



**The Institute of
Chartered Accountants
in Australia**

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**Submission on Exposure Draft Tax Laws Amendment (Research and Development)
Bill 2010**

Dear Paul

The Institute of Chartered Accountants in Australia (the Institute) welcomes the opportunity to provide our submission on the Exposure Draft of Tax Laws Amendment (Research and Development) Bill 2010 (the ED) in relation to the new R&D tax credit which is proposed to commence on 1 July 2010.

The Institute is the leading tax and accounting professional body in Australia. Our reach extends to more than 62,000 of today's and tomorrow's business leaders, representing over 50,000 Chartered Accountants and 12,000 of Australia's best accounting graduates who are currently enrolled in our world class Chartered Accountants postgraduate program.

At the outset, it is important to acknowledge that the Institute supports the broad policy objectives of the proposed new Research and Development (R&D) tax credit as reflected in the Explanatory Material (EM), namely to:

- encourage innovation which is recognised internationally as an important driver of productivity and economic growth;
- provide a better incentive for companies to invest in R&D to improve global competitiveness and ongoing profitability;
- direct the new R&D tax incentive towards assisting those activities most likely to generate 'spillover' benefits to the Australian economy; and
- tilt assistance in favour of smaller innovative firms as they are likely to respond to fiscal incentives.

Given the stated policy intent, the Institute has several concerns in relation to the manner in which the proposed R&D tax credit has been designed and reflected in the ED. The Institute is doubtful about the ability of the new R&D tax credit to deliver the desired policy objectives outlined by the Government.

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The Institute welcomes a number of aspects of these reforms, in particular:

- a tax credit with an increased rate of benefit, from 7.5 cents in the dollar to 10 cents in the dollar for large companies with a turnover of \$20 million or more, and to 15 cents in the dollar for small to medium companies (SMEs) with a turnover up to \$20 million;
- a refundable credit available to SMEs;
- the proposed increased flexibility to enable tax incentives for R&D activities outside Australia, subject to advance approval and special circumstances; and
- the removal of the formerly unlimited amendment period and alignment with the standard time period of four years from the date of lodgement.

Overall, however, we believe that the proposed R&D tax credit represents a step backward in terms of incentivising R&D. We consider that the changes in the ED are significant and that their combined effect is overly restrictive and do not create an incentive that accords with the recommendations of Dr Terry Cutler in his recent review of innovation. We also believe that the design of the new tax credit as laid out in the ED differs from that contemplated by the Government in its 2009-10 Federal Budget announcement.

Our members believe that the new credit will operate to deter R&D activity in Australia, and worse, may also encourage the more mobile innovative industries such as Information Technology (IT) to move R&D investment offshore. The Institute's key concerns exist around:

- the tightening and changing of numerous fundamental aspects of the definition of core R&D activities, introducing overly restrictive tests which will create significant uncertainty;
- the making of a greater distinction between core and supporting R&D activities, creating heightened complexity and compliance burdens;
- the exclusion of a range of traditional R&D activities from eligibility, in particular software-related activities and other activities, many of which are typically integral to the successful completion of an R&D project; and
- the augmentation of the feedstock rule by introducing a broad 'net expenditure' approach which effectively claws back financial support to an R&D project at the vital developmental and commercialisation-end of the process, if successful output is produced.

The Institute is concerned that the focus of the new credit operates in a way that limits support only to research and more theoretical activities. It fails to incentivise the proving of the technology to commercial viability which fundamentally changes the essence of the incentive. The new credit appears to have been designed and implemented based on the understanding or perception that the greatest 'spillover' benefits are generated by the carrying-out of 'research', rather than developmental activities that have a practical commercial focus.

We believe that the proposed changes will prohibit those companies most likely to generate 'spillover' benefits from accessing the incentive, such as innovators who have "close to market" products or work collaboratively with their customers. Many such companies are likely to be SMEs, the very firms towards which the new R&D tax credit is intended to be directed.

The issues detailed above have been the subject of detailed discussions with Treasury and the Department of Innovation over recent weeks. As a result of those discussions, we understand that there is some scope to refine critical aspects to the design and implementation of the credit in relation to each of the key issues outlined above.

