CPA Australia
ABN 64 008 392 452

CPA Centre
Level 28, 385 Bourke Street
Melbourne VIC 3000 Australia
GPO Box 2820AA
Melbourne VIC 3001 Australia

T +61 3 9606 9606
F +61 3 9670 8901
E vic@cpaaustralia.com.au
W www.cpaaustralia.com.au

3 February 2010

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

By email: rdtaxcredit@treasury.gov.au

Dear Sir or Madam

SUBMISSION ON TAX LAWS AMENDMENT (RESEARCH AND DEVELOPMENT) EXPOSURE DRAFT LEGISLATION AND EXPLANATORY MATERIALS

CPA Australia represents the diverse interests of more than 129,000 members in over 110 countries. Our vision is to make CPA Australia the global accountancy designation for strategic business leaders.

Against this background, we now provide this submission concerning the Exposure Draft Legislation and accompanying materials on the Tax Laws Amendment (Research and Development) Bill (2010) issued on 18 December 2010. This submission is made not only on behalf of our members but also for the accounting profession and in the broader public interest.

The development of a streamlined, efficient and equitable R&D tax credit regime is essential if Australia is to ensure that it has a robust, productive and internationally competitive economy for the next generation.

The availability of such a scheme is necessary if the private sector is to successfully deal with a raft of unprecedented challenges including, amongst others, reducing carbon emissions, constructing a national broadband network, competing for international investment in R&D, and coping with the increasing cross border exchange of intellectual property via the internet.

We also appreciate the necessity of ensuring that the proposed R&D tax incentive is only available for appropriate expenditure. However, if the design of the proposed law is too restrictive there is a significant risk that R&D will be lost offshore to other jurisdictions with more competitive incentives to the long term detriment of the Australian economy, Australian businesses and jobs.

We strongly endorse the introduction of a refundable 45 per cent R&D tax credit for companies carrying out R&D whose aggregated turnover is less than $20 million, and the introduction of a non-refundable 40 per cent R&D tax credit for companies whose aggregated turnover exceeds that amount, so that all companies have a strong incentive to carry out R&D activities in Australia.

However, various key design features of the exposure draft legislation are significantly flawed which will have a highly detrimental impact on the utility of the new R&D tax incentive for both small to medium sized enterprises (SMEs) and corporate groups.

In particular, the combined impact of the proposed augmented feedstock rules, the stricter definition of core R&D activities, the expanded list of excluded activities and the reduced eligibility of supporting activities will drastically cut the number of eligible claimants and significantly increase compliance costs.

The adverse implications of each of these issues and our proposed recommendations to rectify these key elements of the exposure draft legislation are detailed in the attached submission.

In summary, we recommend that:

- the proposal to expand the application of the feedstock provisions in Subdivision 355-G should be excluded from any finalised legislation
- the existing definition of core R&D activities be retained under proposed section 355-25(1) so that activities are potentially eligible if they involve either innovation or high levels of technical risk
- proposed section 355-35(1) should be amended to excise the requirement that supporting activities be undertaken for the dominant purpose of supporting core R&D activities
- the proposed list of activities excluded from being core or supporting activities in proposed section 355-35(2) should be amended so that market testing, compliance with statutory requirements or standards and pre-production activities are all retained as eligible supporting R&D activities. In addition, the only exclusion for software projects under section 355-35(2) should be where the software activity was a core R&D activity which was not undertaken for the purpose of supply to two or more non-associates, and
- a 60 per cent R&D tax credit should be introduced to encourage the development of new or improved low-emissions technology to reflect the higher commercial risks associated with the development of such technology. Such credits should only be refundable to the extent that an eligible company's aggregated turnover does not exceed A$20 million.

Accordingly, we strongly believe that the finalisation of the exposure draft legislation should be deferred until further consultation has taken place with all major stakeholders including CPA Australia to ensure that the proposed regime can be introduced on a revenue neutral basis whilst addressing the structural flaws of the current exposure draft legislation.

If you have any questions regarding the above, please contact Mark Morris, Senior Tax Counsel, on (03) 9606 9860 or via email at mark.morris@cpaaustralia.com.au.

Yours faithfully

Paul Drum

Paul Drum FCPA
General Manager – Policy and Research

T: +61 3 9606 9701
E: paul.drum@cpaaustralia

Enc

Submission on the Exposure Draft Legislation and accompanying materials on the Tax Laws Amendment (Research and Development) Bill (2010)

CPA Australia has long advocated the need to enact a streamlined, efficient and equitable new R&D tax incentive to ensure Australia has a robust, productive and internationally competitive economy for the next generation.

The availability of such an incentive is necessary if the private sector is to successfully deal with a raft of unprecedented challenges including, amongst others, reducing carbon emissions, constructing a national broadband network, competing for international investment in R&D, and coping with the increasing cross border exchange of intellectual property via the internet.

