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The proposed new Research and Development tax incentive - Exposure Draft legislation

Caltex would like to make the following submission in relation to the Exposure Draft legislation released on 18 December 2009.

Caltex Australia Limited ("Caltex") welcomes the Government's intention to reform the Research and Development (R&D) tax concession rules, acknowledging the important role played by R&D in facilitating growth in the economy and supporting the development of a skilled workforce.

Caltex is disappointed that the concerns outlined in its submission to Treasury on the R&D Discussion Paper released in September 2009, as well as those raised in many other submissions, have not been taken into account in the Exposure Draft. The recommendations coming out of the Cutler Review have also not been reflected in this Exposure draft.

The impact of the proposed R&D changes

Caltex has a long history of investment in R&D, spending an average of approximately $15 million on R&D projects each year. These include technology design, software development, management of environmental emissions, energy efficiency, waste management techniques, developing new products and identifying new sources of feedstock.

By investing in R&D, Caltex is able to keep its products and processes up to date and compete not only with local competitors but also with much larger and more modern refineries in Asia. This investment in R&D has a direct benefit to the Australian economy, upskilling Australian workers, creating jobs and driving innovation through the development of new technologies. It also secures a local supply of refined product, without which Australia would be dependent on imports from overseas.

In its refining operations, Caltex uses "old" infrastructure – i.e., infrastructure which was established many years ago. The cost of replacing refining infrastructure in its entirety is prohibitive. This means Caltex is forced to regularly make incremental improvements to its infrastructure to ensure safe and reliable operations and secure consistent production. In this context, Caltex is constantly required to improve its processes and develop new and novel methodologies and products using"old" refining infrastructure.

Caltex's significant investment in R&D initiatives to date has been supported by the R&D tax concession. Over the years, marginal R&D projects would have been delayed or postponed for financial reasons had it not been for the assistance of the R&D tax concession. The R&D tax concession is playing a much more important role in assisting marginal projects to achieve the required after tax return for the go ahead to be given. Without these projects, consequential benefits to the Australian economy from the oil refining sector would not be achieved.

It is Caltex's view that the proposed R&D provisions in the Exposure Draft do not provide the same level of support for investment in R&D as the existing rules. If the Exposure Draft provisions are enacted in their current form, Caltex's R&D claim will be dramatically reduced. This will have a detrimental impact on Caltex's ability to initiate R&D projects with R&D projects having to be delayed or shelved for not meeting the hurdle rate for return on investment. This will dramatically reduce Caltex's ability to respond to competitive cost pressures from offshore refiners and as a result, maintain its current level of investment in Australian innovation.

Further, with many other large Australian businesses being similarly affected, we believe the proposed R&D tax measures will significantly reduce the overall deductions claimed by corporate taxpayers for R&D costs. Hence, we are of the view that the Government's aim of making the R&D tax incentive changes revenue-neutral will not be achieved, but instead revenue savings will result.

Set out below are key areas of the Exposure Draft provisions which Caltex believes need to be modified in order for the Government's objectives to be achieved.

Issues identified in the Exposure Draft

1. Changes to the definition of R&D activity

The proposed tightening of the definition of R&D activity to require considerable novelty and high levels of technical risk takes a more academic, rather than a realistic approach.

The requirement that an activity involves "considerable novelty" when the Exposure Draft does not define "considerable" creates uncertainty for taxpayers as to when an activity is eligible for the tax incentive.

Caltex's R&D investment is incremental and evolves from idea to inception, stemming from process reviews, testing and implementation across its current processes. This means that although the novelty aspect may not be met in the incremental stages of a project, eventually novelty will be achieved. Under the proposed definition of R&D activity, Caltex would not meet the eligibility criteria.

This is viewed by Caltex as too restrictive an application of the R&D incentive, one that will impede R&D activities carried out on a commercial scale. The proposed definition does not reward genuine R&D investment that the company conducts.

Without continuous substantial process improvement, the refining industry in Australia cannot sustain its current levels of productivity. If Australian refineries cannot compete with Asian refineries which employ more sophisticated technology, there is a real risk to the ongoing viability of refining in Australia. This increases the nation's reliance on imported fuels and thereby increases the risk of energy supply disruptions.