Accordingly, in our detailed submission in the attached Appendix we provide comments on each of our key areas of concern, including our recommendations as to how we believe the ED and EM could be amended within the bounds of Treasury's policy approvals from Government. We believe that making the changes recommended in this submission will deliver the intended policy outcomes sought by the Government, without unnecessarily jeopardising the future of R&D investment in Australia.

The Institute welcomes the opportunity to continue working with the Department of the Treasury, the Department of Innovation and the Government in designing new R&D tax credit rules that deliver a globally competitive incentive regime. At a time when increased expenditure on R&D is vital to driving productivity growth throughout the economy, it is important that we take the time to get the design of this new regime right.

If you would like to discuss any aspect of this submission, please do not hesitate to contact Donna Bagnall on 02 9290 5761 or me on 02 9290 5623.

Yours sincerely



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APPENDIX

1. Underlying Policy Rationale

1.1 Objects clause and policy intent

An objects clause (section 355-5) has been inserted into the ED to the effect that the object of the new incentive is to achieve 'additionality' in R&D activities and to generate spillover benefits. Significantly, however, the objects clause does not retain any of the references in the current law to the objective of "creating an environment that is conducive to increased commercialisation of new processes and product technologies" (section s73B(1AAA)).

Consistent with this, we note that there is a constant theme throughout the ED which denies the incentive to commercially focused industrial research and development activities. The EM at page 12 highlights how the law in fact inhibits the scope of the new R&D credit where it says "The R&D tax incentive is not intended as a subsidy for innovation in general." (Schedule 1, item 1 subsection 355-5(2))

The combined effect of the new rules produces outcomes that contradict the intended objectives of encouraging technology innovation by:

- withdrawing the R&D tax incentive from companies which successfully undertake R&D, at the point of commercialisation and sale of productive output for the benefit of the Australian economy; and
- subsidising companies whose R&D activities result in learned principles, which when applied commercially produce failed results.

We discuss our concerns about this further below in the context of the 'PKI test', the 'dominant purpose test' and the 'augmented feedstock rule', which collectively operate to either deny or claw back financial support to an R&D project at the vital developmental and commercialisation-end of the process. Effectively, if the current focus on 'research' is retained, the new regime will remove any real investment by the Government in commercially productive 'developmental' activities.

Assuming this outcome does not reflect the actual policy intent of the Government, the ED and EM will need to be amended significantly in the areas discussed below to achieve the desired objectives of the new R&D tax credit.

In our view, the policy outcome should be to reward all companies who take the risk of innovating, but in particular to ensure that those who convert successful R&D into innovative outputs are rewarded so that further advances can be pursued by those successful companies. It is by directing the public investment in this manner that will lead to a multiplier effect in innovation and will deliver the greatest 'bang for buck' for taxpayers.

2. R&D activities

2.1 Core R&D activities

2.1.1 Cumulative test – AND instead of OR

The Government has taken the position in the ED that it is desirable to adopt a cumulative test, by changing the requirements of R&D to involve both innovation *and* high levels of technical risk.

As stated in our submission on the consultation paper, the Institute has long held the view that the definition of 'core R&D' should be maintained as one requiring activities which involve either "innovation or high levels of technical risk". Our current opinion on this issue remains unchanged.

The Institute believes that the arguments raised on this issue before the Senate in 2001 remain equally valid in the context of the current proposal to change the “or” to an “and” in the definition of ‘core’ R&D activities. In particular, the Senate inquiry found that the impact of a requirement for activities to satisfy both criteria was not understood in a context where there were widely-differing interpretations of the definition of “innovation” between government and industry. This point is particularly pertinent given the narrow view of “innovation” taken by many AusIndustry assessors, and even more so in light of the proposed heightening of the degree of “innovation” required under the ED, discussed further below.

While we recognise that the current budgetary imperative to restrict the cost of the concession to \$1.4 billion per annum presents a new challenge which necessitates some tightening of eligibility, we believe that a cumulative test makes Australia’s R&D definition significantly more onerous and less attractive by global standards. This is quite apart from any of the other proposed changes to the definition.

