



The Treasury Consultation Paper The new research and development tax incentive

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1. Executive summary

The announcement of the new Research and Development (R&D) Tax Credit (the Credit) in the May 2009 Federal Budget heralded the replacement of the complex and outdated R&D Tax Concession (the Concession) with a simplified and enhanced R&D tax incentive.

Michael Johnson Associates Pty Limited (MJA) welcomes many of the reforms contained in the announcement. These included higher base rates of support, introduction of foreign-owned intellectual property (IP) into the program and the abolition of the Premium Concession and the International Premium.

However, the subsequent release of the Treasury consultation paper, “The new research and development tax incentive” (the Paper), has placed the positive reforms contained in the Credit in jeopardy.

In concluding that the proposals contained in the Paper will actually result in a more complex and less predictable R&D tax program, MJA’s submission will make the following points:

- Requiring taxpayers to split claims into core and supporting R&D activities will add the single greatest layer of complexity, uncertainty and compliance burden in the history of the program
- The Treasury’s case for reform is not made out either in terms of R&D policy or Budget revenue neutrality
- Changing the definition of R&D disproportionately impacts on small to medium enterprises (SMEs)
- The changes will have an immediate negative impact on Australia’s international competitiveness and BERD (Business Expenditure on Research and Development)
- By proposing to change the definition of R&D activities, the Federal Government is seeking to restrict the breadth of R&D support at the very time that corporate Australia is being asked to lift its R&D effort in areas of vital national significance such as the Carbon Pollution Reduction Scheme and the National Broadband Network

In summary, the Treasury proposals will result in a much more complicated R&D support framework and they run the risk of severely curtailing R&D support in Australia at a most inappropriate time.

2. Our reaction to the Paper

MJA greatly appreciates the opportunity to make this submission in response to the Paper regarding the proposed design of the Credit.

MJA believes that the Credit offers an exciting opportunity to revitalise broad-based government support for Australian business R&D. We are pleased by many of the aspects announced in the May Federal Budget and look forward to assisting Australian industry with understanding and implementing these positive changes.

MJA has acted as a service provider to Australian companies with respect to the Concession since 1985 and has been an active participant in all the program reviews since that time.

Most recently, we were an enthusiastic contributor to the Review of the National Innovation System (the NIS Review) in its assessment of tax and innovation. We were delighted by the direction taken in the report of the Review Panel (the Panel) entitled "Venturous Australia".

In recommending the introduction of an R&D tax credit system, the Panel adopted a tagline contained in the MJA submission that the Concession had become "underpowered and overcomplicated" in the period 1996 to 2008. Restoring meaningful value and simplicity to the R&D tax incentive clearly drove the Panel's recommendations.

Similarly, in announcing a new Credit in this year's Federal Budget (which adopted the Panel's recommendations with some variations), the Government emphasised that it was introducing a system that provided certainty and simplicity for businesses seeking to invest in R&D. It also announced that it was redistributing support in favour of SMEs and that this would be principally achieved by providing a higher rate of credit (to companies with annual group turnover of less than \$20 million), along with access to a generous refundable component to those eligible companies in tax loss.

It was also announced that foreign-owned IP was to become claimable in a meaningful way. The costly and complicated incremental concessions were also to be removed, drawing a curtain over a mechanism that delivered questionable value at best.

MJA supports all these announcements.

The Government also announced that eligibility criteria would be tightened to ensure that the Credit supported only "genuine R&D", albeit without defining the meaning of that term.

The Paper is the direct result of the announced review of the program eligibility criteria. Consistent with "Venturous Australia" and the Budget, it heralds "...less complex and more predictable tax credits." at Paragraph 9. The Paper goes on to make the argument for reduced complexity as follows:

"Companies will no longer need to distinguish between their base and incremental expenditure on R&D in working out their claim."

This is true and, indeed, a welcome development. However, what the Paper fails to mention is the fact that as a direct consequence of its own recommendations regarding eligible R&D activity:

Companies will now need to distinguish between their 'core' and 'supporting' R&D activities in working out their claim.

MJA submits that changes to the definition of R&D activities along the lines proposed by the Treasury would be the single largest introduction of legislative uncertainty and complexity in the history of the R&D tax program. Furthermore, with added uncertainty and complexity inevitably come higher compliance burdens and administrative costs which are highly undesirable outcomes.

The net result will be a more complicated and less predictable Credit when compared with the Concession. The risk is that the Credit will end up as a far less effective mechanism for supporting business R&D in Australia.

In making its case for definitional change, the Paper draws heavily on the reasoning contained in the Productivity Commission's *Public Support for Science and Innovation: Research Report* of March 2007 (the Productivity Commission's 2007 Report) which advocated a severe curtailing of government support for commercially-focused R&D.

A key recommendation of the Productivity Commission was the legislation of a narrower definition of R&D consistent with the approach that has been taken in the current Paper. Another recommendation of the Productivity Commission was the abolition of the base R&D Tax Concession for large companies, defined at that time as having an annual group turnover of greater than \$5 million, and replacing it with an incremental-only version.

The NIS Review dealt squarely with this viewpoint and concluded the polar opposite – increase the base incentive and discontinue the incremental premiums along with a consideration of the possible refining of other eligibility criteria and improvements to administrative guidelines.

The Federal Budget reached the same conclusions with some variation. The Budget Night press release referred to a tightening of eligibility criteria to ensure only genuine R&D was supported.

Yet, in the face of the fact that the NIS Review's position has been adopted by the Government in its Budget, the Treasury has proposed wholesale changes to the well-established and well-understood definition of business R&D and has apparently offered up only the unsubstantiated opinion of the Productivity Commission as its policy authority.

MJA has spoken to well in excess of one hundred clients, industry bodies and other taxpayers in the days since the release of the Paper. It has yet to hear one voice from that audience that supports the Treasury's conclusions. Not one voice in support has been forthcoming.

In short, MJA opposes the proposed changes to the definition of eligible R&D activities.

This response seeks to detail the basis of our position and will also argue that the Treasury fails to make out its case for reform either in terms of the revenue neutrality imperative or in terms of effective R&D policy.

We will point out that, in rewriting the general definition of eligible R&D activities, the new Credit will unavoidably have a disproportionately negative impact on the very SMEs towards which the program is seeking to provide additional assistance.

We will also turn our minds to some of the other design questions raised in the Paper and list some other key issues that we believe are in play. Given the recent indications that an Exposure

Draft of the Credit legislation will be delivered shortly, we will not pursue any of these issues in any great measure as there is insufficient detail in the Paper to facilitate a focused response.

In taking our position, MJA wishes to stress that its total concern is with effective program design and delivery. We would not include ourselves in the category of "...some stakeholders [that] are satisfied with the current definition" as described at Paragraph 50 of the Paper if the inference is that we simply prefer the status quo on the basis of the interests of our business.

In the NIS Review, MJA campaigned vigorously for the closure of the incremental provisions despite actively assisting taxpayers in making claims in this area. In the past, we have supported many changes to the program which have enhanced our business (eg. introduction of planning requirements) and many that have reduced our business (eg. closing of retrospectivity provisions).

In declaring our views, we have always been guided by what we see as being in the best interests of innovation policy and its contribution to Australia's economic prosperity.

MJA is concerned that the predictable outcry regarding the proposed changes to the definition of R&D will divert attention from the many laudable aspects of the new Credit. We firmly believe that it offers a sound base for successful support for Australia's Business Expenditure on R&D (BERD) future and that base can be delivered if a different approach is taken to that contained in the Paper.

The outstanding potential of the new Credit will be undermined if it is encumbered with a scientific definition of business R&D rather than the well-established and well-understood industrial one that has served Australia well.

At a time where the Federal Government looks to corporate Australia to tackle key social programs such as the Carbon Pollution Reduction Scheme (CPRS) and the National Broadband Network by concerted R&D effort, it is impossible to understand the severe eligibility restrictions being proposed by the Treasury. Globally, many governments are bolstering support to tackle these issues so we are running the risk of being at a competitive disadvantage internationally.

We look forward to a speedy resolution of the definitional issue so that we can go on to make a meaningful contribution to the Credit's design so that it can indeed be seen as introducing a less complex and more predictable R&D tax program to help Australia in the pursuit of its R&D goals.

