



Tax Laws Amendment (Research and Development) Bill 2010

John Murray
Law and Bills Digest Section

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Tax Laws Amendment (Research and Development) Bill 2010

Date introduced: 13 May 2010

House: House of Representatives

Portfolio: Treasury

Commencement: Sections 1 to 3 and anything in this Act not elsewhere covered commence on Royal Assent. Schedules 1, 2, 4 and Parts 1 to 4 and Part 6 of Schedule 3 commence on Royal Assent. Part 5, Division 1 of Schedule 3 commences on the later of the start of the day of Royal Assent or the commencement of Schedule 2 to the *Tax Laws Amendment (Transfer of Provisions) Act 2010*, or not at all if that Act is not passed.¹ Part 5, Division 2 of Schedule 3 commences on Royal Assent, or not at all if the *Tax Laws Amendment (Transfer of Provisions) Act* is not passed.

Links: The [links](#) to the Bill, its Explanatory Memorandum and second reading speech can be found on the Bills page, which is at <http://www.aph.gov.au/bills/>. When Bills have been passed they can be found at ComLaw, which is at <http://www.comlaw.gov.au/>.

Purpose

The Tax Laws Amendment (Research and Development) Bill 2010 (the Bill) proposes to establish the framework for a new research and development (R&D) tax incentive in the *Income Tax Assessment Act 1997* (ITAA 1997) and to repeal the provisions of the existing incentive currently contained in the *Income Tax Assessment Act 1936* (ITAA 1936).²

Background

Outline of the existing and proposed R&D tax measures

The following sections provide a general outline of the existing and proposed R&D tax measures and include a worked example of how the two would operate in relation to a particular circumstance.

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1. The Bill for the *Tax Laws Amendment (Transfer of Provisions) Act 2010* passed the House of Representatives on 13 May 2010 but is yet to be debated in the Senate. It is likely to commence on 1 July 2010.
 2. The Bill and a supporting Bill (the *Income Tax Rates (Research and Development) Bill 2010*) also make consequential amendments to the *Income Tax (Transitional Provisions) Act 1997*, the *Income Tax Rates Act 1986*, the *Taxation Administration Act 1953* and the *Industry Research and Development Act 1986*.

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More detail on the major definitional and policy differences between the two measures are discussed in the ‘key issues’ section of this Digest.

The existing R&D tax concession (the “existing incentive”)

The existing incentive consists of four elements:

- the basic 125 per cent tax concession
- the 175 per cent premium concession³
- the 175 per cent international premium concession⁴, and
- the refundable R&D tax offset for small companies.

The concession elements of the existing incentive are enhanced tax deductions which reduce the taxpayer’s taxable income by increasing⁵ the amount it can claim as a deduction for R&D expenditure.⁶ Companies with a turnover of less than \$5 million⁷ can claim a refundable R&D tax offset instead of a deduction.

The existing incentive has undergone several changes since its introduction in 1986.⁸

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3. The 175 per cent premium concession allows an entity to claim R&D expenditure at 175% (instead of the usual 100%) for certain labour-related expenditure over and above the entity’s average expenditure over the previous three tax years.
 4. The 175 per cent international premium concession applies to qualifying R&D expenditure where relevant intellectual property is held off shore.
 5. By 25 per cent or 75 per cent depending on circumstances.
 6. ITAA 1936 section 73BA.
 7. ITAA 1936 section 73K.
 8. For further information on the legislative history and details of the existing incentive, see:

K Del Villar, *Taxation Laws Amendment (Research and Development) Bill 2001*, Bills digest, no. 44, 2001–2002, Parliamentary Library, Canberra, 2001, viewed 7 June 2010, <http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=Id%3A%22legislation%2Fbillsdgs%2FKOW46%22> and

L Nielson, *Tax Laws Amendment (2007 Measures No.5) Bill 2007*, Bills digest, no. 42, 2007–2008, Parliamentary Library, Canberra, 2007, viewed 7 June 2010,

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The term ‘*research and development activities*’ is defined broadly in the ITAA 1936, the threshold requirement being that eligible activities involve either innovation *or* high levels of technical risk.⁹

Around 8000 businesses are currently registered for the existing incentive.¹⁰

The cost of the current incentive for the current financial year has been estimated to be around \$1.5 billion.¹¹

The proposed new R&D tax incentive (‘the proposed new incentive’)

The proposed new incentive is included as part of a suite of measures designed to stimulate productivity growth and innovation.¹² The objects clause of the Bill refers to encouraging R&D activities that might not otherwise be conducted but where the knowledge gained is ‘likely to benefit the wider Australian economy.’¹³ This is known generally as ‘spillover’, although the term is not used in the Bill or the Explanatory Memorandum.

The proposed new incentive replaces the existing incentive, and comprises two main components:

- a 45 per cent refundable tax credit for eligible entities with a turnover of less than \$20 million, and
- a 40 per cent non-refundable tax credit for all other eligible entities.

<http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=Id%3A%22legislation%2Fbillsdgs%2FED8O6%22>

9. Subsection 73B(1) of the ITAA Act 1936. The objects provision in subsection 73B(1AAA) of the ITAA 1936 is also broader than the object clause in the Bill.
10. Innovation Australia, ‘R&D Tax Credit Fact Sheet’, website, 30 April 2010, viewed 3 June 2010,
<http://www.innovation.gov.au/Section/AboutDIISR/FactSheets/Pages/RDTaxCreditFactSheet.aspx>
11. See discussion in the *Financial Impacts* section of this Digest.
12. The new measures are also intended to complement the Government’s \$196.1 million investment in a new Commonwealth Commercialisation Institute.
13. **Proposed subdivision 355-5** of the ITAA 1997

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The incentive is available for expenditure on eligible research activities or for the decline in value of depreciating assets used for eligible research activities.¹⁴

The 45 per cent refundable tax credit is equivalent to a 150 per cent tax deduction, and doubles the current base incentive for smaller entities to expend money on R&D. Because the 45 per cent credit is refundable, eligible entities can access the incentive as a cash refund when submitting their tax returns. The Government anticipates that 5500 small firms could benefit from the incentive.¹⁵

The 40 per cent non-refundable tax credit is equivalent to a 133 per cent tax deduction, and raises the current base incentive for larger entities by one third.¹⁶ The incentive is also open to international entities which hold relevant intellectual property offshore.

