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No. 44 2001–02

Taxation Laws Amendment (Research and
Development) Bill 2001

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I N F O R M A T I O N A N D R E S E A R C H S E R V I C E S

Bills Digest
No. 44 2001–02

Taxation Laws Amendment (Research and Development)
Bill 2001

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Law and Bills Digest Group
10 September 2001

Contents

Purpose	1
Background	1
Tax Concessions.	2
Start grants and loans for R&D	2
Downturn in spending on R&D	2
Need for reform	3
House of Representatives Committee Report	3
National Innovation Summit	4
Report of Chief Scientist.	4
The Government’s response - <i>Backing Australia’s Ability</i>	5
Main Provisions	6
Who is currently eligible for the R&D tax deduction?.	6
Objects clause.	6
Changes to the definition of R&D activities	7

R&D activities must meet both innovation and technical risk criteria	8
R&D activities must have an R&D plan.	8
Some R&D supporting activities excluded.	8
Changes to R&D plant	8
Removal of ‘exclusive use’ test from definition of ‘R&D plant’	9
Pilot plant exempt from capital gains tax	9
125 per cent effective life tax write-off for R&D plant	9
Refundable R&D tax offset for small companies	10
175 per cent premium R&D tax concession	12
Errors.	13
Concluding Comments	14
Changes to the definition of R&D activities	14
Changes to R&D plant	14
175 per cent premium R&D tax concession	15
Position of other political parties	15
Conclusion	16
Endnotes.	17

Taxation Laws Amendment (Research and Development) Bill 2001

Date Introduced: 27 June 2001

House: House of Representatives

Portfolio: Treasury

Commencement: Upon Royal Assent. However, the measures contained in the Bill have different application dates, which are set out in the Main Provisions section of this Digest.

Purpose

To amend the existing 125 per cent tax concession for research and development (R&D) to:

- introduce a premium 175 per cent concession for additional R&D
- introduce a refundable R&D tax offset for small companies
- change the eligibility requirements applicable to R&D plant, and
- tighten the definition of R&D activities.

Background

The Government has two principal ways of encouraging industry to invest in R&D. The first is via a tax concession under section 73B of the *Income Tax Assessment Act 1936* (the Tax Act 1936), and the second is through a scheme of grants made under the *Industry Research and Development Act 1986* (the IR&D Act). The grants scheme is ‘intended to address gaps in the tax concession scheme by providing direct assistance to those companies undertaking R&D activities which cannot take advantage of tax concessions.’¹

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Tax Concessions

A 150 per cent tax deduction for eligible expenditure on R&D was introduced by the then Labor Government in May 1986 (commencing retrospectively from 1 July 1985) as a temporary measure. However, after various policy changes and consequential amendments to the legislation, the Labor Government announced in the 1992–93 Budget speech that the 150 per cent concession would be continued indefinitely.²

In 1996, the new Coalition Government, as part of its Budget measures on R&D, decided to reduce the maximum concessional rate of deduction from 150 to 125 per cent. It also tightened the eligibility criteria for accessing the R&D concession and made the tax concession unavailable to new syndicates. These measures were driven by concerns that the R&D tax concession was not tax effective, that it was not encouraging a significant amount of R&D that would not have otherwise been undertaken, and that decisions on investments in R&D were often determined by the tax consequences of the investment rather than the nature of the R&D being undertaken.³

Start grants and loans for R&D

To ameliorate the changes to the R&D tax concession, the Coalition also announced in the 1996 Budget the introduction of a new scheme, the Strategic Assistance for Research and Development (Start) program. The aim of the Start program is to provide R&D assistance through a mixture of grants and concessional loans for R&D projects which have commercial potential and which generally would otherwise be unlikely to proceed due to lack of finance.⁴ The Industry Research and Development Board determines who is eligible for funding. The Start program is worth \$1.5 billion over 8 years (1998/99–2005/06), including \$535 million announced in the Innovation Action Plan in January 2001.⁵

In addition to the Start program, Commercialising Emerging Technologies (COMET) is a new program designed to bolster R&D investment, and thereby stimulate innovation and business growth, by providing business advice or assistance to obtain management qualifications.⁶ The COMET program has a budget of up to \$30 million over three years starting from the financial year 1999–2000. An additional funding of \$40 million for 2001/02–2004/05 was announced in the Innovation Action Plan.⁷

Downturn in spending on R&D

Business expenditure on research and development (BERD), expressed as a percentage of gross domestic product (GDP), recorded a strong upward trend from 1991–92 to 1995–96 but has declined substantially from 1996–1997.⁸ The latest figures show that this downward trend continued in 1999–2000.⁹ Australia remains thirteenth out of seventeen OECD countries in the ratio of BERD to GDP. In 1999–2000, Australia's BERD to GDP

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ratio was 0.64 per cent, compared with ratios of over 2 per cent in Finland, Japan and the United States, and between 1 and 2 per cent in Korea, Germany, France, Denmark, United Kingdom, Netherlands and Iceland. Moreover this ratio increased in most of these countries in the preceding two years, in contrast to the decline in Australia, widening of the already large deficit between BERD in Australia and that in most other OECD countries.¹⁰

There has been considerable debate about reasons for this downturn in BERD in Australia. Many commentators have identified the lowering of the R&D tax concession in 1996 from 150 to 125 per cent as the major cause of the decline.¹¹ Although arguably necessary to remove the tax rorts on the R&D tax concession, this has effectively reduced the Government subsidy on R&D from 18 cents in every R&D dollar (23 cents in the 1980s, when the company tax rate was 46 per cent) to nine cents in every dollar.¹² The Business Council of Australia estimated from a 1998 survey that R&D spending was one-third or \$1.5 billion lower than it would have been if the previous rate of growth had been maintained. This suggests that R&D is much more sensitive to tax concession assistance than earlier studies indicated.¹³ There have also been suggestions that the administrative costs associated with compliance with the eligibility criteria are too great to justify to obtain a marginal benefit of less than 10 per cent.¹⁴

There has been some speculation that the downward trend may be bottoming out. The latest figures suggest that, were it not for a substantial decrease in R&D spending in the mining industry, BERD may have begun to increase in 2000-2001. R&D expenditure increased in a number of industries, including the scientific research, property and business services, finance and insurance industries.¹⁵ The 2000-01 Budget Papers also indicate a recent increase in the uptake of the R&D tax concession. Revenue foregone for the concession increased in 1999-2000 to \$553 million and is expected to increase to \$600 million in 2000-2001. This compares with the peak outlay on this concession of \$902 million in 1995-96.¹⁶

Need for reform

There have been no less than three reports in the last two years recommending a review of Government incentives for business to conduct R&D.

