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Tax hangover or cure? Reforms for research and development tax incentives

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The proposed research and development (R&D) Tax Credit Bills (R&D Tax Credit) are currently waiting to be debated in the Senate, after passing the House of Representatives without amendment on 22 November 2010.

As currently drafted, the R&D Tax Credit significantly narrows the scope of the definition of eligible R&D activities, and reduces the amount of expenditure that will be claimable under the new R&D tax incentive. The purpose of the new R&D tax incentive is to encourage additional R&D activity in areas where there is a high degree of technical risk involved, which would otherwise prevent the project from proceeding, if not for the R&D tax incentive. In the government’s view, these riskier projects will provide spillover benefits to the economy as a whole.

In brief

• The Federal Government is attempting to introduce tighter eligibility measures for Australian companies claiming R&D tax incentives.
• As it currently stands, small and medium enterprises (SMEs) and industries such as biotechnology, will benefit most from the 45% refundable R&D tax offset for eligible companies with a turnover of less than $20 million.
• Lawyers and professional advisors working with companies carrying on R&D activities in Australia should be aware of the new legislative changes and how they may benefit their clients after the introduction of the new R&D Tax Credit.
• It appears increasingly likely that the commencement date of the R&D Tax Credit will be deferred to 1 July 2011, creating uncertainty for industry in respect of which rules should be applied to projects currently underway.

Background

In September 2008, the government released a review of Australia’s innovation system entitled Venturous Australia: Building Strength in Innovation (Cutler report), recommending significant changes to the current R&D Tax Concession. The government adopted many of the Cutler report’s recommendations and, in the 2009–10 Federal Budget announced the new R&D Tax Credit to replace the existing R&D Tax Concession. Soon afterwards, the government released the Exposure Draft (ED) material dealing with the new R&D Tax Credit, along with an explanatory memorandum on 18 December 2009. A second ED was released on 31 March 2010.

Key features of the R&D Tax Credit

In brief, the R&D Tax Credit seeks to increase the base rate of support for all Australian companies by introducing the following measures:

• For SMEs and start-ups with less than $20 million turnover, financial support will increase from 7.5 cents in the dollar to 15 cents, whereas for larger companies, the increase represents a smaller jump from 7.5 cents to 10 cents in the dollar.
• Local R&D activities can be claimed even when the intellectual property is owned by foreign entities — allowing Australia to attract further international R&D expenditure.

The key features of the proposed R&D Tax Credit (in proposed Div 355 of Income Tax Assessment Act 1997 (Cth)) are summarised below:

• Tax offset for expenditure on eligible R&D activities, regardless of where the resulting intellectual property is held. There is no expenditure cap, but there is a minimum expenditure threshold of $20,000.
• Companies eligible to claim the R&D tax offset are Australian companies, foreign corporations that carry on R&D activities through a permanent establishment in Australia, and public trading trusts with a corporate trustee.
• Eligible companies with a turnover of less than $20 million will have access to a 45% refundable R&D tax offset, obtainable even though no income tax may be payable. All other companies will be eligible for a 40% non-refundable R&D tax offset.
• Eligible R&D activities will fall into two categories: “core” and “supporting” R&D activities.
Core R&D activities will be experimental activities whose outcome cannot be known or determined in advance, and can only be determined by applying a systematic progression of work for the purpose of generating new knowledge.7 Supporting R&D activities must be activities directly related to core R&D activities, or in the case of production activities, undertaken for the dominant purpose of supporting core R&D activities.8 This new definition of “supporting R&D activities” imposes a stricter test on activities more likely to be undertaken for normal (business as usual) operations.

- Some R&D activities conducted overseas will also qualify in limited circumstances where the activities have a significant scientific link to the core R&D activities, and such activities cannot be undertaken in Australia.9
- Software R&D activities (“in-house” software) related to the development, modification or customisation of software will not be eligible core R&D activities where the software is developed for internal business use.10 However, Software R&D may still qualify as a supporting R&D activity if it satisfies the “dominant purpose” test.
- The augmented feedstock provisions provide that any expenditure that directly relates to the production of feedstock output, which is the result of R&D activities, is offset by that output’s “market value”.11 The government has yet to clarify the scope of these feedstock provisions,12 but as they stand seem to reward failed R&D activities.

The new R&D Tax Credit will continue to operate on a self-assessment basis, i.e., the company will assess for itself whether its activities conducted in an income year are eligible R&D activities. As part of this process, the R&D Tax Credit requires separate identification of core and supporting R&D activities.13 Innovation Australia will continue to administer the registration of R&D activities under the Industry, Research and Development Act 1986, together with increased powers to revoke a company’s registration.14

As a consequence of the new legislative changes, the government is attempting to reduce the R&D tax incentives being claimed on “business as usual” activities, by tightening the eligibility criteria for R&D activities. At the same time, the new R&D tax incentive will offer more generous benefits to SMEs and start-ups, at a cost to industry in terms of limiting “whole of mine” claims for large mining and construction projects.15 Where the traditional approach to reform has been for legislative amendments to be transitioned into force in a way that minimises their impact on the rights of existing applicants, the introduction of the R&D Tax Credit represents a comprehensive policy shift towards innovation in Australia.16

Tax hangover or cure?

As it currently stands, the R&D Tax Credit is due to be debated when the Senate next sits this year, but before then a number of other considerations need to be sorted out, including the commencement date and the relevant administrative guidelines. Past discussions in the media have centred on the R&D Tax Credit being applied retrospectively, however, it is increasingly likely that the legislation will now commence on 1 July 2011.

These reforms of the R&D tax incentive seem to reflect a theoretical shift in government support for Business Expenditure on R&D (BERD) by basing eligibility on a scientific definition of R&D rather than the present industrial definition. Although the current R&D Tax Concession has raised some unwanted consequences or “delayed after-effects” for the government, in the same vein, the new R&D Tax Credit may also create some undesirable aftereffects even though the reforms have been widely publicised as containing significant benefits for particular industries.17 So the question is, will the new R&D Tax Credit as drafted extend the aftereffects or “hangover” for industry and start-ups or are they genuine reforms that further the government’s commitment to innovation in Australia?

The new R&D tax incentive represents a significant change in the policy mindset of the Federal Government as it relates to BERD and innovation policy in Australia. Contrary to its stated position in recent policy reviews,18 it appears that there’s no cure in sight as the government intends to pare back its role in supporting innovation in the future.

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Footnotes
1. Tax Laws Amendment (Research and Development) Bill 2010 and Income Tax Rates Amendment (Research and Development) Bill 2010.
2. Explanatory memorandum to R&D Tax Credit, cl 2.7.

5. This threshold will not apply in relation to any R&D activities performed by a registered research service provider or by contributions to a cooperative research centre.

6. Tax Laws Amendment (Research and Development) Bill 2010 (Cth), s 355-35, Item 1, Sch 1.

7. Above note 6, s 355-25(1), Item 1, Sch 1.

8. Above note 6, s 355-30, Item 1, Sch 1.

9. Above note 6, s 355-210(d), Item 1, Sch 1.

10. Above note 6, s 355-25(2)(h), Item 1, Sch 1.


12. Explanatory memorandum to R&D Tax Credit, cl 2.46.

13. Above note 6, s 27A, Item 1, Sch 2.

14. Above note 6, s 27N, Item 1, Sch 2.


16. The nature of the R&D Tax Credit will add to an emerging view that the Australian R&D tax incentive is less favourable than overseas alternatives, eg, Singapore.