Given its significance to the nation, CPA Australia previously lodged a detailed submission in respect of the 'Consultation Paper – The new research and development tax concession' on 26 October 2009 in which we made 18 recommendations on the key design features on the new proposed R&D tax credit regime.

We therefore welcome the opportunity to make a further submission in respect of the above exposure draft legislation and accompanying materials.

This submission sets out our general comments concerning the key features of the new R&D tax incentive which is followed by a list of specific concerns and accompanying recommendations.

General Comments

Prima facie the provision of a refundable 45 per cent R&D tax credit for companies carrying out R&D whose aggregated turnover is less than $20 million, and the introduction of a non-refundable 40 per cent R&D tax credit for companies whose aggregated turnover exceeds that amount, provides a strong incentive for all eligible R&D entities to carrying out R&D activities in Australia.

However, we firmly believe that the proposed design features of the exposure draft legislation will have a highly detrimental impact on the utility of the new R&D tax incentive for both small to medium sized enterprises (SMEs) and corporate groups.

In particular, the combined impact of the proposed augmented feedstock rules, stricter definition of core R&D activities, expanded list of excluded activities and reduced eligibility of supporting activities will drastically cut the number of eligible claimants and significantly increase compliance costs.

In our view these changes will inevitably reduce the perceived value of the new R&D tax incentive so that its take up rate will in fact be far less than that currently realised under the existing R&D tax concession.

Such an outcome is totally contrary to the Treasurer's announcement on 18 December 2009 that the exposure draft legislation will '…deliver a more generous, more predictable and less complex tax incentive by replacing the outdated and complicated R&D tax concession'.[1]

We understand that many of the above changes have been proposed to ensure that the cost of the new R&D incentive is revenue neutral whilst increasing the level of support for eligible claimants under both the refundable and non-refundable tax offsets.

However, as set out in our earlier submission on the Consultation Paper, we believe that the bulk of the cost of financing the revised R&D tax credit regime can be funded from the proposed abolition of the 175 per cent incremental R&D deduction. To the extent there is a funding shortfall we believe it can be potentially addressed through other means including the potential capping of R&D claims by corporate groups or making specific targeted R&D supporting activities non-creditable.

[1] Joint Media Release of Treasurer and Minister for Innovation, Industry, Science and Research on 18 December 2009, New R&D Tax Credit – Exposure Draft Legislation

Both of these options would be much more preferable that the proposed widespread recalibration of the R&D tax provisions as set out in the exposure draft legislation.

Accordingly, we strongly recommend that the finalisation of the exposure draft legislation be deferred until further consultation has taken place with all major stakeholders including CPA Australia to ensure that the proposed regime can be introduced on a revenue neutral basis without creating highly adverse complications for claimants.

Finally we reiterate our long standing view that a 60 per cent R&D tax offset be included for expenditure incurred by companies engaged in conducting R&D to develop low-emissions technology. Such credits should only be refundable to the extent that an eligible company's aggregated turnover does not exceed A$20 million.

Specific concerns and recommendations

We provide the following comments in respect of specific elements of the proposed R&D tax incentive together with our accompanying recommendations:

1. Proposed Subdivision 355-G – Feedstock adjustments

The most detrimental element of the exposure draft legislation is the augmentation of the existing feedstock provisions in proposed Subdivision 355-G.

Essentially, proposed section 355-450(1) provides that the market value of any output produced by an R&D activity (other than new knowledge or information) at the time of production, must be offset against the total expenditure directly relating to the production of that output in determining the amount of expenditure potentially eligible for the R&D tax offset. The only exception to this calculation is certain quarantined expenditure which will be excluded from the calculation which is currently limited solely to conceptual design costs.

As such the scope of the proposed provision is far wider than the existing feedstock provisions in section 73B of the Income Tax Assessment Act (1936) ('the ITAA (1936)') which excludes the cost of materials, goods and energy inputs incurred in a process of transformation which occurs as part of an R&D project.

Our concerns with the proposed expansion of these feedstock rules are twofold.

Firstly, it effectively ensures that any R&D activities conducted will be ineligible for the new R&D tax incentive where the work results in any outputs whose market value will exceed the costs of the eligible R&D undertaken.

Accordingly, companies whose R&D projects ultimately result in successful outcomes will not be able to make a claim since their eligible costs are less than the value of any goods, products or other outputs realised. This restriction is only aggravated by the proposed expansion in the list of excluded core and supporting R&D expenditure which is discussed below.

We note that the above approach ignores the commercial reality that claimants cannot guarantee the quality of outputs when they initially embark on R&D projects as the related uncertainty in any R&D project can only be resolved through systematic, experimental and investigative activities to address technical risks and/or identify innovative solutions to overcome technical obstacles.