House of Representatives Committee Report

A 1999 House of Representatives Standing Committee Report on Australia's R&D concluded that the decrease in BERD from an already low base ought to be cause for concern.¹⁷ The Committee recommended that the Government determine an appropriate policy response to the reduction in BERD from 1996-97 onwards. Among other measures, it recommended that the National Innovation Summit consider whether the R&D tax concession should be restored to 150 per cent, and whether it should be extended to

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include up-front payments, equivalent to tax relief, to start-up companies recording tax losses.¹⁸

National Innovation Summit

The National Innovation Summit was held in February 2000 in Melbourne, co-hosted by the Department of Industry, Science and Resources and the Business Council of Australia. The Final Report of the Innovation Summit Implementation Group, entitled *Innovation – Unlocking the Future*, was delivered in August 2000.¹⁹ It contains a number of recommendations designed to help Australian business and industry develop and use new ideas and technology. Among other key recommendations aimed at developing ideas discovered during R&D and encouraging research in universities, such as by doubling Commonwealth Government funding for the competitive research grants schemes administered by the Australian Research Council over a five-year period, the Summit recommended the Commonwealth Government should:²⁰

- increase the base rate of the R&D Tax Concession to 130 per cent
- raise the rate of the R&D Tax Concession to between 170 per cent and 200 per cent for additional R&D over and above a threshold base. To qualify, businesses would need to increase their level of R&D by an average of 10 per cent over the identified base rate determined by, for example, their previous claim history, and
- introduce a cash-out option for small enterprises with a turnover of less than \$1 million and an investment in R&D of less than \$1 million, based on the 130 per cent rate.

The increase in the base rate for the concession to 130 per cent was recommended to maintain the effective amount of the Government subsidy once the company tax rate is reduced from 36 per cent to 30 per cent. Although it is estimated to cost \$100 million per annum, this proposal does no more than maintain the amount of support previously available.²¹

The idea of a cash-out option was intended to provide smaller businesses with access to cash flow, which can be used to accelerate growth and increase the amount spent on research and development. It was estimated this initiative would benefit between 600 and 700 Australian firms.²²

Report of Chief Scientist

The Final Report of the Chief Scientist, Dr Robin Batterham, entitled *The Chance to Change*, delivered in November 2000, also adopted some of these recommendations. The Chief Scientist made recommendations specifically aimed at the commercialisation of R&D, in addition to recommendations aimed at education and increased funding for universities and research. Key issues were the provision of venture capital (that is, capital invested in start-up companies involved in high technology or innovative businesses²³) and

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the provision of pre-seed capital to universities, Innovation Centres and government-funded research agencies such as CSIRO.

Specifically in relation to the R&D tax concession, the Chief Scientist supported the increase to a base tax concession rate of 130 per cent, and repeated the call for a cash-out option for R&D expenditure by smaller businesses. The latter initiative he claimed would 'encourage investment in innovation and, importantly, help expose small and medium-sized enterprises to innovative activities with reduced financial risk'. The Chief Scientist went further than the National Innovation Summit in recommending incentives to attract significant R&D projects to Australia by providing a tax incentive in the order of 200 per cent or an equivalent incentives package for overseas companies to locate R&D facilities in Australia.²⁴

The Government's response - *Backing Australia's Ability*

The Government has responded to these reports by announcing, on 29 January 2001, the *Backing Australia's Ability* package. This commits an additional \$2.9 billion in Government expenditure over five years to science, technology and innovation.

Many of the key initiatives provide additional funding for universities and research institutions.²⁵ The package also includes changes to funding for R&D, including continuing the R&D Start Program (which would otherwise have expired) with funding of \$535 million over five years. In relation to the R&D tax concession, while the Government has decided not to implement the recommendation to increase the base rate of the concession from 125 per cent to 130 per cent (or even, as some suggested, to 150 per cent), it has heeded the call for a cash rebate for small companies, particularly those in tax loss.

This Bill implements the following changes to the R&D tax concession announced in the *Backing Australia's Ability* package:²⁶

- introducing a premium rate of 175 per cent for additional R&D activity
- applying effective-life write off to R&D plant, which will make the R&D tax concession consistent with the reforms of the business taxation system
- allowing future experimental plant which is also used for production purposes to receive depreciation deductions at 125 per cent during the R&D phase, and
- introducing a tax rebate for the R&D tax concession for small companies.

The Government is also introducing changes to tighten the definition of R&D. This is despite the fact that in 1999 the House of Representatives Standing Committee on Industry, Science and Resources recommended that the Government maintain the current definition of activities eligible for the R&D tax concession.²⁷

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In January 2001, the Government estimated that the reform of the R&D tax concession scheme would cost \$115 million over five years. This has now increased due to a change in the eligibility rules for the 175 per cent premium tax concession. It also estimates that over five years up to 1300 small companies that are in tax loss will get early access to \$30 million at a net cost of \$13 million.²⁸

Main Provisions

Who is currently eligible for the R&D tax deduction?

A company wishing to claim the R&D tax concession must first be registered with the Industry Research and Development Board.²⁹ The Board determines whether taxpayers qualify for the 125 per cent R&D tax concession. If the Board is of the opinion that any of the results of R&D activities have not been exploited on normal commercial terms, for the benefit of the Australian economy or that those activities do not have sufficient Australian content, no deduction is allowable.³⁰

The R&D tax concession is available to companies incorporated in Australia, and in certain circumstances partnerships,³¹ which are involved in 'research and development activities'. The definition of 'research and development activities' is given below. The R&D activities do not have to be carried on in Australia or in an external Territory.³²

Annual eligible R&D expenditure must exceed \$20 000 if the company carries out the R&D itself, to obtain the full 125 per cent deduction. Expenditure below this threshold qualifies for a 100 per cent tax concession. If R&D is carried on by a registered research agency (such as the CSIRO) on behalf of a company or partnership, the \$20 000 threshold is waived.

The Bill proposes a number of amendments to the current situation, which are described below.

