

# POWERING INNOVATION THROUGH TAX CONCESSIONS: THE CHANGING RESEARCH & DEVELOPMENT TAX INCENTIVES

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*The changes to the R&D tax concession in 2011 were touted as the biggest reform to business innovation policy in over a decade. Three years later, as part of the 2014 Federal Budget, a reduction in the concession rates was announced. While the most recent of the proposed changes are designed to align with the reduction in company tax rate, the Australian Federal Government also indicated that the gain to revenue from the reduction in the incentive scheme will be redirected by the Government to repair the Budget and fund policy priorities. The consequence is that the R&D concessions, while designed to encourage innovation, are clearly linked with the tax system. As such, the first part of this article considers whether the R&D concession is a changing tax for changing times. Leading on from part one, this article also addresses a second question of 'what's tax got to do with it'? To answer this question, the article argues that, rather than ever being substantive tax reform, the constantly changing measures simply alter the criteria and means by which companies become eligible for a Federal Government subsidy for qualifying R&D activity, whatever that amount is. It further argues that when considered as part of the broader innovation agenda, all R&D tax concessions should be evaluated as a government spending program in the same way as any direct spending on innovation. When this is done, the tax regime is arguably merely the administrative policy instrument by which the subsidy is delivered. However, this may not be best practice to distribute those funds fairly, efficiently, and without distortion, while at the same time maintaining adequate government control and accountability. Finally, in*

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# POWERING INNOVATION THROUGH TAX CONCESSIONS

*answering the question of 'what's tax got to do with it?' the article concludes that the answer is: very little.*

## 1. INTRODUCTION

On 13 May 2014, the Australian Federal Government announced that the rates for both refundable and non-refundable research and development (R&D) tax incentives would be reduced, thereby saving an estimated AUD 70 million in 2014-15 and more than AUD 160 million in subsequent years. This reduction is consistent with the Government's announcement that company tax rates would be reduced to 28.5 percent from 1 July 2015.<sup>1</sup> However, the Government also stated that 'the gain to revenue and savings from this measure will be redirected by the Government to repair the Budget and fund policy priorities'.<sup>2</sup> This reduction comes only three years after the overhaul of the R&D tax concession, which expanded the incentive regime, and a few months after the announcement that businesses with an assessable income of AUD 20 billion or more would no longer be eligible for the R&D tax offset.<sup>3</sup> The Australian Federal Government had previously announced fundamental changes to the R&D tax concession on 12 May 2009, with those changes aimed at enhancing and simplifying the current regime and designed to provide better incentives and

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<sup>1</sup> It should be noted that companies with a taxable income exceeding AUD 5 million will be subject to the Paid Parental Leave Levy at 1.5%. As such, they will effectively not get the benefit of the reduction in the corporate tax rate.

<sup>2</sup> The Commonwealth of Australia, 'Budget Measures 2014-2015' (Budget Paper No 2, The Commonwealth of Australia, 13 May 2014) 18 available at: <[http://www.budget.gov.au/2014-15/content/bp2/download/BP2\\_consolidated.pdf](http://www.budget.gov.au/2014-15/content/bp2/download/BP2_consolidated.pdf)>.

<sup>3</sup> [http://www.aph.gov.au/About\\_Parliament/Parliamentary\\_Departments/Parliamentary\\_Library/pubs/rp/BudgetReview201415/RandD](http://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/pubs/rp/BudgetReview201415/RandD).

more support for Australian jobs. Exposure Draft Legislation and the accompanying Explanatory Materials, outlining the proposed new regime, were released on 18 December 2009.<sup>4</sup> Those proposed changes to the R&D tax concession, culminating in the enactment of legislation effective from 1 July 2011, were a result of the recommendations of the 2008 Venturous Australia Report and touted as part of the Federal Government's innovation policy agenda for the 21<sup>st</sup> Century.<sup>5</sup>

The former R&D tax concession, estimated to amount to approximately AUD 1.14 billion for the 2009-10 income year, was at that time the largest single Government innovation outlay. From the 2011-12 income year, the R&D tax offset replaced the existing concession with a combined refundable and non-refundable tax credit system, dependent on annual turnover. The latest figures indicate that the R&D refundable tax offset for the 2012-13 income year was an ATO administrative expense of AUD 1.586 billion,<sup>6</sup> while the non-refundable tax offset was a tax expenditure of AUD 690 million.<sup>7</sup> The current regime provides that entities with an annual turnover of less than AUD 20 million are entitled to a refundable tax offset of 45

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<http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2009/124.htm&pageID=003&min=wms&Year=&DocType=>.

<sup>5</sup> Powering Ideas – An Innovation Agenda for the 21st Century (Innovation Report), 12 May 2009,

<http://www.innovation.gov.au/innovationreview/Pages/home.aspx>.

<sup>6</sup> Australian Taxation Office, 'Commissioner of Taxation Annual Report 2012-13' (Annual Report, Australian Taxation Office, 3 October 2013).

<sup>7</sup> The Australian Government, the Treasury, 'Tax Expenditures Statement 2013' (Annual Statement, The Australian Government, the Treasury, January 2014) 91.

## **POWERING INNOVATION THROUGH TAX CONCESSIONS**

percent of their R&D spending, equivalent to a concessional tax deduction of 150 percent. Entities with an annual turnover of more than AUD 20 million are entitled to a non-refundable tax credit of 40 percent of their R&D spending, equivalent to a concessional tax deduction of 133 percent. There is no cap on the amount of the offset. However, there was a tightening of the definition of eligible R&D activity. There is also draft legislation currently before Parliament to limit the offset to businesses with an annual turnover of less than AUD 20 billion.

