



Fletcher Building Australia

Level 11, Tower B Zenith Centre

821 Pacific Highway

Chatswood NSW 2067

Locked Bag 7013 Chatswood DC 2067

Telephone +61 2 8986 0924

Facsimile +61 2 8986 0920

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

By e-mail to: rdtaxcredit@treasury.gov.au

Dear Sir

Submission on Consultation Paper – The New Research and Development Tax Incentive

Fletcher Building Australia Pty Limited (FBA) welcomes the Federal Government's initiative in reviewing Australia's Research and Development (R&D) tax incentive following the findings of the Review of the National Innovation System (the NIS review).

FBA strongly support the enduring value created by the Government in their ongoing support of the R&D tax incentive.

FBA is a subsidiary of and Australian holding company of Fletcher Building Limited (Fletcher Building). Fletcher Building is the largest diversified building products company in Australia/New Zealand. Its separate operating divisions represent the following Australian brands:

- Stramit (roll formed steel);
- Fletcher Insulation (Pink Batts and Fat Batts);
- Laminex and Formica (laminated building products & Australia's last remaining manufacturer of High Pressured Laminate);
- Rocla Pipes (concrete pipes, railway sleepers and concrete poles);
- Rocla Quarry (sand and aggregates, including the mining of silica for glass manufacture); and
- Oliveri sinks (Australia's last remaining manufacturer of sinks).

FBA supports the overall reform objective of making “the new R&D tax incentive more effective in delivering support for business R&D and in targeting that support to where it is most likely to produce net-benefits for the Australian community.” The prospect of a less complex and more predictable R&D incentive is also welcomed.

We offer the following comments on certain specific aspects of the Design Principles and related questions contained in the Consultation Paper. We have not commented on every aspect of the Design Principles, commenting only in respect of those aspects which have the potential to impact materially in respect of FBA’s R&D activity.

Summary

- FBA supports an exception to the general rule that eligible R&D activity must be conducted in Australia, where that activity cannot be conducted in Australia.
- Consideration should be given to the design of the new R&D tax credit so as to enable any benefit arising from the R&D tax incentive to be accounted for “above the line”.
- FBA supports the continuation of the existing treatment of R&D expenditure that is currently deductible at 100%.
- FBA has concerns with the practical application of the new policy objectives set out in Principle 5. FBA is concerned that the current review is not focussed on achieving the desired outcome of encouraging sustainable investment in R&D, but is simply limiting the scope of what qualifies R&D.
- FBA does not support the proposed changes to the definition of Core R&D activity and recommends the inclusion of “and” instead of “or” in the definition be reconsidered.
- FBA is of concerned that the distinction between core and supporting R&D activities (and associated expenditure incurred in performing each) will significantly increase the compliance costs of claiming R&D tax incentives.
- FBA is of the view that the uncertainty arising from all the proposed changes will create a greater administrative burden on taxpayers.
- FBA request that Treasury urgently review and publish a more up to date guide to eligible activities, to help clarify the Government’s opinion and interpretation of activities undertaken by industry.
- FBA seeks clarification on any transitional rules as many R&D projects have proceeded on the basis that the existing R&D tax incentive applied and there is potential for the proposed changes to significantly adversely impact on these projects.

Principle 1 – Access to New Incentive

Question 1 – Should there be any exceptions to the general rule that eligible R&D activity must be conducted in Australia?

FBA strongly supports that the majority of R&D activities should occur in Australia, BUT also supports an exception that where the activity cannot be undertaken within Australia, that activity can be conducted overseas, capped to an acceptable level (currently at 10%).

It is often the case that there is either no capacity or the relevant equipment is not available to undertake the R&D activity wholly in Australia. This is particularly a concern in relation to our Laminex division where it has been necessary in the past for us to avail ourselves of the use of overseas pilot plant facilities. It would not have been possible for us to have completed many R&D projects if the overseas activities were not undertaken.

The current concessions in relation to R&D activity outside Australia are well established and should be retained

Principles 2 and 3 – New R&D Tax Credit

Question 2 – How should the new R&D tax incentive treat R&D expenditure that is currently deductible at 100 per cent?

FBA supports the continuation of the existing treatment of R&D expenditure that is currently deductible at 100 per cent.

Non enhanced deductions expenditure should continue to be handled as part of the R&D tax incentive. FBA is concerned that the Australian Taxation Office may deny a deduction for such expenditure if the deductibility of such expenditure was considered outside the R&D tax incentive. There is a risk that such expenditure could be considered to be of a capital nature and be treated as non-deductible. Such a result would erode the benefit of the R&D tax incentive. It would also create additional unnecessary uncertainty when determining the deductibility of such expenditure.

Tax credits in lieu of deductions:

In finalising the design features of the tax credit model, the Government should ensure that it is designed so as to ensure that R&D credit can be reported “above the line” in accordance with relevant accounting principles.

The ability to report the R&D credit in earnings results will provide a significant additional incentive for large businesses, with no additional cost to Treasury.

Principle 4 - Administration

FBA welcomes the prospect of more efficient and effective administration of R&D.