Objects clause

New subsection 73B(1AAA) inserts an objects clause in section 73B of the Tax Act 1936, with effect from Royal Assent. A similar provision is inserted in the IR&D Act by **new section 39AA**. The stated objective is to make companies which are eligible for the R&D tax deduction 'more internationally competitive' by:

- encouraging them to develop innovative products, processes and services
- increasing their investment in R&D activities

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- promoting their technological advancement through a focus on innovation and high technical risk in R&D activities
- encouraging them to use strategic R&D planning, and
- creating an environment that is conducive to increased commercialisation of new processes and product technologies developed by them.

The objects clause goes on to state that ‘the benefits of the tax incentive are targeted by being limited to particular expenditure on certain defined activities.’

Objects clauses may be used by courts as an aid to interpretation but are not enforceable. This objects clause makes clear that the definition of ‘R&D activities’ is critical to the availability of the tax deduction, and that not all expenditure on R&D will be eligible for the concession. The *Explanatory Memorandum* explicitly states that the reason for the insertion of the objects clause is to limit the interpretation of the definition of ‘R&D activities’ given by the Administrative Appeals Tribunal and the Federal Court.³³

Changes to the definition of R&D activities

Schedule 1 makes a number of significant amendments to the definition of R&D activities. Currently, there are two categories of research and development activities. These are:

- *core activities*. These are ‘systematic, investigative or experimental activities’ that meet one criterion from each of the following pairs of criteria:
 - they involve either:
 - innovation (that is, an appreciable element of novelty) or
 - high levels of technical risk, and
 - they are carried on for the purpose of either:
 - acquiring new knowledge, regardless of whether it will have a specific practical application (this covers basic as well as applied research³⁴) or
 - creating new or improved materials, products, devices, processes or services (that is, experimental development), and
- *supporting activities*. These are activities carried on for a purpose directly related to the carrying on of core activities.

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R&D activities must meet both innovation and technical risk criteria

Item 3 of Schedule 1 amends the definition of ‘R&D activities’, with effect from 29 January 2001, the date of the announcement of *Backing Australia’s Ability*. As described above, currently ‘R&D activities’ must involve either innovation or high levels of technical risk. **Item 3** amends this, to require that such activities must henceforth meet *both* the innovation and high level of technical risk criteria.

This will mean that not all activities currently eligible for the R&D tax concession will continue to be eligible.

R&D activities must have an R&D plan

The Bill also inserts a new condition that all R&D activities commenced after 29 January 2001 must be carried on in accordance with an R&D plan (**new section 73B(2BA)** of the Tax Act 1936). The R&D plan must comply with guidelines set by the IR&D Board (**new section 39KA** of the IR&D Act).

The stated aim of this new requirement is to force companies to plan R&D activities before incurring expenditure. It is hoped that this ‘will be a useful tool for the successful management of R&D projects, providing focus and structure to R&D activities and thereby enhancing the likelihood of successful outcomes.’³⁵

Some R&D supporting activities excluded

Section 73B(2C) of the Tax Act 1936 currently lists a range of activities, including market research, prospecting for oil or minerals, quality control, management studies, patenting and licensing costs, which are excluded from the definition of ‘core’ R&D activities. **Item 8 of Schedule 1** extends that exclusion, so that such activities can no longer be considered to be ‘supporting activities’ which are incidental to core R&D. Thus, from 29 January 2001, no tax deduction will be able to be claimed in respect of such activities at all. The *Explanatory Memorandum* notes that this is because such activities are not directly related to R&D, but rather relate to post-R&D production and commercial activities such as sales.³⁶ This explanation fails to take into account that some activities, such as market research, are commonly not post-R&D activities.

Changes to R&D plant

Currently, expenditure on acquiring or constructing plant for exclusive use in carrying on R&D activities is deductible as ‘plant expenditure’. Plant expenditure is deductible over three years, and the 125 per cent tax concession applies if the company spent at least \$20 000 on R&D activities in the particular year. Otherwise, plant expenditure is deductible at 100 per cent.³⁷

Schedule 2 makes three principal amendments to the treatment of R&D plant in relation to the R&D tax concession.

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Removal of 'exclusive use' test from definition of 'R&D plant'

Item 1 of Schedule 2 amends the definition of 'plant expenditure' so that it must be used exclusively for R&D activities only 'at least for an initial period'. This amendment is retrospective from 1 July 1985, the date when the R&D tax concession first became available (**item 2**). It is not clear what will constitute an 'initial period'.

This means that plant which is bought or constructed initially for exclusive use for R&D, and later is used for other purposes, will remain tax deductible.

Pilot plant exempt from capital gains tax

As from 21 September 1999, pilot plant (that is, non-commercial experimental models of plant used in R&D) is retrospectively made exempt from the application of the capital gains tax provisions (**item 3 of Schedule 2**). Thus, any profit made on the sale or disposal of pilot plant after that time will not be subject to capital gains tax. This concession will not apply in 2001–2002 or later years and formalises existing arrangements.

125 per cent effective life tax write-off for R&D plant

Where construction was commenced or a contract for purchase or construction of R&D plant was entered into after 29 January 2001 (**item 7 of Schedule 2**), plant expenditure incurred after that time will be subject to an effective life write-off (**new sections 73BG and 73BN** of the Tax Act 1936).³⁸ Currently, plant expenditure is deductible over a three year period, which in most cases is shorter than the effective life of the plant, giving an accelerated rate of deduction.

The effective life of plant is the length of time for which it can be used for R&D, assuming reasonable wear and tear, and assuming it is maintained in good condition. The Commissioner of Taxation may make a determination specifying the effective life for a particular item of plant.

Although the period of time over which the tax deduction may be claimed has been extended, the rate of the deduction remains the same (**new sections 73BA and 73BH** of the Tax Act 1936). R&D plant expenditure will continue to be deductible at 125 per cent, provided a company's total expenditure on R&D in that year exceeds \$20 000. Otherwise, the rate of the deduction will be 100 per cent.

To be eligible for the deduction, a company must be the owner or quasi-owner of the plant.³⁹ The company must be registered with the IR&D Board, and must use the plant for R&D activities. Certain expenditure, including non-arms length expenditure and expenditure on activities not which do not meet the requirements of the IR&D Act, are excluded when either the Commissioner of Taxation or the IR&D Board so determines (**new sections 73BD and 73BK** of the Tax Act 1936). Special rules apply to determine the percentage contribution to R&D plant expenditure for each partner in a partnership (**new sections 73BE and 73BL** of the Tax Act 1936).