This article investigates the substantive change from an R&D tax concession to an R&D tax offset, which was purported to align with the changing economic conditions both during the global recession and into a global recovery, along with subsequent minor changes. It evaluates the current R&D tax offset both as part of the Government's innovation agenda for the 21<sup>st</sup> Century and as part of the tax expenditures regime within the Australian tax system. As such, this article initially considers the R&D tax concession as a pillar of the Government's innovation agenda and asks whether maintaining the R&D tax incentives within the tax regime is desirable given the continual changes. It does so by initially examining the history of the R&D tax concession followed by an examination of the features of the current R&D tax offset within the overall context of the Federal Government's innovation agenda at that time. The second part of the article considers the current R&D tax offset as part of the tax expenditures regime and evaluates it within a government spending paradigm, asking whether the promotion of business innovation, through the R&D tax offset, is an appropriate use of the tax system. This is done with the knowledge that the most recent data from the Organisation for Economic Co-operation and Development (OECD), in its comparative report on R&D tax incentives, indicates that Australia decreased its annual direct funding on R&D at a rate of 13.3 percent between 2006-11 while it increased its tax

support by an annual growth rate of 8.1 percent.<sup>8</sup> Further, in 2011 Australia's tax incentive share of government funds for R&D was significant at 82 percent.<sup>9</sup>

## 2. A PILLAR OF INNOVATION POLICY FOR THE 21ST CENTURY

Australia has provided tax concessions for R&D spending for the last 28 years. While the form of these concessions has been modified over this time, the purpose for which these concessions are provided has not changed. Principally, the concessions are designed to encourage investment in R&D activities with the aim of making Australia internationally competitive. Like all OECD countries, Australia continually aims to strengthen innovation, increase productivity and ensure long term growth and development. These are valid aims, especially in light of recent global economic uncertainty. Few would argue that government spending on R&D activities for these purposes should not be a priority. As such, any Federal Government innovation agenda for the 21<sup>st</sup> Century which is designed to make Australia more productive and competitive is, prima facie, a justified use of federal funding. However, R&D tax incentives are not the only way to achieve these goals and, as seen in the recent Federal Government Budget, there were other strategies announced to 'build Australia's future', most notably the announcement that a AUD 20 billion Medical Research Future Fund will be established from 1 July 2015.<sup>10</sup>

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<sup>8</sup> OECD, *Measuring R&D Tax Incentives* OECD Directorate for Science, Technology and Innovation (2013) <<http://www.oecd.org/sti/rd-tax-stats.htm#design>>.

<sup>9</sup> Ibid.

<sup>10</sup> Australian Federal Government, Budget Measures, Budget Paper No. 2, 2014-15, available at: [http://www.budget.gov.au/2014-15/content/bp2/download/BP2\\_consolidated.pdf](http://www.budget.gov.au/2014-15/content/bp2/download/BP2_consolidated.pdf).

# POWERING INNOVATION THROUGH TAX CONCESSIONS

Yet government priorities require public funding in some form and supporting R&D through tax concessions has historically been a significant part of the overall innovation strategy.

The current Federal Government appears to envisage an R&D tax incentive to continue in the role of supporting innovation in Australia for the next decade. However, given the expenditure on the R&D tax incentive is estimated to be over AUD 3 billion for the 2013-14 income tax year, it is of fundamental importance that the program distributes those funds fairly, efficiently, and without distortion while at the same time ensuring there is adequate government control and accountability. These issues are addressed in the second part of this article after a discussion of the development of the regime as part of the Government's innovation policy.

## 2.1 The Introduction of an R&D Tax Concession: 1986

The R&D tax concession was first introduced in Australia with the enactment of s 73B of the *Income Tax Assessment Act 1936* (Cth) (ITAA36), applying from the 1985-86 income tax year. While the R&D tax concession is currently part of the Australia income tax regime, it is administered jointly by Innovation Australia (AusIndustry<sup>11</sup>) and the Australian Taxation Office (ATO). Sec 73B(1AAA)<sup>12</sup> provided guidance as to the purpose for which the provisions were enacted and stated that the object of that section was to provide a tax incentive, in the form of a deduction, to encourage research and development activities in Australia and make eligible companies more internationally competitive by:

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<sup>11</sup> The business program delivery division in the Federal Government Department of Innovation, Industry, Science and Research.

<sup>12</sup> This objects clause was inserted into the ITAA36 in 2001.

- (a) encouraging the development by eligible companies of innovative products, processes and services;
- (b) increasing investment by eligible companies in defined research and development activities;
- (c) promoting the technological advancement of eligible companies through a focus on innovation and high technical risk in defined research and development activities; and
- (d) encouraging the use by eligible companies of strategic research and development planning; and
- (e) creating an environment that is conducive to increased commercialisation of new processes and product technologies developed by eligible companies.

The regime, introduced in 1986, provided an increased deduction of 125 percent for eligible R&D expenditure (150 percent for expenditure incurred prior to 20 August 1996). Only companies incorporated in Australia and undertaking eligible Australian-owned R&D activities were entitled to claim the tax concession. However, a prerequisite to a claim in the company's annual tax return was the registration with Innovation Australia. Applications for registration were lodged annually under the *Industry Research and Development Act 1986* (Cth) (IR&D Act). Where a company met the eligibility criteria, the R&D tax concession was then claimed as part of the company tax return.