Whereas the value of the existing incentive is determined by multiplying the value of the concession by the company income tax rate, the proposed new incentive is decoupled from the company income tax rate due to its offering a tax offset calculated by reference to the value of the qualifying expenditure.

The proposed new incentive distinguishes between ‘core’ and ‘supporting’ R&D. Eligible expenditure under both categories qualifies for a tax credit under the proposed new incentive. The Bill sets out several definitions and tests (mostly distinct from those in the existing concession) to determine whether a given activity qualifies for the incentive. The purpose of these tests is to ensure that the incentive is directed towards scientific research and away from such activities as industrial development with an element of novelty.

The proposed new incentive is intended to stimulate more companies, particularly smaller companies (sometimes described as small to medium enterprises or SMEs), to undertake R&D activities.

The proposed new incentive applied and compared with the existing incentive

The Explanatory Memorandum contains a series of worked examples illustrating how aspects of the proposed new incentive would operate.

14. **Proposed section 355-100** of the ITAA 1997.

15. W Swan (Treasurer) and K Carr (Minister for Innovation, Industry, Science and Research), *R&D tax credit to boost business investment*, joint media release, 12 May 2009, viewed 7 June 2010, <http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=Id%3A%22media%2Fpressrel%2F3OJT6%22>

16. **Proposed section 355-100** of the ITAA 1997.

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In example 1.1¹⁷, Green Light manufactures outdoor lighting and has a turnover of \$5m, which qualifies it for the 45 per cent refundable tax offset under the proposed new incentive. In a given tax year, Green Light incurs \$1m of eligible expenditure.

Under the existing incentive as per the worked example, Green Light could claim a refundable tax offset of \$375 000:

Grossed-up value of offset for eligible expenditure (standard full deduction plus 25 per cent base offset)	\$1 250 000
Reduction in tax liability (at 30 per cent tax rate)	\$ 375 000
Advantage	\$ 375 000

By comparison, under the proposed new incentive Green Light would receive a refundable tax offset of \$450 000:

Value of eligible expenditure	\$1 000 000
Multiplied by the value of the credit (45 per cent)	\$ 450 000
Advantage (as credit or cash refund)	\$ 450 000

This example also illustrates how the proposed new incentive is decoupled from the corporate tax rate. Whilst a reduction in the corporate tax rate would reduce the amount of assistance under the existing incentive, the amount of assistance under the proposed new incentive would remain static.

The development of the new R&D measure and the Bill

The 2007 Productivity Commission Inquiry

On 9 March 2007, the Productivity Commission released its research report, *Public Support for Science and Innovation* (the Productivity Commission report).¹⁸ In relation to the existing incentive, the key findings of the Productivity Commission report were that the criteria for the basic 125 per cent tax concession do not screen out R&D which would have happened anyway, that the benefits of the existing incentive are not large and could in fact be negative,¹⁹ and that the net payoff from the concession could be substantially improved by maintaining the access to the concession for small entities only.²⁰

17. Adapted from Explanatory Memorandum, op. cit., paragraph 1.36.

18. Productivity Commission, 'Public Support for Science and Innovation', Research Report, 2007, viewed 3 June 2010, <http://www.pc.gov.au/projects/study/science/docs/finalreport>

19. Ibid., p. xxvii.

20. Ibid.

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The Productivity Commission report recommended several changes to the design of the then existing incentive including:

- restricting access to the basic 125 per cent R&D tax concession to small entities (finding 10.5)
- maintaining the 175 per cent premium R&D tax concession for both small and large entities (finding 10.6), and
- narrowing the criteria for eligible R&D requiring that eligible activity be both highly innovative *and* involve high levels of technical risk, in line with the *Frascati Manual*²¹ rather than the criteria in the existing incentive that eligible R&D be either innovative *or* highly risky.

The Productivity Commission acknowledged that restricting the scope of the concession would increase administrative and compliance costs, and that unforeseen consequences would likely arise.²²

The 2008 Review of the National Innovation System ('the Cutler review')

On 22 January 2008, Senator Kim Carr announced a review of Australia's national innovation system, to be conducted by an expert panel chaired by Dr Terry Cutler. The report of the review, *Venturous Australia - building strength in innovation*, was released on 29 August 2008.²³ Relevant findings of the Cutler review were:

- that the existing incentive should be changed from a tax deduction to a tax credit (recommendation 8.2)
- that a 40 per cent tax credit should be available to large entities and a refundable 50 per cent tax credit should be available to smaller entities with an annual turnover of under \$50 million (recommendation 8.3)

21. The *Frascati Manual* contains internationally accepted standards for surveys on research and experimental development. The *Frascati* definition of R&D comprises *basic research*, *applied research*, and *experimental development*, the key criterion being an 'appreciable element of novelty' and 'the resolution of scientific and/or technical uncertainty, *i.e.* when the solution to a problem is not readily apparent to someone familiar with the basic stock of common knowledge and techniques for the area concerned'. OECD, *Frascati Manual*, sixth edition, Paris, 2002, pp. 30 and 34.