3. Focus of this submission – definition of eligible R&D activities

The Paper sets out the proposals for definitional change at Paragraphs 48 -77. It does so under the overall heading of 'Eligible R&D Activity'.

This section of the MJA submission is headed "...- definition of eligible R&D activities" with a distinct purpose in mind. In contrast to the Paper which uses singular terminology, MJA wishes to emphasise that the current definition of R&D, namely "research and development activities" as contained in Subsection 73B (1) of the *Income Tax Assessment Act 1936* (the ITA Act), is pluralistic in nature.

The Paper details potential changes to the definition of 'core' and 'supporting' R&D (making use of outmoded terminology discontinued in the Concession many years ago) and indicates that taxpayers will have to split project activities into these separate categories. The Paper goes on to propose that distinct limitations will be applied to those activities held to be supporting.

The proposed splitting of activities into two categories would have a dramatic impact on the way in which companies identify and claim R&D projects.

The current definition recognises the interdependencies of the activities that make up an eligible R&D claim. Activities may be eligible if they fall into one or both of two categories – 'systematic, investigative and experimental (SIE)' and 'directly related'.

The original design of the legislation did not define 'activity' so these interdependencies could be taken into account by the taxpayer in making its self-assessment of eligibility. In addition, the administration set up a system by which claims could be made for groups of activities described as R&D projects. Again, 'project' is not defined and the approach makes sense in terms of how businesses actually conduct their R&D.

A key factor to be remembered is that there is already a limit on R&D activities imposed by the operation of Subsection 73B(2) of the ITAA 1936 that defines excluded activities. These are activities which might ordinarily be considered part of an R&D project, such as prospecting and market research, but are specifically excluded from being SIE activities. These activities may qualify as directly related activities in certain circumstances but taxpayers shy away from the making of such claims.

Consequently, there has been a legislative distinction in place since the Concession began which limits the breadth of R&D activities that can be subject to the concessional treatment. Activities that do qualify can do so by either the SIE or directly related route but there is no legislative compulsion to separate them into two distinct categories in order to help oversee eligibility.

Of fundamental importance, the same concessional treatment applies irrespective of the class (SIE or directly related) to which individual activities may be best attributed. The Concession does not reduce or restrict the basis of support for those activities better seen as directly related. This is in accordance with the concept that an R&D project requires all of its activities to achieve its technical objectives and, hence, all necessary activities should be incentivised equally.

The separation into two groups has been required in administrative contexts in the past, such as registration and assessments but these exercises have had no basis in law.

The Treasury proposals seek to unravel this well-proven and well-understood fabric. The push away from the pluralistic approach is reinforced by the intention to confer different levels of benefits based directly on the self-assessment of taxpayers, requiring them to split activities into two distinct categories. It is a distinction, of course, able to be challenged by program administrators in the assessment arena.

The risk is that this is a legislative move to establish an audit technique known as “mosaicing” whereby activities are progressively defined in more and more iterations so they lose their core and/or supporting character and are subsequently disallowed.

Core R&D

The only clearly announced change is the fact that core activities will need to demonstrate the involvement of both innovation and high levels of technical risk.

Paragraphs 53 and 54 put forward an argument in favour of the change based on enhanced prospects of additionality and spillover.

These are concepts contained in the Paper’s Design Principle 5 and will be considered in more detail in the next section of this submission. Suffice to say here that no authority is put forward that activities reflecting only innovation *or* high levels of technical risk have a lesser impact in respect of either additionality or spillover.

Nor does the Paper give an example of the type of activity that would be excluded under the definition. The illustration provided at Page 10 of the Paper certainly adds nothing to the discussion. In fact, MJA has never experienced an eligible R&D project that involves only one of the two required factors of innovation and technical risk.

MJA is well aware that other commentators do believe that such projects do exist and that the change will have a severely restrictive effect on the breadth of R&D supported. Whatever view prevails, the net result is a heightened level of uncertainty as to what the thereby reduced proportion of currently eligible SIE activities will qualify under the new Credit.

This debate is a direct echo of the dialogue that occurred around the previous attempt to make this legislative change in the Bill that emerged from the Coalition’s Innovation Action Plan in 2001.

The change was ultimately recommended against by the Senate Economics Committee as there could be no agreement on the extent of the restrictive effect associated with a change which was being sold through by the administration of the time as a ‘clarification’ of the original legislation’s intent.

The same holds true today. The change is being pushed through by the Treasury with no guidance as to the potential restrictive effect either quantitatively or qualitatively. The new Credit is meant to be delivering certainty and simplicity. This change delivers neither. In contrast, it creates increased uncertainty, administrative complexity and compliance burden.

It may or may not save program costs in the Budget but it will definitely add costs to taxpayers. MJA is hearing this message again and again from all the private sector parties it has consulted in the past few weeks.

MJA would also like to dispute the Treasury's comments in Paragraph 55 that the making of the change to the definition of core R&D would better align the Credit with the Frascati Manual and international practice.

Our investigations suggest that innovation and technical risk do not form part of the Frascati definition of R&D (which sets out the elements making up applied research, basic research and experimental development) but are commented on elsewhere as factors that help distinguish R&D from related activities (Frascati Paragraph 2.3.1). In addition, most jurisdictions do not have these elements as part of their fundamental R&D definitions.

As to the comments on the breadth of definitions internationally, the discussion would more productively be held in the context of the overall benefits offered by a jurisdiction. The Paper's suggestion that Australia's program is broader than others such as those in the United Kingdom and the United States owing to our supposedly broader definition can be immediately challenged by considering other comparisons such as the scope of R&D capital allowances available in the various jurisdictions.

Paragraph 55 does not amount to a definitive statement regarding Frascati or overseas jurisdictions and should not be regarded as authoritative.

Supporting R&D

The Paper takes a comparatively dismal view of so-called supporting activities. In highlighting that these are activities that typically occur in the production environment and may generate income for the taxpayer, the Paper advocates a series of possible restrictions to this aspect of R&D – claim caps; purpose requirements; expenditure offsets; and lower rates of credit.

All these possibilities seem to stem from a view that supporting activities contribute less in terms of the public good and that, historically, large claims of these supposedly lower value-add activities are being hung off small amounts of claimable core activities.

MJA has already described the way in which the current pluralistic definition of R&D activities equally incentivises SIE and directly related activities without distinction. Critically, the second class of activities requires a **direct relationship** to sustain eligibility.

MJA recognises that business R&D often involves later stage activities such as prototyping, the construction of pilot plants and production-based trials and they often make up the majority of eligible costs in many claimable R&D projects. This is what business R&D actually looks like and is what the pluralistic definition recognises. If the relationship cannot be proven to be a direct one (i.e. necessary to the successful execution of the R&D project), then these activities are simply not claimable.

The various limitations seek to penalise these types of activities as being somehow less meritorious than the newly-defined core activities. All the proposals would greatly dilute the incentive effect at the critical point in R&D investment being the time where the decision is made to incur the expenditure. If R&D decision-makers believe that certain activities will be subject to claim limits because of their production or income-generating nature, then the impact of the Credit will be diluted or lost on most business R&D projects which customarily have commercial goals.

With respect to Question 4 of the Paper, we would like to make the following comments about the suggested options:

- a) Capping supporting activities as a proportion of core activities – As discussed above, all activities are fundamental to the technical objective and should be incentivised. If supporting activities end up as being seen as those that occur in the production environment, then the costs attributable to supporting activities are going to be much larger than core activities in the majority of business R&D projects, so a claim cap will have a severe impact on large companies and SMEs alike.
- b) and c) Purpose restrictions – Supporting activities customarily have more than one purpose as they are conducted by companies with commercial goals so restrictions around purpose, particularly of a production nature, stand to decimate claims.
- d) Net expenditure basis – The Paper describes the incentive in terms of being a “subsidy”. This misunderstanding of the role of an incentive is most striking when it is suggested that the incentive might only apply to circumstances where R&D results in some form of net loss. This raises many definitional questions and could be seen as incentivising failure only. An incentive is meant to have its impact at the time expenditure is incurred. It is not a form of compensation for economic loss. If a company understands that the Credit will not apply to its commercially successful R&D, where success will customarily be the company’s intention at the outset of the project, then the incentive will have no impact on the R&D investment decision.
- e) Lower rate of assistance – This approach sets up a system where taxpayers will have their level of support differentiated by the election they make on a basis that has not been significant for the first 25 years of the program. As with all the options described above, this election becomes fraught because of the direct impact it has on R&D funding decisions.