The basic eligibility requirement to access the original R&D tax concession was that the company was engaged in eligible R&D activities as defined by the ITAA36. There were two kinds of eligible R&D activities: core activities and supporting

## **POWERING INNOVATION THROUGH TAX CONCESSIONS**

activities. Core activities consisted of systematic, investigative, and experimental activities that involved innovation or high levels of technical risk and were carried on for the purpose of acquiring new knowledge (whether or not that knowledge will have a specific practical application) or creating new or improved materials, products, devices processes, or services.<sup>13</sup> Supporting activities were those other activities that were carried on for a purpose directly related to the carrying on of core activities.<sup>14</sup> Qualifying expenditure generally included salaries expenditure, other expenditure incurred directly in respect of R&D activities (overheads and administrative costs), contracted expenditure, certain assets (125 percent depreciation), feedstock expenditure, core technology expenditure (100 percent to a maximum of one-third of the amount of R&D expenditure), interest expenditure (100 percent deductible), and payments to a cooperative research centre.

In addition to the basic eligibility requirement of eligible R&D activity expenditure, a company also had to be able to demonstrate that there had been an annual minimum R&D expenditure of AUD 20,000, that the activities had been carried out by, or on behalf of the company, that the R&D activities were to the benefit of the Australian economy and the results exploited on normal commercial terms, that the R&D activities were carried out in Australia (subject to a 10 percent de minimis rule), and that the R&D activities contained adequate Australian content.

### **2.2 Amendments to the Regime: 2001-2007**

The basic regime introduced in 1986 was then supplemented by three further incentives which subsequently expanded the

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<sup>13</sup> Section 73B(1) ITAA36.

<sup>14</sup> Ibid.



125 percent increased deduction. The first, introduced in 2001, was the refundable R&D tax offset available to small companies. Qualifying companies could elect to take the concession as an offset rather than a deduction. However, these companies had to have an annual group turnover of less than AUD 5 million, have R&D expenditure that exceeded AUD 20,000, and have grouped expenditure on R&D below AUD 1 million for years prior to 2008-09 or below AUD 2 million for the 2009/10 income year. This alternative concession was aimed at providing incentives to small innovative companies, where there was a tax loss. The second additional incentive, also introduced in 2001 for income years after that date, was the 175 percent premium concessional deduction for additional expenditure. The 175 percent deduction was available for expenditure which exceeded a base level determined by the average R&D expenditure over the previous three year period. The third additional incentive, introduced from the 2007-08 income year, provided a 175 percent international premium which was available to Australian incorporated companies belonging to multinational enterprise groups. In this case, a base deduction of 100 percent was available for any R&D expenditure incurred on behalf of the grouped company with an additional 75 percent deduction for expenditure in addition to the three-year average.

### **2.3 The Cutler Report: 2008**

On 22 January 2008 the then Federal Minister for Innovation, Industry, Science and Research commissioned a Review of the National Innovation System. The Review Panel of the resulting report, known as *Venturous Australia – Building Strength in Innovation*<sup>15</sup> or, informally, the Cutler Report,

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<sup>15</sup> Terry Cutler, Submission to Department of Innovation, Industry, Science and Research, *Review of the National Innovation System* -

## POWERING INNOVATION THROUGH TAX CONCESSIONS

released its findings and recommendations on 29 August 2008. Within the overall context of innovation, the Review Panel identified the need for a reappraisal of the current national innovation system and argued that the policies it comprises require renewal, refurbishment, recasting, and, in some cases, re-imagining.<sup>16</sup> Most specifically, the Report identified the current tax incentives as requiring transformation and rationalisation.

The Review Panel primarily commented on the problems the R&D concessional regime had faced since inception as well as the ‘band-aid’ additional programs introduced to tackle those problems. Two limitations to the regime were specifically addressed: the inability to benefit firms in a tax loss position along with the very tight targeting of the subsequent addition of the R&D tax offset; and the reduction of the rate of the concession, initially from 150 percent to 125 percent and the subsequent reduction caused by the lowering of the company tax rate.<sup>17</sup> It commented that the latter causes the concession to provide ‘relatively low levels of assistance and not surprisingly this strongly constrains the extent to which it induces additional R&D. Further, the concession was accounted for “below the line” and so it was often invisible in company financial decision making.’<sup>18</sup> The Report also commented on the ultimately unsuccessful expansion of the scheme in 1989 to allow syndication, that is, projects carried out by a group of companies.<sup>19</sup> The Cutler Report concluded that the shortcomings

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*Venturous Australia: building strength in innovation [Cutler review]*, 29 August 2008.

<sup>16</sup> Ibid xii.

<sup>17</sup> Ibid xiii.

<sup>18</sup> Ibid.

<sup>19</sup> This expansion of the scheme was ultimately repealed in 1996.

of the regime and the subsequent attempts at a correction had resulted in fragmentation and complexity.<sup>20</sup>

Following the recognition of the problems associated with the R&D concessional regime, the Cutler Report made several recommendations. It recognised that the R&D concessions were introduced at a time when the prevailing model of business research involved in-house corporate laboratories.<sup>21</sup> As such, the ensuing R&D tax concession recommendations contained both substantive and administrative aspects. The substantive recommendations were twofold. First, the R&D tax concession be changed from a tax deduction to a tax credit.<sup>22</sup> Secondly, the R&D tax concession, consisting of the basic 125 percent deduction, the 175 percent premium, the R&D tax offset, and the international premium, be replaced with a tax credit of 40 percent for large firms and a refundable tax credit of 50 percent for smaller firms with a turnover of less than AUD 50 million.<sup>23</sup> The Cutler Report also recommended changes to the definition of eligible R&D activity, effectively tightening eligibility.