22. Productivity Commission, *op. cit.*, p. 385

23. Cutler and Company, *Venturous Australia - building strength in innovation*, Melbourne, 2008, viewed 3 June 2010, http://www.innovation.gov.au/innovationreview/Documents/NIS_review_Web3.pdf

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- that all R&D undertaken in Australia which meets the relevant definitions be eligible for the tax credit (recommendation 8.4), and
- that R&D expenditure undertaken in Australia by foreign owned entities be eligible for the 40 per cent tax credit (recommendation 8.6)

Powering Ideas: the Government's response to the Cutler review (2009)

Released on 12 May 2009, *Powering Ideas: An Innovation Agenda for the 21st Century* (Powering Ideas)²⁴ is the Government's response to the Cutler review. It contains the Rudd Government's long-term innovation policy agenda. The Government accepted the tenor of the findings of the Cutler review and announced the proposed new incentive and the repeal of the existing incentive. The proposed new incentive was included as a measure in the 2010–11 Budget.²⁵ In announcing its response, Senator Carr stated that:

.... the new R&D Tax Credit will better reflect the financial realities facing many businesses during the global recession. It will help ensure that Australian businesses are well placed to take full advantage of generous incentives to innovate during the global recovery.

.....

Under the new Tax Credit system, eligibility criteria will be tightened to make sure that our investment is getting the best results – supporting only genuine R&D. This will provide offsetting savings to fund improvements to the system.²⁶

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24. Australian Government, *Powering ideas: An innovation agenda for the 21st Century*, Canberra, 2009, p 46, viewed 3 June 2010, http://www.innovation.gov.au/innovationreview/documents/poweringideas_fullreport.pdf
25. Australian Government, *Budget measures: budget paper no.2: 2009-2010*, Commonwealth of Australia, Canberra, 2010, viewed 3 June 2010, http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=Id%3A%22library%2Fbudget%2F2009_15%22.

As an interim measure designed to attenuate the financial effects of the proposed new incentive on smaller entities, on 10 September 2009 Senator Kim Carr announced the passage of the Tax Laws Amendment (2009 Measures No. 4) Bill 2009 which increased the R&D expenditure threshold for the existing concession from \$1 million to \$2 million. <http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=Id%3A%22media%2Fpressrel%2FVCNU6%22>

26. W Swan and K Carr, *R&D Tax Credit to Boost Business Investment*, op. cit.

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Initial consultation on the Bill and First Exposure Draft

On 18 September 2009 the Government issued a consultation paper on the Bill, Treasury receiving 197 submissions in response.²⁷ The First Exposure Draft of the Bill was issued on 18 December 2009, with the Treasury receiving 131 submissions.²⁸ Many submissions to both exercises raised practical concerns about the operation and effect of the proposed new incentive, and several identified drafting errors.

The main concerns outlined in submissions were that:

- the proposed new definition of ‘core R&D activity’ would exclude many categories of business R&D such as prototyping, construction of pilot industrial plants and production-based trials
- the proposed distinction between ‘core’ and ‘supporting’ R&D activities would result in a more complex and less predictable incentive
- the proposed scheme would impact disproportionately upon SMEs²⁹, and
- no modelling of the proposed new incentive had been released.

Second Exposure Draft

The Treasurer, Wayne Swan and the Innovation Minister, Senator Kim Carr, released the Second Exposure Draft on 31 March 2010. Treasury received 55 submissions on the Second Exposure Draft, most of them more supportive than those on the First Exposure Draft, but generally opposing the proposed changes to the definitions and tests which apply under the current incentive.³⁰ Specific concerns raised in the submissions include:

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27. Submissions available at:
<http://www.treasury.gov.au/contentitem.asp?ContentID=1664&NavID=037>
 28. Submissions available at:
<http://www.treasury.gov.au/contentitem.asp?ContentID=1740&NavID=037>
 29. Tax law firm, Michael Johnson Associates, states that the scheme would disproportionately affect SMEs because of increased compliance costs and because the proportion of operating costs of SMEs attributed to R&D are much higher than in larger entities. See Michael Johnson Associates, ‘Response to Exposure Draft and Explanatory Materials’, 19 April 2010, p. 18, viewed 3 June 2010,
http://www.treasury.gov.au/documents/1808/PDF/Michael_Johnson_Associates.pdf
 30. Senate Standing Committee on Economics, *Reference: Tax Laws Amendment (Research and Development) Bill 2010*, Proof Committee Hansard, 20 May 2010, p. E 47, viewed 3 June 2010, <http://www.aph.gov.au/hansard/senate/committee/S13142.pdf>.

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- that the ‘dominant purpose’³¹ test applied in determining eligible supporting activities³² is too broad and difficult to apply
- that the definition of ‘core activities’ is too narrow
- that the issuing of the draft and the call for submissions was not accompanied by any comparative analysis of the treatment of R&D activities under the existing R&D incentive as compared with the new R&D incentive
- that the proposed new incentive would result in greater administrative complexity
- that the generous ‘guaranteed return to investors’ provisions in the existing incentive³³ has been scrapped in favour ‘expenditure not at risk’ exclusion, which ‘opens up the potential for changing the R&D tax incentive from a largely guaranteed upfront concession at the time R&D decisions are made to an after-the-fact compensation measure for research that fails’³⁴
- concerns that the new incentive adopted only part of an internationally recognised standard definition of R&D contained in the *Frascati Manual*³⁵
- that the expansion of AusIndustry’s powers will create uncertainty, and
- that for certainty in taxpayer planning, the proposed new incentive should not come into effect any earlier than 1 July 2011.

The following table³⁶ summarises the Government’s response to key issues raised in submissions on the Second Exposure Draft, and resulting changes (if any) to the Bill as introduced:

31. See discussion under the *Key Issues* section of this Digest.

32. Ibid.

33. Under ITAA 1936 section 73CA eligible expenditure which earns income remains eligible for the incentive provided that the Commissioner of Taxation is satisfied that the entity or an associate of the entity could reasonably expect consideration for the expenditure.