In short, if a company successfully applies its resources to systematically resolve a technical problem it will be effectively penalised as it will be denied any support under the tax incentive because of the clawback rules in proposed section 355-450(1). By contrast a company whose R&D project is a failure will be able to make a claim under the new R&D tax incentive to the extent that the outputs realised are less than the expenditure incurred.

Hence, the new regime will result in the perverse outcome that successful R&D projects will not be supported by the new R&D tax incentive but that R&D projects which technically fail will be the recipients of the tax offset.

We believe that such a result is misguided as the R&D tax offset should be introduced to encourage successful R&D rather than to incentivise failure. .

It should be stressed that this measure will impact on both SME and corporate claimants, and will apply irrespective of whether the existing or proposed definition of core R&D activities is applied.

Our second concern is that practical compliance with the provisions of Subdivision 355-G appears to be extremely complicated.

Under the proposed changes a company must determine the value of an output produced as part of an R&D activity at the time of production. This valuation issue will be very problematic where an R&D activity results in an intermediate product which is not in a saleable condition at the time the R&D activity has taken place. Where such a valuation cannot be determined otherwise eligible claims may have to be deferred or lodged claims must be retrospectively amended once reliable valuations can be obtained.

Companies will similarly have difficulty in identifying specific 'directly related' costs at the particular time the R&D outputs are produced.

For all of the above reasons CPA Australia strongly recommends that the proposal to expand the application of the feedstock provisions in Subdivision 355-G be withdrawn from any finalised legislation as it is a misconceived measure. Should this recommendation not be accepted costs quarantined from section 355-450 should be expanded to include all labour costs as they are likely to have the most effective 'R&D spillover' benefits for the wider economy.

Recommendation 1

The proposal to expand the application of the feedstock provisions in Subdivision 355-G should be excluded from any finalised legislation. Should this recommendation not be accepted costs quarantined from the scope of this Subdivision should be expanded to include all labour costs.

2. Proposed Section 355-25 – Stricter definition of 'core R&D activities'

As detailed in our earlier submission on the consultation paper, CPA Australia strongly opposes any change to the definition of eligible core R&D activities.

We were originally concerned that the requirement that R&D activities involve both innovation and high levels of technical risk would adversely effect claims as the bulk of companies, advisers and Ausindustry personnel hold the view that innovation imposes a more rigorous requirement than the 'high level of technical risk' criteria.

Hence, we strongly supported the retention of the well established and commonly understood definition of core R&D activities being systematic, investigative and experimental activities that involve innovation or high levels of technical risk.

This view stemmed from our strong conviction that the R&D tax concession should not be limited to pure research but that it should have a much broader focus in assisting Australian companies to incrementally develop internationally competitive products and processes.

Our concerns with the introduction of a dual eligibility criteria in the definition of 'core R&D activities have only been exacerbated by the provisions in proposed section 355-25(1) that core R&D activities be experimental activities that are systematic and investigative which involve considerable novelty and high levels of technical risk.

Whilst we remain highly concerned with the introduction of a dual eligibility requirement we find the insertion of the term 'considerable novelty' in lieu of 'innovation' to be additionally problematic.

In our view the term 'innovation' has been reasonably well understood by companies, advisers, Ausindustry, the Australian Taxation Office and the courts over the 24 years the R&D tax concession has been operative.

We do not believe that the replacement of the term ‘innovation’ with the expression ‘considerable novelty’ adds any value to the tax incentive as it will only create uncertainty until that expression is appropriately clarified. Moreover, we are uncertain as to whether there can be multiple gradations of ‘novelty’ in a project and how in practice reasonable novelty can be effectively differentiated from ‘considerable’ novelty.

Our preferred view therefore is that the existing definition of core R&D activities be retained. Should this recommendation not be accepted the proposed definition of core R&D activities should be amended so that it relates to systematic, investigative and experimental activities involving innovation and high levels of technical risk.

Recommendation 2

The existing definition of core R&D activities in section 73B(1) be retained under proposed section 355-25(1) so that activities are potentially eligible if they involve either innovation or high levels of technical risk. Should this recommendation not be accepted the proposed definition of core R&D activities should be amended so that it will be met if there are systematic, investigative and experimental activities involving innovation and high levels of technical risk.

3. Proposed Section 355-35(1) – Dominant purpose of supporting R&D activities

We note that proposed section 355-25(1) states that supporting activities will be activities undertaken for the dominant purpose of supporting core R&D activities.

In our view the newly added inclusion of a dominant purpose test in claiming supporting activities is unnecessary as many related activities will be undertaken for a variety of reasons, and it will often be difficult to identify the most important or influential of these purposes.

