# ADITUS CONSULTING

5 February 2010

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

Dear Sir/Madam

**Exposure Draft of the Tax Laws Amendment (Research and Development) Bill 2010**

We are pleased to submit our comments in relation to the Exposure Draft legislation.

Aditus Consulting Pty Ltd is a small consulting firm specialising in the provision of R&D tax advice to a wide range of clients ranging from small clients accessing the R&D offset scheme to larger clients accessing the 125% R&D tax concession. We have been continuously advising clients for 20 years. The scheme works effectively in actively supporting R&D across all sectors of the economy and the various stakeholders generally work within the well accepted and understood rules of the system.

Generally, we support the broad aim of the introduction of a more streamlined tax incentive however, after discussions with our clients, other consultants and a review of the Exposure Draft Bill and Explanatory Memorandum, the proposed changes fall well short of the mark in delivering the desired policy objective.

We have major concerns with the Exposure draft Bill both at a policy level and on more practical terms.

The new R&D tax credit in our view will significantly reduce the number of claimant companies not only in the SME market but more generally across the broad spectrum of companies operating in the industries we advise. For a large number of companies, the increased compliance costs to initially implement the proposed changes together with the ongoing maintenance, will outstrip the cost benefit of the incentive offered and many will not bother to make a claim. The proposed changes are definitionally complex and unwieldy to implement. The definitions lack clarity and often rely on a subjective assessment of whether a taxpayer has met the relevant tests, of which there are many. Some terms are not defined at all. There are inconsistencies in explanations provided in the EM compared to the draft version of the relevant provision. There are no transitional provisions. There are no draft regulations outlining how the two administering bodies would like the information to be presented. And the start date is 1 July 2010. How can businesses and advisors progress with any certainty in this environment?

All these changes combine to render the program effectively useless in the commercial R&D marketplace. At a time when investment in Australian industry and increased productivity is critical for economic survival in a competitive world economy, it is not the time to wind the policy clock back to 1985 in the name of fiscal restraint.

The current R&D tax concession has been around for 25 years. This is ably supported by a body of case law, Guidelines, Tax Rulings, Interpretative Decisions and the recently consolidated 125% R&D Tax Guide to Benefits. The scheme works effectively in actively supporting R&D across all sectors of the economy and the various stakeholders generally work within the well

accepted and understood rules of the system. All this will be thrown out when/if the new Bill is passed.

The administration of the proposed scheme both in the implementation and ongoing monitoring will be phenomenally onerous and costly for both Government and corporate Australia.

This group has come together to specifically address our concerns with the draft provisions. Each firm will be making its individual submission that addresses issues relevant to its client base. We have summarised our key policy concerns:

**Core and Supporting Activities**

A conjunctive test for R&D projects to contain both "considerable novelty and high levels of technical risk" has a serious risk of contracting the numbers of claimant companies who will struggle to meet both tests particularly where incremental innovation is involved. This conjunctive test is restrictive enough but when coupled with the additional need to meet the "Systematic, Investigative and Experimental" test and the "Purpose, Knowledge, Improvements" test makes the determination of an eligible core activity overwhelmingly complicated. This is a policy reversion to the "mosaic-ing" approach favoured by AusIndustry over ten years ago that was ultimately overturned by the courts.

For most companies conducting more than a handful of R&D projects a year, this would be an administrative nightmare. Most engineers and technical personnel do not think in terms of core or supporting activities rather they consider activities on a project basis or delivered outcome.

The additional administrative compliance and costs required to effectively administer the scheme once implemented will render the R&D Tax Credit cost ineffective for the majority of companies. This will reduce the target market to a small handful of companies in the SME space undertaking pure research and significantly reduce the size and number of claims made by larger companies.

**Dominant Purpose test**

The proposed introduction of a "dominant purpose" test in respect of supporting activities is short-sighted in the extreme. The dominant purpose test imports a test that is subjective, and is heavily dependent on a strong working knowledge of existing tax case law that is generally not within the reach of engineers and technical personnel undertaking the R&D. The decision will invariably fall back to a company's in-house tax team or external advisors to determine. To compound the complexity, this will need to be applied for every supporting activity.

It will undermine the incentive to conduct applied research by Australian businesses. Essentially, the program focus will be on the conduct of research phase activities and not the development phase of activities. In general, the role of supporting R&D is fundamental to the validation of any theoretical or conceptual idea and their progression from the laboratory to production. For years, we have been trying to educate companies to think beyond the traditional notion of "white lab coats and foaming test tubes" and expand the concept of what it actually takes to develop a concept into a real product or process. This proposal rolls back Australian R&D to the policy void pre 1985 when it was recognised that Australian companies were slipping behind OECD companies BERD measures.