34. Michael Johnson Associates, ‘Response to Second Exposure Draft’, 19 April 2010, p. 5 viewed 3 June 2010,
http://www.treasury.gov.au/documents/1808/PDF/Michael_Johnson_Associates.pdf

35. See note 18.

36. Treasury, ‘The new research and development tax incentive – summary of consultation process’, (undated), viewed 3 June 2010,
http://www.treasury.gov.au/documents/1772/PDF/Consultation_Summary.pdf

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Issue	Response
Concerns about the meaning of ‘new knowledge’ in the definition of core R&D creating ambiguity	The Bill as introduced retains the definition of core R&D from the Second Exposure Draft
Concern about the dominant purpose test for eligibility of supporting R&D activities	The Bill as introduced retains the dominant purpose test from the Second Exposure Draft
Concern about the scope of the exclusions list	The Bill as introduced contains significantly fewer exclusions than the Second Exposure Draft, given the new stricter tests for core and supporting R&D activities
Concern about the planned augmented feedstock rule ³⁷	As per the Second Exposure Draft, the Bill as introduced maintains a rewritten version of the existing feedstock rule contained in the ITAA 1936
Technical flaw in provisions relating to the clawback of government grants	Relevant provisions refined to ensure a more neutral and equitable outcome

Committee consideration

On 13 May 2010 the Senate referred the Bill (and the accompanying Bill) to the Senate Standing Committee on Economics for inquiry and report by 15 June 2010.³⁸ The committee conducted hearings on Thursday 20 May 2010 in Canberra, and on Friday 21 May 2010 in Sydney. The issues raised by, and the positions of, persons and entities at these hearings are dealt with in the next section of this Digest.

37. See note 71.

38. Selection of Bills Committee, *Report no. 7 of 2010*, 13 May 2010, pp. 3 and 11–13, viewed 3 June 2010, http://www.aph.gov.au/Senate/committee/selectionbills_ctte/reports/2010/report0710.pdf

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Position of significant interest groups/press commentary

At the Canberra hearing of the Senate Committee inquiry on 20 May 2010 the committee heard from witnesses representing the research-based medicines industry, tax advisory entities, the university sector, the Treasury, and the Department of Innovation.

Witnesses from Medicines Australia were strongly supportive of the proposed new incentive, with minor qualifications about the complexity of rules relating to core and supporting R&D.

Witnesses from Ernst & Young and taxation advisory firm BDO repeated concerns aired in theirs and other submissions in relation to the exposure draft of the Bill, particularly that activities with both productive output and R&D purposes would not be eligible under the proposed new 'dominant purpose' test, and that this would impact disproportionately on SMEs many of which, according to evidence given, combine production-related activities with R&D. A further concern was aired over the effect of the \$20 million turnover threshold for the more generous 45 per cent refundable tax credit, evidence being given that many SMEs have high turnover but low profitability, and that many formerly eligible manufacturing sector activities would not attract any incentive after the passage of the Bill.³⁹

Witnesses representing the university sector were somewhat ambivalent in their evidence, but suggested that should the proposed new incentive result in less R&D being performed in Australia this would impact negatively upon the amount of R&D conducted by universities, and conversely, that a more expansive definition of eligible R&D would benefit the university sector.⁴⁰

Witnesses from the Treasury and the Department of Innovation, Industry, Science and Research offered evidence contrary to that offered by Ernst & Young and BDO regarding the eligibility of production activities, citing the examples in the Explanatory Memorandum.⁴¹

39. R Parsons, Senate Standing Committee on Economics, *Reference: Tax Laws Amendment (Research and Development) Bill 2010*, 20 May 2010, p. E 18, viewed 7 June 2010, http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=Id%3A%22committee%2Fcommbill%2F13142%2F0000%22http://parlinfo.aph.gov.au/parlInfo/download/committees/commbill/13142/toc_pdf/7642-1.pdf;fileType=application%2Fpdf-search=%22tax%20laws%20amendment%20research%202010s%202010%2005%2020%22.

40. *Ibid.*, S Allan, p. E 25.

41. *Ibid.*, pp. E 50, E 51. See also Explanatory Memorandum examples 2.10 and 2.11, both of which describe instances of eligible production–line R&D.

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At the Sydney hearing on 21 May 2010 the committee heard from witnesses including representatives from the petroleum sector, tax advisory entities, industry groups, and Innovation Australia.

Witnesses from the Australian Industry Group repeated earlier concerns about the effect of the dominant purpose test for supporting R&D, the selected adoption of elements of the *Frascati* definition of R&D, and the projected start date for the new incentive.⁴² Witnesses from medical implant firm Cochlear Ltd were generally supportive of the proposed new incentive, although cited compliance costs and the effect of the dominant purpose test as concerns.⁴³

Witnesses representing the Advanced Manufacturing Coalition⁴⁴ drew attention to potential negative consequences for Australian manufacturers, the main concern being the application of the dominant purpose test.⁴⁵ Witnesses from Innovation Australia⁴⁶ were broadly supportive of the Bill.⁴⁷

Mention was made in the both hearings of the possibility that the current incentive is subject to rorting.⁴⁸ No specific evidence was offered by witnesses as to whether any alleged rorting was an illegitimate abuse of the existing incentive or a legitimate exploitation of existing rules, although Ms Murray, representing taxation advisory firm

42. Dr P Burn and A Willox, Senate Standing Committee on Economics, *Reference: Tax Laws Amendment (Research and Development) Bill 2010*, Senate Proof Hansard, 21 May 2010, pp. E 2–E 10, viewed 3 June 2010, <http://www.aph.gov.au/hansard/senate/commtee/S13143.pdf>

43. Dr C Roberts, Senate Standing Committee on Economics, *op. cit.*, pp. E 11–13.

44. Comprising the Australian Manufacturing Workers Union, Thales Australia, Varitan Australia, Marand Precision, Cochlear Ltd and Hoffman Engineering.

