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Mr Paul McCullough
General Manager
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The Treasury
Langton Crescent
PARKES ACT 2600

Dear Paul,

The New Research and Development Tax Incentive - Exposure Draft Legislation

The Australian Bankers' Association ("the ABA") welcomes the opportunity to comment on the Exposure Draft of December 2009 concerning the new Research and Development ("R&D") tax incentive.

The ABA works with its members to provide analysis, advice and advocacy and contributes to the development of public policy on banking and other financial services. It also works to ensure the banking system can continue to deliver the benefits of competition to Australian banking customers.

The ABA supports the reform objectives of making the new R&D tax incentive more effective in delivering support for business R&D and targeting that support to where it is most likely to produce benefits for the Australian community.

However, as set out in our submission on the consultation paper on the design of the new scheme, dated 26 October 2009, the ABA also has some serious concerns with the effects the net changes will have on the wider Australian economy. Many of the changes will discourage innovation in essential areas that will be key enablers of productivity and efficiency gains, jobs and skill retention, and growth.

The ABA also supports the submission of the Corporate Tax Association on the Exposure Draft.

Australian Bankers' Association Inc. ARBN 117 262 978
(Incorporated in New South Wales). Liability of members is limited.

Government Policy and the current environment

The proposed changes appear to be inconsistent with the stated policy objectives of the Government in relation to the ageing population and the need for substantial productivity gains in the future.

The changes do not provide the positive signal to the private sector necessary substantial investments required for the resolution of the productivity challenge facing the Australian community.

In order to remain competitive in innovation and productivity, Australia has a real and urgent need for significant investment in technology infrastructure (over and above the National Broadband Network), now and into the future. This will require substantial investment in high value added services that enable, complement and support the "education revolution" to not only maintain but improve the average Australian's standard of living and productivity.

The Government has also stated its support for the Cutler Review's findings and for the development of Australia as a financial services centre.

Unfortunately the proposed changes to the R&D incentive would hinder achievement of these goals and reduce Australia's ability to effectively and efficiently deal with the significant issues we face. Many of the changes would have the opposite effect to that sought from R&D reform.

The most obvious problems with the existing R&D rules relate to:

(1) the lack of certainty (for all sections of the business community, small, medium and large) on what will be eligible for an R&D incentive and the amount of the incentive available, which uncertainty continues in some cases until after the project is under way or completed;

(2) the level of administrative bureaucracy and documentation, which in particular discourages less sophisticated and smaller businesses from undertaking research from making an application;

(3) the mixing of interpretation and enforcement functions within the same bodies. This has led to R&D claims being discouraged or limited. This sends conflicting messages to business, encouraging the undertaking of R&D, but setting an expectation that the process for claiming incentives will be difficult and costly;

(4) the appearance of some level of inequity, as some businesses claim R&D on significant infrastructure or mining projects which would appear to be contrary to the policy intention.

As a result of the above, there is a disincentive to participate in the scheme, particularly for those undertaking smaller R&D activities.

The proposed changes do not appear to address these issues and will:

(1) increase administration and documentation requirements for small and large businesses alike;

(2) add further limitations to the definitions that will reduce R&D within Australia. The proposed change to the definition of R&D will result in one of the most restrictive definitions in the world, particularly in comparison with Canada, the USA and the approach taken in the OECD Frascati Manual 2002 (refer para 84);

(3) create further uncertainty on what would qualify for the concession, firstly as a result of what is essentially an artificial character split between types of costs, and secondly as a result of the additional definitional hurdle;

(4) limit many areas of important R&D, which would contradict the recommendations and findings in the Cutler Review (that was strongly endorsed by the Government);

(5) significantly increase the potential for unproductive and costly disputes and create additional demand on government staff to monitor and enforce the more complex rules;

(6) introduce a clear bias against certain types of R&D, such as technology and software, with no explanation or justification for such an approach;

(7) over time, drive more technology innovation, skills and jobs overseas, particularly given the strong overseas competition for these skills and the relative ease with which some functions can be performed offshore; and

(8) in net terms, discourage incremental innovation and investment.