A final concern with the proposals is that there has been no contemplation of the temporal issues involved in preparing claims where limits around factors such as caps and net expenditure are in operation. R&D activities and projects routinely occur across financial years and the need to adjust claims at a later time that would be necessitated by these limits would result in a heavy compliance burden on taxpayers long after the expenditures have been incurred.

Overall Impact of the Proposed Changes

At Page XXVIII in its Key Points section, the Productivity Commission’s 2007 Report advocated the following:

“More generally, a narrower definition of R&D *in line with international conventions* [emphasis added] should be considered, which requires eligible R&D to be *innovative and highly risky* [emphasis added] (rather than the present condition for R&D to be highly innovative *or* highly risky). If administratively feasible, this change has a higher chance of generating spillovers.

As noted previously, the increasing focus of some business programs on later-stage commercialisation, **rather than research** [emphasis added], runs the risk of supporting R&D that might have occurred anyway and of shifting support away from the stage of R&D where spillovers are most likely.”

In other words, the Productivity Commission was interested in driving support programs towards the research done by businesses at the expense of their commercially-oriented R&D programs which is the work the Frascati definition of R&D describes as experimental development.

The Treasury has adopted the same position. By all means, it argues, the Government should provide a more generous tax credit to the basic and applied research done by companies, which is known to be comparatively rare and low cost. However, whenever corporates stray into their natural province involving the experimental development of new and improved products and processes, the support must be severely curtailed or removed altogether.

The net result is a new definition of business R&D that is scientific rather than industrial in nature.

After the Concession has spent 25 years sending a strong cultural signal to corporate Australia that R&D is not just 'white coats and foaming test tubes', the proposed definitional changes will rapidly reinstitute that debunked viewpoint.

As shall be argued later in this submission, the impact on BERD will be immediate and the effects will be felt disproportionately by the very SMEs who are the intended target of the redistributed support offered by the Credit.

The proposed new definition of R&D activity is not aligned with Frascati and it will put Australia's competitive position in peril internationally.

4. The Treasury's design principles and its case for reform

Given the above analysis, MJA clearly does not support the proposed changes to the definition of R&D activities on the grounds that they will create additional program uncertainty, complexity and compliance burden.

Turning to the Treasury's Design Principles and its case for reform, MJA supports Design Principles 1-4. However, we are concerned about the Treasury's application of Design Principle 5 relating to the concepts of additionality and spillover in reaching the conclusions contained in Design Principles 6 and 7.

Principles 6 and 7 outline the proposed changes to the definition of R&D and do read more as decisions already taken rather than principles of future program design.

Rather than dwelling on this point, MJA wishes to review the Treasury's case for reform put forward at Paragraphs 8-14 of the Paper as a justification for changing the current definition of R&D activities to see if the case is made out in terms of budgetary need or effective business R&D policy making.

The Treasury's case for reform may be summarised as follows:

- To facilitate more effective delivery of support for business R&D and targeting support at areas most likely to produce net benefits for Australia
- To restrict claims facilitated by the current definition of R&D where there is not a strong rationale for public support
- To facilitate increased rates of additionality and spillover
- To act upon the recommendation of the NIS Review to review the definition of eligible R&D activity
- To ensure that the Credit is revenue neutral over its first four years of operation on an underlying cash basis

MJA submits that the Treasury has not made out its case for changing the definition of R&D activities in respect of any of the above criteria.

Effective Delivery and Targeting

No real indication is given as to what is meant by "effective delivery" and "targeting" but the balance of the Paper would suggest that the Treasury is keen to provide the highest level of support to core activities conducted by SMEs as these are the activities that supposedly generate the highest social net benefits.

As with the Productivity Commission's 2007 Report, no research or metrics are provided in support of this proposition so it is impossible to establish the basis on which the assertions are put forward.

The issues attached to effective delivery and targeting are best considered in the light of the analysis of the other arguments put forward by the Paper and our views immediately follow.

Restricting Currently Eligible Claims on Rationale of Public Support

According to the Paper at Paragraph 11, the current R&D definition is "...allowing claims to be made for activities where there is not a strong rationale for public support. In the absence of Government action, these claims are likely to continue and to increase." These are regarded as lower value-add claims.

By way of supporting evidence, Attachment A of the Paper entitled "Examples Of Concern With The Current Scheme" describes three example R&D projects which seem to be linked by a belief that the claim size is out of proportion with the project objectives. The general tenor of the commentary implies that, in particular, large companies are able to leverage a disproportionate amount of government support by claiming activities undertaken in a production environment.

Annexure 1 to MJA's submission provides a more detailed analysis of the examples provided by the Treasury and reaches the conclusion that none of the projects as described can be definitively regarded as allowable under the Concession in their entirety.

In fact, MJA has tangible evidence of recent decisions of the Tax Concession Committee of the Innovation Australia Board (the Board) that disallow activities claimed under the existing Concession on the same basis that the Paper believes currently permit eligibility. These include claims made up of activities described as being generic in nature representing broad project phases and activities that represent "a blend of core and supporting activities".

Neither of these grounds are accurate characterisations of the actual claims being submitted by the taxpayers concerned, nor do they have meaning in the context of the legislative framework. Yet they are being used by the Board to knock out claims as opposed to letting them through.

MJA is most alarmed by the inconsistencies highlighted here and sees it as a stark example of why there has been a loss of confidence amongst our clients about the current administration of the program. It is misleading for the Paper to suggest that the example projects, particularly 1 and 2, qualify in their entirety for the Concession, thereby advancing the case for definitional change.

The Paper's assertion that there is not a strong rationale for public support of these particular activities warrants further consideration.

In designing an effective R&D Tax Credit program, the Federal Government needs to acknowledge that, in most instances, the successful development of a new product or the implementation of an improved business process can only be achieved in a production environment. Very few companies have a clear delineation between what could be considered to be an isolated 'R&D lab' and production facilities for this very reason. By highlighting these scenarios, the inference is that there should not be the same support for activities undertaken within a production context. To argue that activities undertaken in a production environment are in any way less scientific or crucial to the outcome of a R&D project is simply not supportable. Adopting the universally accepted scientific method from hypothesis to experiment and subsequent conclusions places no greater importance on any one set of activities in reaching a valid conclusion. This applies equally for small and large companies.

The Federal Government also needs to accept that any definition of business R&D applied without sectoral bias will always result in a strong correlation between absolute claim size and company turnover as all companies need to keep on innovating to become or remain successful. In doing so, large companies will inevitably undertake larger and more expensive projects and their R&D claims will reflect this reality. There is no evidence or financial modelling presented to support the claim that the type of expenditure incurred by large companies in undertaking these projects leads to results of comparatively lesser benefit to the Australian community than those delivered by the

R&D of SMEs. In fact, anecdotal evidence suggests there is more to be gained by incentivising large companies to commit to new projects in Australia. Apart from contributing more taxes, it is the large companies which have the greatest capacity to relocate and undertake new projects overseas if the economic incentives are more attractive elsewhere. This reality, coupled with the fact that many towns in regional Australia and a considerable number of local SMEs rely solely on the support of large companies to survive, makes it hard to rationalise that there is less merit to this type of public support.

In this context, it is worth considering the consistency or lack thereof of the proposed changes with other current policy drivers of the Federal Government.

Carbon reduction is a prime example. The key report in framing the Federal Government's policy response to carbon abatement has been the Final Report of The Garnaut Climate Change Review. At page 405, Garnaut had the following to say:

"Demonstration and commercialisation: The new knowledge generated by early research is applied to the real world through pilot, demonstration and first commercial-scale projects. These activities tend to be capital intensive in nature, requiring research bodies or firms to take on substantial risk since the technology is yet to be proven in the intended operating environment. Because the technology may not yet be cost-competitive (even after factoring the impact of a price on emissions), commercial returns are problematic. Projects must therefore rely on high-risk venture capital funding, government support, niche market support or philanthropic patronage. Some studies have termed this phase 'the valley of death', where most technologies fail either technically or financially."

