CORPORATE TAX
ASSOCIATION
of Australia Incorporated

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

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By email rdtaxcredit@treasury.gov.au

SUBMISSION ON R&D EXPOSURE DRAFT

The Corporate Tax Association (CTA), which represents the taxation interests of about 120 of Australia's largest companies, welcomes this opportunity to offer comments on the Exposure Draft (ED) released on 18 December 2009. This submission should be read in the context of the CTA's response to "Venturous Australia" dated 3 October 2008, as well as our 28 October 2009 submission on the September 2009 Consultation Paper.

There are a number of positive aspects included in the package – in particular the increase in the level of the concession; the expansion of the concession to foreign entities; and the repeal of the unlimited amendment periods.

However, corporates are highly concerned that in combination, the various "integrity" measures that are aimed at containing the overall cost of the program will have a far greater impact on eligible claims than could have been anticipated in the undisclosed revenue estimates made by Treasury. Large corporates have advised me of reductions in their current R&D claims in the range of 40, 50 and 60 per cent if the proposed new tightening of the eligibility criteria were to be implemented (although this is in combination with the ending of the premium R&D scheme).

As it currently stands, we believe the ED would decimate eligible R&D claims available to business, and outcomes will fall a long way short of achieving the government's stated policy objective of providing tax credits in the order of $1.4 billion per annum.

Level 11, 455 Bourke St,
Melbourne Victoria 3000
Telephone: (03) 9600 4411
Facsimile: (03) 9600 4055
Email Address: admin@corptax.com.au

We have seen a number of other submissions which set out in some detail the specific issues and concerns that arise from the ED. For the sake of completeness we will briefly summarise those issues:

- *"Appreciable" to "Considerable" Novelty*

  Presumably this tweaking of the definition is intended to raise the threshold for the level of novelty that will in future be required for an activity to qualify as core R&D. But the EM does not make this clear and some lawyers will no doubt argue the two words have more or less the same meaning. All this change would achieve is to create new uncertainty about what has been for some years been thought to be a reasonably well settled part of the definition.

  The narrowing of the definition for core R&D was certainly signalled in last year's Consultation Paper. However, the basis put forward in that paper for tightening up the definition was based on an unsubstantiated and faulty assertion - which was that the current definition is far more generous than that in the Frascati Manual. For one thing, the Frascati Manual 2002, at para 84, refers to an appreciable level of novelty. That is to say, the current Australian definition conforms to the international benchmark in this respect.

  In tightening up the definition the ED simply repeats the error made in the Consultation Paper, and would in fact leave Australia with the most restrictive definition of eligible R&D expenditure in the OECD.

- *Novelty **and** technical risk*

  While there is a range of industry views about the expected impact of this proposed change, it is likely to have some negative impact by disqualifying activities that are clearly innovative, but which might not have the requisite level of technical risk, or *vice versa*. Projects or activities can result in improved products or processes without necessarily satisfying both requirements. Such a change was rejected in 2001 following a Senate enquiry.

- *Dominant purpose test for supporting activities*

  This proposal would discriminate against what is left of Australian manufacturing industry because most of the R&D conducted by large business has been characterised by the Bureau of Statistics as applied research (32%) or experimental development (62%), while only about 6% of expenditure relates to pure or strategic basic research [ABS Business Expenditure on R&D analysis 2005-06 to 2007-08].

  Because most businesses cannot justify a stand-alone basic research facility, much of this applied or developmental research is carried out in a production environment where the supporting activities clearly relate directly to the research activities but their dominant purpose may not be R&D. Yet it is through applied and developmental research that conceptual ideas which result in worthwhile process improvements are proven up. Moreover, some processes are very difficult to scale up in a basic research laboratory environment and can only be tested in a large and robust production environment.

- *Augmented feedstock rules*

  These new rules will further reduce what would otherwise be eligible R&D activities that are carried out in a production environment. Unless the R&D project is an unqualified failure, and no saleable product results from the activity (either this year or in the future), it seems likely that most applied and developmental R&D (the core R&D area for large business) will not attract the credit. This outcome is expected to occur because the range of input costs that will in future have to be offset against eligible R&D expenditure would be extended beyond raw materials and energy. We strongly reject the philosophy of penalising success that underpins this aspect of the proposed new policy.

- *Not at Risk Rules*

  The proposed new "not at risk" rules set out in draft sec 355-405 seem to reflect some of the thinking behind the Tax Office's Discussion Paper on sec 73CA that was recently withdrawn. As they stand, the draft provisions replicate much of the uncertainty about who bears the commercial risk of an R&D project that remained unresolved from the Discussion Paper.