45. S McLaughlin, *ibid.*, p. E 29.

46. See note 72.

47. Dr R Edwards and P Thomas, *ibid.*, pp. E 49–63. In response to concerns around the potential confusion created for claimants by the imminent date of effect of the proposed new incentive, Dr Edwards gave evidence that around 62 per cent of companies which currently apply for the existing incentive are represented by consultants.

48. For example, see Senator Xenophon, Senate Standing Committee on Economics, 20 May 2010, *op. cit.*, p. E 17, Senator Cameron, pp. E 15 and E 16 and Senator Bushby, p. E 33. See also Senator Cameron, Senate Standing Committee on Economics, 21 May 2010, *op. cit.*, pp. E 14 and E 37.

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BDO, stated her opinion that “there is no doubt that the majority of R&D concession is held in the hands of very few claimants.”⁴⁹

The various exposure drafts and the Bill as introduced have also attracted significant media attention. In most reports, representatives of and consultants acting for larger entities have been quoted as opposing the proposed new incentive. Smaller entities, in particular biotechnology entities and their representatives, have been quoted as supporting the Bill.

Some representative comments are as follows:

- an editorial in the *Australian Financial Review* speculated that ‘business expenditure on R&D – which is only half the level of leading nations and 25 per cent below the OECD average – will plunge after years of strong growth’⁵⁰
- Michelle Gallagher, representing biotechnology industry body BioMelbourne Network, was quoted congratulating Canberra ‘on behalf of the industry’ (on the assumption that eligibility criteria will not exclude clinical trials)⁵¹
- Australian Industry Group Chief Executive Heather Ridout was quoted labelling the proposed new incentive ‘deeply flawed’ and would ‘significantly reduce’ innovation⁵²
- Biotechnology entity AusBioTech was reported as urging the government to persist with the Bill’s passage⁵³

49. T Murray, Senate Standing Committee on Economics, 20 May 2010, op. cit, p. E 17.

50. ‘Innovation policy needs reinventing’, *Australian Financial Review*, 11 February 2010, p. 62, viewed 7 June 2010,
<http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=Id%3A%22media%2Fpressclp%2FS3VV6%22>

51. M Gallagher, ‘Biotech needs shot in the arm’, *Weekend Australian*, 20 March 2010, p. 11, viewed 7 June 2010,
<http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=Id%3A%22media%2Fpressclp%2F0P7W6%22>

52. M Skulley, ‘Ridout denounces R&D tax squeeze’, *Australian Financial Review*, 14 May 2010, p. 5, viewed 9 June 2010,
<http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=Id%3A%22media%2Fpressclp%2FE7PW6%22>

53. A Sharp, ‘Industry blasts Rudd over research plan’, *The Age*, 21 April 2010, p. 10, viewed 9 June 2010,
<http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=Id%3A%22media%2Fpressclp%2FN0HW6%22>

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- PricewaterhouseCoopers tax partner, Sandra Mason, was quoted describing the proposed new incentive as ‘a kick in the guts for business’⁵⁴
- Amalgamated Metal Workers Union industry advisor, Nixon Apple, was quoted as saying that ‘if this legislation goes ahead, this is the end of the Button revolution⁵⁵ and it is the end of the innovation revolution.’⁵⁶

Despite negative comments from Australian representatives of KPMG in both the press⁵⁷ and in submissions⁵⁸, a recent report from KPMG’s Canadian division ranked Australia, on the assumption that the Bill becomes law, ahead of all other nations with similar incentives already in place, including Canada, France, Italy and Japan.⁵⁹

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54. P Roberts, ‘It’s a double-cross for R&D’, *Australian Financial Review*, 1 February 2010, p. 53, viewed 9 June 2010, <http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=Id%3A%22media%2Fpressclp%2F2LRV6%22>
55. This is a reference to the original 1986 R&D tax incentive, known popularly as the ‘Button RD tax concession’ (after its key proponent Senator John Button).
56. P Roberts, *Australian Financial Review*, op. cit., p. 53.
57. For example, KPMG tax partner David Gelb: “The R&D tax concession was broad-based and available to every company. With this nonsensical and complex piece of legislation, they are killing it.” Reported in *Australian Financial Review*, ‘It’s a double-cross for R&D’, 1 February 2010, p. 53. <http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=Id%3A%22media%2Fpressclp%2F2LRV6%22>
58. See, for example, KPMG, *R&D Tax Credit Second Exposure Draft Legislation*, KPMG, 19 April 2010, viewed 3 June 2010, <http://www.treasury.gov.au/documents/1808/PDF/KPMG.pdf>
59. KPMG, *Competitive Alternatives 2010 – Special Report: Focus on Tax*, p. 19, tabled by Treasury in Senate Standing Economics Committee hearing, 20 May 2010, viewed 3 June 2010, http://www.aph.gov.au/Senate/committee/economics_ctte/research_and_development_tax_credits_10/submissions.htm

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Coalition/Greens/Family First/independent policy position/commitments

Opposition spokesperson on innovation, Sophie Mirabella MP, suggested the Government should ‘abandon this fundamentally flawed bill and go back to the drawing board.’⁶⁰

Neither the Greens nor independents have publicly articulated a policy position on the proposed new incentive as far as the writer is aware. Senator Xenophon participated actively at the recent Senate Select Committee on Economics hearing in Canberra on 20 May 2010.⁶¹

Drafting errors

Several drafting flaws in the First and Second Exposure drafts were corrected in the Bill. A Correction to the Explanatory Memorandum is also available on the Bill’s homepage, correcting 28 minor drafting errors in the Explanatory Memorandum.⁶²

Financial implications

Assessed on an underlying cash balance, the Government estimates the effect of the Bill to be revenue neutral over the next four fiscal years.⁶³

The estimated effect on fiscal balance differs from the effect on underlying cash balance. The fiscal balance recognises payments under a refundable tax offset in the year in which qualifying activity occurs, whereas the underlying cash balance recognises these payments in the following year. The difference is shown in the following two tables.