Ultimately, it was the Cutler Report, delivered six years ago, which proposed the ‘transformation and rationalisation of the suite of available tax concessions.’<sup>24</sup> Subsequently, the previous Federal Government adopted the thrust of the Cutler Report recommendations in relation to the R&D tax concessions.

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<sup>20</sup> Cutler, above n 15, 102.

<sup>21</sup> *Ibid* 101.

<sup>22</sup> *Ibid* 107, Recommendation 8.2.

<sup>23</sup> *Ibid* Recommendation 8.3.

<sup>24</sup> *Ibid* xiii.

# POWERING INNOVATION THROUGH TAX CONCESSIONS

## 2.4 Powering Ideas: An Innovation Agenda for the 21st Century

On 12 May 2009 the Australian Government released its innovation policy agenda to 2020. Senator Kim Carr, the then Minister for Innovation, Industry, Science and Research, in the 67 page document entitled *Powering Ideas – An Innovation Agenda for the 21<sup>st</sup> Century* (Innovation Report),<sup>25</sup> outlined the reform agenda designed to make Australia more productive and more competitive. Only one and a half pages were devoted to tax incentives and, consistent with the Cutler Report, this Report also commented on the shortcomings of the current R&D concession. In particular, the Innovation Report relied on a 2007 Report<sup>26</sup> which evaluated the extended R&D measures introduced in 2001 and concluded that the premium concessions were too complex and did not influence R&D spending decisions.<sup>27</sup> The same Report also concluded that, while the then existing R&D tax offset did encourage small firms with tax losses to increase their R&D expenditure, the AUD 5 million turnover limit excluded many small, innovative companies and the AUD 1 million expenditure limit discouraged firms from exceeding that threshold.<sup>28</sup>

Given its similar conclusion as to the lack of effectiveness of the then exiting R&D concessions, the Innovation Report

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<sup>25</sup> Department of Innovation, Industry, Science and Research (Cth), ‘Powering Ideas – An Innovation Agenda for the 21<sup>st</sup> Century’ (Department of Innovation, Industry, Science and Research, 12 May 2009) (‘Innovation Report’).

<sup>26</sup> The Australian Government ‘New Elements of the R&D Tax Concession’ (Evaluation Report, The Australian Government, June 2007).

<sup>27</sup> Innovation Report above n 25, 46.

<sup>28</sup> Ibid.

accepted the thrust of the recommendations of the Cutler Report. However, it did not accept the 50 percent refundable tax offset for smaller firms with an annual turnover of less than AUD 50 million. Rather, the Innovation Report outlined the Government's proposed R&D tax offset, which was also announced in the 2009 Federal Government Budget, to apply from 2010-11 as a 45 percent refundable tax credit for Australian-owned firms turning over up to AUD 20 million a year and a 40 percent non-refundable tax credit to all other firms.<sup>29</sup>

The Innovation Report outlined the rationale for the introduction of a tax offset, providing five reasons for adopting the new regime:

- It tilts support in favour of small and medium-sized businesses, which are more responsive to fiscal incentives;
- It makes cash refunds available to more firms, including capital-starved start-ups in biotechnology and other high-tech industries;
- It is simpler and more predictable than the present tax concession;
- It increases certainty by uncoupling the level of R&D support from the corporate tax rate; and
- It is consistent with international best practice.<sup>30</sup>

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<sup>29</sup> Ibid.

<sup>30</sup> Ibid 47.

## **POWERING INNOVATION THROUGH TAX CONCESSIONS**

In relation to the fifth point, the Innovation Report argued that because tax credits were already used in the United States, Japan, and many parts of Europe, ‘the new system will be familiar to international firms headquartered in these places, making Australia a more attractive destination for foreign R&D investment in defence, pharmaceuticals, and a host of other industries.’<sup>31</sup> The Innovation Report did not provide any further details in relation to R&D tax concessions as part of the Government’s innovation agenda for the 21<sup>st</sup> Century as this part of the agenda was left to the Treasury.

### **2.5 The Current Research and Development Tax Incentive**

Subsequent to the Innovation Report, a Treasury Consultation Paper (Consultation Paper),<sup>32</sup> released in September 2009, outlined in greater detail the proposed changes to the R&D tax concession initially due to come into effect from 1 July 2010 but ultimately in force from 1 July 2011.<sup>33</sup> The process from proposal to implementation was a long and difficult one. The Consultation Paper provided that the case for reform was based on the contention that the new regime would be both more effective in delivering support for business R&D and more

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<sup>31</sup> Ibid.

<sup>32</sup> The Australian Government the Treasury, ‘The New Research and Development Tax Incentive’ (Consultation Paper, The Australian Government the Treasury, September 2009) (‘Consultation Paper’).

