29 Torrens Street
BRADDON ACT 2612
AUSTRALIA

T +61 2 6273 8111
F +61 2 6273 8011
W www.a3p.asn.au

12 February 2010

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

Attention: James O'Toole

Email: rdtaxcredit@treasury.gov.au

New R&D Tax Incentive — Exposure Draft Legislation and Explanatory Memorandum

Thank you for the opportunity to comment on the exposure draft legislation and explanatory materials for the new R&D tax incentive.

About A3P and the importance of R&D

A3P is the national industry association representing the interests of all segments of the plantation-based wood products and paper manufacturing industry. A3P members employ more than 13,500 people in plantation management, sawmills, panel board, and paper manufacturing and specialty plantation products plants, mainly in rural and regional areas. Each year, A3P members create and sell products worth more than $4 billion, and produce more than 12 million cubic metres of logs, 3 million cubic metres of sawn timber, and more than 2 million tonnes of paper.

A3P members conduct research and development directly and indirectly. The latter is carried out through other organisations, such as Southern Tree Breeders Association, Cooperative Research Centre for Forestry, and Forest and Wood Products Australia, to which companies contribute voluntary or compulsory funds for industry-wide R&D.

Directly, A3P members carry out their own company-specific R&D — to varying degrees, given the wide diversity of the plantation growing and processing sector in scale, products and complexity. However, whatever the scale of their operations, the companies make use of the existing R&D tax concession, and have indicated its importance in helping them maintain and improve their competitiveness in a highly competitive international industry.

This company-specific R&D is carried out to improve the companies' products and services and production and distribution processes, and most is conducted 'on the factory floor', so to speak, as a process of 'continuous improvement' and with a particular focus on improvements that will be commercially viable. **Member companies and their advisers are indicating that these two features will be discriminated against under the new R&D tax offset arrangements**.

A number of leading companies in Australia's wood and paper industry are international, although they conduct R&D here to be better adapted to the Australian resource and to the Australian production and distribution environment and marketplace, as well as to improve their competitive efficiencies in the global market. These companies have indicated the importance and utility of the longstanding R&D tax concession in their decisions to continue their R&D investment within Australia, rather than going offshore.

Comments on the consultation process

It should be no surprise that the scheduling of this consultation process has been viewed with some disquiet. While the unrelenting constraints of the legislative timetable must be acknowledged, it is nonetheless quite unreasonable to release a draft Bill (89pp) and EM (112pp) on 18 December 2009, with a submission deadline of 5 February 2010. The consultation period coincides with the now almost universal period of recreation leave over Christmas-New Year-school holidays, which most of the interested parties (including the Government's own policy officers) take advantage of.

For many organisations, A3P among them, the consultation only came to notice in mid-January, with just two to three weeks remaining to examine the documents and the existing law, conduct internal consultations, and prepare an agreed submission.

Regardless of the other criticisms of the draft legislation (see below), this unfortunate and unreasonable scheduling should alone prompt the Government to formally extend the consultation period by at least another month.

This could and should be extended even further if the Government decides to take seriously the emerging widespread condemnation of the fundamental policy shift embodied in the draft legislation.

A3P has encouraged member companies to make individual submissions if they wish to provide more detail about the way the proposed changes will impact on their company-specific R&D investments. You may get only a couple in this consultation, but more would be likely if the consultation is extended.

For now, A3P's industry-wide submission is more general and overarching, based on our own comparative examination of the existing and proposed arrangements and on a distillation of initial responses from diverse member companies and their own R&D tax advisers.

Comments on the draft bill and EM

The Government's admirable intent is to deliver a "more generous, more predictable, and less complex tax incentive", and to tighten eligibility in order to minimise the potential to rort or otherwise misuse the concession.

A welcome element of the proposed arrangement is the increased level of the concession, combined with its decoupling from the company tax rate by converting from an enhanced deduction to a tax credit.

Despite this, A3P finds it very difficult to see how the legislation as currently drafted can fulfil the primary intention quoted above. By contrast, the provisions in the draft bill would seem to guarantee that the precise opposite will be the outcome. Ironically, it is the number and severity of the new restrictions to tighten eligibility that appear to be the main reason why the new concession will fail to achieve its primary stated intention.

As a general comment about the purpose of the tighter restrictions, A3P would prefer to see questionable R&D claims reduced or eliminated through the use of one or more specifically targeted integrity measures, rather than through the wholesale changes proposed in the draft bill.

A3P is aware of other submissions that are offering rather more detailed criticism of the bill and suggesting specific remedies. A3P's submission merely highlights the issues of most concern to A3P and its members, and seeks a substantially extended period for more detailed consultation and amendment of the draft.

