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General Manager
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Dear Sir/Madam,

Re: Draft Legislation - "The new research and development tax incentive"

The following is BDO's response to the exposure draft legislation and associated explanatory materials released by Treasury on 18th December 2009.

In making our submission, BDO understands that changes needed to be made to the current R&D Tax Concession legislation. When Treasurer Wayne Swan initially announced a scrapping of the old R&D Tax Concession program in favour of a 'better targeted, more generous, more predictable, less complex incentive for R&D activities', BDO welcomed the announcement and interpreted this move as a real indication on the Government's continuing commitment to support innovation in Australia. However, when the draft legislation was released, BDO was surprised and disappointed that the resulting legislation did not deliver the Government's intended policy.

The overriding concern is that the wording of the proposed legislation appears to produce a result that fundamentally changes the nature of the R&D Tax incentive program. Instead of being more generous, more predictable and less complex, the proposed legislation is more complex, subjective in nature and can produce instances whereby the final net benefit to a company can only be determined years after the actual R&D activities are completed. BDO is specifically concerned about the following:

- Various activities excluded from the definition of both 'core' and 'supporting' R&D activities;
- The Government's interpretation of the dominant purpose requirement for supporting R&D activities;
- The legislation appears to reward failure rather than risk or innovation; and
- The impact of the augmented feedstock provisions and the 'expenditure not at risk' provisions and the potential that, as a result of the application of these provisions, the financial benefit a company receives can only be assessed in retrospect.

Activities excluded as either core or supporting R&D activities

Section 335-35 of the draft legislation provides a list of activities that are excluded from being considered eligible R&D activities (either core or supporting). BDO is of the opinion that the inclusion of a number of activities on this list will result in instances whereby legitimate activities needed to directly support the conduct of core R&D activities will be deemed ineligible for the purposes of claiming the R&D Tax Credit. The following examples illustrate this point.

Complying with statutory requirements or standards

In its current form, the draft legislation indicates that activities associated with complying with statutory requirements or standards (including maintaining national standards, calibrating secondary standards and routine testing and analyses of materials, compounds, products, processes, soils atmospheres and other things) will not meet the definition of 'supporting R&D activities' under the R&D Tax Credit program.

As an example of the potential unintended consequences of such a provision, the development of a drug for use in the human population requires the conduct of activities in a very structured manner, commencing with the discovery of a new compound capable of producing a desired outcome, followed by a series of investigative tests in order to ensure the discovered compound/drug does not produce an adverse effect to the intended recipient. Trials and experiments are generally conducted in order to meet minimum regulatory requirements (both domestically and internationally) prior to the drug being considered a technical success. Regulatory bodies require structured, standard routine testing in order to evidence the rigor of the scientific approach taken.

Based on the application of the proposed wording of the legislation as it stands, the 'Phased Testing'(i.e. Phase 2, Phase 3 etc.) associated with drug development will be deemed an ineligible supporting R&D activity. In addition, as many of the experimental trials and tests conducted during 'Phased Testing' include well structured and established tests, the activities associated with 'Phased Testing' will also fail to meet the necessary requirements to be considered as core R&D activities'. This is due to the fact that 'Phased Testing' uses established methodologies and techniques and, as a result, would most likely fail to meet the 'considerable novelty' requirement to be an eligible core R&D activity.

If the 'Phased Testing' activities are not core activities, and are ineligible to be considered as supporting activities (as is the conclusion upon application of the current wording of the legislation), the majority of the innovative R&D undertaken by drug development companies will be ineligible under the proposed R&D Tax Credit program.

Given AusIndustry holds drug development companies out as companies engaged in pure R&D activities, it can not be the intention of the draft legislation to deem such activities as ineligible R&D activities, for the purposes of claiming the proposed R&D Tax Credit incentive.

Commercial, legal and administrative aspects of patenting, licensing or other activities

In order for activities to be eligible R&D activities, the draft legislation requires that the activities must be undertaken with a view to, if successful, commercialising the results. It is, therefore, difficult to understand why activities associated with protecting intellectual property generated during the conduct of R&D activities are excluded as an eligible supporting activity, particularly during the developmental phase of a project.

