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**Treasury Consultation Paper - The New Research and Development Tax Incentive**

Caltex is pleased to provide the following comments in response to issues which are raised in the Treasury's recently released consultation paper – *The New Research and Development Tax Incentive*:

1. Principle 5: Research and development (R&D) tax incentive should target R&D that is in addition to what otherwise would have occurred and provides spillovers;
2. Principle 6: Tightening of the definition of eligible R&D tax concession – R&D activity to be defined as systematic, investigative and experimental activity that involves both innovation and high levels of technical risk; and
3. Principle 7: Limiting scope of the supporting activities.

**Principle 5**

***The new R&D tax incentive should target R&D that:***

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

Caltex is of the view that the availability of the R&D tax incentive has a direct positive impact on the level of investment which industry-participants are willing to commit to R&D.

By their very nature, the vast majority of Research & Development ("R&D") projects undertaken in Australia's petroleum refining industry are capital and labour intensive, requiring significant levels of funding and resourcing, including highly-skilled workers.

As one of Australia's largest employers in the industrial sector, Caltex employs many Australian workers (including graduates and trainees) who are exposed to a wide range of projects and initiatives which involve R&D. These activities provide a significant level of "spillover" benefits to the wider community by providing development opportunities for many Australian workers.

Another spillover benefit of Caltex's R&D activities is that it drives technical innovation and the development of new knowledge in the industry. In order to remain competitive in the Australian market, it is essential that Caltex continues to invest in the development of new technologies and processes. Also, as an organisation, Caltex promotes a culture of operational excellence, regularly seeking business improvements in all aspects of its operations.

Caltex therefore continues to commit significant levels of funding for R&D activities which are designed to bring about process improvements and product enhancements and minimise our impact on the environment. We therefore believe it is imperative that corporations such as ours which contribute to the development of technical know-how and the skills of Australian workers on such a large scale continue to be recognised for their contribution in the form of the R&D tax incentive.

#### *Recommendation*

Caltex recommends that Principal 5 be used as an overarching objective of the proposed new incentive and not as one of the specified criteria which need to be satisfied for eligibility to the incentive.

#### **Principle 6**

***Eligible R&D activity will be defined as systematic, investigative, and experimental activity that:***

- (a) involves both innovation and high levels of technical risk; and***
- (b) is for the purpose of producing new knowledge or improvements***

The Consultation Paper proposes narrowing the definition of “eligible R&D activity” such that an activity will not qualify for the proposed R&D tax incentive unless it satisfies all of the requirements noted above. In broad terms, as outlined in the Consultation Paper, this proposed amendment is designed to ensure that the R&D tax incentive is available for R&D activities which add a significant level of value.

We believe this proposed change will significantly reduce the number of R&D projects and activities which will qualify for the incentive. The proposed narrower definition does not allow flexibility in determining whether an activity is eligible for the incentive as both tests must be satisfied for the incentive to apply. Projects may commence in the high technical risk category (without necessarily being innovative) and then develop into innovation. Under the proposed new definition these projects will not qualify for the incentive.

This would be the case for R&D activities which identify new processes through testing, experimentation and investigation of results, leading to new ways of thinking. Such projects may not be considered innovative at their inception but lead to innovation throughout the course of the project, resulting in conducting R&D which would not currently be performed.

Projects with a high level of technical risk often provide spillover benefits through increased production. For example, “dual purpose” activities not only result in the development of new know-how but also bring about an increase in production. Such activities typically generate increased revenue, which in turn leads to an increase in Government revenue through increased taxes.

Under the proposed narrower definition of “eligible R&D activity” such dual purpose projects will not be eligible for the R&D incentive. This may discourage taxpayers from conducting these activities and lead to a potential reduction in revenue and taxes.

We believe the definition of eligible R&D activity is too restrictive and scientific and will greatly reduce access to the R&D tax incentive which will in turn have a detrimental effect on the level of investment in R&D in Australia. This, we believe, steers away from the original intention of the Government – to drive innovation and provide a stimulus for R&D in the economy.

In relation to the narrowed definition, the Consultation Paper notes (at paragraph 54) that:

*"Subsidising an activity that is innovative but not technically risky may lead to additional benefits outside the company – but it is more likely to do no more than subsidise a company for doing what is already commercially sensible.*

*Subsidising an activity because it is risky but not innovative is seen as unlikely to deliver benefits beyond the individual company."*

The view that R&D activities provide benefits only for the "individual company" undertaking the R&D is a narrow view. As discussed above (under Principle 5), Caltex's R&D initiatives impact many stakeholders including the skilled employees employed to be directly involved in R&D projects, as well as contractors and suppliers.

Further, many R&D initiatives undertaken in the industrial sector have a positive impact on the community at large, including initiatives designed to reduce the carbon footprint and minimise the environmental impact.

The Consultation Paper is also unclear about how the requisite level of innovation (specifically in areas of novelty) and technical risk are to be defined and how taxpayers should determine whether a particular R&D activity satisfies each of these criteria.

### **Recommendation**

Caltex opposes the proposed changes to the definition of eligible R&D activities. Caltex strongly recommends retaining the existing definition in order to retain and increase the levels of investment in effective R&D in Australia. The R&D incentive should recognise and support those entities that take the initiative to invest in R&D which result in economy-wide benefits.

### **Principle 7**

***Supporting R&D will continue to be recognised under the new R&D tax incentive but claims will be subject to new limitation.***

Caltex welcomes the proposal to continue recognising supporting R&D under the proposed measures, however disagrees with the proposed new limitation.

Under the proposed changes, Caltex will be required to distinguish between its core and supporting activities on eligible R&D when determining its entitlement to the R&D tax incentive. This will impose significant additional compliance obligations on Caltex as it will require a complete review of the accounting systems to record the necessary allocation of core and supporting activities.

Further, the Consultation Paper is unclear as to the definition of supporting activities, instead, providing five options for determining an entity's supporting activities. The proposed options do not support any cost allocation which Caltex currently adopts, and will therefore result in increased compliance obligations for Caltex (and taxpayers in a similar position).

Another potential issue which emerges for Caltex under the proposed measures is that new processes are usually tested and implemented through existing systems – not new systems as is implied by principle 7. For efficiency reasons, the successful development of a new process/product or innovative idea is predominately run through the existing production environment. It is not economically viable or practical to build separate process flows and create isolated test environments for R&D.

With the increase in the compliance burden (in calculating R&D spend and extracting information from our systems to identify supporting activity costs) and because our R&D activities are predominately supporting activities, we expect a significant reduction in Caltex's R&D claims, to the point that we would not consider making a claim on any R&D projects.

Not having access to the R&D tax incentive will impede Caltex's investment in R&D activities, going completely against the Government's objective in introducing the R&D tax provisions – to encourage investment in R&D.

### **Recommendation**

Caltex does not support any of the options provided to calculate the supporting activities component of the claim.

We request the Government carefully consider the impacts that this principle will have on corporations that are driving R&D activities. We recommend that the principle is more specific, targeting supporting activities which would not be appropriate to claim rather than eliminating supporting activities all together.

October 26, 2009

## Conclusion

In summary, the tightening of the definition of eligible R&D activity and the limitations in claiming supporting activities will significantly reduce the R&D claim that Caltex will make if the proposed amendments are legislated. We believe this will have a negative impact on the Australian economy by reducing the important spillover benefits enjoyed from the R&D activities.

Yours sincerely

Handwritten signature of Kathrine Bolton in black ink.

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