Australian
Coal Association

PO Box 9115
Deakin ACT 2600
Tel +61 2 6120 0200
Fax +61 2 6120 0222

info@australiancoal.com.au
www.australiancoal.com.au
ACN 095 274 472
ABN 11 095 274 472

26 October 2009

General Manager
The Treasury
Business Tax Division
Langton Crescent
PARKES ACT 2600

Dear Sir/Madam

Response to "The new research and development tax incentive" consultation paper

The Australian Coal Association (ACA) is pleased to make this submission in response to the questions and principles outlined in the Treasury's consultation paper "The new research and development tax incentive" ("the consultation paper") regarding the proposed measures for the new research and development ("R&D") incentive to be introduced from 1 July 2010.

The ACA submits that:

- R&D activities conducted outside of Australia should be eligible for the R&D incentive where the activities cannot be conducted in Australia. The current 10% threshold should be applied on a self assessment basis with any claims for amounts in excess of 10% subject to pre-approval from Innovation Australia;
- In accordance with the principle of supporting collaborative efforts towards common R&D solutions which result in R&D that is in addition to what otherwise would have occurred and provides spillover benefits to the industry and community, the "on own behalf" requirements of the legislation be drafted to create certainty in relation to the eligibility of collaborative arrangements such as the ACA Low Emissions Technologies Ltd (ACALET) COAL21 Fund; and
- Parties should be allowed to contractually agree which entity will claim the benefit of R&D tax incentives, subject to the requirement that the party claiming the incentive has incurred the expenditure and is at financial risk in relation to the expenditure.

We set out our reasoning for these submissions further in the attached paper. If you would like to discuss this submission in more detail please contact Samantha McCulloch, Director Policy & International, on ph.02 6120 0206 or samantha.mcculloch@australiancoal.com.au.

Yours sincerely,

Ralph Hillman
Executive Director

The ACA's response to the consultation paper is focused on the application of the following points in relation to the proposed amendments to the R&D tax incentive:

1. Overseas activities; and
2. Collaborative arrangements and modification to the eligibility requirements of the 'on own behalf' rules under S 73B(9) of the ITAA 1936.

1. Overseas Activities

The ACA agrees that Australian based R&D activities should remain the dominant form of support in relation to the R&D tax credit, as outlined in Principle 1 and Question 1. However, as described in *venturousaustralia*[1], the way R&D is undertaken is changing and international collaboration on R&D activities is now being encouraged to answer 'big science' questions that require facilities and intellectual resources beyond the scope of a particular small country such as Australia.

In order to adapt to the emerging changes in the way R&D is being undertaken, we suggest the R&D tax credit allows for certain R&D activities to be conducted overseas where the activities cannot be conducted in Australia, for example where there is limited domestic expertise, technology or resources. We suggest the implementation of the following strategy in the R&D tax credit regime for conducting overseas R&D activities, namely:

- To preserve the current R&D tax concession 10% threshold for overseas R&D expenditure where Australian-owned R&D includes R&D conducted overseas but make changes to allow for:
  - a self-assessment arrangement where overseas R&D expenditure is less than 10% of overall R&D expenditure; and
  - consideration of claims in excess of 10% by the requirement to obtain pre-approval from Innovation Australia where overseas R&D expenditure exceeds 10% of overall R&D expenditure. We envisage that pre-approval will require a thorough examination of overseas R&D activities by Innovation Australia to determine, for example, whether it is essential the activities are conducted overseas, and whether the outcomes will benefit the Australian economy.

We believe the R&D tax incentive will benefit from the implementation of this strategy for the following reasons:

- The self assessment arrangement will streamline the conduct of R&D activities by providing a straightforward and reasonable approach to allowing core R&D activities to be carried out in Australia, and to source relevant expertise and technologies not readily available domestically;
- The requirement for pre-approval will provide a safeguard in relation to ensuring that Australia benefits appropriately from R&D activities conducted overseas that is subsidised by Australian tax payers, in particular where overseas R&D expenditure becomes more significant in the R&D claim; and
- To avoid the administrative costs associated with obtaining pre-approval for overseas R&D activities, companies may limit the overseas R&D expenditure claim to within 10% of overall R&D expenditure, in particular where foreign R&D expenditure is approximately 15-20% of overall R&D expenditure. In R&D claim years beyond 2010, limiting overseas R&D expenditure to within the 10% threshold may also become more prevalent in the budgeting phase of the R&D project.