The current joint administration model between AusIndustry and the ATO has worked effectively and does not require significant change.

There is a real risk that the uncertainty arising from the proposed changes to eligible R&D activity and the definitions of Core and Supporting R&D outlined in the Consultation Paper (discussed further below) will create a greater administrative burden on taxpayers.

Principle 5 – Eligible R&D activity

The Principle states that the R&D incentive should target R&D that “is in addition to what otherwise would have occurred.”

FBA submits that this Principle is potentially flawed as companies do not make a decision to proceed with R&D based solely on the existence of a tax incentive.

The R&D tax incentive has been successful in driving sustainable investment in R&D for over 20 years. It has been successful not because of the availability of the incentive in any particular year or for any particular project but because it has entrenched a culture of innovation and development, an environment that encourages the commercialisation of new products and processes. It is this culture that has ensured Australian companies, like FBA, are competitive domestically and internationally.

It is submitted that the maintenance of this culture is more important than “chasing” the projects that would otherwise not have occurred. A shift to focus the R&D tax incentive on only that which would not have occurred has the potential to erode this positive industry behaviour over time.

The Principle also states that the R&D incentive should target R&D that “provides spillovers” and spillovers “that are large relative to the associated subsidy”.

FBA does not necessarily disagree with this aspect of the Principle. However to legislate such a Principle is extremely difficult given that, by its very nature and definition, R&D is risky and the outcome can not be known until the research is complete and the commercialisation of the product or process is complete.

The changes in the Consultation Paper seem to seek to implement this Principle by focusing solely on the costs that qualify for the R&D tax incentive (and ways of limiting the cost). The correct assessment should be on the benefit (spillover) that any individual project delivers or has the potential to deliver in the future, regardless of its cost. The value created for each dollar claimed under the R&D tax incentive is a clear indicator of the success of the program.

Principle 6 – Core R&D

Change of R&D definition: The Consultation Paper has not set out a strong and compelling rationale for the proposed changes to the current R&D definition.

Changing the definition will generate unnecessary confusion and will only undermine the goal of creating a less complex and more predictable R&D system.

Given the intention for the new R&D tax incentive to apply to both new and existing R&D projects, there is the potential for existing R&D projects to be excluded once the new definition takes effect, notwithstanding that business decisions may have been made based on the R&D incentive applying.

Inclusion of “and” instead of “or” in definition: A requirement for “innovation and high levels of technical risk” imposes a much stricter test on eligibility.

Technical risk and innovation are not mutually exclusive, but require the same level of scientific solution, technical people working to develop or overcome a problem. Not all R&D results in a new product, some is performed to overcome a technical problem in a new way, or simply improve an existing product. These projects have the potential to be excluded.

If the Government chooses to proceed with the change in definition, FBA would like to see detailed guidelines on the new definition at the same time as the Government issues any draft legislation. Understanding the implications of the change in the R&D definition is core to understanding the proposed changes to the R&D system and its potential impact on our business.

In FBA's experience it is not clear to us that projects with both innovation and high levels of technical risk give rise to greater spillovers than projects that only involve technical risk.

Principle 7 – Supporting R&D

Question 5 – Should the current list of activities excluded from being considered core R&D be amended?

FBA does not support any change to the content of the “excluded activities”, as this list has been well established and is well understood by companies undertaking R&D.

FBA does not support the extension of these “excluded activities” to eligible supporting R&D activity.

Capping of Supporting R&D Activities:

FBA does not support the capping of eligible supporting R&D activity expenditure.

The amount of expenditure on core R&D is not a reliable basis for determining the reasonableness of expenditure on supporting activities. Accordingly, any cap would need to be set quite high, at least 5 times of the expenditure on core R&D. There is a significant risk that by capping supporting activities, the integrity of the R&D Project may be scientifically affected, with the potential of eroding the quality of research undertaken.

Sole purpose test:

FBA does not support a sole purpose test. A lesser test, such as “predominately” for the purpose of supporting core R&D activity would be more appropriate.

We would like to see detailed guidance on the practical meaning of a “predominate test” at the time of issue of any draft legislation.

Exclude production activities or dual role activities:

This exclusion would have the potential of significantly limiting plant trials qualifying as R&D. Plant trials are an essential process in ensuring new products make it to market. Theoretical laboratory studies and even pilot scale trials are insufficient in many cases in resolving the problems that can occur with new product development or even product improvements.

Further FBA does not maintain separate manufacturing lines for R&D activities, so production trials necessarily have dual role activities if we are to meet demand for our products. The net expenditure offset effectively limits the magnitude of these trials, so as to prevent “double dipping”

Net expenditure basis

Supporting activities are as essential in the product development cycle as core activities and should not be netted off.

Lower rate of assistance than core R&D:

FBA does not support any dilution of the rate of assistance given to supporting activities. In our experience eligible supporting activities are as essential as core R&D activities in generate spillover benefits.

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I trust that the above comments will be helpful in finalising any proposed changes to the R&D tax incentive. Should you also want to discuss any of our comments, please do not hesitate to contact me on (02) 8986 0924.

Yours sincerely



Sam Lo Ricco
Group Tax Adviser