The proposed changes would also appear to reduce the size of R&D claims, despite the stated aim that the current level should be maintained.

Over the last 24 years the objective of the R&D tax incentives, while not fully realised, has been to engender a culture of innovation and development in Australia and create an environment that is conducive to increased commercialisation of new processes and product technologies. This should continue to be the principle behind the new R&D tax incentive.

Clarity, simplicity, and certainty in R&D definitions and in the availability of tax incentives will drive the growth and productivity gains essential for Australia.

Financial Services

Productivity Commission Reviews have confirmed that the R&D tax concession has resulted in net economic and social benefits. R&D undertaken by members of the ABA has provided significant benefits to the Australian economy, achieved

through development of sophisticated systems and product offerings. Innovation in banking technologies has changed the way in which all Australian customers and businesses conduct their banking and investment activities. Customers are now able to do their banking at a time and place that suits their needs, and can buy and sell products and services across the world. This has contributed greatly to productivity gains across the economy.

The Government has an objective to make Australia a financial services centre, and R&D in the Australian financial services sector should be seen as essential to maintaining Australia's competitive advantage, which will benefit all Australians by providing:

- employment;
- market efficiencies; and
- retention of valuable intellectual property and human capital for Australia.

ABA members believe that R&D is imperative to the future success of financial services. For the banks to be globally competitive and provide value to customers, it is essential that they provide world class financial services and cutting edge financial products.

Bank R&D provides many benefits to the economy more generally. For example, when banks upgrade their software or web-based systems, the value to customers is enhanced and the banks remain cost-competitive, which in the longer term, provides benefits to Australian shareholders and to the economy as a whole. There are also positive and significant effects on national employment and skills development.

Software

The changes to the software rules are of particular concern. The proposed changes include an attempt to move the current R&D definition to an old and antiquated "sale" model for software. It is proposed that eligible R&D activities would only be available where the development is undertaken for the purpose of making a commercial return directly from the supply of that software, and this applies to both core and supporting software related activities.

This restriction seems to be contrary to the modern business practice of bundling services and making commercial returns through the provision of services or through advertising. As an example, Google, one of the largest contributors to R&D activities in the world, is widely admired for its innovation in software development, but does not directly make commercial gains from the supply of its software.

It would appear that the Government is making an artificial distinction between different business models being adopted by business. The direct charging for traditional "shrink wrap" licenses is only a relatively small segment of the software market. It would be regressive if business is forced to charge

consumers for the supply of software - as would have been the business practice a decade or more ago.

Even if a direct charge is made for the supply of software, modern software applications and services often involve the development of a combination of architecture, middleware, data warehouses, etc.

A large proportion of computer applications are hosted centrally by the service provider, while end users are supplied with software which enables them to effectively communicate with the host systems and access other software applications. The applications are often closely inter-linked and integrated. It would be very difficult in practice to determine what commercial return relates to the supply of which particular pieces of software.

It is also important to note that innovation in bank technology occurs within business as usual development programs. Many significant innovations occur during the upgrading or enhancing of core customer systems.

Further, software technology is being developed and utilised for a broad range of industrial applications, from biotechnology, to automotive, engineering, etc. For example, complex vehicle collision avoidance systems require the development of complex software to detect potential collisions. Complex animation would not be possible without the development of highly advanced graphics software. The proposed restriction and exclusion would appear to be providing an artificial bias against any in-house software development.

The OECD Frascati Manual 2002 (at paragraph 135) states that software development project can be classified as R&D provided that its completion must be dependent on a scientific and/or technological advance, and the aim of the project must be the systematic resolution of a scientific and/or technological uncertainty. Further, paragraph 137 states that the nature of software development is such as to make identifying its R&D component, if any, difficult. Software development which is an integral part of a project may be classified as R&D if it leads to an advance in the area of computer software. Such advances are generally incremental rather than revolutionary.