Yet these are the very types of activities that are squarely in the sights of the restrictions proposed for supporting activities. Using the words of Garnaut, the definitional changes will make 'the valley of death' that much deeper. The Paper's position seems at odds with current developments in climate change policy and other high-profile Federal Government initiatives such as the National Broadband Network.

Additionality and Spillover

The Paper's definitions of additionality and spillover are sparsely detailed. For example, there is no real assessment of the different aspects of spillover such as technical and economic. Further, no evidence is delivered to support the Paper's position that activities involving only innovation or technical risk reduce the likelihood that such activities will produce spillover benefits and be in addition to what would otherwise occur.

As discussed earlier in this submission, it is hard to imagine any scenarios where it could be argued that innovation and high levels of technical risk do not occur together within the context of an eligible R&D project.

Innovation is measured as activities which *involve an appreciable element of novelty*. In applying a novel solution for the purpose of producing new knowledge or improvements, then there will inevitably be uncertainty as to the probability of achieving a successful outcome at the project outset as it is, by definition, new and untried.

Equally, where a project is judged to contain *high levels of technical risk*, this is because the outcome cannot be known or determined in advance of the project. Logically, this infers that an appreciable degree of novelty will exist in the solution(s) being developed.

Before asserting that lower levels of additionality and spillover occur with activities reflecting only one of these qualities, the Paper needs to establish examples of such activities so that a sensible comparison can be made.

In the absence of any examples or related evidence, the argument cannot be sustained.

Recommendations of the NIS Review

Paragraph 13 states that the NIS Review recommended a review of the definition of eligible R&D activity. This is an over-simplification of what was actually set down in “Venturous Australia”.

In Chapter 8 of its report, the Panel discussed its concerns about the extent to which large “one-off” projects in areas such as mining and civil engineering could be claimed under the current Concession and suggested that this area could be looked at in more detail by the Federal Government.

It is important to note that the Panel regarded such projects as both risky and innovative which is a pointer to the fact that the proposed change to ‘core’ activities may not have an impact on the eligibility of these projects.

The Panel went on to suggest that control measures should be taken to protect revenue and ensure ongoing program viability and that they could include the following:

- refining the definition of R&D
- development of more comprehensive administrative guidelines
- establishing ceilings on projects of a particular scale
- limiting the nature and extent of ‘directly related costs’ able to be claimed against eligible R&D activities

Critically, the Panel was unable to satisfy itself in the time available as to how best to deal with this perceived problem.

MJA submits that the Panel actually recommended a review of a series of possible approaches rather than an immediate definitional review. In terms of the definition of R&D, at best, it advocated a **refining** [emphasis added] of the current pluralistic definition rather than the introduction of a fundamentally different definition of an eligible R&D activity which has been the exercise embarked on by the Treasury.

MJA responded at the time that the evidence of the supposed problem should be demonstrated by the Federal Government before major reforms are contemplated. Our position was that the development of more comprehensive administrative guidelines and practices was the critical design issue to be addressed for any program reform.

To date, no concrete evidence has been delivered and, consequently, our position remains unchanged.

Achieving Revenue Neutrality

It is acknowledged that the new Credit is to be designed to provide a similar amount of support as that currently provided under the Concession program to encourage BERD in Australia, albeit with some redistribution to meet the Federal Government’s objectives. Anything less than this will only impact negatively on BERD at a critical time in our economic recovery and fail to meet the objectives of the Federal Government.

To address the concerns of the business community about the impact of the mooted definitional changes on BERD, it could have been expected that the Paper would have detailed exactly how the new program could achieve the stated aims within its budgetary constraints. To do this, the Treasury could have modelled the impacts of the cost-saving measures against the cost of new stimulus measures. Any modelling would have needed to consider:

1. the impact of the removal of the Premium Concession and the International Premium;
2. the projected BERD if the existing Concession continued at the base concessional rate of 125% with no other changes to the program; and
3. the revenue savings of each of the proposed definitional changes of the Credit.

MJA believes that the first two considerations can and should have been modelled to identify the need to pursue the third before this Paper was released.

It is also worth noting that there is no reference in the Paper to the additional economic returns generated by successful R&D projects including increased taxation revenues. Any comprehensive assessment of ultimate program costs would surely need to take this factor into account.

In the absence of Treasury modelling, MJA has undertaken an analysis of the announced changes by modelling the revenue impacts of the first two considerations above using publicly available material. While a number of assumptions have been made, we believe our calculations provide conservative estimates of both the cost savings of the removal of the Premium Concession and the impact of the Global Financial Crisis (GFC) on BERD.

The details of our modelling are provided in Annexure 2 to this submission.

The analysis shows that the removal of the Premium Concession coupled with the anticipated drop in BERD (as a direct result of the GFC), will alone ensure that the new Credit achieves a revenue neutral outcome.

Specifically, our modelling shows that

- the likely saving from removing the Premium Concession would be \$465 million per annum over the four year period commencing 2010/11 if the level of BERD remains the same
- since the introduction of the Premium Concession, BERD has increased at similar rates to company tax payments
- BERD is likely to drop in a similar way to the Treasury 2009/10 Budget Papers forecasts on company tax payments due to the impact of the GFC
- a conservative estimate of BERD and, therefore, the cost of the 125% Concession (if it remained unchanged over the four year period commencing 2010/11), would be \$3.852 billion
- therefore, there is already a \$1.75 billion saving without any changes to the definition as a result of the removal of the Premium Concession and the drop in BERD. (Note this modelling assumes a conservative estimate of the cost of the current Concession of \$5.6 billion for the four year period commencing 2010/11. In their recent consultation sessions, the Government estimated the Concession would cost \$1.4 billion for the 2010/11 year but expected year-on-year increases. Our conservative estimate of \$5.6 billion does not take into account any year-on-year increases.)

Given this modelling, there appears to be no case for any reform to the definition of R&D based on the need for maintenance of budget neutrality.

Summary

MJA submits that the Treasury has failed to establish its case for reforming the definition of R&D on any of the grounds put forward.

We have argued vigorously that the continued stability of the concepts underpinning the definition of R&D activities is critical to the delivery of a simplified and predictable Credit.

We are not saying that the definition can never be changed. Past reforms such as the changing of the SIE requirement to "...**and** experimental", the amplification of the meaning of innovation/high levels of technical risk and the introduction of the planning requirements were all successfully absorbed because they preserved the breadth of a definition that reflected the true dimensions of business R&D.

However, the Paper's proposals would move the definition of R&D away from what accords with business R&D in practice. Core and supporting activities are both essential to project success. Legislating a distinction between them will undermine all business R&D projects.

5. The impacts of change on SMEs, Australia's international competitiveness and BERD

Impact on SMEs

MJA believes that the proposed restrictions to supporting activities will disproportionately impact on the very SMEs to which the Treasury purports to be redistributing support.

It needs to be remembered that the changes to the definition will apply to all taxpayers, big and small. It should also be appreciated that SMEs conduct R&D in exactly the same manner as large corporates. Theoretical advances are only translated into new and improved products when they are proven to be technically available at a commercial scale. SMEs construct prototypes, build pilot plants and conduct production-based trials in exactly the same manner as their larger brethren.

The true difference lies in the fact that the proportion of operating cost spent by technically-oriented SMEs and start ups is dramatically greater than in the large corporate sector. If you restrict the industrial nature of the definition, you end up hitting SMEs harder.

To demonstrate this point, MJA reviewed the last 3 years of registrations lodged with the Board on behalf of its clients. The results were as follows:

- 67 companies had a turnover of less than \$20 million (SMEs).
- 174 companies (not groups) had a turnover of greater than \$20 million (large companies).
- The average claim of the SMEs was \$625,000.
- The average claim of the large companies was \$7,890,000.
- The median total claim/turnover ratio of the SMEs was 26.87%.
- The median total claim/turnover ratio of the large companies was 1.22%.

The clear insight offered by these results is that any restrictions to the breadth of claimable activities will impact SMEs in a disproportionate way, even though more raw dollars would be saved from the large companies.

The Credit targets SMEs by offering a refundable option at a higher rate of benefit which becomes even more important in the absence of competitive grants such as Commercial Ready. However, the viability of these organisations, particularly in loss-making phases of growth, will be threatened if the access to that Credit is hampered by a significantly restricted definition of R&D activities.