If a company chooses to undertake innovative and technically risky activity, it is prudent business practice to protect intellectual property as it is generated, to ensure the resulting intellectual property remains confidential whilst being developed. This protection enables a company to conduct its program of R&D activities uninterrupted, without the risk of a competitor obtaining details of the R&D activities and lodging their own patent, thus precluding the completion of the company's R&D activities.

Such activities are integral to the conduct of core R&D activities and therefore, should never be considered ineligible and undeserving of Government support as part of any innovation program.

Supporting R&D activities undertaken for a dominant purpose

Under the draft legislation, there is a requirement that supporting R&D activities be undertaken for the dominant purpose of supporting a core R&D activity.

In illustrating how the dominant purpose test applies to supporting activities, the explanatory memorandum (EM) provides an example (Example 2.7) whereby a mining company undertakes R&D activities on a new tunnel support technique, which presumably, constitutes an eligible core R&D activity. In order to conduct their experiments, roads and access tunnels are built to access the mine site. The company is hoping their program of R&D activities will be successful and, therefore, the roads and access tunnels are built to a standard to service the mine over its expected five-year commercial life. Despite the fact that access to the mine is essential to the conduct of the core R&D activities, the EM concludes that the dominant purpose for building the road is commercial (due to the fact that the roads were built to a '5 year' standard, rather than a 'life of experiment' standard). As such, all costs associated with the road construction activity are excluded costs for the purposes of claiming the proposed R&D Tax Credit.

BDO is deeply concerned about the impact of this concept and the potential adverse consequences it could have for three reasons. Firstly, we are concerned that this approach fails to take into account the reality that all R&D activities conducted by companies are undertaken with a commercial focus, thus it could be argued that the dominant purpose of all R&D activities is commercial. Secondly, we are concerned with the 'all in or all out' treatment of expenditure that results from the application of the provision. There is no concept of marginal costing that reflects the R&D component of a commercial activity. Thirdly, we are concerned that such an interpretation may force companies to engage in uneconomical/uncommercial behaviour, simply in order to claim the R&D Tax Credit. This type of behaviour will result in inefficient business practices, will not produce spill over benefits and will be detrimental to the economy.

Rewarding failure rather than rewarding risk or innovation

As currently drafted, the augmented feedstock rules will result in Government policy that rewards failure, rather than a policy that encourages companies to take on technically risky R&D activities.

The proposed feedstock provisions require a company to identify the costs associated with the conduct of R&D activities and to then offset these costs against the market value of the results of the R&D activities. Thus, the operation of the augmented feedstock provisions will reward failed R&D over commercially successful R&D, regardless of the merits of the project. Failure to reward R&D projects simply because they were successfully completed is akin to requiring grant recipients to pay back funding if they successfully complete and commercialise their projects. BDO submits that the legislation should not discriminate against R&D projects that result in a commercially successful outcome, as it is this exact attribute (i.e. R&D that is successful both technically and commercially) that the Government is seeking to drive.

The retrospective nature of the feedstock and 'expenditure not at risk' provisions

BDO holds grave concerns with respect to the Government's ability to achieve its stated goal of developing 'a more predictable, less complex' program via the introduction of the draft legislation

as it stands. Specifically, the operation of the feedstock and 'expenditure not at risk' (ENAR) provisions have the potential to change the R&D tax incentive from a principally guaranteed upfront incentive to a retrospective compensation measure for failed R&D activities. In short the proposed legislation will lead to frequent situations where the level of benefit cannot be determined until years after the R&D project has been completed.

Under the draft legislation, the feedstock provisions require the calculation of a 'market value of any output from the R&D activities at the point it reaches a 'marketable state' (which could be a number of years after incurring the R&D expenditure) and a 'netting off' of this value against the costs associated with the conduct of the R&D activities. Similarly, the ENAR definition also incorporates the concept of 'netting off' R&D expenditure against all future consideration (i.e. revenue) received as a **direct or indirect result** of the expenditure incurred.

