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Dear Sir or Madam

The Federation of Automotive Products Manufacturers (FAPM) welcomes the opportunity to comment on the Exposure draft legislation and explanatory materials for the new R&D tax credit incentive.

FAPM is an association of manufacturers engaged in the production of a comprehensive range of automotive products. It has a membership of approximately 100 companies, employing around 35,000 people.

FAPM is not supportive of the introduction of a new simplified tax R&D credit in its draft status. We have serious concerns over the impact the implementation of the proposed legislation will have on members of the automotive component sector.

We have highlighted in this document some of these key concerns and ask that they be carefully considered and amended prior to the finalisation of the legislation.

Please contact me on (03) 9863 2404 if you would like further information on this submission.

Yours sincerely

A handwritten signature in blue ink that reads "Richard Reilly". The signature is fluid and cursive, with a stylized flourish at the end.

Richard Reilly  
Chief Executive

**Federation of Automotive Products Manufacturers**

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## **Tax Laws Amendment (Research and Development) Bill 2010**

### **355-25 Core R&D activities**

The Exposure Draft defines Core R&D activities as experimental activities that:

- (a) are systematic and investigative; and
- (b) involve considerable novelty and high levels of technical risk; and
- (c) are conducted for the purpose of acquiring new knowledge or information, including knowledge or information about the creation of new or improved materials, products, devices, processes or services, other than activities mentioned in subsection 355-35(2) (excluded activities).

As with many submissions received during the initial consultation period, we believe that the need for an R&D activity to contain elements of both considerable novelty (innovation) *and* high levels of technical risk (a core activity) to qualify for the new R&D credit is problematic for members of the automotive supply chain.

We believe that such a narrowing of the definition of eligible R&D would adversely affect automotive component manufacturers, reduce the number of these companies that are eligible to claim the new tax credit and limit the R&D activities and associated R&D projects that are eligible for the scheme.

R&D developments within the automotive industry have historically been based on incremental changes. 30 years ago, a standard car contained four doors, four wheels, a steering wheel, an engine, an exhaust and a windscreen (amongst many other components). Today's cars, while still also containing the same basic elements described above, are by any measure simply much more sophisticated vehicles to those produced in 1980.

These technical improvements to modern day vehicles were generally the result of incremental developments undertaken over a period of time, rather than 'big bang' R&D step-change developments.

R&D activities have been undertaken by automotive component and car manufacturers that have over time produced the technical innovations to develop radically different components and vehicles, yet in their most basic sense, are still cars with four doors, four wheels etc.

Quite clearly, component companies have been undertaking technically risky R&D activities on automotive components for many years. Work has gone into making parts lighter, for example, or improving production lines to ensure a part is produced in a more efficient manner. Most, if not all these developments have qualified as eligible R&D and have contained in R&D parlance, high levels of technical risk.

That is, at the commencement of the R&D activity, either the final technical outcome wasn't known on the basis of existing knowledge, or the path to technical success wasn't known. Either way, there was an uncertainty of outcome, which is an indicator of technical risk.

However, in the above example, incremental R&D would in all likelihood not meet the new qualification definition of an activity needing to contain both novelty and high levels of technical risk. But in our view, not all activities need to meet both these threshold hurdles to be legitimate R&D.

R&D definitions have historically been based on the OECD's Frascati Manual. It should be noted that nowhere in the Manual does it indicate that to be an eligible R&D activity, the activity must contain both innovation and high levels of technical risk.

We believe that placing this requirement on R&D activity will constrain the level of activity within the component sector in Australia, are not necessary for the conduct of normal R&D activity and are unwarranted.

FAPM strongly urges that the need for an activity to meet both criteria of novelty and a high level of technical risk be amended and the current definition be retained.

### **355-35 *Supporting R&D activities***

The Exposure Draft defines Supporting R&D activities as those activities undertaken for the dominant purpose of supporting core R&D activities.

This proposed change to add a *dominant purpose* to the eligibility of supporting activities is not supported by FAPM.

We view the distinction between core and supporting activities as essentially an artificial one that doesn't take into account the practical nature of R&D projects. We view the introduction of this requirement as adding complexity to an already complex scheme.

Our experience with our membership base is that there is rarely, if any, distinction made between core and supporting R&D activities within the confines of an R&D project conducted within the automotive supply chain.