The impact of restricting the definition is perhaps brought into even starker relief with the Commercialisation Australia announcement made on 21 October 2009. It has been revealed that this new program will offer cash support to SMEs for proof-of-concept and early commercialisation activities. As a result, it appears that the government framework is boosting support for the research and early commercialisation phases undertaken by SMEs at the same time that assistance for the development stage is being significantly pared back by changes to the R&D tax framework. It is difficult to identify a consistent policy line in this approach.

Finally, the complexities described in this submission will test the compliance resources available to SMEs to breaking point. Typically, all tax work is outsourced and the compliance costs associated with the Credit may lead many SMEs to conclude that their tax risk profile precludes them from investing in the support necessary to safely secure an R&D tax claim.

International Competitiveness

A consistent message that has been relayed by stakeholders to MJA since the release of the Paper is the inherent contradiction in the apparent paring back of eligible R&D support at the very time that the Federal Government is looking to Australian industry to help solve key social challenges in areas such as climate change and connectivity.

Initiatives such as the CPRS and the National Broadband Network make it clear that experimental development work is needed from Australian industry to meet the ambitious targets being set. Yet, at the same time, the main form of government support for the required R&D is being reduced.

The companies that have been speaking to MJA are confused by this very apparent contradiction. No doubt this point will be echoed in many of the submissions being made in response to the Paper.

In addition, companies are expressing their concern that the proposed reforms will continue a process that has seen Australia become a significantly less attractive place to do R&D in recent times. The international competitiveness of our private sector R&D system stands to be significantly eroded.

Opening up claims to foreign-owned IP means little if the R&D does not qualify under a tightened definition. A more generous refundable credit fails to ignite effort if there is material uncertainty as to how much, if any, of the commercial R&D work undertaken in a project is eligible for support.

Impact on BERD

As detailed in the above discussion with respect to SMEs, the MJA large company claim/turnover ratio is 1.22%. This sits consistently with recent Australian Bureau of Statistics (ABS) figures regarding Australia's BERD/GDP ratios. In the period 2005-08, the ratio has averaged 1.18% and sees us currently ranked 16th in OECD nations. Large companies definitely spend most of our innovation effort and this is reflected in the figures. The higher comparative spend of SMEs gets washed out in the overall measure.

These figures reflect healthy rates of growth in the ratio in the mid-decade period when the Australian economy was growing rapidly and R&D spend was increasing as recognised in growing Premium Concession claims.

Since that period, the GFC has occurred and R&D budgets are reported to be in retreat. Our inquiries indicate that cost pressures on the Concession associated with the incremental Premiums are easing. This adds to the concern that now is a particularly bad time to be restricting the basis of R&D support.

We have noted the disproportionate impact that the definitional changes would have on SMEs. However, the impact on Australia's overall BERD effort must also be considered in terms of the restrictions the changes will place on the R&D efforts of large organisations.

The ABS data shows that investments in R&D depend strongly on the size of the business. Most of BERD (70%) is contributed by larger sized businesses (> 200 employees). A relationship is also

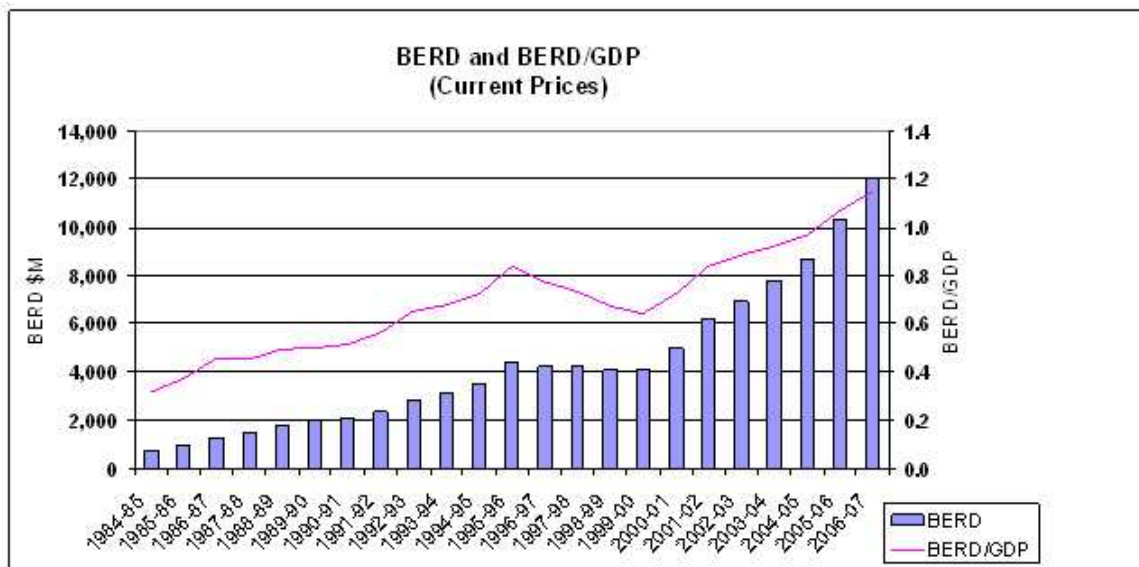
apparent between size and indicators such as innovative activity and information technology uptake in Australian businesses.

A recent ABS survey found that the proportion of innovation-active businesses increased significantly with the size of the business from 37% for businesses with 0-4 employees to 71% for businesses with more than 200 employees.

Restrictions on the types of projects conducted by large companies will immediately show up in overall BERD figures.

Finally, MJA has observed that most taxpayers complete their ABS forms based on their R&D tax returns. If the Credit restricts the extent of expenditure pertaining to supporting activities claimable as R&D, it is highly predictable that BERD reported to the ABS will fall concomitantly. As we have seen, there is no evidence that the higher rates of credit or introduction of foreign-owned IP will in any way compensate for the impact of the definitional restrictions on all Australian companies.

We can expect a repeat of the impact that the halving of the Concession (along with the introduction of the feedstock offset and the closing of syndication) had on BERD in 1996 – a precipitous fall that took several years to arrest as demonstrated below.



Source:
<http://www.innovation.gov.au/Section/AboutDIISR/FactSheets/Pages/BusinessExpenditureonResearchandDevelopmentFactSheet.aspx>

MJA believes that this is a predictable impact of the definitional changes and is a risk simply not worth taking.

6. Other design questions and issues

MJA recognises that the Paper asks a series of questions on subjects other than changes to the definition of R&D and that it raises the possibility of other issues being put forward in response to the Paper in anticipation of the Exposure Draft of the legislation.

MJA believes that it is most appropriate to provide detailed responses on key design features when the Exposure Draft appears but we will give brief responses to the six Design Questions as well as providing some feedback on the accounting impact of the Credit and a summary of some of the other issues we believe are of particular importance.

Design Questions

Question 1 – Could some eligible R&D activity be conducted outside Australia?

MJA supports a review of the overseas R&D provisions with a view to continuing to allow some activity in certain circumstances.

Question 2 – How should the 100 per cent items be treated?

MJA would prefer to comment at the Exposure Draft stage.

Question 3 – Should only cash payments to associated entities be eligible?

MJA has no clear preference at this stage but would support a consistent approach to normal accounting and taxation practice.

Question 4 – Changes to supporting activities

MJA does not support any of the changes suggested.

Question 5 – Should the excluded activities list be altered in any way?

MJA is not opposed to changes in this area but would need to see detailed proposals to comment sensibly.

Question 6 – How should R&D software be treated?

MJA does not support any additional eligibility criteria with respect to software R&D.

The multiple sale requirement should be removed.

Accounting/Organisational Impact of the Credit

We understand that the Federal Government is investigating ways to better target those sectors within companies that actually perform the R&D by addressing the shortcoming in the operation of the existing Concession where the benefit of the Concession is measured as an after-tax calculation or is a *below-the-line* result.

MJA recognises that this is an issue that is regularly raised by our clients as a barrier because the departments or business units that actually undertake the R&D are typically measured on EBIT (Earnings Before Interest and Tax) or, alternatively, on costs of production or against a cost budget. As a result, the individuals who are undertaking the R&D do not see the financial benefit of the Concession as it is only quantified as an after-tax result or in cashflow by the company head office. All the operational individuals see is the cost of performing the R&D and the administrative costs of making an R&D claim.