<sup>33</sup> At the time of writing this paper, exposure draft legislation had not been released. However, the Government intends to introduce legislation into Parliament in early 2010. The new provisions will move the R&D concessions from the ITAA36 to the ITAA97. Associated amendments will be made to the *Industry Research and Development Act 1986* (Cth).

effective in the targeting of that support to produce net-benefits for the Australian community.<sup>34</sup>

The detail of the new R&D tax concession, which had not previously been released by the Federal Government, was contained in this document. Consistent with the Innovation Report, incentive as applied from 1 July 2011 is described as having two core components: a non-refundable 40 percent standard R&D tax credit and a 45 percent Refundable R&D tax credit. Significantly, the Consultation Paper provided detail of the third element to the new regime. Until the release of the Consultation Paper, the new regime had generally been couched in terms of a refundable and non-refundable tax credit with only passing reference made to the proposed changes to the eligibility criteria. However, the Consultation Paper expanded the two substantive elements of the proposed regime to a third essential element contained within the proposed changes, the tighter definition of R&D activity. The tighter definition of R&D activity was an integral part of the proposed changes as it was only with this tightening that the new tax incentive was arguably revenue neutral. The aim of the then Federal Government was to maintain the same spending, in a tax expenditure context, on R&D over the first four years of operation of the new regime.<sup>35</sup>

## ***2.6 Tax Laws Amendment (Research and Development) Act 2011***

On 18 December 2009, the Treasury released Explanatory Materials and Draft Legislation, which, after several iterations, became the Taxation Laws Amendment (Research and Development) Bill 2010 (Cth). This Bill was subsequently passed and the operative provisions for the R&D tax

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<sup>34</sup> Consultation Paper above n 32, 2.

<sup>35</sup> Ibid.

## **POWERING INNOVATION THROUGH TAX CONCESSIONS**

concessions are now contained in Division 355 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97). In addition to the amendments to the income tax regime, the corresponding administrative rules were amended and are now contained in Part III of the IR&D Act. These provisions set out the role of Innovation Australia in relation to the administration of the R&D regime. Essentially, the regime continued to operate on a self-assessment basis with Innovation Australia continuing to register entities and assess whether activities are eligible for the R&D tax concession. As McKerchar and Hansford point out in their comprehensive analysis of the current regime, many of the elements of the Australian system are similar to the United Kingdom regime.<sup>36</sup> The core elements of the current regime along with the changes from the previous regime are briefly considered below.

### ***2.6.1 R&D Activities***

Apart from the two core components of the proposed regime, the most significant change was the tightening of the definition of R&D activities. Consistent with the previous regime, activities are still defined as either core or supporting. However, both definitions were tightened. In particular, core activity now requires the taxpayer to produce new information and needs to do an experiment to discover that knowledge rather than the previous requirement of innovation (appreciable degree of novelty) *or* high levels of risk. Supporting R&D activities now need to be undertaken for the dominant purpose of supporting core R&D activities compared to the previous

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<sup>36</sup> Margaret McKerchar and Ann Hansford, 'Achieving Innovation and Global Competitiveness through Research and Development Tax Incentives: Lessons for Australia from the UK' (Paper presented at 24th Annual Conference of the Australasian Tax Teachers Association, University of Sydney, 16-17 January 2012) 3.



requirement that they needed to be undertaken for a purpose directly related to conducting core activities. Generally, only R&D activity conducted in Australia will qualify for the R&D tax concession.

### ***2.6.2 R&D Entities***

The category of entities eligible for the proposed R&D tax incentive was expanded to include three categories of entities: corporations that are Australian residents for tax purposes; foreign corporations that carry on R&D activities through a permanent establishment; and public trading trusts with a corporate trustee. It was stated that the expansion to include Australian permanent establishments of foreign entities was designed to provide inducement for companies to conduct R&D activity in Australia.<sup>37</sup> However, it is arguable that the principle driver of this inclusion is the Non-discrimination Articles contained in Australia's double tax treaties.

### ***2.6.3 R&D Expenditure***

Neither the refundable or non-refundable tax offset is subject to an expenditure cap. However, the minimum expenditure threshold of AUD 20,000 continues to apply except where activities are performed for an R&D entity by a research service provider. Further strengthening the incentives provided to multinational entities is the ability of an entity to claim the concession for eligible R&D activities regardless of where the intellectual property is held. However, where expenditure is incurred to an associate entity, the tax incentive is available only on a payment basis.

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<sup>37</sup> Taxation Laws Amendment (Research and Development) Bill 2010 (Cth), Explanatory Memorandum.

# **POWERING INNOVATION THROUGH TAX CONCESSIONS**

## ***2.6.4 R&D Offsets***

As previously stated, the current offsets consist of a 45 percent refundable tax offset for R&D entities with an aggregated turnover of less than AUD 20 million (unless they are a tax exempt entity or majority owned or controlled by tax exempt entities) and 40 percent non-refundable tax offset for all other R&D entities. Any unused non-refundable tax offset may be carried forward under the tax offset carry forward rules.

## **2.7 A Changing Tax for Changing Times**

The above analysis of the history of Australia's R&D tax incentives reveals that the drivers of change to the tax policy centre not around tax imperatives but rather innovation strategies. Yet, at no stage was it suggested that the R&D tax incentives be removed from the tax regime and replaced with a direct spending policy. As such, it appears that it is the tax regime which is changed as the needs of the nation change throughout the 21<sup>st</sup> century. As it has been demonstrated that it is the tax regime which keeps being amended to meet these needs, the next part of this article considers the effects of evaluating the R&D tax incentives as direct spending initiatives rather than maintaining the current tax expenditure paradigm. The remainder of this article now turns to an evaluation of the proposed R&D Tax Concession, as part of the Government's spending program.