We do welcome, however, the clarification in the EM (paragraph 2.16) that the dual requirement is to be instituted at the project level, not the activity level. That is, for activities to qualify as core activities, they are assessed as part of a combination of activities of experiments, which together exhibit those features. We consider that this addresses the Government’s policy to direct the incentive towards subsidising endeavours that are both innovative and technically risky, without adopting the wholly undesirable departure from the Frascati model that a cumulative test at the activity level would have constituted.

2.1.2 “Considerable novelty”

In addition to the cumulative test, the ED goes further and replaces the term “innovation” with the expression “considerable novelty”, such that activities must now involve “*considerable* novelty and high levels of technical risk”. By contrast, under the current law, “innovation” is the statutory criteria and is defined to mean “an appreciable element of novelty”.

The Institute is concerned that this change marks a significant departure from what is understood as satisfying the current “innovation” test, and from that required under accepted international definitions of R&D. As mentioned above, this change is exponentially restrictive in its effect when used in combination with the more stringent cumulative (“and”) requirement in the new definition.

Specifically, the Institute’s concerns are two-fold. Firstly, the requirement for “considerable novelty” creates unwarranted new complexity and uncertainty, and is likely to be interpreted by administrators and adjudicators as lifting the level of novelty required. We submit that the introduction of the adjective “considerable” to qualify the degree of novelty required imposes an unnecessary additional hurdle, when satisfaction of the dual criteria of “innovation and high levels of technical risk” will intrinsically require that a sufficient degree of novelty exists in the activities to warrant subsidy as R&D. To our knowledge no other jurisdiction in the world specifies the degree of novelty required for eligible R&D as “considerable”. We submit that this creates confusion and a risk of overzealously narrow interpretation of the threshold of novelty required for activities to be eligible. Even the current definition has led to R&D assessors interpreting “novelty” very narrowly, requiring the subject matter to be a world first or the one in the world.

Our second concern is with the decision to move away from the cornerstone concept of “innovation” as the statutory criteria in the definition of “core” R&D accepted definitions of R&D. We are also somewhat perplexed as to why the Government would desire or what is to be gained by actively removing the reference to “innovation” from the primary piece of legislation underpinning the central industry incentive for innovation.

Our strong preference is that the term “innovation” be retained, and that it be defined in line with the OECD definition in the Frascati Manual. In this way, the current nebulous concept of “appreciable element of novelty” would be replaced with a more certain, comprehensive, globally consistent, and meaningful definition specifying that “innovation” encompasses the following:

1. Patentable results;
2. New processes;
3. Existing technology applied in a new way;

4. New knowledge; and
5. Integration for the first time of two or more different technologies (synergies).

R&D is discretionary, rationed expenditure, therefore if Australia has an overly narrow definition for accessing the incentive, it will not only fail to provide a better incentive, but we will become internationally uncompetitive. Whilst a 10 percent tax saving on its own may not be decisive, it a part of the decision matrix and is important as an indicator of the Government's broader attitude to technology innovation. A poorly designed concession sends entirely the wrong signal to multinational enterprises.

A narrow definition of innovation is especially detrimental to SMEs who often gain their competitive edge being an adaptor of existing technologies. In our view, the OECD definition is the most appropriate, and reflects the fact that innovation can be seen to exist in many ways that do not involve world firsts. It is often through many small steps that paradigm shifts in performance are achieved. Resolving high levels of technical risk also creates new knowledge and is therefore an innovative activity, even if the end result is not itself innovative. The Oslo Manual definition also illustrates that "new" ought to include new to the company.

So that the meaning of "innovation" provides the necessary certainty for claimants and administrators we urge that this definition be enshrined in the legislation, not just proffered administratively in sectoral guidance.

By way of summary, we consider that the combined changes to the definition of "core" R&D activities puts the new tax credit at odds with international practice and will place Australia at a distinct competitive disadvantage, at a time of increasing competition for the highly mobile global R&D investment market.

2.1.3 PKI test (purpose of knowledge / improvements)

The Institute considers that the change from the former dual "purpose" test (i.e. either acquiring new knowledge or creating new things) to the new PKI test involves a significant movement of the policy line in terms of what activities are considered to be worthy of subsidy as core R&D.

