Australian
Coal Association

SUBMISSION

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

February 2010

Introduction

The Australian Coal Association (ACA) represents Australia's black coal industry which is Australia's largest export earner (valued at $54.7 billion in 2008) and provides over 56 percent of Australia's electricity.

Through the $1 billion COAL21 Fund, the ACA is making a significant investment in low emission coal R&D and this submission is limited to R&D tax issues specific to the COAL21 Fund, particularly:

- The restrictive nature of the "on own behalf" requirements for collaborative R&D;
- Replacing the current concept of "innovation" with the proposed narrower concept of "considerable novelty" and replacing the "innovation or technical risk" test with a more restrictive "considerable novelty and technical risk" test;
- Definitional changes to 'core' and 'supporting' R&D activities particularly introduction of a dominant purpose test;
- Changes to the feedstock and plant rules; and
- Clawback provisions.

The ACA is concerned that many of these proposed changes will significantly reduce the scope of eligible R&D activities and act as a disincentive for investment in R&D while also discouraging collaborative partnerships such as the COAL21 Fund.

If the Government chooses to pursue these changes the ACA recommends a period of more considered consultation to 1 July 2011 be undertaken to develop a workable approach and to reduce the substantial costs associated with adjustment to the new law as a result of the impacts on case law precedent and increased compliance burden on business. Such an approach would be consistent with the following three principles advocated by the Business Coalition for Tax Reform:

1. The tax system should be simple, transparent and should minimise uncertainty.
2. The design, administration and operation of the tax system should be undertaken with full and effective consultation with relevant stakeholders including the business community; and
3. The tax system should fairly balance the need to protect the taxation revenue base with the principles of a good tax system, i.e. efficiency, fairness (horizontal and vertical equity), simplicity, clarity, certainty and low compliance costs.

This submission should also be read in conjunction with the submission of the Minerals Council of Australia which addresses broader R&D tax issues associated with mining. The ACA supports the MCA submission.

The COAL21 Fund

In 2006 the ACA established the COAL21 Fund as part of a world-first whole-of-industry funding approach to address greenhouse gas emissions. The COAL21 Fund will raise $1 billion over 10 years from a voluntary levy on black coal production to support the pre-commercial demonstration of low emission technologies in the power generation sector, including Carbon Capture and Storage (CCS).

CCS has been identified by governments and industry as a technology of considerable strategic interest to Australia. By supporting the development and commercial-scale demonstration of CCS, the COAL21 Fund complements Australian Government initiatives such as the $2 billion CCS Flagship Program and the Global CCS Institute.

The Australian coal industry's collaborative approach to R&D has a number of benefits:

- By pooling industry resources, the COAL21 Fund is able to support large-scale demonstration projects which require considerable capital contributions, personnel and expertise which is beyond what is typically available within individual companies;

- A coordinated industry approach avoids the duplication of R&D activities and achieves solutions in a more economically efficient manner; and
- The approach supports more efficient technology transfer with contributing companies obtaining the knowledge and use of the intellectual property rather than this being concentrated within one company. This is particularly important in the case of low emission technologies where accelerated deployment is critical to achieving domestic and global emissions reductions targets.

ACALET

ACA Low Emissions Technologies Ltd (ACALET) is the company established to administer the COAL21 Fund. ACALET is an income tax exempt entity that receives voluntary levies from Australian black coal producers, of which all levy contributions are directed towards low emission coal RD&D projects. The contributors receive benefits from the RD&D projects, including their interest in the results of the projects concerned, which are commensurate with the contributions made. ACALET does not enter into 'joint ventures' with project proponents but rather provides 'grant' funding for low emission coal RD&D.

The ACALET 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.

The "On Own Behalf" Requirements

Recommendation 1: The "on own behalf" requirements should be amended to provide for collaborative R&D arrangements.

The legislative principles prescribe the 'on own behalf' rules and outline the one claimant principle in respect of claiming expenditure in relation to R&D activities. 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.

The ACA supports the 'on own behalf' requirements and the one claimant principle, however we believe that the 'on own behalf' requirements should provide certainty regarding the eligibility of collaborative arrangements, such as ACALET's, as an acceptable R&D structure. The 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.

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, demonstrating appropriate levels of control and effective ownership can create 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 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.

The ACA recommends that the legislation be amended 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.

Activities Conducted for Other Entities

Recommendation 2: Section 355-205 should be amended to clarify that it is not intended to change the existing position that projects may be funded by a group of funders, not all of whom will be taxpaying entities.