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R&D plant, unlike plant used for income-producing purposes, can include trading stock used for R&D, and capital works (with the exception of buildings) (**new sections 73BB and 73BI** of the Tax Act 1936). However, intangible assets are not included.

Special rules for balancing adjustments currently apply where R&D plant is disposed of, lost or destroyed. If the value at the time of disposal is less than the depreciated value of the R&D plant, the difference is claimable as a deduction. However, if the value at the time of disposal is more than the depreciated value of the R&D plant, the difference is taxable as income. These rules will continue to apply under the new provisions dealing with R&D plant (**new sections 73BF and 73BM** of the Tax Act 1936).

Automatic capital gains tax roll-over relief where R&D plant is transferred between eligible companies within the same wholly-owned company group will continue to apply under the new provisions (**new sections 73EA and 73EB** of the Tax Act 1936). The effect of this is that the disposal of R&D plant to another company within the same group does not incur a capital gains tax liability, and no balancing adjustment is required to be made. The company acquiring the R&D plant also inherits the previous owner's R&D deduction entitlements, and is taken to have incurred the plant expenditure actually incurred by the previous owner.

Refundable R&D tax offset for small companies

Schedule 3 of the Bill contains amendments which create a new tax rebate, known as the R&D tax offset. This is designed to assist small companies, especially those in tax loss, by giving them the cash equivalent of the R&D tax concession, thus increasing 'the cashflow of such companies when they most need it – during their initial growth phase'.⁴⁰

From the first year of income commencing after 30 June 2001 (**item 19 of Schedule 3**), certain companies will have the option to choose a tax offset rather than the R&D tax concession. Whereas the R&D tax concession operates to reduce a company's *taxable income* by 125 per cent of the value of the R&D expenditure, the R&D tax offset will reduce the amount of *income tax* payable by a company.⁴¹

An eligible company must elect between the R&D tax concession and the R&D tax offset at the time of submitting the annual tax return (**new subsection 73I(2)** of the Tax Act 1936).

A company is eligible for the R&D tax offset if it meets the following four criteria (**new section 73J** of the Tax Act 1936):

- it would be eligible for the R&D tax concession (including being registered with the IR&D Board)
- its total R&D expenditure exceeds \$20 000

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- the total R&D expenditure of the company and other companies or persons in the group is less than \$1 million, and
- the R&D turnover of the company and other companies or persons in the group is less than \$5 million.⁴²

However, a company will not be eligible for the R&D tax offset if a tax exempt entity or entities control at least 25 per cent of the voting power or 25 per cent of the right to distributions of income or capital (**new subsection 73J(2)** of the Tax Act 1936).

The amount of the tax offset is 30 per cent of the R&D concession that would otherwise be available (**new subsection 73I(3)** of the Tax Act 1936). Seeing as a company must spend at least \$20 000 on R&D in that year, the tax offset will be 30 per cent of the 125 per cent R&D tax concession. Its effective value is thus 37.5 per cent of the total expenditure on R&D.

The R&D tax offset is refundable to the extent that it exceeds the amount of income tax payable by a company or entity in a year (**item 13 of Schedule 3**).⁴³ This represents a significant advantage for companies which have invested heavily in R&D but either do not make a profit in any given year or are liable only for a small amount of income tax. The R&D tax concession is of no or reduced value to such companies:

Example: If a company makes a tax loss in a particular year, but incurs \$100,000 in R&D expenditure, it will be eligible to claim the tax offset. The amount of the cash rebate will be \$37,500.

Example: A company's taxable income is \$100,000. At the present rate of company tax of 30 per cent, the tax payable on \$100,000 would be \$30,000. Being in a growth and development phase, the company spent \$100,000 on R&D. The company is not able to take full advantage of the \$125,000 R&D tax concession, as its taxable income is only \$100,000. However, if the company claims the R&D tax offset, this results in a \$37,500 tax rebate. Seeing as the company's total tax liability is only \$30,000, the company would receive a cash refund of \$7,500.

New sections 73L and 73M of the Tax Act 1936 prescribe detailed tests, based on control, for determining when entities are in the same group. Simplistically, one company controls another if it has the right to receive more than 50 per cent of any distribution of capital or income, or has the right to exercise more than 50 per cent of the voting power in the other company. There are different rules for control of individuals companies and fixed trusts, non-fixed trusts, and partnerships. The stated aim of the grouping rules is to 'ensure that businesses that are part of a larger group do not gain access to the tax offset.'⁴⁴

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175 per cent premium R&D tax concession

Schedule 4 of the Bill introduces what the Government refers to as the ‘incremental tax incentive’. A 175 per cent premium tax concession will apply to certain R&D expenditure (**new section 73Y** of the Tax Act 1936) incurred in the first year of income starting after 30 June 2001 (**item 11 of Schedule 4**).

To be eligible for this premium rate, a company must have been eligible for the 125 per cent R&D tax concession for four years running - the current year and the three previous years (**new section 73Q** of the Tax Act 1936). This means the company must either have spent at least \$20 000 each of those four years on R&D, or have paid a registered research agency to do R&D on its behalf.⁴⁵ The company must also be registered with the IR&D Board in each of those four years to qualify.⁴⁶

Basically, a company is eligible for the 175 per cent R&D tax deduction (**new subsection 73Y(2)** of the Tax Act 1936) on that portion of its eligible R&D expenditure which exceeds the average expenditure on R&D over the last three years. This is called the ‘premium amount’ (**new section 73W** of the Tax Act 1936). The premium amount is reduced slightly if there have been reductions in R&D spending of greater than 20 per cent in any of the prior three years (**new sections 73T and 73V** of the Tax Act 1936).

The Government had initially announced its intention to base the formula for determining the increase in R&D on research intensity (basically, R&D spending as a proportion of total turnover). However, on 23 May 2001 the Government announced the premium would be calculated more simply, on the increase in R&D spending.⁴⁷ The change is estimated to cost the Government an extra \$80 million over the five year term of the program.