Under the current R&D program, the feedstock provisions enable a calculation to be undertaken at the end of the income year, thus providing certainty at year end. Under the proposed feedstock provisions, the market value (required for the 'netting off' calculation) cannot be calculated until the feedstock output reaches a marketable state. There are numerous industries whereby the output of the R&D activities do not achieve a 'marketable state' until years after the financial year in which the R&D commenced. For example, each iteration of an improved technique can take 2-3 years to get to market, and drug development can take upwards of 15 years to achieve a marketable state. A broad interpretation of the legislation could feasibly lead to a situation whereby a company is required to repay monies to the ATO years after receiving the initial R&D tax credit.

An additional concern is the fact that the proposed ENAR provisions do not contemplate a time restriction with respect to 'clawing back' the revenue received against the R&D expenditure incurred. This could also lead to a situation whereby monies are required to be repaid years after a company receives the tax credit.

These concept lead to a scenario whereby a company is of the opinion that it is eligible to claim the R&D Tax Credit at the start of the project and instigates a program of documentation, reporting, etc in order to generate the specific types of documentation required to evidence eligibly to the R&D Tax Credit (such as dominant purpose, innovation, etc). The value of the tax credit is then crystallised at the time the Income Tax Return is lodged. If the project is successful and the results of the R&D activity have value, then the feedstock and ENAR sections will then operate to cause the company to pay back (in a subsequent year) what is likely to be a significant proportion of the tax credit received. For eligible R&D activities with long development periods (e.g. in the primary industry, construction or pharmaceutical industries), the requirement to pay back Tax Credits could easily occur years after the expenditure has been incurred and the rebate received. This would result in serious cash flow issues and make short to medium range forecasting and budgeting problematic.

This type of retrospective assessment, where eligibility to the proposed tax credit system can only be determined **after all activities are completed** seems counter to the Government's claim that the new program is expected to deliver more predictable results to key decisions makers within a company.

Conclusion

BDO has a real and genuine concern that one or more of the issues outlined in our response will have an immediate and material adverse impact on the level of R&D conducted by Australian business if the proposed legislation is enacted in its current form.

In this regard, we note the breadth and depth of the submissions put forward in response to the R&D Consultative Paper released by Treasury and were disappointed that the concerns of the Australian business and academic community appeared to be largely ignored by Treasury, resulting in the production of draft legislation that does not deliver the Government's stated policy goals. Therefore, we strongly encourage Treasury to carefully consider our concerns, as well as submissions put forward by the wider Australia business community, to ensure changes are made to the proposed legislation to enable it to deliver the Government's promise of support for companies undertaking R&D activities.

As it currently stands, the draft legislation requires R&D projects to technically fail or produced nothing of value in order to access the R&D Tax Credit. If a company's R&D activities are successful and the company is commercially smart enough to be able to exploit the successful R&D project, the current provisions will result in the company being disadvantaged for being smart and commercially successful, while other companies are compensated for technical or commercial failure.

A company that conducts R&D activities that are either technically unsuccessful or commercially unsuccessful provides limited net benefit to the Australian community, however, this company will receive the full support of the Australian Taxpayer, via the ability to make an R&D claim.

While the Government's hopes for this program appear to be well intended, these hopes have not been realised through the draft legislation. Significant changes are required if the Government wants to deliver an effective incentive for Australian businesses to conduct technically and financially risky R&D activities. Without change, the best advice for Australia's innovators is this:- if you've been smart enough to first develop a solution or product that was technically risky and then commercially savvy enough to make money out of your R&D project, don't bother making an R&D claim. It is as simple as that, if urgent changes are not made to this attempt to support innovation and R&D in Australia.

BDO appreciates the opportunity to put forward its views on this issue. If further comment is required, please contact Tracey Murray on 07 3237 5832.

Yours sincerely
BDO (QLD) Pty Ltd

Tracey Murray
Director
Research and development