s.355-35(2), thereby offering the same opportunities and benefits



to the software industry as to other Australian companies undertaking experimental R&D activities.

## **R&D Expenditure**

### Expenditure that can be notionally deducted

We note with concern that the draft legislation contains no definition of “research and development expenditure” as is currently contained in the Concession legislation. BSI recommends that the Government amend the draft legislation to include expenditure classifications and definitions for “salary expenditure”, “contract expenditure” and “other expenditure”.

### Feedstock Adjustment

The augmented feedstock adjustment provisions (s.355-450) represent the most significant reduction in benefit levels relative to the existing R&D Tax Concession. To require the market value of all outputs of an R&D program to be subtracted from the cost of producing those outputs, undermines the entire basis of a tax-based incentive for private sector R&D.

The Concession has operated for more than 20 years on the basis that a benefit (in the form of an additional tax deduction) is provided to companies conducting experimental R&D activities, with the justification that successful R&D projects will deliver economic growth, and therefore greater tax receipts to Government in the mid-long term. That is, the long-term cost to revenue of the Concession could arguably be shown to be negligible or perhaps even negative. To change this policy setting, as the draft legislation does, to a situation where companies conducting R&D are effectively “taxed” on their R&D effort twice (once via a feedstock adjustment, and then again on sale as assessable income) seems entirely counter-productive to the objectives of the program.

BSI recommends that the Government remove the Feedstock Adjustment provisions at s.355-450 and replace them with those which currently operate within the Concession program for materials or good that are subject to processing or transformation (s.73B(1)).

### Core Technology

The removal of accelerated deductions for core technology acquisitions in the draft legislation is curious with respect to the overarching objectives and justifications for a tax-based R&D incentive.

It is our experience that companies actively seek to license technology, and other intellectual property as a natural “jumping-off” point for commencing an experimental R&D program of their own. To date, this has been encouraged and facilitated by the core technology provisions operable within the Concession and their eligibility for the R&D Tax Offset election.

As part of our submission to the consultation paper, BSI noted the importance of the 100% deduction and associated R&D Tax Offset benefits, for small, early-stage technology companies who are severely constrained in terms of working capital while undertaking an R&D program. The existing situation allows these firms to effectively draw down on their future profitability (via the R&D Tax Offset) so as to generate the necessary funds to finalise the R&D activities. To remove this eligibility, as the draft legislation does, represents a significant lowering of Government support for exactly the type of R&D activities that are intended to be encouraged.

These issues with the draft legislation can be argued to reflect a misunderstanding on the part of Government as to the day-to-day issues which impact an R&D program within the private-sector. We strongly urge a review of these provisions to ensure that core technology purchases are not only encouraged, but also eligible for the refundable tax credit at a lower rate equal to the prevailing company tax rate (i.e. 30%).

### **Expenditure not at risk**

The expenditure at risk provisions in the new legislation can be read broadly, with the result that when there is a reasonable expectation of consideration being received as an indirect result of R&D expenditure being incurred, an entity cannot deduct expenditure under s.355-200, or s.355-480.

It is BSI's view that a clarification is required that clearly sets out that arrangements which provide for the normal commercialisation of the output(s) of an R&D program are not captured by this section. For example, a company conducting R&D to fulfil a fixed-price contract should not be affected by this section.

### **Other Issues**

#### Building Expenditure

We believe that there is an unintended restriction in eligible R&D activities that has been created by development and amendment of the R&D Tax Concession legislation over time.

In s73B of the ITAA 1936 the definition of "*research and development expenditure*" specifically excludes expenditure incurred in the acquisition or construction of a building or of an extension, alteration or improvement to a building. This provision has been carried over into the current exposure draft of the R&D Tax Credit legislation under s355-220(1)(a). This excluded expenditure was intended to relate to building acquisition, construction or improvement to a building owned or leased by the company and used as premises to conduct R&D activities (e.g. R&D laboratory) rather than being the subject of the R&D (refer IT2442 Building expenditure).

However, as s73B has evolved and inoperable clauses have been removed, this exclusion has lost its context.

It could be taken to imply that R&D activities conducted in the development of building technologies and processes and necessary prototyping and testing would be ineligible. As the program is intended to be broad based and not exclude the building industry, we would recommend that this provision is clarified.

### **Alternative Approach**

We believe that there is another method to achieve the aims of the new program that will provide certainty to claimants and a viable cost control for the Government.

The existing R&D Tax Concession legislative structure should be retained with the inclusion of the new tax credit benefit provisions and the exclusion of the existing Premium 175% benefit.

This approach would allow the program to retain the existing definitions and methodology of claiming both Core and Supporting expenditure.

The program benefit would be limited to a pre-set maximum claim for any company in a financial year. This could be set at a figure that supports cost neutrality, possibly in the range of \$10-20 million or whatever government modelling supports. This would maintain and control the overall cost of the program and drive the benefit down to SMEs.

Large companies that exceed this level of R&D expenditure could be compensated by allowing the excess expenditure to benefit from a tax credit at 100% of the prevailing company tax rate.

A major benefit of this approach is that all existing guidance material, industry knowledge and more than 20 years of case law remains relevant. This will also provide confidence to applicants that have a long history and familiarity with the requirements of the program.

## **Conclusion**

Over more than 20 years the R&D Tax Concession has successfully taken Australia's Business Expenditure on Research and Development (BERD) from near the bottom of the OECD ladder to about 13th place. However, in terms of BERD to GDP, we still only spend about half that of the international leaders.

This improvement has been achieved with all the benefits of the current program. If the R&D support is slashed, as it will be under the proposed R&D Tax Credit program, Australian BERD will quickly head back to the bottom of the ladder.

If the Government wants to encourage an "Innovation Revolution" it must, at the very least, maintain the current level of support for innovative Australian companies to undertake increasing levels of research and development.

If you have any questions, please give me a call on 02 9212 5505 or 0414 225 995 at any time.

Yours sincerely  
BSI Innovation Pty Limited

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