In calculating whether a company is eligible for the premium 175 per cent rate, not all expenditure is counted. Plant hire or purchase is excluded,⁴⁸ although these expenses are within the general definition of ‘R&D expenditure’ eligible for the 125 per cent concession.⁴⁹ Other items which are excluded from the definition of ‘R&D expenditure’ and hence are ineligible for the 125 per cent tax concession will also be ineligible for the 175 per cent premium. These include expenditure on core technology, interest, residual feedstock, and the acquisition or construction of plant or pilot plant:

Example: If a company spends \$200,000 on R&D in a given year, and its average spending over the previous three years was \$150,000, the company will receive the 125 per cent tax concession on the \$150,000, and a 175 per cent deduction for the additional \$50,000. This represents a total tax deduction of \$275,000, compared with \$250,000 at the current 125 per cent rate.

Companies who are eligible to claim the 175 per cent premium tax concession will be able to choose to take it as a tax offset rather than a tax deduction, if they meet the eligibility criteria for the tax offset described above.⁵⁰

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Mandatory grouping rules apply to the 175 per cent premium tax concession. This means that the R&D expenditure of a company will be considered together with that of all other companies or entities grouped with it. Whether entities belong to the same group is determined using the control tests set out in **new section 73L** of the Tax Act 1936. The grouping rules are complex, and include other companies that are grouped with one company in the group but are not part of the primary group, known as ‘secondary group members’ (**new section 73R** of the Tax Act 1936). There are also special rules for determining when a company entered or exited from a group. Where a group of companies has engaged in R&D spending, the premium amount is divided between group members in proportion to their contribution to R&D expenditure (**new section 73X** of the Tax Act 1936).

New section 73Z of the Tax Act 1936 introduces an anti-avoidance measure designed to prevent companies from adjusting the amount of R&D expenditure in prior years downwards, so as to increase the difference between their R&D expenditure history and their expenditure in the current year. Where the Commissioner of Taxation considers that the purpose of amending prior year R&D expenditure downwards is to increase the amount eligible for the 175 per cent premium tax concession, he or she may disregard the amendment in working out the company’s expenditure which is eligible for the 175 per cent rate.

Items 1 to 4 of Schedule 4 also amend the clawback provision in section 73C of the Tax Act 1936. The section currently provides for clawback where a company claims a tax deduction for R&D expenditure, but later becomes entitled to a refund or grant covering some or all of that expenditure, to ensure no doubling up of benefits. The amendments provide that where one company in a group claims a tax deduction for R&D expenditure, and another company in the group receives a grant or refund in relation to that expenditure, for clawback purposes the grant or refund is taken to have been received by the company which claimed the tax deduction.

Errors

There are two typographical errors in the Bill that have not been corrected in the amendments tabled in the House of Representatives on 8 August 2001:

- the references in **new subsections 73H(1) and (2)** of the Tax Act 1936 to section ‘72L’ should instead be to section ‘73L’ (**item 5 of Schedule 3**), and
- **item 2 of Schedule 4** should amend ‘paragraph 73C(3)(b)’ of the Tax Act 1936, not ‘paragraph 73(3)(b)’.

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Concluding Comments

Business and industry groups and the research community have generally welcomed the package of funding measures announced in *Backing Australia's Ability*, saying that it represented an important step towards encouraging innovation and research. Concerns have, however, been expressed about the changes to the R&D tax concession. Specific aspects of this are discussed below.

Changes to the definition of R&D activities

The changes to the definition of 'R&D activities' have been introduced because the IR&D Board is concerned that a small number of claims for the R&D tax concession involve normal commercial activities rather than R&D. The Government considers that requiring activities to meet both the innovation and high degree of technical risk criteria should remove these marginal claims.⁵¹

John Schubert, president of the Business Council of Australia, considers the proposed changes to the eligibility criteria, together with the changes to the depreciation schedule for R&D plant, will make the 125 per cent concession less attractive to business. Steve Batrouney, from Arthur Andersen, agrees that it will be more difficult for companies to access the 125 per cent R&D concession, as most firms have traditionally relied on the criterion of high technical risk rather than innovation. Now, they will be forced to meet both criteria, and hence to be able to explain the innovative nature of what they are proposing by differentiating their research from what others in the same industry are doing.⁵² In addition, they will have to develop an R&D plan, which will add to the administrative burden of qualifying for the R&D tax concession, regardless of the level of expenditure by a business on R&D.

Although the budget statement does not quantify the estimated savings from the tightening of the definition, some experts claim 'it will greatly restrict tax-deduction claims and in some cases make it difficult to qualify at all. One said it would 'decimate' the concession but it is hard to know by how much.'⁵³ However, the Government claims that 'the vast majority of claims will not be affected by this change'.⁵⁴

Changes to R&D plant

The change to effective life write-off for R&D plant, rather than an accelerated three year write-off, effectively slows the rate of deductability for expenditure on R&D plant. This alteration is consistent with the recommendations of the *Ralph Review of Business Taxation*, and has already been implemented, in respect of plant not used for R&D, in the *New Business Tax System (Capital Allowances) Act 2001*, which commenced on 30 June 2001.

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The executive director of the Corporate Tax Association, Frank Drenth, has criticised the proposal to offset profits from successful plant trials which lead to profitable production against eligibility for the 125 per cent tax concession, saying: ‘it makes it awfully difficult to get any benefit from R&D plant now. Why should you be penalised because you were successful?’ Jamie Munday, a partner at Deloitte Touche Tohmatsu, agrees that the change would reduce the incentive for companies in industries such as manufacturing or mining to experiment with the development of new production processes.⁵⁵

175 per cent premium R&D tax concession

Industry groups generally welcomed the introduction of the 175 per cent premium tax concession. The Government’s decision to change the eligibility requirements from a formula based on R&D as a percentage of turnover, to a formula based on an increase in the amount of R&D expenditure over a three year period was also hailed. The former scheme was considered to reward failed companies, not those who are commercially successful.⁵⁶

Tax experts at KPMG and Deloitte Touche Tohmatsu said the premium rate had the potential to provide incentives for some companies to increase their expenditure on R&D at the right time in their product development cycles. It also may entice overseas companies to base more R&D in Australia.⁵⁷

Problems were nevertheless identified with some specific aspects of the proposal. Rob Durie, executive director of the Australian Information Industry Association, said that the requirement for companies to have a three year claim history of previous R&D expenditure would still prevent start-up companies from accessing the concession, as they would not have been in existence for that length of time.⁵⁸ Heather Ridout also described the continuance of the three-year rule as ‘regrettable’.⁵⁹

