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Ms Roberta Bausch
Science and Innovation Study
Productivity Commission
PO Box 80, Belconnen
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Dear Ms Baush

R&D Tax Concession – Comments on draft findings

The Taxation Institute of Australia (Taxation Institute) welcomes the opportunity to provide comments on the draft Productivity Commission Report released on 2 November 2006 and, specifically, the recommendations concerning the Research and Development (R&D) tax concession. Our comments on the draft legislation are set out below.

We refer to the draft Productivity Commission Report released on 2 November 2006 and, specifically, the recommendations concerning the Research and Development (R&D) tax concession.

In draft finding 9.1, the Commission has suggested that the R&D tax concession could be improved by:

1. shifting the orientation of the concession towards its 175 per cent incremental component;
2. relaxing the beneficial ownership requirement and the expenditure and turnover thresholds for the tax offset for the incremental scheme alone;
3. changing the base on which the incremental subsidy is paid to a firm's ratio of R&D to sales at a given, fixed date; and
4. allowing access to the incremental scheme to start-up firms.

Given our understanding of the Federal Government's strong endorsement of the R&D tax concession in its *Backing Australia's Ability* and *Backing Australia's Ability: Building our Future through Science and Innovation* packages, we value the Commission's consideration of ways in which the R&D tax concession could be made even more effective.

We believe that the R&D tax concession has encouraged many companies in Australia to continue investing in local R&D, notwithstanding the intense competitive pressures in the ever-changing global marketplace. In particular, given Australia's isolated location and competitive disadvantages in relation to labour costs, the R&D tax concession has been pivotal in enabling industry to develop significant R&D capabilities in Australia. The tangible benefits from the commercial exploitation of R&D projects are also very clear, with significant contributions to increased revenue and profitability and improved products and processes.

The positive impact that the Backing Australia's Ability measures has had on Australia's BERD performance clearly demonstrates that the current R&D tax concession regime is effective and any proposed changes thereto should be by way of enhancement rather than restriction.

Please find below our feedback on the draft findings in the report, with a particular emphasis on the practical implications of the draft findings on R&D tax concession claimants.

Greater emphasis on the 175 per cent incremental component

Whilst we consider that the 175 per cent incremental concession, although relatively new, has been successful in inducing additional R&D, we are concerned at the Commission's recommendation in relation to the 125 per cent base concession.

We are strongly opposed to the suggested reduction/elimination of the 125 percent tax concession deduction. If adopted, the Productivity Commission's recommendation will result in a lower net benefit to companies from missing out partly or completely on claiming the 25 per cent component of the R&D tax concession every claim year. That is, for every \$1 of eligible R&D expenditure, a company could be, as a starting point, up to 7.5c worse off under the proposed change in comparison to the current scheme. (This argument assumes that companies will maintain current/expected levels of R&D activity and ignores the potential increases in R&D activity that may result under a changed scheme.)

As well, as noted by the Commission, companies do not increase their R&D in perpetuity, and will therefore be penalised and invariably miss out on significant R&D tax concession benefits in years of stable or decreased R&D activity. In short, companies eager to invest and drive their R&D effort will be unsure at the start of the income year as to whether they will incrementally benefit from the R&D tax concession. Throughout the year, this uncertainty will remain as R&D effort continues. It will not be until year end, when the realities of the business and R&D effort are calculated, will the company have any certainty as to the benefit of the R&D tax concession, if any. This provides an overall environment of uncertainty and provides no basis for budgeting, planning and long term investment. We believe the 125 per cent base provides this, where a pure 175 per cent incremental model does not.

It is worth noting that for 2004/05 only 1,182 companies accessed the incremental concession out of a total of 5,961 companies that registered with AusIndustry. As a result, if we take this as a typical year, it would mean that about 80 per cent of companies engaging in R&D would not have received any support for their R&D during 2004/05 if the base concession was removed. We believe that this would send a very negative message to a large number of companies during a time when innovation is seen to be key to increasing the global competitiveness of the Australian economy.

Indeed, many companies have accessed the R&D tax concession for a number of years and it forms an integral part of their ongoing business operations in assisting to embark on projects where the inherent project risks would have otherwise precluded the sanctioning of the project, either in terms of budgetary constraints and/or timing. Furthermore, over a number of years, the R&D tax concession has also enabled many companies to more readily justify the recruitment of additional resources to enable them to facilitate their R&D projects and the procurement of equipment to assist in that process.

We also note that in the scenario whereby the 125 per cent concession is abolished, whilst retaining the current 175 per cent incremental concession model, companies would not be able to access any support until their fourth claim year. This is unless there was a change to the legislation allowing companies to access the scheme after a shorter period of time in accordance with the fourth draft finding above.

Relaxing the beneficial ownership requirement and the expenditure and turnover thresholds for the tax offset for the incremental scheme alone

The proposal to relax the beneficial ownership requirement for the IP resulting from the R&D activities for the incremental scheme alone mirrors the current arrangements in place for the Pharmaceuticals Partnerships Program (P³). If the intention is to simply increase the level of R&D activity in Australia similar to the intent of P³ (to promote additional, high-quality R&D and encourage partnerships and collaborations between multinational firms and local companies), then this suggestion may be effective. However, as noted in AusBiotech's submission to the Commission, there are many other reasons for locating R&D activities in Australia and this proposed change to the scheme may not be a sufficient incentive in itself.

In relation to the proposed changes to the expenditure and turnover thresholds for the tax offset for the incremental scheme alone, we understand that the recent review of the success to date of the R&D tax offset by DITR took into account the reasonableness or otherwise of the current thresholds. We believe it prudent to consider the recommendations to be made in that report before considering or supporting any other proposed changes.

Changing the base on which the incremental subsidy is paid to a firm's ratio of R&D to sales at a given, fixed date

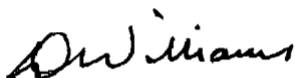
The Commission's report acknowledges the impact that a volatile R&D spend can have on a company's ability to access the 175 per cent incremental concession. Similarly, we would suggest that the proposal to change the base to a company's ratio of R&D to sales at a *given, fixed date* could result in adverse outcomes for those R&D intensive companies with low or no sales revenue at that given, fixed date. As such, companies in this situation with a high level of R&D intensity would be presented with a significant challenge in subsequent years when sales commence or increase to, once again, access the incremental concession at all or to the same extent.

Allowing access to the incremental scheme to start-up firms

Measures to allow start-up firms to access the incremental concession would be welcomed, particularly by those high technology companies that are typically R&D intensive in their formative years.

We will welcome the opportunity to provide further information as necessary. If you have any queries in relation to any of the issues raised in this submission, please contact the Taxation Institute's Senior Tax Counsel, Dr Michael Dirkis, on 02 8223 0011.

Yours faithfully



David Williams
National Technical Committee Deputy Chair