### 3. EVALUATING R&D TAX INCENTIVES WITHIN A GOVERNMENT SPENDING PARADIGM

In 2009, the initial Explanatory Materials to the Exposure Draft Legislation for the current regime stated that ‘[t]he new R&D tax incentive is the biggest reform to business innovation support for more than a decade. It cuts red tape and provides a better incentive for companies to invest in R&D.’<sup>38</sup> It went on to provide that ‘[t]he new R&D tax incentive is also an opportunity to ensure support for business R&D is consistent with the underlying rationale for government intervention and delivers value for money for taxpayers.’<sup>39</sup> Given the R&D tax incentive is part of the Australian Government’s innovation agenda the obvious question is: ‘What’s tax got to do with it?’

For those who do not want to probe further, the answer is simple: the tax regime is the vehicle by which the subsidy is delivered. The case for subsidising R&D is outlined in the original Explanatory Materials to the current legislation and is also worth noting for its lack of substantive tax content. It highlights the following reasons for providing a subsidy:

- Innovation is recognised internationally as an important driver of productivity and economic growth. It encompasses a wide range of activities in the economy, including workforce skills, venture capital, knowledge transfer, technology uptake, management practices and R&D;

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<sup>38</sup> Explanatory Materials, Taxation Laws Amendment (Research and Development) Bill 2010 (Cth), First Exposure Draft 18 December 2009, 5.

<sup>39</sup> Ibid.

## **POWERING INNOVATION THROUGH TAX CONCESSIONS**

- In a global economy, companies have incentives to invest in R&D to improve their competitiveness and ongoing profitability. Broader economic factors such as macroeconomic stability, competitive markets, efficient credit markets and access to skilled labour are all important influences on a firm's decision to invest in R&D;
- Knowledge produced by firms as they perform R&D often has beneficial impacts on other firms or the economy as a whole (often referred to as spillovers). A firm may choose not to undertake R&D because of technical uncertainty in cases where the knowledge generated would spillover to the benefit of other firms and the wider economy. In such situations, less R&D may occur than would be optimal for the economy as a whole; and
- A public subsidy that appropriately targets such spillovers can be beneficial for the economy as a whole and improve productivity. To this end, the new R&D tax incentive redirects assistance to those activities most likely to generate spillovers. It also tilts assistance in favour of smaller innovative firms as they are more likely to respond to fiscal incentives.<sup>40</sup>

This leads to the fairly obvious conclusion that the R&D concessions are primarily viewed as part of the Government's spending on the innovation agenda. However, it is unlikely that stakeholders view tax incentives as part of any direct spending program and would see these concessions as merely one component of the broader business tax regime. While the current

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<sup>40</sup> Ibid 6.

R&D tax incentive regime was introduced by the previous Federal Government, we have not seen any indication, apart from ‘tinkering’, that the regime will be substantively altered. However, as these concessions are contained within the tax regime, they may also be regarded as tax expenditures.<sup>41</sup>

### **3.1 Australia’s Tax Expenditures Regime**

In Australia, tax expenditures are reported in the Annual Tax Expenditures statement, which commenced in 1986. For annual reporting purposes, a tax expenditure is defined as ‘a concession that provides a benefit to a specified activity or class of taxpayer... Tax expenditures can be provided in many forms, including tax exemptions, tax deductions, tax offsets, concessional tax rates or deferrals of tax liability.’<sup>42</sup> They are also described, by way of comparison, as ‘an alternative to direct expenditures as a method of delivering government assistance or meeting government objectives’.<sup>43</sup> Until 2011, a measure of the total R&D expenditures was provided within these annual statements. Subsequent to the introduction of the current regime, the cost associated with the R&D tax offsets is split between the tax expenditures system and the direct spending programs. That is, some tax offsets, particularly refundable offsets, are classified as spending programs even though they are administered through the tax system by the ATO. As such, the reporting of the total cost of R&D concessions requires a reconciliation of the two. The 2013

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<sup>41</sup> Interestingly, only the non-refundable R&D tax offsets are reported in the annual Tax Expenditures Statement while the refundable offsets are reported in the ATO Annual Report.

<sup>42</sup> The Australian Government the Treasury, ‘Tax Expenditures Statement 2008’ (Annual statement, The Australian Government the Treasury, January 2009) 1.

<sup>43</sup> Ibid.

## **POWERING INNOVATION THROUGH TAX CONCESSIONS**

Annual Tax Expenditures Statement estimates that the non-refundable R&D tax offset will cost AUD 1 billion for the 2013-14 income year while the refundable R&D tax offset for the same period is estimated as part of the annual budgetary process to cost AUD 2.246 billion. However, it is proposed that such a distinction in this case is merely semantics as it is unlikely that stakeholders view the refundable offset as a direct spending program given it is administered through the tax system. Further, as already mentioned, the most recent data from the OECD, in its comparative report on R&D tax incentives, indicates that Australia decreased its annual direct funding on R&D at a rate of 13.3 percent between 2006-11 while it increased its tax support by an annual growth rate of 8.1 percent.<sup>44</sup> Further, in 2011 Australia's tax incentive share of government funds for R&D was 82 percent.<sup>45</sup> It is yet to be seen whether the OECD reports the refundable R&D tax offset as a direct spending program. However, this is unlikely given its classification. As such, this article maintains that the R&D refundable tax offset should still be regarded as a tax expenditure, given that it falls within the definition of a tax expenditure and mimics many of the defined qualities which warrant such classification. This will become evident as discussed below.