Supporting activities are integrally linked to the carriage of a successful R&D project but not all supporting activities are carried out for the dominant purpose of the core R&D. This proposed change will effectively eliminate those associated costs referred to as indirect other expenditure or overheads where it cannot be demonstrated that the activity was undertaken for the dominant purpose of the core R&D.

The current legislation specifies that the supporting activities need to be directly related to the carrying on of the "core" R&D. This is an extremely clear test. The expenditure incurred on supporting activities adheres to the same test. By imposing a dominant purpose test on the extent to which you can claim supporting activities will limit R&D. Why change a test that is so clearly expressed as this?

**Augmented Feedstock Calculation**

The augmented feedstock rule and related provisions fundamentally alter the nature of the R&D tax benefit and its calculation. The draft provisions are complicated, open ended and lacking definitions. The available benefits can only be calculated after the "market value" of the R&D can be assessed. Given that companies will plan for most of their R&D to generate a valuable output, they will therefore intend in most cases to not access the credit, rendering it as a form of relief that will only be considered after the R&D has been completed. If the R&D succeeds, then none of the R&D costs can be recovered except those that relate to conceptual design.

Very few businesses have the luxury of pilot plant facilities to test scaled up process improvements or new product formulations. A large part of industrial R&D by necessity needs to be undertaken in a production environment. If the dominant purpose test does not eliminate the R&D claim, the augmented feedstock provisions certainly will.

Any R&D undertaken in a production environment will be significantly impacted by these proposed changes.

**Core Technology**

Core technology acquisitions and interest on R&D financing should be supported in the new scheme as both aspects are critical in diffusing new technologies in large and small companies alike. Interest costs should also be included as part of the R&D tax credit.

We recommend that this is reviewed and be included at the concessional rate.

**Overseas Expenditure**

The restriction that the R&D activities be conducted in Australia specifically impacts a number of biotechnology companies conducting critical clinical trials both offshore and in Australia. The requirement for companies to demonstrate that the related R&D activities conducted in Australia will be significant compared to the activity carried out overseas is highly subjective on the one hand and extremely restrictive on the other. What boundaries will be placed around this requirement? Will it be in terms of where the IP is held, the significance of the technical breakthrough or the monetary relativity between the two sets of activities?

This restriction is outmoded and reflects a 1950s view when Australian companies operated in a vacuum and not as part of a global economy. How can Australian based companies legitimately produce world beating pharmaceutical and medical breakthroughs when the critical phase of development; namely Phase 2 and 3 clinical trials may not be funded via the new tax credit due to rigid policy? Provided the Australian entity controls the R&D and funds the R&D, this should be sufficient.

We recommend that the subjective element of "significance" be removed altogether together with the additional administrative hurdle of having to apply for approval from Innovation Australia.

**Registration Complexity**

There is a lack of information on how the Board will register R&D activities as core and supporting on every project lodged by the applicant company. Presently this is a self assessment scheme that relies on the integrity of the tax payer to lodge a group of activities that comprise the R&D project. Under the current scheme, the applicant entity receives a letter saying that the activities have been registered and a registration number is allocated.

How will the Board practically achieve this for every project submitted by the applicant? We see this as a potential administrative nightmare that will create unnecessary delays for those companies wishing to access the refundable credit as soon as possible after the year end.

**R&D Plans**

As much as R&D Plans created another layer of administration for the existing scheme, its removal after almost ten years of practical implementation will be a disaster. This is even more the case under the new scheme where each activity will need to meet a multi-layered suite of tests to satisfy the definition and then, each supporting activity will need to satisfy a dominant purpose test in order to qualify.

The absence of R&D plans means an absence of audit trail.

**Conclusion**

In a global economy, companies need incentives to invest in R&D to improve their competitiveness and ongoing profitability. The 125% R&D Tax concession has been a successful program in achieving that outcome. Unfortunately, the drafted provisions do little to achieve that goal. There are many unanswered questions in both the draft Bill and in the accompanying Explanatory Memorandum. Please don't sacrifice a well oiled, broad based industrial R&D scheme for a scheme that is poorly defined, unduly complicated and favours research companies over industrial based companies.

Please read the submissions of the many consultants, companies and industry bodies that comprise and advise the R&D sector and revise the Exposure Draft to make a scheme that benefits more than a handful of companies.

We welcome the opportunity of discussing these concerns in more detail and can be contacted on 02 9969 3913 or 0407 898 493.

Yours sincerely

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