Another issue is that the three year average means that each increase in R&D raises the base average for the following year. This means that, to continue to be eligible in subsequent years, a company must continually increase its R&D expenditure compared to previous years. Some commentators doubt whether companies can keep increasing R&D expenditure every year, suggesting that a more sustainable policy would be to encourage companies to maintain a reasonable level of R&D spending over the long term.⁶⁰

Finally, the 175 per cent premium concession rate only applies to labour components of R&D spending, which will advantage labour-intensive R&D activities but disadvantage researchers involved in developing prototypes or machinery.⁶¹

Position of other political parties

The leader of the Opposition, Kim Beazley, claimed the Howard Government was merely ‘playing catch-up’ by restoring some of the research funding slashed in the 1996 budget.⁶²

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In its *Knowledge Nation* platform, the Australian Labor Party has committed itself to doubling Australia's overall R&D as a percentage of GDP by 2010, bringing Australia to the top of the OECD tables (recommendation 3).⁶³ It has not yet nominated any specific methods of achieving this, although tax changes and financial incentives for commercialisation, along with measures targeted at specific industries, are part of Labor's preliminary thinking on the issue (recommendations 3 and 4).⁶⁴

The Australian Democrats share the concern to do more to foster R&D, particularly business investment in R&D. Specifically, they propose the restoration of the 150 per cent tax deduction for business R&D, but with the scheme tightened against tax avoidance abuse. They also wish to promote the commercialisation of, and business involvement in, Government supported R&D programs.⁶⁵

Conclusion

In contrast to the disappointment expressed by the business community, one commentator considers the tightening of the controls on the R&D tax concession a welcome restraint, and even stated that the 'new two-step tax concession for business R&D is too generous' and that 'governments should be very cautious about trying to boost the level of private R&D.'⁶⁶

Despite enthusiasm for the innovation package generally, business groups have expressed disappointment with the proposed tax concessions, saying that the promised tax breaks are largely negated by the amendments which tighten the definitions and eligibility requirements. This is seen to reduce the incentive for investment in innovation and research, and to 'be building more speed bumps for investment'.⁶⁷ One extremely critical appraisal summed it up thus:⁶⁸

Reduced benefits and unworkable eligibility rules now stand in stark contrast to the Government's grandstanding about its desire for businesses to embark on R&D to improve our products and industries. ... Instead of making the R&D tax concession more available to companies, brick walls rather than hurdles have been placed in front of them, which is likely to result in R&D expenditure coming to a dead halt for many companies.

While most commentators from business and industry would not go as far this, it is clear that the touted benefits are not as great as they may first seem.⁶⁹ The 175 per cent premium tax incentives for R&D is estimated to cost \$540 million over five years, and the tax offset for small companies is estimated to cost \$13 million over five years. However, \$415 million of this will be offset by planned clawbacks through changes to the depreciation schedule for R&D plant.⁷⁰ There may be further savings from changes to the eligibility rules for R&D activities, requiring R&D expenditure to be both innovative and of high technical risk. Hence, the net benefit to business will be just \$138 million over the five-year life of the package, which translates to just \$27.6 million per year.

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Industry groups, while supportive of the broad thrust of the measures contained in the package, are not confident it will be enough to reverse the continuing decline in R&D expenditure by business. John Schubert, president of the Business Council of Australia, states:⁷¹

The government should be congratulated for its response, which has picked up many of the key requirements of a national innovation strategy. More resources and further initiatives will be required over time, especially in relation to commercialisation of research, if the innovation strategy is going to have the impact required to transform the economy.

Heather Ridout, policy director of the Australian Industry Group, agrees that although the innovation package would greatly enhance science, education and the development of knowledge-based industries, the changes to tax concessions 'may not be substantial enough or structured well enough to reverse the decline in R&D spending by business'.⁷²

Professor Alan Trounson, a Monash University researcher in the area of embryonic cells, which contain the promise of eventually providing treatments for conditions such as Parkinson's disease and diabetes, emphasises the need to invest in research and its commercialisation to prevent it from moving overseas. He queries whether the innovation package 'will be sufficient, given the massive investment being made by other countries'.⁷³

Business groups emphasise the need for further measures to effectively encourage innovation and the commercialisation of research. They continue to call for a return to a tax concession of 150 per cent, as a minimum, saying the current 125 per cent rate is too low to encourage R&D to the extent required.⁷⁴ It has been noted that with the reduction in the company tax rate from 34 per cent to 30 per cent, the tax concession needs to be raised to 130 per cent just to maintain the current 9 cents in the dollar value of the concession.⁷⁵ It has also been suggested that measures such as tapering capital gains tax rates or tailored R&D incentives are required to attract investment in new industries, and provide incentives for large overseas companies to locate R&D projects in Australia rather than other countries.⁷⁶

Endnotes

- 1 See *Australian Tax Practice, Commentary*, Volume 4 at [73B/1].
- 2 See *Australian Tax Practice, Commentary*, Volume 4 at [73B/1].
- 3 See Chris Field, *Bills Digest* on the Taxation Laws Amendment Bill (No 3) 1996, Digest No 59 of 1996/97.
- 4 The Start program has five separate components – R&D Start-Core, R&D Start-Plus, R&D Start-Premium, R&D Start-Graduate and R&D Start-Concessional Loans. R&D Start-Core

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provides grants for R&D projects of up to 50% of eligible project costs for companies with an annual turnover of less than \$50 million in each of the previous three years. R&D Start-Plus provides grants for R&D projects of up to 20% of eligible project costs for companies with an annual turnover of \$50 million or more. R&D Start-Premium provides a repayable component which ‘tops up’ either a Start-Core or a Start-Plus R&D grant to a maximum of 56.25% of eligible projects costs. R&D Start-Graduate provides grants to companies with an annual turnover of less than \$50 million in each of the previous three years to engage a graduate on a R&D related project that is undertaken in collaboration with a research institution. R&D Start-Concessional Loans provides assistance of up to 50% of eligible project costs for companies/groups with fewer than 100 employees for the early commercialisation of technological innovation of goods, systems or services. See Ausindustry, *R&D Start Program Fact Sheet*, <http://www.ausindustry.gov.au/documents/dir39/doc536739.pdf> (accessed 31 July 2001).

