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General Manager
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Attention: Mr James O'Toole

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Research and Development Tax Provisions

The Australian Petroleum Production & Exploration Association Ltd (APPEA) is the peak national body representing Australia's petroleum exploration, development and production industry. APPEA is writing to you to raise the petroleum industry's concerns with respect to the proposed changes research and development tax provisions.

Background

The petroleum industry is dependent on innovation for its continued existence, while significant funding is required to maintain the future supply of reliable and competitively priced energy. As part of this process, the industry employs highly skilled workers with a diversity of skills. Much of the research that has been adopted and refined in other sectors of the economy has been based on the ground breaking work undertaken in the petroleum industry (including, for example, in the areas of carbon capture and storage and environmental science).

Companies engaged in petroleum operations in Australia make use of the existing R&D incentive provisions. Because of the very high up-front capital costs associated with many activities in the industry, measures that assist in either reducing risk or assisting project economics (including through the use of the R&D tax incentive) influence decisions. The existing R&D incentive has had a positive impact on the decisions of companies to both undertake research and to base the focus of their efforts in Australia.

Proposed Changes

APPEA notes that under the provisions outlined in the Exposure Draft, R&D tax credit eligibility will effectively be constrained thereby restricting eligibility, heightening complexity and creating increased uncertainty for businesses wishing to utilise the

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provisions. Advice from APPEA member companies suggests that there will be a significant fall in the level of eligibility, notwithstanding the fact that the potentially ineligible activities would meet any normal definition of being R&D in nature.

- Definition of Core R&D activities

The Exposure Draft proposes changes to the definition of core R&D activities from currently requiring innovation or high levels of technical risk to in future requiring both 'considerable novelty and high levels of technical risk'. The change creates both additional uncertainty and a narrowing of eligibility. The term 'considerable novelty' remains undefined. The practical impact of the change will see a shift from R&D undertaken in a business context to a more academic focus. There are also a number of important elements that remain either undefined and/or are unclear in the Exposure Draft.

APPEA recommends that term 'innovation' be used within the new provision rather than the term 'considerable novelty'. In addition, the 'or' test should be reinstated rather than making it a requirement that both 'innovation' and 'technical risk' be present for an activity to be considered a core R&D activity.

- Supporting Activities

The Exposure Draft requires supporting R&D activities must be carried on for the dominant purpose of supporting core R&D activities, and that 'dominant' is the prevailing or most influential purpose. It is APPEA's view that the dominant purpose test is inconsistent with the commercial nature of many business activities (including those in the petroleum industry) and this will unnecessarily exclude items that would have otherwise been eligible. It will potentially result in a bias towards the 'laboratory' type eligibility at the expense of the more commercially focussed endeavours.

The very nature of activities undertaken in the business sector will mean that when they are R&D in nature, they will have the dual purpose of being both R&D and commercially driven. This, by definition, will raise the level of uncertainty for companies wishing to utilise the R&D tax provisions. This will also impose an additional compliance burden on businesses as detailed documentation will need to be maintained to evidence the activity being undertaken. Furthermore, the Exposure Draft further limits supporting activities by effectively excluding supporting R&D activities which under the current would be eligibility if a nexus test could be met. APPEA notes that there is further uncertainty surrounding pre-production and experimental activities.

To resolve these issues, it is recommended that the 'dominant purpose' test be removed and substituted with 'a purpose' test that is consistent with the existing provisions. In addition, the list of excluded activities (section 355-35) should only apply to core R&D activities and not supporting activities.

- Core Technology

Section 355-220 specifically excludes core technology expenditure from being notionally deducted in determining the R&D tax offset. Under the current rules, core technology expenditure is deductible at a rate of 100%. We recommend that consistent with the current provisions, core technology should be deductible at a rate of 100%.

- Augmented Feedstock Rules

Under the proposed new 'augmented feedstock rules', feedstock output is defined very broadly and refers to any output (other than new knowledge or information) produced by the R&D activities (core R&D and supporting R&D activities) and all costs incurred that directly relate to the production of feedstock output will need to be clawed back. There appears to be little guidance on what comprises expenditure directly related to the production of feedstock output, however conceptual design is specifically excluded.

With a view to providing greater clarity, it is recommended that the list of expenditure that is excluded from the feedstock rule be expanded to include expenditure such salary expenditure, overhead expenditure, feasibility costs, consumables and commissioning. In addition, greater clarity would be provided for determining feedstock output value if the emphasis was placed on consideration received for the feedstock output where transactions are at arm's length, rather than the market value.

Conclusion

It is critical for the R&D regime to be structured in a way that encourages the development of internationally competitive and innovative industries in Australia. A number of the proposed changes have the real potential to fundamentally change the framework for R&D decision making from a balanced approach that includes business innovation to one that is focussed on academic outcomes.

Many of the activities undertaken in the petroleum industry have been important to the wider community and the business sector. These have included drilling and surveying techniques, engineering advancements and improvements in our knowledge and responses to environmental challenges. The proposed changes contained in the Exposure Draft will exclude many genuine R&D activities which are currently eligible for support under the existing R&D tax concession.

APPEA would be pleased to further expand on any of the issues raised in this letter. Contact is Noel Mullen, telephone 02 62670904, email nmullen@appea.com.au.

Yours sincerely

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DEPUTY CHIEF EXECUTIVE