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<sup>44</sup> OECD, above n 8.

<sup>45</sup> Ibid.

### 3.2 Evaluating the R&D Tax Concession as a Direct Expenditure

Tax expenditures are generally accepted as deviations from the normal tax base, however defined. As such, they have very little to do with tax policy. Rather, it is suggested that the decision to place a spending program into the tax regime 'is solely a matter of institutional design.'<sup>46</sup> Generally, an assessment of any part of the tax regime is undertaken using the design criteria of equity, efficiency, and simplicity. However, if it is accepted that tax expenditures are solely a matter of institutional design and are the equivalent to direct spending, an alternative assessment model is that which would apply to direct expenditures. The author, in a previous article,<sup>47</sup> relying on the work of Brooks,<sup>48</sup> suggests that a four-stage inquiry process should be adopted to evaluate both proposed and existing tax expenditures. As such, these steps can be applied in the current context to evaluate the R&D tax offset. They are:

1. Is the [proposed] tax expenditure serving a valid government objective and does it reflect a government spending priority;
2. Assuming the [proposed] expenditure serves a valid government purpose, and using budgetary criteria:

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<sup>46</sup> Neil Brooks, 'The Under-Appreciated Implications of the Tax Expenditure Concept' in Chris Evans and Richard Krever (eds), *Australian Business Tax Reform in Retrospect and Prospect* (Thompson Reuters, 2009) 233.

<sup>47</sup> Kerrie Sadiq, 'The Under-Appreciated Implications of the Tax Expenditure Concept (Commentary)' in Chris Evans and Richard Krever (eds), *Australian Business Tax Reform in Retrospect and Prospect* (Thompson Reuters, 2009) 259.

<sup>48</sup> Brookes, above n 46.

## **POWERING INNOVATION THROUGH TAX CONCESSIONS**

- Are the benefits distributed fairly;
  - Is the program target efficient (for example, does it reach intended beneficiaries);
  - Does the program avoid causing any unintended distorting effects;
  - Are the administrative and compliance costs of the program reasonable;
  - Does the government have control over the spending program and is it politically accountable for it;
  - Is the program [to be] appropriately implemented;
3. What is the best government policy instrument for the [proposed] expenditure; and
4. If the spending program is [to be] delivered through the tax system, what is the most appropriate design?<sup>49</sup>

Each of these is addressed in turn.

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<sup>49</sup> Sadiq, above n 47, 264.



### ***3.2.1 Question 1: A valid government objective and a government spending priority***

A consideration of the first section of this article indicates that spending on R&D is a valid government objective and, further, is clearly a current government spending priority. As such, the spending would seem to be justified. However, it is essential that a distinction be made between *need* and *design*. This first question addresses the need for such expenditure but does not result in an answer as to design. It is in the remaining three questions that this substantive issue arises.

### ***3.2.2 Question 2: An evaluation using budgetary criteria***

Tax expenditures, since the 1970s, have been considered the equivalent of direct expenditures. Yet, despite this supposition, tax expenditures are not evaluated in the same manner as direct expenditures. In particular, they are not subject to the same regulatory controls and are not part of the annual budget process. Despite the refundable R&D tax incentive being classified as a direct spending program, it suffers from the same fate as the non-refundable offset as it is viewed as a tax incentive rather than a direct spending program simply because of both the reliance on the tax reporting regime and the manner in which it is administered. Tax expenditures also suffer from transparency problems and, despite tax expenditures reporting, are generally poorly managed. The R&D tax offset, whatever form, is no exception. However, if budgetary criteria are used, issues of equity, efficiency, possible distortion, administrative and compliance costs, and implementation are then considered.

First, we can ask whether the benefits will be distributed fairly. The current regime applies thresholds for determining the level of support provided to companies engaged in R&D

## **POWERING INNOVATION THROUGH TAX CONCESSIONS**

activity. While the post 2011 regime applies more generous levels to small and medium companies, it remains an arbitrary and absolute cut-off. Secondly, we can ask whether the program target is efficient; that is, does it reach the intended beneficiaries. The program requires registration of the R&D activities and then the inclusion in the company tax return. At this stage, it is arguable that the program may be subject to both rent seeking and strategies to ensure that spending falls within the criteria of eligible R&D activity. To this extent, the third issue to be addressed under this question is whether the program avoids causing any unintended distorting effects. This may clearly be the case.

The fourth issue to be addressed under this question we can ask using budgetary criteria is whether the administrative and compliance costs of the program are reasonable. Arguably, there is a double handling of the program as the initial step for an entity to undertake is registration approval from Innovation Australia. Only then can an eligible entity claim the R&D tax offset in their company tax return. Essentially, this means that two government bodies must deal with the one transaction. Finally, we can ask whether the program is to be appropriately implemented. Arguably, in this context, there is very little difference between the prior R&D tax concession and the current regime.