The R&D tax concession as it stands requires that only one R&D activity conducted within an R&D project be a core activity to be eligible to claim the R&D tax concession. For a supporting activity to be eligible, R&D claimants must show a clear nexus between the conduct of the core activity and the conduct of the supporting activity.

The introduction of a dominant purpose test for supporting activities will limit the R&D claims of companies within the supply chain, as the dominant purpose test may not be able to be met in most instances. This is problematic as in our view as this fact doesn't limit the overall eligibility of the R&D that is being conducted, it just means that the deemed activities and expenditures do not meet the proposed new R&D definition.

We also submit that pre-production trials and trial production runs (usually supporting activities within an R&D project) currently included in the proposed legislation's exclusion list at 355-35 2 (h) be removed as an exclusionary activity where these trials and trial production runs are a necessary activity to resolve a key technical project matter. This should apply to both core and supporting activities.

### **355-404 *Expenditure not at risk***

FAPM has concerns regarding the potential interpretation of the 'expenditure not at risk' provision of Subdivision 355F of the Integrity Rules.

This section is ambiguous in the way it currently reads; if interpreted on a literal basis, it appears to knock out all R&D, which is patently not its intended result. It needs to be redrafted to address only the mischief for which it was intended in the current R&D tax concession.

Clearly, most if not all companies undertaking R&D expect to receive, eventually, some sort of consideration as a result of the R&D expenditure being incurred.

### **355-450 Feedstock adjustments**

The augmented feedstock rules proposed in the new legislation would net off from the costs of the R&D (other than expenditure related to 'conceptual design' activities) the market value of any outputs produced directly from the R&D activities.

This would affect members of the automotive supply chain who for a direct fee (usually a fixed fee) charge for prototypes. If these companies make a profit on the development project, and some component producers only do applications engineering involving development of prototype parts for a fee, they would have no expenditure left, other than for concept design, to actually make a valid R&D claim.

Comparing the current feedstock rules with the proposed augmented feedstock rules, it appears the outcome for claimant companies is very poor, with the introduction of this measure alone most likely meaning little to no benefits from the new tax credit to those supply chain companies doing business and undertaking projects in the way described above.

FAPM believes that this concept must be altered, and that the feedstock provisions in the current R&D tax concession legislation should be maintained.

### **Software rules**

The new legislation continues that exclusion of in-house software as an eligible R&D activity and continues the 'multisale' test of the software resulting from the R&D having been developed for the purpose of making a commercial return to two or more non-related entities. The multisale test can only be satisfied where the purpose of the supply is to make a commercial return directly from the supply.

FAPM urges the government to remove the 'multisale' test on the development of software. It is an anachronism in today's world and unfairly penalises certain R&D activities developing software vis-à-vis other R&D activities. We believe software development activities should be treated as other core R&D activities are treated.

The proposed new rules require a direct fee be charged for software for it to be eligible under the new scheme. This is problematic in the automotive industry.

From the perspective of an automotive component producer, software is usually a sub-component embedded in another component that is subsequently the subject of commercial consideration ie. the fee charged is generally in relation to this subsequent component (most likely involving a hard component). For example, this would be the case in an engine management system.

Component producers developing software as a sub-assembly to be incorporated into a larger assembly would fail the proposed new software rules.

### **Clawback**

FAPM recommends that the clawback rules as they apply in the current legislation be maintained. We understand the provisions in the exposure draft have not yet been completed and so cannot comment in detail.

Suffice to say, overly complicated clawback rules are a disincentive for supply chain companies to avail themselves of benefits under the current ACIS Scheme and the R&D tax concession scheme for the same R&D project where overlap occurs.

## **Conclusion**

FAPM has very serious concerns on a range of issues proposed in the new legislation. Our members are very concerned that the legislation's implementation in its current form will provide another obstacle to overcome and create unwanted, additional financial pressures on companies within an industry that continues to be under enormous financial pressures.

The automotive component sector has overriding concerns primarily on the cumulative effect that these proposed measures would have on the automotive component industry. If the new legislation proceeds un-amended in its current form, we believe it will render the new R&D tax credit completely ineffective for members of the automotive supply chain and will not meet any of the key policy objectives the government put forward in its Innovation Policy document "*Powering Ideas*" released at budget 2009.