Whilst we support any attempt to review this limitation and investigate ways to better target those actually doing the R&D, we believe this review needs to take into consideration the potential inequities that can result from any attempt to push the benefit *above-the-line*.

The only way an *above-the-line* result can be achieved is by structuring the Credit so that it is recognisable as a revenue item or a credit against costs under A-IFRS (The Australian version of the International Financial Reporting Standards).

One way to achieve this could be to structure the Credit as a *government assistance* payment that is *non-taxable income* under the Accounting Standard AASB 120 "Accounting for Government Grants and Disclosure of Government Assistance". However, we note that the Australian Accounting Standards Board (AASB) Interpretations Advisory Panel has considered the treatment of tax-related payments and receipts in Paragraph 40 of its recommendations on Australian Petroleum Resource Rent Tax (AASB Interpretation 1003 (http://www.aasb.com.au/admin/file/content105/c9/INT1003_11-07.pdf)). In this Interpretation, the AASB found that most businesses treated tax-related items as after-tax amounts and this treatment was the preferred view of the AASB.

Whatever method is adopted to bring the Credit *above-the-line*, the Government would need to work closely with the AASB to ensure that the benefit can be treated this way under A-IFRS.

Whilst the AASB may accept a structure that brings the refundable Credit for SMEs as an *above-the-line* result, it is unlikely that the AASB will accept the non-refundable Credit (i.e. the Credit for the non-SME market) as a before-tax item. The non-refundable credit against income tax payable would be a tax adjustment by the *Deferred Tax Asset* definition in AASB 112 "Income Taxes" Paragraph 34. This treatment is consistent with international treatment; refer to the International Accounting Standards Board Meeting Notes 24/1/2007 on Investment Allowances (<http://www.iasb.org/NR/rdonlyres/CD7DE551-726E-4FD2-B493-8D03CF825523/0/InTax0701b06obs.pdf>).

Therefore, we urge the Treasury to consider the contradictory accounting outcomes that arise if the refundable Credit, in comparison to the non-refundable Credit, is recognised as *above-the-line*. If a company grows so it is just one dollar above the SME threshold of \$20 million group turnover, not only will that company lose one third of any R&D incentive benefit (i.e. a 40% credit *cf* 45% credit) incurring a massive effective marginal tax rate, that company will also lose out on an *above-the-line* accounting treatment.

Other Issues

Administration/Unlimited amendment powers

The new Credit must be supported by a compliance framework that is transparent, consistent and ensures timely service delivery as suggested in Paragraph 44 of the Paper.

The previous discussion regarding Attachment A of the Paper has highlighted the real concerns held by MJA and its clients regarding the recent performance in the delivery of the Concession. It is submitted that this performance has been commercially unacceptable and needs to be a priority of the new Credit.

A key feature must be an orderly end to the Commissioner of Taxation's unlimited amendment powers. The ironic result of these powers has been that AusIndustry and the Board have been able to conduct assessments of taxpayer claims that continue for many years without resolution. The reputation of the Concession has suffered in the market place as a result and the new Credit offers a real prospect of reversing this trend.

MJA is fully available to work with the Government and its administration to achieve a compliance framework for the Credit that is in the interest of all stakeholders.

Increase in tax-exempt ownership to 50%

MJA supports this announcement.

Introduction of foreign-owned IP including access to the refundable offset

MJA supports these initiatives.

R&D planning

The Paper makes no mention of the current R&D planning requirements despite these forming part of the eligibility criteria for R&D activities.

MJA responded to an AusIndustry discussion paper regarding changes to the planning issue that was released in January of this year. In that response, we cautioned against the use of R&D plans as the principal compliance document.

We understand from the recent public consultation sessions that the planning requirements will be reviewed in the Exposure Draft and we look forward to responding at that time.

Tax Consolidation

The current R&D Tax Concession is needlessly complicated in that it fails to recognise tax consolidated groups. The introduction of the Credit offers the opportunity to correct this. Providing suitable mechanisms that recognise tax consolidation will simplify the management, reporting and registration of R&D activities within a consolidated group.

Currently, each R&D company within a consolidated group must register with AusIndustry separately. However, under tax consolidations, there is only one recognised taxpayer - the head company or the nominated head company in a foreign owned Multiple Entry Group. Therefore, the R&D claim must be made in the head company's income tax return.

A mechanism to enable registration of a consolidated group should be introduced. This would provide a means of dealing with a number of problems associated with the current Concession:

- There are complexities associated with the 'on own behalf' rules. Where R&D is performed within a consolidation group by a number of members, the group currently has to split costs and activities for registration;
- The separate registration by each company creates the possibility that projects are broken up and activities performed by one of the companies may become ineligible. This is a horizontal inequity where these activities would be otherwise claimable except for the artificial breakup by legal entity, especially when income tax law does not recognise this breakup; and
- Frequently, there is a necessity for financial transactions to transfer costs within a group that serve no other benefit than to meet the registration requirements. These transactions then have to be eliminated in the tax return to meet the consolidations law.

Facilitating the registration of tax consolidated groups would make a significant contribution towards the achievement of the simplification objectives of the Credit.

Commitment

MJA commits to delivering a comprehensive submission regarding the design features of the Credit following the release of the Exposure Draft.

7. Conclusion – delivering certainty and simplicity

Despite the specific concerns and critiques raised in our submission, MJA remains excited by the possibilities opened up by the new Credit.

The Budget announcement built on the NIS Review's recommendations in a positive way. Higher rates of benefit were announced compared to the support offered by the base Concession. A generous refundable component was made available to SMEs within realistic parameters regarding group turnover. The impact of the location of R&D was given its due by the introduction of foreign-owned IP into the scheme in a meaningful way. The expensive and complex Premium Concession was thankfully abolished ending an instrument of questionable policy value.

Yet all these positive developments are put in jeopardy by the proposal to fundamentally change the key building block on which R&D support has been based – the current definition of R&D activities.

Rather than delivering a simplified and predictable Credit, the Government will be introducing unprecedented levels of complexity, uncertainty and compliance burden to R&D support at the very time when it is looking to the private sector to rebound from economic slowdown and to respond to the technical challenges of our time.

And the Treasury's case for making the change is simply not proven.

The history of the Concession shows us that program reform is always possible without changing the established and accepted definition of R&D. That lesson is ignored at our collective peril.

Annexure 1 - Analysis of “Examples of concern with the current scheme”

Example 1 Blended core and supporting activities

A mining company develops a significant new resource project. The project is for the progressive implementation of new mine, mill and waste management processes over a period of 6 years. All of the activities described by the company are somewhat generic in nature and broadly represent project phases. Most activities are claimed to contain a blend of both core and supporting activities.

Taken together these activities account for a significant percentage of the total mining costs in any particular year. The actual cost of the core R&D activity within one of the blended activities is likely to be a small fraction of the total activity. The blending of core and directly related activities makes it difficult to distinguish core activities from supporting activities, or make appropriate expenditure allocations. The claim is expected to be in the order of \$30 million over the life of the project.

The first paragraph of this example broadly describes the development of a “significant” new mine, including the mine itself, the mill to process the mineral(s) and the associated waste management processes. As written, there is insufficient evidence in this example to make a definitive determination of eligibility. The term “*progressive implementation of new mine mill and waste management processes...*” suggests the taxpayer is merely applying new processes in a phased manner and is not undertaking activities that are of an investigative and experimental nature. It is not apparent in this scenario that the current definition of R&D is met.

There are, however, potential circumstances in which the activities described here might reasonably be claimed as R&D. If the establishment of the mine itself and the mining of the minerals require the development of new or improved processes, and the taxpayer can establish that undertaking this development carries high levels of technical risk, or involves innovation, requiring one or more SIE activities, then they are able to establish eligibility. If the taxpayer can also establish that the design, construction and early operation of the mill requires the development of new or improved processes, and can illustrate high levels of technical risk or innovation associated with the conduct of the activities required to achieve the objective, then this too establishes the eligibility of this particular set of activities. Applying the same logic to the development of the waste management processes results in the same conclusion. It is therefore possible that all three sets of development activities for mine, mill and waste management processes are eligible if it can be ascertained that SIE activities have been undertaken to resolve or reduce technical uncertainty to achieve an eligible technical objective for each operation. The length of time required to achieve the technical objective is immaterial, as the taxpayer must establish that there is at least one SIE activity in respect of each of the different phases of a project to which there is a direct nexus in respect of the directly related activities claimed.

