Hear now. And always Cochlear™

4 February 2010

General Manager
Business Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Sir/Madam,

Re: Cochlear Ltd's Response to the New R&D Tax Incentive Scheme

We appreciate this opportunity to provide feedback on the exposure draft of the Tax Laws Amendment (Research and Development) Bill 2010 released 18 December 2009 ("the exposure draft"). Under this submission Cochlear Ltd ("Cochlear") will outline specific examples and challenges confronted by the organisation under the proposed changes and may suggest alternatives to address these issues.

Executive Summary

We note that the draft legislation does not appear to reflect the intention of the Government's earlier position under its *Venturous Australia* paper and statements released as apart of the 2009-2010 Federal Budget (*Powering Innovation*), which are to promote productivity and international competitiveness in Australia.

The tightening of the definition of R&D also introduces considerable compliance uncertainty, complexity and cost and non-value adding compliance planning and monitoring of projects. The overall impact of the changes on Cochlear Ltd will be very unfavourable at a time of planned significant growth in our R&D activities in Australia.

Innovation "and" High Technical risk

Of the proposed changes to the incentive, Cochlear believes the requirement for both considerable novelty **and** high technical risk will have the most unfavourable impact with respect to claim dilution, eligibility uncertainty and increased compliance cost.

In our view the difficulty is more with the concept of *novel activities,* than *high technical risk* where there is generally a nexus between the uncertainties and the experimental process developed to resolve them. Considerable novelty on the other hand is subjective and indecision about this is more likely to result in a lot of beneficial R&D not being claimed. There is also a concern that novelty eligibility at the start of a project may not be met in subsequent years in a multiple year project. This could occur with the availability of published information and the progression of in-house knowledge in subsequent years. This could result in the subsequent years' activities being challenged despite the R&D tax credit being included in the original business decision. The proposed change will require constant monitoring throughout the life of a project with attendant uncertainty and compliance costs.

Also given the long project duration and high R&D expenditure commitments Cochlear will likely have to seek periodic advance rulings/findings from Innovation Australia. This would be an unnecessary burden on the company and AusIndustry.

Cochlear Limited ABN 96 002 618 073 14 Mars Road (PO Box 629), Lane Cove NSW 2066, Australia
Tel: +61 (0)2 9428 6555 Fax: +61 (0)2 9428 6353 **www.cochlear.com**

> To reduce the uncertainty and the level of compliance burden on both parties, Cochlear proposes that original novelty eligibility be preserved throughout a project's life.

Core and Supporting Activities

Cochlear believes that the separate reporting and costing of "Core" and "Supporting" activities would be counter productive by requiring significantly more compliance, administration effort and cost.

Separate reporting and costing would necessitate an additional level of activity reporting in labour time sheeting and accounting systems. This would require a predetermination of all ESI activities specific to each project in order that engineers would know what stage they are working on and whether it is core or a supporting activity. This would require more detailed R&D planning and periodic reassessment of the status of activities as the project develops.

> These activities would have little value adding purpose to the project, other than for the R&D tax incentive registration requirement and therefore Cochlear recommends that current reporting and costing measures be retained.

Software development

We have two concerns with the proposed changes to software eligibility. The first is the requirement for software development to be for the purpose of making a commercial return directly from supply to at least two other entities. This requirement will impact our plans to increase product sales through internet based direct recipient interfacing. This relates to the innovative provision of personalised goods and services to our customers in diagnostics,self service and repairs. We are also very concerned that the requirement could be applied to software embedded in saleable products and devices. We trust this later case is not the intention and that embedded software will continue to be eligible.

> In this context we believe the development of software in support of product sales and functionality should continue to be eligible for the R&D tax incentive.

Our second concern is that software developments that support the design and experimental development of new products and processes will no longer be eligible. Product functionality and simulated testing of recipients depends upon computer modelling of the many complex algorithms which may require unique code or significantly modified proprietary code. This modelling of functionality and complex algorithms may also be used directly to verify the equivalent embedded product code and therefore is an essential part of the product R&D process.

> We recommend that software development activities that support product development and testing should continue to be eligible for the R&D tax incentive.

Feedstock

The majority of Cochlear's R&D activities are "product related", however our "production related" activities are no less important. Many "production related" ESI activities are equally if not more technically challenging than many "product related" and this is clearly reflected in the low yield and high warranty costs we experience when having to build near perfect products in a production environment.

Limiting "production" activities would discriminate against tool and process R&D simply because it generates saleable product while product R&D (presumably "conceptual design") usually does not. The current existing feedstock provisions already severely limit claimable "production" activities and do not compensate for scrap (unsaleable, unusable and un-recyclable) generated, and loss of production capacity during trials because these costs are often offset by saleable outputs from the same or related activities.

The "augmented feedstock provisions", effectively limit R&D Incentives to the net expenditure on the R&D activities. This obviously decreases the benefit of the incentive to Cochlear. It also has other commercial consequences as follows:

a) it makes the tax incentive less predictable, as the value of the output may be clawed back at a future date; and

b) it favours failure over success which would detrimentally change the R&D culture within the organisation; and

c) Cochlear incurs a real opportunity cost by diverting key staff and assets from business as usual duties to an R&D activity.

   We recommend that the scope of inclusions in the "output's cost" should not include labour, overhead costs and plant depreciation.

   As a minimum a credit should be provided under the new rules for the cost of scrap (unsaleable, unusable and un-recyclable product) produced during dominant R&D purpose trials as eligible R&D expenditure and therefore not offset by saleable outputs.

Transitional arrangements

Overseas expenditures

We support the current draft legislation which removes the 10% limit on overseas R&D. However, in the event that the limit is reduced we recommend that existing 39ED provisional certificates should be grandfathered in view of the long term commitments already made by companies conducting R&D,

Core Technology

Cochlear believes that all existing core technology projects and contracts in place before royal ascension of the new R&D Tax Incentive Scheme should be grandfathered under the existing arrangements rather than be re-directed to the capital allowance provisions, which would require complex legislation if there was an objective to equal the current treatment.

If you would like to discuss this submission, please feel free to contact me on 02 9428 6555 or Andrew Chia (Group Tax Manager) on 9425 3696.

Yours sincerely,

Neville Mitchell
Chief Financial Officer and Company Secretary
Cochlear Limited