

5 February 2010

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

Dear Sir/Madam,

RE: R&D Tax Credit Draft Legislation

NOAH Consulting welcomes the opportunity to provide feedback on the draft legislation for the proposed R&D Tax Credit.

About NOAH

NOAH Consulting specializes in assisting organizations seeking to access Federal Government support for innovation, with a primary focus on the R&D Tax Concession. NOAH's Directors have in excess of 25 years experience in the R&D funding industry. Our client base ranges from small family run businesses to large global corporations across a wide variety of industries, including software, business intelligence, tooling, mining and resources, manufacturing, medical and health care. As such, we feel well placed to assess the potential impact of the proposed new legislation on the wider innovation community, and industry in general.

Our Concerns

NOAH commends the Federal Government for recognizing the important role innovation and technological advancement plays in enhancing economic development. NOAH strongly supports any initiative with the objective of increasing investment in local R&D. However, we feel it is important to recognize the extensive benefits delivered from incremental improvements and enhancements to existing technologies and processes, in particular, the integration of software and other computing solutions into the business environment of all companies. We feel that the draft legislation does not sufficiently recognize this aspect of R&D endeavour.

In addition, NOAH has a number of other concerns regarding the impact that the draft legislation for the new R&D Tax Credit will have on the levels of business expenditure on research and development (BERD). These concerns are outlined below:

1. Some elements of the draft legislation appear at odds with the stated policy aim of streamlining and simplifying the program. The changes to the definition of core R&D activities introduces new wording and has the potential to confuse, with the purpose test being stated as to acquire “new knowledge or information, including new knowledge or information about the creation of new or improved materials, products, etc.” Does this mean that activities that give rise to the development of an improved process would qualify? Is the aim of the changes simply to institute a requirement for both innovation and high levels of technical risk, while keeping the breadth of purpose currently available under the R&D Tax Concession? If so, amending the existing definition to require core activities to exhibit innovation *and* high levels of technical risk, may better achieve the desired outcome of simplification.
2. It is well-established that research and development does not take place in a commercial vacuum. As such, NOAH believes the introduction of a “dominant purpose” test for supporting activities will have a significant negative impact on the level of commercial R&D undertaken in the private sector. It is critical that the nation’s flagship innovation program continues to support “development” that occurs in a production or real-life environment, as well as “fundamental research”.

A dominant purpose test will exclude a large proportion of production trial activity that is a necessary and legitimate part of the research, development and commercialization cycle. If the aim is to contain the cost to revenue associated with large and open-ended production trials, the introduction of a cap on the value of supporting activities claimed as eligible project trial expenditure may more effectively achieve this objective.

3. The enhancement of the feedstock provisions further skews the program to solely supporting fundamental research. These enhancements will claw back the majority of claimable R&D expenditure (except concept design) whenever the R&D outputs generate value beyond the cost of the inputs. The introduction of this provision fails to recognize the important role of production trials in verifying the validity of core R&D outcomes. Furthermore, the program will effectively provide incentives solely for R&D projects that fail. As with the dominant purpose test, the institution of an expenditure cap may more effectively achieve the Government’s desired outcome.
4. The retention of the multiple sale requirement for software development, and the inclusion of additional exclusions for development involving open source software and the integration of off-the-shelf software components, fails to recognize the important

role of such activities in the business operations of companies across all industry sectors. It displays a poor understanding of the technical challenges and innovations involved in such software development. Furthermore we strongly believe that the introduction of these limitations will be extremely detrimental to the development of applications and other technologies for use on or with the National Broadband Network. As per current trends, it is reasonable to expect that software developments and related activities will be outsourced to other emerging economies, which will then be imported into Australia for local use.

5. The changes proposed to the registration process and content will add complexity and increase the compliance burden for all claimants. Companies will be required to distinguish between core and supporting activities and explain the nexus between these activities. The draft legislation also holds out the prospect that Innovation Australia may request additional information as part of the registration process, adding further complexity and increasing the compliance burden for claimants.
6. The 'expenditure not at risk' provisions appear to limit claims to situations where the claimant has no reasonable expectation of obtaining consideration as a direct, or indirect, result of conducting the R&D. As a consequence, access to the R&D Tax Credit may be limited to entities conducting "blue sky" research.

Summation

The draft legislation fundamentally changes the nature of the Federal Government's flagship innovation program. Under the new rules, the program will no longer be broad based, ceasing to support industrial research and development. Instead, the scope of eligible R&D activities will be severely restricted, primarily aimed at supporting fundamental research conducted in a non-commercial context.

The changes will also add complexity to the process of project characterization, and the registration process, neither of which will support the stated policy aims of simplifying and streamlining applications.

Based on preliminary calculations across our own client base, it appears that the proposed R&D Tax Credit legislation, has the potential to reduce support for R&D by as much as 80%. As our client base is representative of the existing R&D Tax constituency, there is every likelihood that a reduction of similar magnitude will be felt across the current 7,000 plus R&D Tax Concession registrants. If so, the results will be disastrous for Australia's level of BERD, and contrary to the Government's objective of maintaining revenue neutrality.

Given the Federal Government is a strong supporter of innovation and is actively seeking to improve the local environment for such activities, it would appear that the implementation of a broad based program that supports commercial R&D would better achieve these objectives. It is imperative that commercial R&D is given strong support, with the long-term objective of increasing investment in the Australian

economy, generating new jobs, and boosting the profitability of Australian companies, directly resulting in increased corporate taxation revenue for the Federal Government.

NOAH would like to take this opportunity to thank the Minister and his Department for its consideration of the aforementioned comments, and we look forward to the release of an amended Bill that will operate to support and nurture the best interests of the Australian R&D community.

Yours sincerely,

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