However, if the taxpayer maintains that the project is eligible in its entirety on the basis of the existence of an SIE activity in only one of either the mine, mill or waste management processes, then under the current definition of R&D, there would not be a case to claim the project in its entirety. If, for example, there was an eligible project with an identifiable high risk or innovative SIE activity or activities in the development of the mine itself, then the activities undertaken in the development of the later processes in the mill and waste management would be considered post-R&D and not eligible for concessional consideration. Similarly, if there was an eligible SIE activity or set of activities in the development of the mill, then the development of a standard mining process would be pre-R&D. The later development of the waste management processes would

also be unlikely to qualify as directly related to the R&D, unless a direct nexus could be identified between the development of the two processes i.e. if the waste management process was intimately tied to the mill processes being developed.

The second paragraph of this example states that “... together these activities account for a significant percentage of the total mining costs in any particular year.” The percentage of the total company costs expended on R&D in a particular year is not relevant to the question of eligibility. Whether developing a new mining technique or a cure for cancer, a company will typically spend a significant proportion of its total expenditure in the development phase. The fact that the SIE activity itself might be a smaller fraction of total costs is also not relevant, as directly related activities are no less vital in overcoming the technical uncertainty or developing the innovation in order to achieve the technical objective. In the example provided, it is also worth noting that the development of a new or improved mining technique involving mining through a pre-determined “trial” period may prove to be a core activity in itself, with systematic, investigative and experimental activities necessary to resolve or reduce uncertainty in the new or improved practice *in situ*.

The example further states that “the blending of core and directly related activities makes it difficult to distinguish core activities from supporting activities, or make appropriate expenditure allocations.” There is no legislative requirement to separately identify SIE (core) or directly related (supporting) activities. Nor is it necessary to do so in order to make adequate expenditure allocations. In identifying an eligible set of R&D activities, it is necessary to follow the process of identifying an eligible technical objective, and associated activities involving innovation or high levels of technical risk, which are by necessity investigative, experimental and systematic. Once this has been done, then expenditure on these, and on directly related activities (ie. activities without which the SIE activity could not occur) can be calculated and allocated across the various categories of expenditure. The first of these steps is a process of “technical” inquiry and, once established, it is not necessary from either an eligibility or an accounting point of view to divide expenditure into, for example, “core ‘other’ expenditure” and “supporting ‘other’ expenditure”.

Example 2 Extensive and multiple repetition of trials

A heavy engineering company enters into a contract to develop a series of new transportation modules for a client. The contracted modules are required to meet certain specifications. Many are standard for that type of module, but some elements of the module push the boundaries of known technology.

The design, development and construction of the full series of modules are claimed under the tax concession on the basis that the performance of the modules in relation to the innovative aspects could only be properly tested in a series of completed modules. The supporting activities involved multiple identical trials being claimed after the core activities had been completed. The claim is expected to be in the order of \$200 million over the life of the project.

The claim illustrates how significant claims can be made in cases where the costs of R&D would already have been reflected in the agreed contract price.

This discussion assumes that the contract between the heavy engineering company and the client clearly identifies that the R&D is undertaken by and for the engineering company and there are no *on own behalf* issues to be addressed here. In these cases, the contract usually “hands over” the engineered modules on completion of cold commissioning to be operated by the client from that point onwards. In this case, it appears that the engineering company has borne the cost of development of the modules, presumably at its own risk, and the cost of trials undertaken to prove that the design functions to specification.

In the absence of detail, it is difficult to see how it would be possible to claim the full cost of designing all modules under the current definition of R&D if, as suggested, each module was able to be separately designed and separately operated. However, if there were a sufficient number of “novel” modules, and/or a sufficiently high level of technical risk on the interaction of the novel modules with the “standard” modules, then the set of transportation modules could satisfy the definition of “innovation” as a unit and qualify as having “high levels of technical risk”. Under these circumstances, the Concession definition will enable the engineering company, providing that it is undertaking the research on its own behalf, to claim the costs of this development. It should be pointed out that a change in definition from *or* to *and* would not alter the outcome here as both innovation and high levels of technical risk could be proven.

This example also describes the engineering firm as claiming the cost of “multiple identical trials”. Multiple identical trials would not be eligible unless they were themselves an SIE (core) activity or if they were not, in fact, identical. For the engineering company to claim the modules in a production context, it must be bearing the cost of these trials and the trials must be either SIE activities in themselves or there must be a direct nexus to an SIE activity. If this cannot be established, then “multiple identical trials” are not eligible. If these modules are not production trials, but are trialed in a pilot plant or in a simulation, then there would be no reason for the engineering company to undertake “multiple identical trials.” If these trials are of individual modules, both novel and standard, on the client’s equipment, then the SIE activities have not in fact been completed as there is still uncertainty as to the success of the development and still the potential for trials to reveal technical issues requiring further design and development (i.e. SIE activities).

The final statement in this example states that “...*the claim illustrates how significant claims can be made in cases where the costs of R&D would already have been reflected in the agreed contract price.*” If there was an explicit clause in the contract between the relevant parties that the client must reimburse the engineering company for its expenditure on R&D undertaken in developing the modules, then the R&D claim would be ineligible because of the ‘on own behalf’ provisions. This R&D expenditure can only attract the concessional rate because the expenditure for the engineering company is at risk i.e. the engineering company is undertaking research and development on its own behalf and it bears the financial risk should the R&D fail. The fact that the engineering company then sells the results of the R&D is immaterial as borne out in the recently released ATOID 2009/107 *Limitations of the Application of s73CA*.

Example 3 Software

A company in the finance industry undertakes to provide customers with an enhanced online experience and more simple use of the company’s products. The business solution will provide customers with access to an extensive range of on-line facilities. The project provides a common platform for delivery of software-based services over the internet. The project involves internal software development and the integration of a number of existing on-line services with single customer sign-in.

All activities are claimed to involve both innovation and technical risk. The existing multiple sale test provision for software is deemed satisfied, because customers are ‘licensed’ to access a single sign-on integrated on-line environment. The claim is expected to be in the order of \$15 million over the 4 year life of the project.

This claim illustrates the weakness of the current multiple sale test and the high level of taxpayer subsidy available to activities which largely involve customisation and/or integration of existing systems.

This project is difficult to respond to in a meaningful way given the details provided.

If the project involves innovation and high levels of technical risk as is suggested in the example, it would qualify under the Treasury's proposed definition.

The Paper does not put forward any proposals regarding the multiple sale test so it is unclear how the test is likely to operate in the new Credit. MJA has submitted that the test should simply be removed.

Annexure 2 - Modelling

Effect of the elimination of the Premium Concession and estimated BERD for 2010/11 to 2013/14

Table 1: Company tax payments compared to R&D Expenditure (actual)

	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07
	(1 st year 175%)						
Company Tax Payments^(A)	28,439,000,000	35,079,000,000	37,503,000,000	44,570,000,000	50,978,000,000	60,131,000,000	
% Increase			23.3%	6.9%	18.8%	14.4%	18.0%
R&D Expenditure^(B)	5,266,000,000	6,116,000,000	6,381,000,000	6,936,000,000	8,258,000,000	9,733,520,000	11,594,730,000
% Increase			4.3%	8.7%	19.1%	17.9%	19.1%
Difference			-19.0%	1.8%	0.2%	3.5%	1.2%
Previous 3 yr Average				5,921,000,000	6,477,666,667	7,191,666,667	8,309,173,333
Increase				1,015,000,000	1,780,333,333	2,541,853,333	3,285,556,667
175% Amount^(C)				976,000,000	1,711,926,437	2,444,186,062	3,159,313,603
% of 175% Amount over the increase of the 3 year average ^(D)				96.2%	96.2%	96.2%	96.2%
Cost of 125% Concession ^(E)					520,200,000	619,350,000	730,014,000
Cost of 175% Concession					146,400,000	256,788,966	366,627,909
Cost of Program^(F)					666,600,000	876,138,966	1,096,641,909

(A) Source: Company tax payments ABS, 55060DO001_200708 - Tax Revenue, Australia, 2007-08. This includes PRRT

(B) Source: IR&D Board / Innovation Australia's Annual Reports and The Australian Government's New Elements of the R&D Tax Concession: Evaluation Report June 2007

(C) Source: IR&D Board / Innovation Australia Annual Reports and The Australian Government's New Elements of the R&D Tax Concession: Evaluation Report June 2007

(D) As information on the 175% Amount is only available for 2003/04, this assumes the same percentage for the 2003/04 period applies in subsequent years

(E) This assumes there are no (or negligible) 100% amounts included in (B)

(F) This assumes the Cost of the Program impacts the Budget performance the year after the R&D Expenditure is incurred

Table 1 models the data available from the Innovation Australia Board (the Board) against the income tax payments made by companies from the latest ABS Survey on BERD. This data shows that R&D expenditure changed at similar rates to company tax payments. On the basis of the June 2007 review following the introduction of the Premium Concession and the Tax Offset, it was identified that approximately 96% of the increase in the prior three years average of total R&D expenditure by all registrants results in 175% claims.

