



The R&D Tax Credit Exposure Draft

Has Treasury given us what we always wanted or just another pair of socks?

By Chris Gale, Managing Director
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December 2009

The Treasury Consultation Paper, "*The new research and development tax incentive*", released in September 2009 was a great disappointment to the Australian R&D community.

How do we know this?

Because 165 submissions to the Treasury were made publicly available and they virtually all rejected the proposal to tighten the definition of R&D.

We then sat back and waited to see Treasury's response. Well, it arrived last Friday just in time for Christmas in the form of the Exposure Draft of the Tax Laws Amendment (Research and Development) Bill 2010. Naturally, we couldn't wait a week to see what was inside and so we opened it up, hoping that the views of the community had been heeded. Sad to say, there wasn't a shiny new toy inside. **Rather, a pair of socks was all to be found.** And not very colourful ones at that.

The key proposals are detailed below and, while the news is not all bad, the new R&D Tax Credit proposed by the Treasury seeks to legislate a considerable narrower definition of R&D coupled with augmented feedstock provisions that would combine to remove any real incentive effect at the critical phases of all R&D projects – the times where decisions are made as to how much expenditure to commit to a project. Along with this minimised incentive effect, the new legislation introduces a slew of new concepts and requirements that add a huge amount of complexity to the program, couching it in language that is confusing and not relevant to technical personnel and again dropping the responsibility for the claim squarely in the lap of the company's taxation team.

Ironically, lack of incentive effect and complexity were the very forces that drove the Cutler Review in recommending changes to the current R&D Tax Concession such as the removal of the incremental concession. The proposed new R&D Tax Credit fails in both these regards. **In short, it is an incentive designed to encourage companies to do R&D outside their normal operating environments and only reward failures which can only be determined after the fact.** It is not interested in assisting companies that seek successful R&D outcomes in commercially-driven environments. As such, the policy drivers expressed in the Exposure Draft become impossible to understand.

The Treasury has given interested parties until 5 February 2010 for responses to be submitted.

Interested parties are invited to comment on the exposure draft legislation and associated explanatory material. While submissions may be lodged electronically or by post, electronic lodgement is preferred. For accessibility reasons, please submit responses sent via email in a Word or RTF format. An **additional** PDF version may also be submitted.

Address written submissions to:

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<http://mjassociates.com.au>/MJ Associates will be making its own submission and is fully available this week and then from January 4 onwards to discuss any questions and concerns that you may have. We will also be liaising with companies and their industry representatives in their direct dialogues with the relevant politicians and their offices. We will keep you updated regularly on progress.

Key Proposals in the Exposure Draft and Explanatory Materials

The release of the Exposure Draft and Explanatory Materials in respect of the *Tax Laws Amendment (Research and Development) Bill 2010* confirms the Treasury's policy intent that first appeared in its September 2009 consultation paper regarding the new R&D Tax Credit. The new incentive will replace the R&D Tax Concession for income years commencing from 1 July 2010 onwards. It is immediately apparent that the draft legislation has paid scant attention to the concerns expressed by the overwhelming majority of Australian stakeholders who responded to the Treasury's previous paper.

As promised, the proposed amendments to the current R&D Tax Concession legislation will deliver a 45% refundable tax credit to small firms (group turnover less than \$20 million per annum) and a 40% credit to companies with a group turnover more than \$20 million per annum.

The new program will be extended to support R&D activities undertaken in Australia by foreign-owned firms and the complex 175% premium and international premium concessions will be abolished. Importantly, it will provide better certainty in respect of the level of support by its detachment from the corporate tax rate and through the introduction of an amendment period of 4 years which will be binding on the Commissioner.

Where the proposed new R&D Tax Credit falls short is in its failure to address the drivers that will deliver a meaningful and effective program to stimulate R&D in Australian businesses operating in a commercial environment and within a broad range of industry sectors.

This inherent failure is immediately evident in the revised "Objects" clause which states: *The object of this Division is to encourage industry to conduct R&D activities **that might otherwise not be conducted** because of technical uncertainty, in cases where the knowledge gained is **likely to spillover to the benefit of wider Australian economy**.*

To any company operating in a dynamic, competitive, consumer-driven market within a global context, this statement falls well short of the mark in describing how R&D decisions are made. Any credibility is further eroded by the proposed introduction of a "dominant purpose" test in respect of supporting activities as outlined in the following Objects clause: *The tax offset is also available for directly related activities that are conducted for the **dominant purpose** of supporting such core experimental activities (rather than for a broader commercial or other purpose).*

This myopic view of industry R&D will undermine any tax incentive for the conduct of applied research by Australian businesses. Essentially, the program focus will be on the conduct of "research" phase activities and not the "development" phase of activities. This equates to a meaningless incentive for companies (large and small) engaged in process technologies where downstream development costs and risks vastly outweigh the initial research effort involved, especially in manufacturing and mining.

The following is a brief summary of the new legislative elements that will transition the current R&D Tax Concession to the new R&D Tax Credit:

Change to the definition of Research and Development Activities: Claimants will need to qualify activities as either core or supporting. Core activities will need to display considerable novelty **and** high levels of technical risk. Supporting activities will need to demonstrate that their dominant purpose was to support the core R&D. This will add complexity, greater uncertainty and a heightened compliance burden for most companies.

Restrictions on claim value: A broader list of excluded activities is proposed and the exclusion will apply to these activities irrespective of whether they are core or supporting. Software development has been hit particularly hard with a significant extension of the 'multiple sale' requirement along with other new restrictions. New augmented feedstock rules seek to clawback the majority of claimable expenditures wherever the R&D outputs generate value beyond their inherent worth as IP. The proposed feedstock adjustments will require the exclusion of R&D expenditure (currently other than for conceptual design) and depreciation amounts that directly relate to the production of a feedstock output. There is also a concern about the operation of an "expenditure not at risk" exclusion.

Innovation Australia's role: The proposed amendments to the function of the Innovation Australia Board will provide it with much wider powers in respect of program administration. While R&D plans will no longer form part of the definition of R&D, the amount of information apparently required from companies to ensure registration will impose a severe compliance burden. A mechanism for advance findings regarding R&D eligibility has been announced. The introduction of program fees is also contemplated.

Conclusion

The draft legislation has paid scant attention to the concerns expressed by the overwhelming majority of Australian businesses who responded to the Treasury's earlier consultation paper. The result is an R&D tax incentive that is far more complex and greatly reduced in value as rather than "simplified and enhanced".

The deadline for the next round of submissions is Friday 5 February 2010.

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