[1] *venturousaustralia* page 21

2. Collaborative arrangements and modifications to the eligibility requirements of the 'on own behalf' rules under section 73B(9) of the ITAA 1936

Benefits arising from collaborative arrangements

In accordance with the concept outlined in *venturousaustralia* and Principle 5 of the consultation paper, we agree that the new R&D tax incentive should support collaborative efforts towards common R&D solutions and target R&D that:

- Is in addition to what otherwise would have occurred; and
- Provides spillovers – benefits that are shared by other firms and the community that are large relative to the associated subsidy

By means of a specific example in relation to establishing a collaborative arrangement for the purposes of conducting R&D activities that focus on the abovementioned benefits, we refer to the formation of ACA Low Emission Technologies Ltd ("ACALET").

Understanding of the ACALET arrangement

ACALET is a company established to administer the Australian black coal industry's $1 billion COAL21 Fund, which is supporting the research, development and demonstration of low emissions technologies for coal-fired power generation. ACALET is an income tax exempt entity that receives voluntary levies from Australian black coal producers ("the contributors"), of which all levy contributions are directed towards low emission coal R&D projects. The contributors receive benefits from the R&D projects, including their interest in the results of the projects concerned, which are commensurate with the contributions made.

The contributors can claim a deduction under subsection 73B (13) of the ITAA 1936 for levies paid to ACALET and applied in return for the performance of research and development activities on their behalf. ACALET does not itself make a claim for the R&D tax concession.

Benefits arising as a result of the ACALET collaborative arrangement

Both additional R&D and spillover benefits are generated from projects funded by ACALET, each of these benefits are briefly outlined below:

- *Additional R&D*

Projects in relation to developing clean coal technologies require considerable capital contributions, personnel and expertise beyond what is typically available within individual companies. Projects that are funded by ACALET and undertaken by various project entities are collaborative arrangements that allow R&D to be undertaken which is in addition to what otherwise would have occurred.

- *Spillover benefits*

Projects that are funded by ACALET are collaborative arrangements that provide spillover benefits, in particular to the coal industry, as a result of:

- Avoiding the duplication of R&D activities and achieving solutions in a more efficient manner; and
- Contributing companies participating in the R&D activities obtain the knowledge and use of the intellectual property resulting from the collaborative R&D efforts, rather than individual companies obtaining separate aspects of the intellectual property.

In the ACALET example, a broader public benefit is also evident whereby the R&D activities of the industry are making a major contribution to domestic – and indeed global – efforts to address climate change through the deployment of Carbon Capture and Storage (CCS) technology. The COAL21 Fund complements

Commonwealth Government activities and will be used to support industrial-scale demonstration projects under the $2 billion CCS Flagship Program.

General application of collaborative R&D arrangements

Although the ACALET example is specific to the coal industry, it highlights the benefits that can be obtained by forming collaborative R&D arrangements. We envisage that similar collaborative R&D arrangements may be achievable across various industries which could have the potential to provide for innovation in that industry and boost slowing productivity in the Australian economy[2].

Modifications to the eligibility requirements of the 'on own behalf' rules under section 73B(9) of the ITAA 1936

The legislative principles in section 73B(9) prescribe the 'on own behalf' rules and outline the one claimant principle in respect of claiming expenditure in relation to R&D activities, ie that only one party is entitled to make a claim in relation to R&D expenditure. Under the ACALET collaborative arrangement the one claimant principle is preserved as only one party, the contributor, is eligible to claim the R&D expenditure, the contributor being the party bearing the requisite financial risk. However, the formation of such collaborative arrangements is not specifically considered in the current definition of the 'on own behalf' rules and accordingly ATO class rulings, which detail how the arrangement satisfies the 'on own behalf' rules, are required on a case by case basis to obtain certainty for claimants to determine that this collaborative arrangement meets the eligibility requirements for the R&D tax concession.

We agree, subject to the comments below, with and support the 'on own behalf' requirements and the one claimant principle as outlined in section 73B(9). We support the preservation of these principles under the new R&D tax credit regime, however, we believe that when structuring the new legislative provisions, the 'on own behalf' requirements should provide certainty regarding the eligibility of collaborative arrangements, such as ACALET's, as an acceptable R&D structure. We believe that modification to the 'on own behalf' provisions is required to provide certainty for claimants in order to minimise the administrative costs of the arrangement and the application of class rulings. This would result in encouraging the establishment of collaborative R&D arrangements to obtain the additionality and spillover benefits as described in *venturousaustralia* and Principle 5 of the consultation paper.