The EM specifically states, at paragraph 2.29, that the line is drawn between the conducting of R&D and the application of R&D, and that this is a question of fact.

The Institute is most concerned that the new purpose test, which is all about new knowledge, reflects the philosophy that the practical application of knowledge for the production or implementation of something is not regarded as R&D. We submit that applied knowledge, incremental advancements, and commercialisation in an industrial context are the very essence of the historical R&D concession. Spillover benefits to the economy:

- start to arise as 'ideas' become reality; and
- grow as projects achieve viable commercial outcomes.

As such, we recommend that the former dual test be reinstated and the PKI test be removed on the basis that it converts the incentive from one designed specifically to subsidise practical 'research *and development*' to one more focused on supporting scientific or theoretical 'research' activities.

2.2 Supporting R&D activities

2.2.1 "Dominant purpose" test

The ED also introduces significant changes to the definition of 'supporting R&D activities'. The first such change is the replacement of the "directly related" test with a "dominant purpose" test. This operates to further narrow the definition of R&D activities by moving away from the previous test of whether activities were "necessary" to conduct the core R&D activities.

The Institute considers that the new test, which requires the dominant purpose to be assisting the core R&D, imposes an extremely high evidentiary burden on claimants, and may significantly restrict the eligibility of many essential production-environment R&D activities.

The EM recognises the degree of uncertainty that this will introduce for claimants, noting at paragraph 2.40 that the critical factor is the extent to which the activities will also achieve other commercial goals over and above assisting with the conduct of the core R&D activities, as well as “the importance of those outcomes in the context”. We consider that the subjectivity of this test is highly undesirable, and that a more objective test is warranted and appropriate.

The Institute believes that the more appropriate test is whether supporting the core R&D is a “real and substantial purpose” of the activity. We consider that this test would ensure that the appropriate nexus exists to warrant subsidising an activity as one that supports core R&D, without imposing an insurmountable evidentiary burden.

2.2.2 Excluded activities: Other than computer software

The Institute considers that the extension of the specific statutory exclusions that were applicable to ‘core R&D activities’ such they also apply to ‘supporting R&D activities’ is unwarranted and likely to lead to unintended outcomes.

There are a number of activities potentially within the scope of the specific exclusions (sub-section 355-35(2)) that we consider should not be the subject of a blanket exclusion from supporting R&D activities. To do so would be to arbitrarily deny integral activities from R&D status regardless of how vital and how intimately connected with the R&D project they may be.

Some specific illustrations are for example para (a) sensory testing for ingredient selection for new product formulas; para (b) monitoring and evaluation of trial results; para (d) cosmetic design drawings for an improved product; para (h) small-scale and factory trials of a new packaging material; and para (l) clinical trials necessary to prove efficacy claims on labels for medicines and therapeutic products.

Each of the above activities should properly be eligible as supporting R&D activities provided the relevant nexus with core R&D can be established, i.e. a real and substantial purpose of the activities is to assist the core R&D activities. Simply excluding the activities specified in ss(2) would involve excluding from the R&D credit some of the more technically and commercially risky and crucial activities in bringing new ideas to market. As such, we recommend that ss(2) be removed from s355-35.

2.2.3 Excluded activities: Computer software

The exclusions in relation to computer software contained in paragraphs 355-35(2)(o), (p) (q) and (r) are a key concern to the Institute. The blanket exclusion from eligibility applies to almost all software-related activities, and will drastically impact R&D eligibility for the entire Information Technology (IT) industry.

The Institute considers that while revenue protection is an important consideration in designing the appropriate scope of eligibility for software activities, due weight must also be given to recognising that software is a key enabler and ‘change agent’ for technological advancements, which is integral to most innovation taking place in other industries.

Due to the central role of software in facilitating innovation across all industries, the Institute advocates that:

- software should have the same generic test for eligible R&D as all other industries (bearing in mind that the cumulative “and” requirement will appropriately tighten what qualifies as ‘core R&D’); and
- specific exclusions be used in a limited way, e.g. to appropriately exclude low-value add in-house software development such as business application software or business information software for use internally or with associates.