Section 355-205 has the effect that expenditure on R&D activities is not deductible if the R&D activity is being conducted, to a significant extent, for an entity which is an exempt entity:

> *an R&D activity is not an activity to which this section applies if the activity is being conducted, to a significant extent, for one or more other entities not covered by any paragraph of subsection (1)*

On its face, this would exclude R&D treatment for any project being jointly funded by exempt and non-exempt entities, including federal and state Governments, and entities which they own, as well as most universities, and many research institutes. Most projects being funded by ACALET will fall into this category.

ACA does not consider that this result is intended. A similar provision is present in the existing provisions, and is not construed by the ATO to give rise to this result, provided that the 'on own behalf' test is retained.

This provision should be amended to make it clear that it is not intended to change the existing position that projects may be funded by a group of funders, not all of whom will be taxpaying entities.

Core Activities: Considerable Novelty AND High Levels of Technical Risk

Recommendation 3: The existing definition of core R&D activities, defined as innovation (appreciable novelty) OR high levels of technical risk, should be retained.

The proposed amendment to require that core R&D activities must involve ‘considerable’ novelty AND high levels of technical risk, rather than innovation (‘appreciable’ novelty) OR high levels of technical risk is not supported. This definitional change will considerably reduce the scope of eligible R&D activities and introduce significant uncertainty with respect to what will constitute ‘considerable’ novelty. Removal of the term ‘innovation’ and replacement of ‘appreciable’ with ‘considerable’ not only breaks with established case law precedent but also would be out of step with the OECD Frascati Manual, which has been an important reference point for the tax concession since its inception.

In particular, it is anticipated that the considerable novelty test may cause difficulty if a number of researchers are independently pursuing the same, or a similar goal, as may often be the case in the development of low emission technologies. Example 2.5 in the Explanatory Memorandum suggests that a company which independently demonstrates a technique developed by another company will fail the 'considerable novelty' test, as the first company has demonstrated that the technique is feasible. The fact that one of them may reach that goal before the others should not disallow treatment of each of them as R&D activities.

It is noted that a similar definitional change was proposed, but ultimately rejected, by Parliament in 2001 because of its potential adverse impact on support for genuine R&D.

Supporting Activities: Dominant Purpose Test

Recommendation 4: The test for supporting activities should be retained as 'directly related' to the carrying on of core activities, rather than the proposed move to a 'dominant purpose' test.

The proposed change of the test of supporting activities to those carried on for the *dominant* purpose of supporting core R&D activities rather than *directly related* will create significant uncertainty around what is considered a 'dominant purpose' and introduce additional compliance burdens where 'core' and 'supporting' activities must be distinguished and costed separately. If interpreted narrowly, the 'dominant purpose' test may also significantly limit the activities which are considered eligible R&D expenditure and directly impact business investment in innovation.

Feedstock Rule

Recommendation 5: The existing feedstock rule should be retained. In the event that the proposed changes are enacted, clarity is required around their application.

The proposed new feedstock rule would significantly reduce available deductions in relation to low emission coal technology demonstration projects whose primary outputs will be electricity, and potentially, the storage of CO_2. The ACA concurs with other industry association submissions that the proposed augmented feedstock rule will:

a. favour narrower projects as it will act to tax successful projects while rewarding R&D that is likely to fail;
b. add to the regulatory burden due to the uncertainty of the impact on a project's R&D entitlement over time; and
c. disadvantage R&D that must be undertaken using existing processes and production facilities.

In the event that this rule is enacted, clarification is required regarding its application to activities conducted on behalf of other entities. The legislation should be amended to ensure that the reduction would be applied to the party which received the benefit of the outputs (typically the project entity), rather than a funding party such as ACALET.

Plant Rule

Recommendation 6: The legislation should be amended to specify that plant rules contained in section 355-220(a) do not apply to organisations which fund research undertaken by others.

The provisions which provide that deductions do not apply to expenditure incurred to acquire or construct plant or buildings (section 355-220) should be amended to ensure that funding organisations such as those which contribute to ACALET are able to claim a deduction for that part of the expenditure which is ultimately spent on acquiring tangible depreciating assets (particularly plant) for R&D purposes.

As currently drafted, these provisions would place ACALET contributors (and anyone else who funded research done by another party) at a disadvantage relative to persons who conduct research on their own behalf as it would mean that they were entitled to neither a direct, nor an indirect, concessional deduction in relation to plant expenditure.

It is noted that the provisions in Subdivision 33-1, which deal with this issue in the case of R&D partnerships by providing for a partial deduction for plant acquired by a partnership, do not apply to ACALET Contributors who are not members of an R&D partnerships.