The Consultation paper makes it clear (paras 31-35) that it is intended that the 'on own behalf' rules be retained, and that they will continue to respond to the three existing key criteria, namely:

- bearing financial risk;
- control; and
- effective ownership.

Practically, the 'on own behalf' test becomes difficult to apply in the case of collaborative research involving a number of parties, particularly where the research may be funded in whole or in part by an industry group. While satisfying the 'financial risk' test does not generally prove problematic, ensuring appropriate levels of control and effective ownership creates substantial difficulties.

The 'control' issues can generally be dealt with by ensuring that a representative of each funder, or each group of funders in the case of an industry body, has a right to be represented in relation to the project. This is generally desirable commercially in any event to ensure proper control over funding.

The effective ownership issues are generally those which create the greatest difficulty in any collaborative project. The parties may have different interests in actually using the outcome of the R&D, or in ensuring that it

[2] *venturousaustralia* page 115

permeates effectively to the community at large. For example, a researcher may agree to contribute substantial knowledge or IP in return for an interest in the further IP to be developed, while a funding party may not have a particular interest in owning or using the IP for itself, but rather merely a desire to ensure that it is used. While those interests may sometime coincide with the 'effective ownership' requirements, they may in other cases be inconsistent with the R&D requirements. In these circumstances, the 'on own behalf' requirements may become the 'tail that wags the dog', and unnecessarily complicate the process of reaching an agreement which meets the commercial objectives of all of the parties.

The reasons given for the retention of the 'on own behalf' requirements are that this rule enables the appropriate claimant to be identified, and prevents duplication of claims where R&D is contracted out.

An alternative method of achieving the same outcome would be to allow for companies to agree contractually on which entity will claim R&D concessions which may be available. This may either be the company which actually carries out the R&D, or the company which provides funding for that R&D.

Provided that appropriate restrictions are placed on financial risk, in order to ensure that companies cannot receive an automatic or defined return on their R&D spend, this does not create a risk to the revenue as the mere presence of an R&D credit will not encourage entities to carry out or fund R&D which is not otherwise to their benefit. Provided that a proper degree of financial risk exists, companies will not spend $100 to claim a tax credit worth less than $100, unless the expenditure is actually for their benefit, whether directly or indirectly. However, companies may contribute to R&D which is perhaps only indirectly to the benefit of their businesses, for example, R&D which benefits the activities of their customers, and maintains or widens the market for the goods. This may occur because the suppliers have a greater interest in the conduct of the R&D, or because the customers do not have the economic capacity to carry it out. There is no reason in principle why such R&D should not be incentivised, notwithstanding that the benefits arising are indirect.

The position would perhaps be more complex in the case of R&D carried out on behalf of suppliers, as integrity rules might be necessary to ensure that payment for goods was not merely re-characterised as R&D spend. These integrity rules might amount to no more than applying the 'financial risk' requirements as they presently exist. Such rules might only be applied in the case of a direct relationship between the particular supplier and the particular customer.

Broadly, we believe that legislative principles should be modified to include collaborative arrangements where companies pay contributions to a fund for the express purposes of undertaking R&D projects, similar to the ACALET arrangement, as eligible R&D arrangements. We would recommend that in order to achieve this, the following be undertaken:

- the “on own behalf” requirements be relaxed in the case of collaborative R&D; and
- parties be allowed to contractually agree which entity will claim the benefit of the R&D tax incentive, subject to the requirement that the party claiming the concession has incurred the expenditure and is at financial risk in relation to the expenditure.

Conclusion

We submit that the changes described above satisfy the objectives of the R&D tax incentive to encouraging R&D which is additional to that which would otherwise have occurred and provides benefits which are shared by the industry and the community. The benefits to be obtained from establishing policies in relation to overseas R&D and collaborative efforts towards common R&D solutions, as discussed above, will positively influence the way R&D is undertaken and will provide value adding innovation to the Australian economy.

We appreciate the opportunity to make this submission and would welcome the opportunity to discuss this further should you wish to do so.