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60. Sophie Mirabella MP, quoted in D Cronin, ‘Aust in world’s top 4 for low tax costs: report’, *Canberra Times*, 31 May 2010, p. 5, viewed 8 June 2010, <http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=Id%3A%22media%2Fpressclp%2FFZUW6%22>
 61. Senate Standing Committee on Economics, op. cit., 20 May 2010, p. E 47, viewed 3 June 2010, <http://www.aph.gov.au/hansard/senate/commtee/S13143.pdf>
 62. The current Bill’s homepage is at: <http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=Id%3A%22legislation%2Fbillhome%2Fr4354%22>
 63. Explanatory Memorandum, op. cit, p. 8.

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1. Fiscal balance estimates for the next four fiscal years⁶⁴

2010-11	2011-12	2012-13	2013-14	2014-15
-\$850m	\$190m	-\$180m	-\$110m	-\$130m

2. Underlying cash balance for the next four fiscal years

2010-11	2011-12	2012-13	2013-14	2014-15
-	\$240m	-\$120m	-\$50m	-\$70m

The existing incentive is currently the largest single mechanism for public funding support of business R&D.⁶⁵ The following table shows the cost of the existing incentive since 2005-06:

3. Cost of existing incentive over the last four fiscal years⁶⁶

2005-06	2006-07	2007-08	2008-09	2009-10
\$867m	\$1045m	\$1208m	\$1369m	\$1563m (est)

Key issues**Definition of 'core R&D activity'**

The proposed new incentive rests on several tests for determining whether an activity is eligible for the incentive as a core R&D activity. These tests, all of which must be satisfied, are:

1. the outcome of the activity is not deducible on the basis of current knowledge, information or experience⁶⁷

64. Ibid.

65. Productivity Commission, *Public Support for Science and Innovation*, op. cit., p. xxvi.

66. Australian Government, *2010-11 Science, Research and Innovation Budget Tables*, Table 1, viewed 3 June 2010, <http://www.innovation.gov.au/General/Corporate/Pages/Budget201011.aspx>

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2. the outcome can only be determined by application of scientific method⁶⁸, and
3. the activity is for the purpose of acquiring new knowledge or information.⁶⁹

The existing incentive requires either that the activity:

1. be systematic, investigative and experimental, and
2. involve either innovation *or* high levels of technical risk.⁷⁰

Definition of “supporting R&D activity”

Activities other than core R&D activities which are directly related to core R&D activities can qualify for the proposed new incentive if they can be shown to be supporting R&D activities. To qualify as a supporting R&D activity, the activity must have a direct, close and relatively immediate relationship with the core R&D activity.⁷¹

Activities which are specifically excluded under **proposed subsection 355-25(2)** of the ITAA 1997, which produce goods or services or which are directly related to producing goods and services, may qualify as supporting R&D activities eligible expenditure if undertaken for the ‘dominant purpose’ of supporting core R&D activities.⁷² The dominant purpose is described in the Explanatory Memorandum as ‘the prevailing or most influential purpose.’⁷³ Under this definition, activities with a commercial purpose may be

67. **Proposed paragraph 355-25(1)(a)** of the ITAA 1997. See also Explanatory Memorandum, op. cit., paragraphs 1.13, 2.11 and 2.13.

68. **Proposed subparagraphs 355-25(1)(a)(i) and 355-25(1)(a)(ii)** of the ITAA 1997. Explanatory Memorandum paragraph 2.14 states that eligible experiments must involve “a clear risk that the outcome of the experiment will not be the desired one.”

69. Explanatory Memorandum, op. cit., paragraph 2.16, and **proposed subsection 355-25(1)(b)** of the ITAA 1997.

70. ITAA 1936 section 73B(1).

71. Explanatory Memorandum, op. cit., paragraph 2.21, and **proposed subsection 355-30** of the ITAA 1997.

72. Explanatory Memorandum, op. cit., paragraph 2.22, and **proposed subsection 355-30(1)** of the ITAA 1997.

73. Explanatory Memorandum, op. cit., paragraph 2.24. The dominant purpose of an activity is a question of fact. The test is drawn from the common law.

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eligible supporting R&D activities provided that the dominant purpose is to support core R&D.⁷⁴

The dominant purpose test operates to ensure that expenditure on a production-related activity which does not support a core R&D activity is not eligible expenditure under the proposed new incentive. The effect of introduction of a dominant purpose test will be to exclude some production-related expenditure which is eligible expenditure under the current incentive. It is this aspect of the proposed new incentive which has prompted the most criticism.

Eligibility of feedstock expenditure

The proposed new incentive contains a feedstock expenditure⁷⁵ adjustment rule equivalent to the feedstock rule in the current incentive. The feedstock adjustment rule operates to reduce the amount of the incentive claimed in relation to expenditure on deductible feedstock inputs (the raw materials used in a process) by reference to the value of feedstock outputs (the resulting tangible product). Rather than a deduction or a tax offset for eligible feedstock expenditure, the rule in the proposed new incentive takes the form of an increase in assessable income equal to the value of the feedstock output.⁷⁶

Exclusions from core R&D

Certain activities are excluded under the proposed new R&D tax incentive. The list contained in the Bill is shorter than the list in the current legislation because the tighter definition of core R&D excludes some activities which are otherwise specifically excluded.⁷⁷ The list of exclusions in subsection 355-25(2) includes:

1. mineral and petroleum exploration
2. reproduction of existing products or processes
3. activities mandated by law
4. research in social sciences, arts or humanities, and
5. software developed internally for internal purposes

74. Ibid.

75. **Proposed subparagraph 355-465(1)** defines '*feedstock inputs*' as goods or materials transformed or processed during R&D activities in producing one or more tangible products (the '*feedstock outputs*').