It is strongly urged that the proposed definition be reviewed and relaxed to ensure that commercial scale R&D activities are eligible for the R&D incentive and considers the nature of companies such as Caltex.

2. Supporting R&D activities

The proposed changes represent a major shift from the current and past policies on claiming the R&D tax concession for supporting activities. Even though supporting activities are recognised in the Exposure Draft as being part of the normal production environment, taxpayers will now need to isolate costs associated with supporting activities from production so as to be able to support the dominant purpose for qualification.

There will be significant reductions in claims due to these changes. Caltex is of the view that detailed costings of the new provisions will be revenue positive rather than revenue neutral as it is being claimed.

Caltex completes its analysis, testing and implementation of its R&D activities on existing production processes. To split the costs associated with R&D between supporting and non-supporting activities would be extremely difficult and unnecessarily impose a significant compliance burden. This goes against the focus of our R&D activities and will require significantly more resources to be spent on R&D administration and compliance,

If Caltex is forced not to use existing infrastructure in carrying out its R&D activities but instead needs to build new models/pilot plant specifically designed for R&D activities, the costs would be prohibitive.

3. Augmented feedstock rules

The proposed incomplete augmented feedstock rules significantly restrict the R&D costs available for the R&D tax incentive for Caltex and many other businesses. Where there is output from the R&D activities, limiting costs available from being claimed due to saleable product or product with market value is seen as rewarding failure not result. In addition, the realisation of any value from the sale of any output may not occur in the same period but sometime after, necessitating amendments and pay back of any benefits previously obtained. This requirement significantly increases the compliance costs associated with the scheme, which is contrary to the stated aim of the Exposure Draft.

This is contradictory to the whole purpose of the R&D tax incentive. It does not recognise the commercial benefits that are derived from R&D and will not reward the risk that companies face in undertaking R&D.

From the Exposure Draft it is understood that the augmented feedstock rules are to be refined. Caltex requests that these rules be widened to ensure that all genuine R&D related activities and costs are included. The risk type costs such as testing, processing and analysis work should all form part of the R&D incentive regardless of whether any resulting product is sold.

4. Software development

IT and software are an important part of any business process and software development is often one of the most crucial and indispensible aspects of an R&D project. By specifically excluding off-the-shelf software development and also requiring that software be on-sold to other entities, the proposed measures deny support for a very important R&D cost for all businesses.

Caltex's operating processes are dependent on complex IT systems which need to be updated and enhanced regularly. Without significant investment in the upgrade and development of software and IT processes, the viability and reliability of Caltex's operations would suffer. Caltex invests heavily in software development in Australia.

Without the benefit of the R&D tax incentive, Caltex and many other large businesses are likely to source complex IT services for R&D projects from more competitively priced offshore suppliers. Australian businesses may be compelled to look outside Australia to achieve concessions in other tax regimes and make their R&D investment more cost effective.

The impact this change will have in retaining skills in the Australian workforce is dramatic. The Exposure Draft provisions run the risk of reducing software development in Australia and will have a material impact on the skills retained in the Australian workforce. .

Caltex strongly recommends that the Exposure Draft be amended to remove the exclusion of software from the R&D concession, as well as the on-sale criteria. Software development costs must be eligible for the R&D tax incentive.

Conclusion

Caltex strongly opposes the Exposure Draft in its current form. The proposed measures do not support the level of investment in R&D activities required on a national level to promote improvements in productivity and the skills of the Australian workforce.

The proposed rules do not meet expectations of the support which R&D incentive should provide. They are restrictive in their application and isolate the eligible R&D to be solely for start-up, brand new products, technologies and processes. It would appear that they are designed to reward failure and not positive results.

The rules discriminate against the IT industry, which reflects its backward narrow view on the way business conducts R&D activities and promote the flight of IT talent away from Australia.

Caltex would welcome the opportunity to meet and discuss its concerns with the Exposure Draft measures in more detail.

Yours sincerely

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