- 5 See *Backing Australia’s Ability: Continuation of the R&D Start Program* <http://www.isr.gov.au/iap/policy%5Flaunch/templates/facta10.doc> (accessed 13 August 2001); and *Backing Australia’s Ability: An Innovation Action Plan for the Future*, January 2001, http://www.innovation.gov.au/iap/Policy_Launch/index.html (accessed 2 August 2001).
- 6 The program offers assistance under two streams. Tailored Assistance for Commercialisation provides individually tailored assistance from a Business Adviser developed to meet a client’s specific needs with regard to commercialisation of innovative products, processes or services. Usually this involves development of sound management team, business plan, market research and intellectual property protection required to successfully commercialise an innovation. Management Skills Development provides financial assistance for individuals and companies to undertake an existing program of management development which will enable them to increase their capacity for innovation and commercialisation. For more information see the Ausindustry *Commercialising Emerging Technologies (COMET) Fact Sheet*, <http://www.ausindustry.gov.au/documents/dir13/doc505813.doc> (accessed 2 August 2001).
- 7 *Backing Australia’s Ability: An Innovation Action Plan for the Future*, January 2001, http://www.innovation.gov.au/iap/Policy_Launch/index.html (accessed 2 August 2001).
- 8 See Report by the House of Representatives Standing Committee on Industry, Science and Resources, *The Effect of Certain Public Policy Changes on Australia’s R&D*, August 1999, pp. 22–24; ‘Business R&D continues to fall – ABS survey’, *Media Release*, 4 June 1999.
- 9 Australian Bureau of Statistics, *Research and Development, Businesses Australia 1999-2000*, 11 July 2001 (8104.0).
- 10 See also Simon Grose, ‘Figures show spending on research may be creeping upwards after steady falls’ *Canberra Times*, 14 July 2001, Greg Baker and Mike Emmery, *The Performance Record of Australian Manufacturing*, Research Paper, No. 22 of 1999/2000, 6 June 2000.
- 11 Cited in Report by the House of Representatives Standing Committee on Industry, Science and Resources, *The Effect of Certain Public Policy Changes on Australia’s R&D*, August 1999, pp. 94–97.
- 12 Greg Baker and Mike Emmery, *The Performance Record of Australian Manufacturing*, Research Paper, No 22 of 1999/2000, 6 June 2000.

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- 13 James Kirby, 'Lights go out in research labs', *Business Review Weekly*, 13 July 1998.
- 14 Report by the House of Representatives Standing Committee on Industry, Science and Resources, *The Effect of Certain Public Policy Changes on Australia's R&D*, August 1999, p. 96.
- 15 Australian Bureau of Statistics, *Research and Development, Businesses Australia 1999-2000*, 11 July 2001 (8104.0), p. 5. See also Simon Grose, 'Figures show spending on research may be creeping upwards after steady falls' *Canberra Times*, 14 July 2001.
- 16 *Science and Technology Budget Statement 2000–01*, Table 3, p. 89. The statement may be found at <http://www.isr.gov.au/science/analysis/Budget2000/statement.pdf> (accessed 15 August 2001).
- 17 Report by the House of Representatives Standing Committee on Industry, Science and Resources, *The Effect of Certain Public Policy Changes on Australia's R&D*, August 1999, p. 24.
- 18 Report by the House of Representatives Standing Committee on Industry, Science and Resources, *The Effect of Certain Public Policy Changes on Australia's R&D*, August 1999, p. 98.
- 19 It can be found at <http://www.isr.gov.au/industry/summit/isigreport.pdf> (accessed 2 August 2001).
- 20 Final Report of the Innovation Summit Implementation Group, *Innovation – Unlocking the Future*, August 2000, p. xiii.
- 21 Final Report of the Innovation Summit Implementation Group, *Innovation – Unlocking the Future*, August 2000, p. 14.
- 22 *Ibid.*, p. 14.
- 23 Recent measures the Government has taken to encourage venture capital include the Innovation Investment Fund program, the Pooled Development Fund program, targeted capital gains tax relief, the collective investment vehicles regime, and scrip for scrip rollover relief. For more information see Final Report of the Chief Scientist, Dr Robin Batterham, *The Chance to Change*, November 2000, p. 83.
- 24 Final Report of the Chief Scientist, Dr Robin Batterham, *The Chance to Change*, November 2000, p. 86–87. <http://www.innovation.gov.au/science/review/ChanceFinal.pdf> (accessed 2 August 2001).
- 25 These include: money to foster scientific, mathematical and technological skills and innovation in government schools, funding 2000 additional university places each year, with priority given to information and communications technology, mathematics and science, doubling the funding available for Australian Research Council competitive grants, boosting research infrastructure funding, a commitment to funding for world class centres of excellence in information and communications technologies and biotechnology, and support for investments in major national research facilities.

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- 26 *Backing Australia's Ability: An Innovation Action Plan for the Future*, January 2001, http://www.innovation.gov.au/iap/Policy_Launch/index.html (accessed 2 August 2001).
- 27 Report by the House of Representatives Standing Committee on Industry, Science and Resources, *The Effect of Certain Public Policy Changes on Australia's R&D*, August 1999, p. 101.
- 28 *Backing Australia's Ability: An Innovation Action Plan for the Future*, January 2001.
- 29 Section 39J of the IR&D Act.
- 30 A certificate is issued to the Commissioner of Taxation under section 39M of the IR&D Act.
- 31 Subsection 73B(3A) of the Tax Act 1936 sets out when a partnership is eligible.
- 32 Section 39EB of the IR&D Act sets out the guidelines relating to expenditure on overseas R&D activities. Section 39EB(3)(c) further provides that expenditure incurred in respect of the overseas component of R&D activities must not exceed 10 per cent of the total expenditure that the company has incurred or proposes to incur on the project of R&D activities.
- 33 *Explanatory Memorandum*, p. 6.
- 34 *Basic research* is experimental or theoretical work undertaken primarily to acquire new knowledge of the underlying foundations of phenomena, and observable facts, without any particular application or use in view. *Applied research* is work undertaken for the advancement of knowledge with a specific practical application in view. It involves consideration of the available knowledge and its extension in order to solve particular problems, and to develop ideas into operational form.
- 35 Department of Industry, Science and Resources, *Backing Australia's Ability* Fact Sheet, *Questions and Answers – The definition of R&D activities*, http://www.innovation.gov.au/iap/policy_launch/templates/definition.doc?Ois=y;template=inntem.html (accessed 3 August 2001).
- 36 *Explanatory Memorandum*, p. 7.
- 37 See subsection 73B(15) of the Tax Act 1936.
- 38 There are two section references for each measure relating to the effective life write-off for R&D plant, because there are two sets of amendments. Transitional amendments apply for the period from 29 January 2001 to 30 June 2001. Their treatment of R&D plant expenditure is based on Division 42 of the *Income Tax Assessment Act 1997* (Tax Act 1997). Division 42 was repealed on 30 June 2001 by the *New Business Tax System (Capital Allowances) Act 2001*, and its provisions incorporated into the new Division 40 of the Tax Act 1997. Accordingly, the provisions dealing with R&D plant expenditure after 30 June 2001 are based on the provisions of Division 40. The two sets of amendments generally parallel each other.
39. **New sections 73BC and 73BJ** of the Tax Act 1936 refer to sections 40-25 and 42-15 of the Tax Act 1997 respectively, which require a person to be the owner or quasi-owner of plant to claim a deduction.