76. Explanatory Memorandum, op. cit., paragraph 1.30, and **proposed subsection 355-H** of the ITAA 1997.

77. Explanatory Memorandum, op. cit., paragraph 2.29

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Note however that activities in these areas may potentially fall within the meaning of supporting R&D activity and hence be eligible for the new incentive.

The role of Innovation Australia and the Australian Taxation Office (ATO)

Innovation Australia⁷⁸ has an enhanced role under the proposed new incentive. It will maintain its advisory role by issuing public sector-focussed guidance documents.⁷⁹ However, under the Bill, it will also be able to issue private rulings. Further, the proposed new incentive creates a two-stage registration process whereby activities must be registered with Innovation Australia in order to be eligible to qualify for support from the proposed new incentive.⁸⁰

The proposed new incentive will operate on a self-assessment basis. The ATO will continue to assess claims and conduct audit and investigation activities in relation to claims in the normal fashion.

Main provisions

The Bill contains four Schedules.

Schedule 1 contains the main components of the new R&D incentive.

Schedule 2 concerns the role of Innovation Australia in administering the proposed new incentive.

Schedule 3 contains consequential amendments related to the proposed new incentive.

78. Innovation Australia is an independent statutory body established in 2007 to assist the Australian Government administer innovation and venture capital programs, including the current incentive.

79. Innovation Australia publishes guidelines for companies claiming deductions under the existing incentive, and will continue to perform this function under the proposed new incentive. Explanatory Memorandum, op. cit., paragraph 5.5. Current guidelines are available at <http://www.ausindustry.gov.au/InnovationandRandD/RandDTaxConcession/Documents/Guidelines/RandDPlansGuidelines120020823102249.pdf> (viewed 3 June 2010).

80. **Proposed section 27A** of the *Industry Research and Development Act 1986*. See also Explanatory Memorandum, op. cit., paragraph 5.12.

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Schedule 4 contains application, savings and transitional provisions related to the proposed new incentive.

The Digest will now address each Schedule in turn.

Schedule 1 – Main components of new R&D incentive

Schedule 1 contains the main components of the new R&D incentive. It introduces a new Division 355 into the ITAA 1997. The division consists of 12 subdivisions, as described below.

Proposed subdivision 355-A

Proposed subdivision 355-A contains the object of the new Division 355:

- to encourage industry to conduct research and development activities that might otherwise not be conducted because of an uncertain return from the activities, in cases where the knowledge is likely to benefit the wider Australian economy, and
- to achieve this object by providing a tax incentive for industry to conduct, in a scientific way, experimental activities for the purpose of generating new knowledge or information in either general or applied form.⁸¹

Proposed subdivision 355-B

Proposed subdivision 355-B contains definitions for terminology used in **proposed Division 355** of the ITAA Act 1997 (such as “R&D activities”) and sets out tests for qualifying expenditure.⁸²

Proposed subdivision 355-C

Proposed subdivision 355-B contains tests for determining an entity’s entitlements to the tax offset.

Proposed subdivision 355-D

Proposed subdivision 355-D sets the lower threshold for eligible R&D expenditure by providing technical rules for calculating the total claimable deduction (using the method of ‘notional deductions’).

81. **Proposed subsection 355-5** of the ITAA 1997

82. See discussion under the *Key Issues* heading in this Digest.

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Proposed subdivision 355-E

Proposed subdivision 355-E contains provisions for deducting the decline in value for depreciating assets used in qualifying activities.

Proposed subdivision 355-F

Proposed subdivision 355-F contains four simple integrity rules. An R&D entity claiming a deduction for R&D expenditure:

- must incur the expenditure at arm's length
- must not deduct the expenditure if it has received consideration that is greater than or equal to the expenditure (where it has disposed of R&D results)
- must not deduct more than the R&D asset's cost before the disposal, and
- must reduce deductions to reflect mark-ups within grouped entities.⁸³

Proposed subdivision 355-G

Proposed subdivision 355-G provide for clawback of benefits provided by Government to prevent 'double-dipping'.

Proposed subdivision 355-H

Proposed subdivision 355-H contains the rule for feedstock deductions.

Proposed subdivision 355-I

Proposed subdivision 355-I contains rules for deducing certain expenses incurred by associate entities of claimant entities.

Proposed subdivision 355-J

Proposed subdivision 355-J contains rules relating to R&D partnerships.

Proposed subdivision 355-K

Proposed subdivision 355-K contains rules relating to treatment of investment in Cooperative Research Centres (CRCs).

Proposed subdivision 355-W

Proposed subdivision 355-W contains rules relating Innovation Australia's assessment role including the effect of findings and provisions for objections to assessments.

83. Proposed sections 355-400, 355-405, 355-410 and 355-415 of the ITAA 1997

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Schedule 2–Innovation Australia’s role

Part 1 - Main amendment

Part 1 inserts a new Part III into the *Industry Research and Development Act 1986* (‘the Industry R&D Act’). The objects of this Part are:

- to provide integrity for the working out of tax offsets under Division 355 of the ITAA 1997,
- to increase certainty through findings about matters relevant to the working out of those tax offsets, and
- to improve access for small and medium R&D entities to quality research services by maintaining a register of research service providers.