Our strong view remains that where a taxpayer is undertaking R&D in order to deliver a contractual result, and it bears the risk of technical failure associated with the R&D, then it should be entitled to the tax concession. It would therefore be more helpful if the provision could expand on the sort of factors that would be relevant in determining the “not at risk” question. This might include matters such as control over the project; financial risk; technical risk; ownership of any resulting IP.

As in the case of the proposed augmented feedstock rules, we would be strongly opposed to a rule that penalises commercial success.

- *Software changes*

  The proposal to restrict the R&D credit to situations where software developers make a financial return from the direct sale of software to third parties seems to ignore modern commercial practices that involve bundling services (including software services) and generating revenue indirectly through advertising or other services.

  This change will exclude any software developed in-house that supports a broader technical R&D objective, even in a dominant purpose sense, but where the software is unlikely to ever be saleable. Such software might include robotics or the computer control of various production operations. It is difficult to understand why the government would want to discourage this sort of innovation.

  If implemented, this change would further discriminate against in-house software development and could further accelerate an already significant off shoring process.

- *Increased compliance and uncertainty*

  The requirement to distinguish between core and supporting R&D activities as part of the registration documentation would represent an increased burden on business looking to access the much reduced concession available under the proposals in the ED. This is likely to lead to further under claiming of legal entitlements, which is already a feature of the current system. The compliance work relating to the identification of feedstock input costs would also become more onerous. Valuations will need to be undertaken of unsaleable products under the proposed augmented feedstock rules.

There would also be a higher level of uncertainty under the proposed ED changes. The cut-off between core and supporting activities would become much more critical than it is now because of the proposed dominant purpose test for supporting activities. If enacted, this will unquestionably lead to numerous disputes with the relevant agencies about exactly where the boundary lies.

The proposed new "considerable" threshold for the degree of novelty may also be expected to create further uncertainty and disputes. The augmented feedstock rules, if adopted, would create uncertainty around the valuation of unsaleable product and also the requirement to reopen prior year claims depending on what happens to the valuation of certain R&D benefits.

The proposal to permit the Board to disallow a registration simply on the basis of its submission is seen as an unnecessary backward step which is inconsistent with the self assessment process. Such an arrangement will create pressure to avoid such outcomes by over preparing the registration (creating further compliance costs). Also, it puts the taxpayer and the Board in dispute on the basis of what is likely to be a desk audit at best, before any meaningful dialogue has taken place between the taxpayer and the Board.

In terms of the stated policy objectives of these proposed measures, we are struggling to see how anyone could have thought they will make the concession more predictable for business and reduce complexity or red tape. Nobody in business takes those aims seriously and, indeed, the changes could not have been better designed to achieve the exact opposite outcomes.

CTA members across a range of industries are telling us that, in combination, the various proposed changes to the scheme would significantly reduce their historical R&D claims. They would also be operating in an environment which has higher compliance costs and greater levels of uncertainty. As they see it, the proposed changes would (with some limited exceptions) shift the focus of the scheme away from applied and developmental research in a production setting almost exclusively to a few dedicated laboratories where basic research is conducted.

In our view, implementing these changes would result in at least as big a drop in business expenditure in R&D as the 1996 changes introduced by the previous government. Policy makers also need to bear in mind that other countries do offer worthwhile tax incentives for R&D and for Australian based businesses and multi-nationals alike, many of these activities are quite portable these days. Australia would be left with an R&D tax incentive which is anything but broad based, and the credit would cease to have any relevance to most mainstream businesses. Given a choice, many Australian businesses would much prefer the tax scheme to be left exactly where it is, with a 7.5 per cent level of support, but without the premium scheme. While we don't have access to the sort of revenue modelling that Treasury presumably has, what members are telling us about the likely impact of the proposed changes strongly suggest the government's revenue objectives would be easily met, and business would be left with a tax incentive that at least retains some marginal impact.

While we recognise that the overall changes made to the program need to be revenue neutral, the measures proposed in the ED are the wrong way of going about that. We have made efforts to engage officials in discussions about more effective ways of achieving the revenue objectives without destroying the incentive, but so far these ideas have fallen on deaf ears. We remain ready to discuss alternative proposals once the government is ready.

Best regards,

Frank Drenth
Executive Director
Corporate Tax Association