With respect to the “multiple sale” test, we are puzzled as to why this antiquated test has been retained (and practically tightened) in the ED, given that the consultation paper itself expressed the clear view that the multiple sale test was outdated and required replacement with an updated test adapted to IT industry practices in today’s world.

We therefore strongly urge that the software exclusions be removed (except for an exclusion for in-house business application software or business information systems) and that administrative guidelines be issued clarifying software eligibility (to be determined in conjunction with further industry consultation).

3. Augmented feedstock rule

The introduction of the augmented feedstock rule is one of the Institute's major concerns with the ED and the overall design of the new tax credit.

The new feedstock rule operates to effectively limit overall eligible R&D expenditure to the 'net cost', i.e. it requires the market value or cost of any output from the R&D activities to be offset against the R&D expenditure.

It appears implicit in the move from a traditional feedstock rule to a broad 'net expenditure' approach that the intention is to claw back financial support at the critical stage of commercialisation. The effect of this is to penalise successful R&D activities, while rewarding unsuccessful activities. A further irony is that the industrial innovation incentive effectively makes no permanent investment in the commercialisation of Australian innovations. In the Institute's view, this outcome runs counter to the policy objectives of:

- providing a better incentive for companies to invest in R&D to improve global competitiveness and ongoing profitability; and
- directing the incentive towards assisting those activities most likely to generate spillovers to the benefit of the Australian economy.

The Institute believes that this failure of the incentive to reward the risk-taking involved in proving technology to commercial viability strikes at the heart of the incentive and fundamentally changes its essence. The EM states at paragraph 2.51 that the subsidy is unwarranted as the company is already profitable, however, we contend that the rationale for rewarding those activities, regardless of their success or failure, is to compensate and incentivise the company for deploying staff on risky activities with an unknown outcome, instead of undertaking profitable "business as usual" activities. Such risk-taking activities invariably involve higher costs, including opportunity costs, additional personnel labour costs, longer trial run times, a greater number of trials, and significant waste, and as such, are worthy of subsidisation on that basis.

We note that the augmented feedstock rule quarantines some limited costs from having to be offset, e.g. conceptual design expenditure, and that the scope of quarantined expenditure is yet to be finalised. The Institute submits that it would certainly be appropriate and necessary to quarantine further categories of expenditure if the policy objectives of the incentive are to be achieved.

While the Institute's preference is to revert to the current feedstock rule, if the augmented feedstock rule is to be maintained, we urge that the following categories of expenditure be quarantined:

- labour expenditure, including apportionable overheads (following Part C 2.3 of the current guide to benefits (formerly IT2552 – R&D expenditure)); and
- plant depreciation.

4. Summary of recommendations

To make the new R&D tax credit a viable and workable incentive, we consider that the following amendments need to be made to the ED at a bare minimum:

1. Retain the existing term “innovation” in the definition of ‘core R&D activities’ and remove the expression “considerable novelty”.
2. Define “innovation” in terms of the internationally accepted OECD model in the Frascati Manual, and remove ambiguous descriptions of degrees of novelty.
3. Reinstate the dual purpose test and remove the PKI test on the basis that it converts the incentive from one designed specifically to subsidise practical ‘research *and development*’ to one more focused on supporting scientific or theoretical ‘research’ activities.
4. Amend the nexus test for ‘supporting R&D activities’ to a “real and substantial purpose” test to achieve the appropriate nexus for subsidising an activity as R&D, without imposing an insurmountable evidentiary burden.
5. Remove the specific statutory exclusions applicable to supporting R&D activities, to avoid unintended outcomes and arbitrary denial of integral activities from subsidy.
6. Remove the exclusion for software (except for in-house business application software or business information systems), and issue administrative guidelines to clarify software eligibility (to be determined in conjunction with further industry consultation).
7. Review the scope and operation of the augmented feedstock rule, and consider reverting to a more limited feedstock rule, or at a minimum, add labour expenditure, including apportionable overheads and plant depreciation as further items of quarantined expenditure.

The EM should also be amended to reflect the overhauled ED. In general, the EM should spell out what R&D is encouraged rather than predominantly focusing on what activities do not constitute R&D.