Proposed divisions 1, 2 and 3 of new Part III contain complex rules for:

- registration of entities (referred to in the Bill as R&D entities) seeking incentive for eligible R&D activities by the Board (defined in the Industry R&D Act as Innovation Australia),
- activities of the Board related to registering R&D entities, including making findings regarding applications for eligible activities, and
- the treatment of R&D activities conducted outside Australia.

Proposed division 4 contains provisions for R&D entities to register as ‘research service providers’, capable of providing research services to R&D entities.

Proposed division 5 contains provisions for review of Innovation Australia decisions regarding R&D entities and R&D activities. Initially the decision will be the subject of internal review by the Board, but an entity affected by a ‘reviewable decision’⁸⁴ may ask the Administrative Appeals Tribunal (AAT) to review the Board’s decision.⁸⁵

Proposed division 6 contains provisions dealing with consolidated groups registering for group R&D activities.

Proposed division 7 contains administrative provisions including approved forms of decision, decision-making principles, and rules for R&D entities incorporated outside Australia or in an Australian territory.

84. **Proposed section 30A** of the Industry R&D Act

85. **Proposed section 30E** of the Industry R&D Act

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Part 2 – Other amendments

Part 2 of Schedule 2 to the Bill inserts a number of new definitions and makes other consequential technical amendments to the Industry R&D Act to give effect to the new incentive.

Schedule 3 – Other amendments relating to the new R&D incentive

Part 1 – Tax offset rules

Part 1 of Schedule 3 to the Bill amends the ITAA 1997 to provide measures for determining which activities are subject to the refundable tax offset rules and which are not.

Part 2 – Prepayments of expenditure

Part 2 of Schedule 3 amends parts of the ITAA 1936 and the ITAA 1997 to allow for deduction of qualifying expenditure for the year of income in which the expenditure or liability for expenditure is incurred.

Part 3 – Capital allowances

Part 3 of Schedule 3 amends the ITAA 1997 to provide rules for depreciating capital assets used for qualifying activities.

Part 4 – Capital works

Part 4 of Schedule 3 amends the ITAA 1997 to provide for deductions related to capital works conducted in pursuit of eligible R&D activities.

Part 5 - Forgiveness of commercial debts

Part 5 of Schedule 3 amends provisions of the ITAA 1936 and the ITAA 1997 relating to forgiveness of commercial debts incurred in relation to eligible R&D expenditure.

Part 6 - Other amendments

Among other things, **Part 6** contains consequential technical amendments necessary to give effect to the proposed Part III of the Industry R&D Act, including minor amendments to the *Income Tax (Transitional Provisions) Act 1997* and the *Taxation Administration Act 1953*.

Schedule 4 – Application, savings and transitional provisions

Schedule 4 contains provisions for ensuring a smooth transition from the existing R&D tax incentive to the new incentive.

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Part 1

Part 1 provides that the amendments made by the Bill apply for income years commencing on or after 1 July 2010.

Part 2

Part 2 contains general savings provisions to ensure that the legal consequences of establishing eligibility for the existing incentive continue to apply in relation to relevant commercial actions which occurred before the provisions of the Bill and the accompanying Bill take effect.

Part 3

Part 3 contains transitional provisions which appear as amendments to the ITAA 1936 and the ITAA 1997 and the *Income Tax (Transitional Provisions) Act 1997*, including complicated rules for balancing adjustments resulting from expenditure incurred for both general tax purposes and for R&D, and adjustments related to capital gains tax events. Part 3 also contains provisions for continuing the application of certain aspects of the existing incentive.

Part 4

Part 4 also contains savings and transitional provisions relating to aspects of the existing incentive, and provides for the Governor-General to make regulations prescribing matters required or permitted (or necessary or convenient) for giving effect to the Bill.

Concluding comments

The proposed new incentive is a significant departure from the existing incentive and could be described as an entirely new measure. Whilst successive exposure drafts of the Bill contained changes in response to concerns expressed in submissions, the essential provisions of the Bill – the reworked definitions and tests – have remained largely unchanged.

The proposed new incentive adopts in part the definition of R&D in the *Frascati Manual*, which is *basic research, applied research, and experimental development*.⁸⁶ In adopting only the research elements of the Frascati definition, the proposed new incentive focuses more on research and less on development. Development activities of some large entities which qualify for the existing incentive will not qualify for the proposed new incentive. The fact that the proposed new incentive is intended to be revenue-neutral could be seen as

86. *Frascati Manual*, op. cit., p. 17

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both an emphatic statement of policy change and an instance of careful management of expense measures intended to stimulate particular investment activities.

The \$20 million revenue threshold for entities claiming the 45 per cent refundable credit will direct more financial support to smaller entities, particularly those entities in tax loss which will receive cash refunds with no limit on the amount claimed. Entities in tax loss conducting R&D will tend to be smaller start-up companies which have not yet commercialised their research.

The tightened definitions of ‘core’ and ‘supporting R&D’ will mean that some non-scientific, industrial research activities will not be eligible activities. This will affect mostly larger entities, and some activities which are continuing and which are eligible for the existing incentive will not be eligible for the proposed new incentive.

Whilst the Treasury has reportedly conducted modelling,⁸⁷ Treasury has not as yet released details. This perhaps reflects the uncertainty involved in modelling an entirely new tax incentive measure. Whilst statistics about the effect of similar incentives in other jurisdictions are available, their probative value is questionable due to different economic and financial circumstances in each jurisdiction.

Significant uncertainty still surrounds the Bill. The Senate Economics Standing Committee is not required to report until 16 June 2010. Should the Bill fail to pass the Senate during this financial year, the possibility of retrospective application may create further uncertainty for claimant entities.

87. G Antioch, Senate Select Committee on Economics, op. cit., 20 May 2010, p. E 50.

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