Table 2: R&D Expenditure estimates based on modelling in Table 1

	2007/08	2008/09
Company Tax Payments^(A)	66,661,000,000	59,550,000,000
% Increase	10.9%	-10.7%
R&D Expenditure Estimate^(B)	13,046,954,087	11,872,445,551
% Increase ^(C)	12.5%	-9.0%
Previous 3 year Average	9,862,083,333	11,458,401,362
Increase	3,184,870,754	- 414,044,188
175% Amount^(D)	3,062,496,409	398,135,101
Cost of 125%^(E)	869,604,750	978,521,557
Cost of 175%^(F)	473,897,040	459,374,461
Cost of Program^(G)	1,343,501,790	1,437,896,018

(A) Source: *Budget Strategy and Outlook: Budget Paper 2009-10*, Statement 9: Budget Financial Statements

(B) These estimates are based on changes in tax payable

(C) These estimates are based on the correlation between company tax payments and R&D Expenditure shown in Table 1 and adjusted by an average difference

(D) These estimates are based on data from IR&DB / Innovation Australia *Annual Reports* and *New Elements of the R&D Tax Concession: Evaluation Report* June 2007

(E) This assumes no (or negligible) 100% amounts are included in (B) (e.g. Feedstock Expenditure, Core Technology Expenditure)

(F) Refer to the modelling in Table 1 in relation to the % of 175% Amount over the increase of the 3 year average

(G) This assumes the *Cost of the Program* impacts the Budget performance the year after the R&D Expenditure is incurred

Table 2 models the application of the findings in Table 1 to the latest complete years based on the figures from the 2009 Federal Budget. This modelling shows that of the approximately \$1.4 billion cost of the program in terms of Federal revenue forgone, the Premium Concession accounts for about \$0.465 billion. This means that for the new Credit to be a revenue neutral replacement for the Concession, the elimination of the 175% would fund about a 50% increase in the base credit before any tightening in the eligibility criteria is required (i.e. the average cost of the 125% Concession is around \$935 million and with a 50% increase in rate this equals the \$1.4 billion). From the information contained in the latest Board *Annual Report*, more than 20% of registrants have turnovers of greater than \$20 million. These registrants will get less by way of the increase in the base rate than the amount they have funded by giving up the Premium Concession. The latest *Annual Report* also highlights that those businesses making claims of more than \$10 million represent less than 3% of all registrants but approximately 55% of the total expenditure claimed. This indicates that the top 20% of claimants who are most likely to be restricted to the 40 % credit (33.3% improvement) will make up the vast majority of the total claimed.

This modelling is conservative in its estimate of the cost of the Premium Concession and therefore understates the savings by its elimination. It is based on the only publicly available figures for the 2003/04 year from the Australian Government's June 2007 *Elements of the R&D Tax*

Concession: Evaluation Report. The 2003/04 year occurred relatively soon after the introduction of the Premium Concession and the Tax Offset and the program uptake was still ramping up. The latest Board *Annual Report* provides figures for 2006/07 year that show an 85% increase in registrants for the Premium Concession against an 8% increase in registrants only claiming the 125% Concession or Tax Offset over the same time period. Also, the average *value* of a claim including the Premium Concession increased 39% whilst the average *value* of 125% Concession claims (ie. those registrants without a Premium Concession) only increased by less than 13% over the three years. This would seem to indicate that the Premium Concession represents much more than a 50% increase over the base cost of the program and that its elimination will also fully fund a 100% increase over the base cost for SMEs. These SMEs represent less than 20% of the total R&D Expenditure claimed (less than \$2 billion of the R&D Expenditure claimed) and the 45% credit would cost less than \$100 million – well within the potential savings generated from the elimination of the Premium Concession.

Table 3: R&D Expenditure - forward estimates based on Budget forecasts

	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14 (est.)
Company Tax Payments^(A)	66,661,000,000	59,550,000,000	56,700,000,000	57,450,000,000	63,960,000,000	68,860,000,000	74,135,390,869
% Increase	10.9%	-10.7%	-4.8%	1.3%	11.3%	7.7%	7.7%
R&D Expenditure Estimate^(B)	13,046,954,087	11,872,445,551	11,501,947,601	11,845,624,818	13,385,180,878	14,633,520,101	15,998,282,916
% Increase ^(C)	12.5%	-9.0%	-3.1%	3.0%	13.0%	9.3%	9.3%
Previous 3 year Average	9,862,083,333	11,458,401,362	12,171,376,546	12,140,449,079	11,740,005,990	12,244,251,099	13,288,108,599
Increase	3,184,870,754	- 414,044,188	- 669,428,945	- 294,824,262	1,645,174,888	2,389,269,003	2,710,174,317
175% Amount^(D)	3,062,496,409	398,135,101	100,000,000	100,000,000	1,581,961,272	2,297,464,578	2,606,039,540
Cost of 125%^(E)	869,604,750	978,521,557	890,433,416	862,646,070	888,421,861	1,003,888,566	1,097,514,008
Cost of 175%^(F)	473,897,040	459,374,461	59,720,265	15,000,000	15,000,000	237,294,191	344,619,687
Cost of Program^(G)	1,343,501,790	1,437,896,018	950,153,681	877,646,070	903,421,861	1,241,182,757	1,442,133,694

(A) Source: *Budget Strategy and Outlook: Budget Paper 2009-10*, Statement 9: Budget Financial Statements

(B) These estimates are based on changes in tax payable

(C) These estimates are based on the correlation between company tax payments and R&D Expenditure shown in Table 1 and adjusted by an average difference

(D) These estimates are based on data from IR&DB / Innovation Australia *Annual Reports* and *New Elements of the R&D Tax Concession: Evaluation Report* June 2007

(E) This assumes no (or negligible) 100% amounts are included in (B) (e.g. Feedstock Expenditure, Core Technology Expenditure)

(F) Refer to the modelling in Table 1 in relation to the % of 175% Amount over the increase of the 3 year average, This also assumes a nominal \$100,000,000 175% Amount for the GFC reduced years

(G) This assumes the *Cost of the Program* impacts the Budget performance the year after the R&D Expenditure is incurred

Table 3 extends Table 2 using Treasury forecasts from the 2009 Budget Papers. It also provides a contrary view to the Treasury position that R&D claims under the current legislation will keep on increasing without regard to the economic performance of Australian business. The table shows the potential impact of the GFC on BERD eligible for the Concession. This modelling shows that if nothing changes to the Concession it is likely to only cost \$4.46 billion over the four year period from 2010/11 to 2013/14. With no Premium Concession over that four year period, the Concession is likely to cost \$3.85 billion. This is in contrast to the minimum figures discussed by Government of a cost of \$1.4 billion annually or \$5.6 billion (plus any year on year increases). This difference of, at least, more than \$1 billion is more than enough to fund all the increases in R&D support proposed without any eligibility changes being required.

This modelling assumes that R&D Expenditure increases will be similar but slightly ahead of increases in tax payments as is the case in most years. This is conservative in that, since the year the Premium Concession was introduced, company tax payments have increased by 111% from 2001/02 (\$28.439 billion) to 2006/07 (\$60.131 billion). At the same time, R&D Expenditure has only increased 90% (\$6.116 billion to \$11.595 billion).