Major concerns

The concerns most frequently raised by our internal consultations were the impacts of:

- the augmented feedstock rules;
- the more restrictive, complex and subjective definitions of R&D for tax purposes; and
- the expanded list of excluded activities.

It has been suggested that these changes will combine to make the new concession less generous, more complex and less predictable for participating businesses.

The need to justify the inevitably subjective interpretations and the need for forensically precise long-term record keeping will substantially increase compliance costs while not eliminating the higher level of unpredictability.

Augmented feedstock rules

In the plantation products and paper industry, R&D investment is inherently linked to developing products, services and processes that derive or increase profit.

By requiring the R&D expenditure to be netted off against an unknown (or, at best, estimated) market value of the output at some time in the future, the 'augmented feedstock rules' makes the concession less predictable and more difficult and complex to budget and account for. R&D projects with long lead-times and payback periods — such as are common in the forestry, wood and paper industries — will be particularly hard hit.

Members anticipate that, under the augmented feedstock rules, most benefit will accrue to those whose R&D fails to become commercially viable, because successful R&D will have most of the concession 'clawed back' in the future.

Under the current feedstock provisions, only the costs of materials and energy are clawed back and thus excluded from the R&D claim. This is quite adequate without the inappropriate addition of labour and plant depreciation (as proposed), which costs are never fully recovered even if the outputs of the R&D are sold.

It would appear that the preferred solution would be to retain the existing feedstock rules or, at the very least, specifically exclude labour and depreciation as input costs under the augmented feedstock rules.

More restrictive, complex, and subjective definitions

New or revised definitions and terminology in the draft legislation, especially when taken in combination, will conspire to restrict the eligible R&D expenditure and create problems of interpretation. The latter could become quite contentious and create new tax risk, particularly if an auditor challenges the company's interpretation some time in the future. Members and their advisers argue that the new eligibility definitions will favour 'blue sky' R&D by academies and research institutes over the innovative continuous improvements that comprise so much business R&D.

Use of the term 'considerable novelty' instead of 'innovation' and 'appreciable novelty' removes a well-defined and well-understood term (innovation) and adds complexity and vulnerability to subjective interpretation ('considerable' in place of 'appreciable').

Making eligibility now dependent on BOTH **considerable novelty <u>and</u> 'high levels' of technical risk** will similarly be vulnerable to subjective interpretation, as well as ruling out currently eligible genuine and meritorious R&D activities because they cannot be unequivocally demonstrated to comply with BOTH requirements.

The new **“dominant purpose” test for supporting activities** is much tighter than the current requirement for a support activity to be for "a" purpose directly related to the core R&D activities. The test will significantly reduce the amount of claimable support activity by imposing a severe burden of evidence and justification on intending business claimants. Few businesses in this industry have the resources to operate stand-alone R&D facilities, and will often, in commercial settings, find it impossible to satisfactorily differentiate core R&D from supporting or commercial activity and determine whether a supporting activity has a dominant R&D purpose.

Excluded activities

The **exclusion of a large number of activities from being either ‘core’ or ‘supporting’** seems arbitrary. Among a number of exclusions raised by others, of particular relevance in the wood and paper manufacturing sector are the exclusions of pre-production trials and demonstrations of commercial viability. Pre-production trials in particular are often critical to determining the success or otherwise of a new product or process and cannot fairly be made ineligible.

Innovation policies and programs complement most other Government policies, and can play a significant role in their successful implementation. A3P believes this inherent complementarity and interlocking must be kept in mind as the Government considers the public and industry response to this draft legislation.

One example of relevance to A3P and its members is the activity of the Pulp and Paper Industry Strategy Group, convened by Senator Kim Carr, the Minister for Innovation, Industry, Science and Research. The purpose of the Group is to undertake a review of the industry and develop a **plan to encourage innovation and attract investment** in pulp and paper manufacturing in Australia.

A3P repeats its call to the Government to extend the period of consultation, so that this very important legislation can be more thoroughly considered and debated with those most affected, and revised to better fulfill its policy intent BEFORE it is finally introduced into Parliament.

A3P is available to have further discussions with the Government if it would add value to the contributions of other bodies that have been taking the most active roles in this consultation. The first contact at A3P should be Alan Cummine, Manager—Plantation Investment, who can be reached on 02 6273 8111, 0407 488 927, and alan.cummine@a3p.asn.au.

Yours sincerely

RICHARD STANTON
Chief Executive Officer

Published by A3P
Braddon, ACT, Australia