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- 40 The Hon. Warren Entsch, MP, second reading speech on the Taxation Laws Amendment (Research and Development) Bill 2001, House of Representatives, *Hansard*, 27 June 2001, p. 28647.
- 41 See the definition of 'tax offset' in section 4-10 of the Tax Act 1997.
- 42 'R&D group turnover' is defined in **new section 73K**. It includes the turnover of other companies or entities in the group. It also includes gambling supplies, but excludes insurance payouts under an insurance policy and loan repayments.
- 43 See sections 67-30 and 67-35 of the Tax Act 1997.
- 44 *Explanatory Memorandum*, p. 24.
- 45 See subsections 73B(13) and (14) of the Tax Act 1936. A company also becomes eligible for the 125 per cent tax concession where it has paid money to the Coal Research Trust Account, which then funds the performance of R&D for the company. Unlike R&D conducted by the company itself, no \$20 000 threshold applies to payments to a research agency or the Coal Research Trust Account.
- 46 Subsection 73B(10) of the Tax Act 1936.
- 47 Department of Industry, Science and Resources, *Backing Australia's Ability* Fact Sheet, *Questions and Answers – The 175% Premium R&D Tax Concession*, http://www.innovation.gov.au/iap/policy_launch/templates/premium.doc?Ois=y;template=innem.html (accessed 3 August 2001).
- 48 See the definition of 'incremental expenditure' in **new section 73P**.
- 49 Subsection 73B(1) of the Tax Act 1936.
- 50 See Department of Industry, Science and Resources, *Backing Australia's Ability* Fact Sheet, *Additional Questions and Answers – The 175% Premium R&D Tax Concession*.
- 51 Department of Industry, Science and Resources, *Backing Australia's Ability* Fact Sheet, *Questions and Answers – The definition of R&D activities*.
- 52 Tom Skotnicki, 'A little help, a little hindrance', *Business Review Weekly*, 2 February 2001
- 53 'R&D scheme heads for failure', *Financial Review*, 3 February 2001.
- 54 Department of Industry, Science and Resources, *Backing Australia's Ability* Fact Sheet, *Questions and Answers – The definition of R&D activities*.
- 55 Allesandra Fabro, 'Bill's fine print reveals erosion of R&D concession', *Financial Review*, 3 August 2001.
- 56 See 'R&D scheme heads for failure', *Financial Review*, 3 February 2001.
- 57 John Rouw, 'Doubts on research tax breaks', *The Age*, 30 January 2001.
- 58 Selina Mitchell and Stephen Brook, 'Start-ups won't benefit', *The Australian*, 29 May 2001.
- 59 Selina Mitchell and Stephen Brook, 'Start-ups won't benefit', *The Australian*, 29 May 2001.
- 60 'R&D scheme heads for failure', *Financial Review*, 3 February 2001.

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- 61 Mike Bannon, 'Deduction for crucial R&D wound back another notch', *Canberra Times*, 25 March 2001.
- 62 Reported in Louise Dodson and Tim Colebatch, 'Unis hail research boost', *The Age*, 30 January 2001.
63. The Hon Kim Beazley, MP, *Opening Remarks at the Acceptance of the Report of the Knowledge Nation Taskforce*, 2 July 2001.
- 64 Knowledge Nation, http://www.alp.org.au/kn/kn_recs_020701.html (accessed 14 August 2001).
- 65 Australian Democrats, Issue Sheet '98, *Trade and Industry: Research and Development*, <http://www.democrats.org.au/issue/tiresearch.htm> (accessed 14 August 2001).
- 66 Alan Mitchell, 'Howard's innovation pitch: The initiative seems money well spent', *Financial Review*, 30 January 2001.
- 67 Tom Skotnicki, 'A little help, a little hindrance', *Business Review Weekly*, 2 February 2001.
- 68 Mike Bannon, 'Deduction for crucial R&D wound back another notch', *Canberra Times*, 25 March 2001.
- 69 See Louise Dodson and Tim Colebatch, 'Unis hail research boost', *The Age*, 30 January 2001, Tom Skotnicki, 'A little help, a little hindrance', *Business Review Weekly*, 2 February 2001, John Rouw, 'Doubts on research tax breaks', *The Age*, 30 January 2001, 'R&D scheme heads for failure', *Financial Review*, 3 February 2001.
- 70 *Explanatory Memorandum*, p. 48.
- 71 'Innovation package good step but tax problems: BCA', *I.T.*, 29 January 2001
- 72 Reported in Louise Dodson and Tim Colebatch, 'Unis hail research boost', *The Age*, 30 January 2001.
- 73 Tom Skotnicki, 'A little help, a little hindrance', *Business Review Weekly*, 2 February 2001
- 74 Selina Mitchell and Stephen Brook, 'Start-ups won't benefit', *The Australian*, 29 May 2001.
- 75 Mike Bannon, 'Deduction for crucial R&D wound back another notch', *Canberra Times*, 25 March 2001.
- 76 Ken Baldwin, 'More bucks for our technological bang', *The Australian*, 31 January 2001.

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