### ***3.2.3 Question 3: What is the best Government policy instrument for the program***

In 2008, the Cutler Report stated that the 'R&D Tax Concession is an iconic program in Australia. It is also the

largest single government innovation outlay'.<sup>50</sup> Yet, the same report went on the state:

The inherent characteristics of a statutory tax instrument create challenges with respect to the availability of data and the transparency of the operation of the scheme. The evidence base around a scheme which has operated for nearly 25 years is astonishingly poor. This paucity of data is largely caused by the legal and probity barriers to open disclosure of taxation data and the lack of progress in producing longitudinal data around matched data sets. A further problem in the Working Group's assessment was the inherent difficulty of accurately forecasting the effects of changes to a tax instrument. This difficulty has been acknowledged previously in Senate hearings and introduces the need for some caution in framing recommendations.<sup>51</sup>

In the overall context of an innovation agenda, it further stated:

In summary, the case is strong for public intervention to provide support for the development of innovative capacity and to aid the diffusion of innovations. Typically, markets either fail, or simply don't exist, when there is a high level of uncertainty about the future, as there often is in the case of innovations. In such circumstances, government can play a pivotal role in facilitating innovation and providing the basis for strong productivity growth and increases in the standard of living in the future. Of course, the presence of uncertainty also means that there are several risks for governments in supporting

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<sup>50</sup> Cutler, above n 15, 101.

<sup>51</sup> Ibid 102.

## **POWERING INNOVATION THROUGH TAX CONCESSIONS**

innovation: money can be wasted unnecessarily and we can find examples of this in the past, both in Australia and overseas. This is why it is so important to adhere to a consistent set of design principles in development an innovation policy. At the present time, Australia has a large number of policies to stimulate innovation that have been developed in a fragmentary and inconsistent way. This must change if we are to have a set of policy instruments that is both highly effective and economical.<sup>52</sup>

The Objects section of Division 355 of the ITAA97 also makes it clear that the fundamental question of taxation is not an issue in this case. It states:

### 355-5 Object

- (1) The object of this Division is 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 gained is likely to benefit the wider Australian economy.
  
- (2) This object is to be achieved 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 a general or applied form (including new knowledge in the form of new or improved materials, products, devices, processes or services).

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<sup>52</sup> Ibid 44.

Continuing to adopt a program which requires the administration of government spending on R&D to be administered through the tax regime is flawed. Yet, surprisingly, and despite the acknowledgement of these issues in the Cutler Report, there was no further discussion as to an alternative. The current Federal Government also seems content to maintain a concessionary regime as part of the tax system rather than investigate the effects of turning the current regime into a direct spending program.

***3.2.4 Question 4: If the program is to be delivered through the tax system, what is the most appropriate design***

When the draft legislation changing the R&D tax concessions to their current form was released by the previous Federal Government on 18 December 2009, it was touted as the ‘biggest reform to business innovation policy in over a decade’.<sup>53</sup> It went on to state that the ‘draft legislation follows through on the Government’s commitment to deliver a more generous, more predictable, and less complex tax incentive by replacing the outdated and complicated R&D Tax Concession’.<sup>54</sup> Further outlining the proposed new regime, the press release stated:

This important microeconomic reform is part of the Government's broad productivity agenda. It will cut red tape and provide better incentives to help boost the competitiveness of the Australian economy.

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<sup>53</sup> The Department of the Treasury, (Press Release, 18 December 2009) <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2009/124.htm&pageID=003&min=wms&Year=&DocType=>.

<sup>54</sup> Ibid.

## **POWERING INNOVATION THROUGH TAX CONCESSIONS**

The R&D Tax Credit is also a central element of the Rudd Government's long-term agenda to lift Australia's innovation capacity and performance, *Powering Ideas*.

It is about boosting investment in research and development, supporting jobs and strengthening Australian companies as they continue to seize new opportunities during the economic recovery.

Given the continued support by the current Federal Government, which seems to have adopted the same view as the previous government which made the changes, it is difficult to reach a scenario where question four needs to be answered.

### **4. AN ALTERNATIVE PROPOSAL**

After considering the previous and current R&D tax incentives, it becomes obvious that tax has very little to do with this part of the Federal Government's innovation agenda and that the tax regime is merely a mechanism by which to deliver over AUD 3 billion of public money in the 2013-14 income tax year to entities engaged in R&D activities. This does not result in the conclusion that this money should not be spent on suitable R&D activities but, rather, that these subsidies should be considered as part of the Federal Government's broader spending program. If the subsidies are to be thought of as part of a broader spending regime then it becomes a question of the best way to deliver these subsidies.

A simple alternative to a tax concession regime is a direct matching grants scheme. The current R&D tax offset currently provides small and medium entities with a refundable tax offset of 45 percent. This means that for every 55 cents an eligible entity spends, the Government provides 45 cents. With large

entities the amounts will be 60 cents spent, matched with 40 cents. There is an administrative body, Innovation Australia, already in place and well qualified to determine eligible R&D activities (because it does so already), there is a mathematical formula in place to determine the matching ratio (as above), and the eligible entities are registered with the existing administrative body so there is no need for any further administrative body to be involved. This would eliminate the need for any legislation to be part of the tax regime thereby reducing the governing legislation to one rather than two statutes, it would eliminate the need for the ATO to be involved, thereby reducing the administrative bodies from two to one, and would reduce compliance costs incurred by the relevant entities by having to deal with one administrative body and one set of forms, rather than two.

On the face of it, the argument for a direct matching grant scheme seems compelling, so why is it not raised as an alternative? Arguably, because there is less public accountability and a better story to tell with a tax concession than a direct spending program. Telling the general public that companies who may not ever pay tax, because they are investing in R&D activities which may never be successful, will receive a share of over AUD 3 billion a year is not nearly as acceptable as telling the public that companies who invest in R&D activities to power innovation in Australia will be granted tax concessions for money they have spent.