We therefore believe that the existing rules should be retained so that supporting activities will be eligible provided they are directly related to an eligible core R&D activity.

In practice, the current regime recognises that a project will typically involve some core R&D activities which are innovative or highly risky which will be necessarily be supported by some other directly supporting activities which must be carried out to ensure that the overall ‘R&D project’ is completed. That is, core and directly supporting R&D activities are invariably interdependent in that both must take place in order for an R&D project to be finalised.

Recommendation 3

Proposed section 355-35(1) should be amended to excise the requirement that supporting activities be undertaken for the dominant purpose of supporting core R&D activities.

4. Proposed Section 355-35(2) – Expanded list of excluded supporting activities

The list of activities excluded from being eligible core or supporting R&D activities under proposed section 355-35(2) substantially replicates the equivalent list of activities currently excluded from being core R&D activities under section 73B(2C)of the ITAA (1936) except that the proposed list is somewhat wider in scope.

This absolute prohibition on funding support for some activities as core R&D activities may be warranted but it is excessive to exclude them from a claim when they are only supporting activities which are directly related to a core R&D activity.

For example, whilst we would concur that market research and compliance with statutory requirements and standards cannot be justified as a core R&D activity we nonetheless believe that both may be valid supporting activities to a company in testing the market or meeting the technical specifications of a particular product.

We further believe that the exclusion of pre-production activities from being an eligible supporting R&D activity is inappropriate as often tooling-up and trial runs provide an essential feedback mechanism as the whether the technical objectives of a core R&D activity are being met.

However, our most material concern with the list of new items in proposed section 355-35(2) relates to software.

Essentially, section 355-35(2)(o) has not only retained the multiple user test in relation to whether the software project is an eligible core R&D activity but extended its scope to where the software development is claimed as a supporting R&D activity.

In both cases the provision now also provides that this test will also require the company to establish that the activity was undertaken for the purposes of making a 'commercial return' to two or more non-associates even though that term itself is undefined.

This may exclude many projects which are trialled with non-associates for relatively nominal amounts which may then be more widely distributed commercially if successful.

In addition, section 355-35(2) (p) and (q) exclude projects integrating off-the-shelf software or open source computer software with other non-software activities as the use of such software will not be regarded as a valid core or supporting R&D activity. In our view this is an extremely simplistic view as the application or integration of existing off-the-shelf software is a common supporting activity for many core activities which are not software oriented but which have a software element to them.

Taken collectively these proposed amendments, (together with a residual software prohibition provision in section 355-35(2)(r)), will effectively prevent the overwhelming bulk of software activities from being either an eligible core or supporting R&D activity which we believe is misguided given the dynamic and evolving nature of that technology.

Given these limitations we believe that the exclusion for software activities should only apply to the extent that it cannot be a core R&D activity unless the activities was undertaken for the purpose of supply to two or more non-associates. Accordingly, the proposed commercial return requirement should be excised as should sections 355-35(2) (p) (q) and (r).

Recommendation 4

The proposed list of activities excluded from being core or supporting activities in proposed section 355-35(2) should be amended so that market testing, compliance with statutory requirements or standards and pre-production activities are all retained as eligible supporting R&D activities. In addition, the only exclusion for software projects under section 355-35(2) should be where the software activity was a core R&D activity which was not undertaken for the purpose of supply to two or more non-associates.

5. Proposed Section 355-100(1) – Inclusion of 60% tax offset for R&D expenditure into developing low emissions technology

As set out in our pre budget submissions for the 2008-09, 2009-10 and 2010-11 years we have long contended that the proposed carbon pollution reduction scheme is only one part of a comprehensive suite of policies required to reduce emissions.

In particular, we believe that appropriate incentives must be introduced to encourage SMEs to invest in new technology to reduce emissions. In our view the development and deployment of a wide range of low-carbon technologies by the private sector is essential in improving energy efficiency and achieving the deep cuts in emissions that are required.

Given the commercial risks in developing low carbon technologies we believe that such incentives should also carry a premium rate given the urgency for business to subsequently develop and commercially market such technologies.

Accordingly, we recommend that a 60 per cent R&D tax offset be included under proposed section 355-100 for expenditure incurred by companies engaged in conducting R&D to develop low-emissions technology. Such credits should only be refundable to the extent that an eligible company's aggregated turnover does not exceed A$20 million so that any equivalent credits derived by a company whose turnover is in excess of this amount will be eligible for the standard R&D tax credit.

Recommendation 5

A 60 per cent R&D tax credit should be introduced to encourage the development of new or improved low-emissions technology to reflect the higher commercial risks associated with the development of such technology. Such credits should only be refundable to the extent that an eligible company's aggregated turnover does not exceed A$20 million.