The proposed changes therefore are a significant backward step and create an artificial and unjustified bias against in house software development and innovation. Australian businesses are required to compete globally and must consider all alternative options. Development of software applications is necessary for the development and supply of new products in this competitive world. There is no logical reason to impose such an artificial hurdle for software development unless the intended goal is to discourage Australian business investment into technology.

Over time, more Australian businesses will see the potential to use overseas providers for their technology needs and this will diminish essential skills in Australia. Without large, complex, high-end technical software development projects in Australia, in particular in the financial services sector and the

telecommunications industry, cutting-edge skills cannot be created or remain in Australia.

Not only will financial services be affected but, above all, Australian customers and employees. Without sufficient skilled people, many organisations may be forced to look elsewhere for those essential and high value adding skills. We need to be encouraging more technology development within Australia, not less, as it is one of the best productivity enablers, and will be essential as our population ages. Further tightening of the software definitions will be counterproductive for all Australians.

Recommendation

We set out in our earlier submission specific comments in relation to the proposed changes. Changes that would make the biggest impact for the whole Australian economy are those which provide clarity, simplicity and certainty. These must be preferred over complexity in R&D definitions and limitations on availability.

Increased complexity and ambiguous definitions will make the R&D credit more likely to be seen as a "bonus for the few", albeit relatively expensive to apply for and comply with, and will not as effectively create the incentive that could be captured in business case analysis to encourage business investment.

As a simple example, the option of an effective, confidential rulings process on R&D projects, or even for aspects of a project, to ascertain their eligibility prior to, or early in a project, would be a significant improvement over the current process. The current process is relatively uncertain, costly, time consuming and can result in later adversarial reviews and audits, resulting in further costs and time.

We submit that the same eligibility requirement be applied to R&D activities across all industries, and software development should not be singled out for additional hurdles. If the Government is concerned in relation to the nature of software projects being eligible, it could consider issuing clear and updated guidelines as to the nature of software projects that would meet the necessary requirements (as in the case in Canada) and work with the industry through consultation, education and audit compliance activities.

The proposed changes in the 18 December 2009 Exposure Draft will not lead to the growth and productivity gains essential for Australia's future economic prosperity.

We fully appreciate the Treasury's desire to achieve revenue neutrality while delivering greater benefits for undertaking R&D activities. However, as stated in this submission, in order for business to undertake R&D activities in Australia, there is a need to create an environment of certainty.

The new changes to the R&D program will result in a climate of uncertainty as businesses come to grips with how the changes would affect their activities, how the new definitions and feedstock rules operate and the likely interpretations from the ATO and Innovation Australia. With these uncertainties, it is likely that many

companies will be reluctant to claim the R&D benefits in their tax return or "book" the R&D benefits in their financial statements. Further, for many public companies, with the introduction of the new FIN 48 tax uncertainty disclosure rules in the U.S., companies and auditors would be hesitant in booking the R&D benefits in the financial statements.

The R&D tax concession has been in place for the last 20 years and businesses are comfortable with the rules. It would be the preference of the business community to keep the existing rules. However, we understand the need for Treasury to deliver an enhanced R&D incentive for business, within revenue constraints.

We propose that, as an alternative, a progressive cap arrangement be examined, while allowing the existing rules to be maintained. This arrangement could involve the 40% tax offset for the first $50m of R&D expenditure and a 37.5% tax offset for remaining eligible R&D expenditure, up to the cap rate, say $200m R&D expenditure.

The capping arrangement should apply to the existing R&D group basis for the premium deduction. This proposal will allow SMEs to receive the enhanced benefits for undertaking R&D activities, while enabling the Treasury to control the costs of the overall program. Further, with the maintenance of existing rules, there is less chance of protracted legal disputes between taxpayers and the ATO.

Yours sincerely

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Tony Burke