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SUBMISSION ON THE EXPOSURE DRAFT TAXATION LAWS AMENDMENT (RESEARCH AND DEVELOPMENT) BILL 2010

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

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INTRODUCTION AND EXECUTIVE SUMMARY

ResMed is a leading developer, manufacturer and marketer of products for the screening, treatment and management of sleep-disordered breathing (SDB) and other respiratory conditions. The company was founded in 1989 and since then has become one of the world's leading respiratory medical device manufacturers, exporting more than 90% of its production from Australia. ResMed is listed on both the Australian and New York Stock Exchanges.

Our focus is on continuous innovation to develop breakthrough products and technologies. As global leaders in sleep and respiratory medicine, we educate and raise awareness by sharing knowledge with patients, clinicians, industry professional and the broader medical community.

ResMed welcomes the opportunity to comment on the Exposure Draft of the Tax Laws Amendment (Research and Development) Bill 2010.

The Exposure Draft unfortunately takes an extremely narrow approach to the definition of R&D, eligible activities and introduces a number of anti-commercial provisions.

It is essential that the Australian R&D tax incentive remains competitive with R&D incentives offered by other countries. Australia operates in a global economy, with greater workforce mobility than ever before. The decision of where to perform long–term value adding R&D activities is largely a factor of cost (providing the level of quality of R&D output can be achieved) and R&D tax incentives play an important role in the overall cost of performing R&D. ResMed regularly monitors R&D tax incentives offered in key jurisdictions.

Whilst the exposure draft has focused on optimising "spillover" effects, it is significantly at risk of having the opposite impact as value adding R&D either does not take place, or takes place overseas to the benefit of other economies.

Further, it is widely recognised that R&D tax incentives play an essential role to small and medium Research and Development companies and an important source of cash flow and tax benefit. ResMed has demonstrated that by supporting Australian R&D through effective tax incentives, the benefits to the Australian economy will be generated in the medium and long term.

ResMed's key concerns and recommendations made in respect to the Exposure Draft are detailed below.

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ResMed Submission

1. s355-25 Core R&D Activities

- ResMed submits that the proposed definition of Core R&D activities will significantly increase uncertainly and takes an extremely narrow approach to R&D. The existing definition of core R&D activities should be retained.

  Considerable novelty or high levels of technical risk can independently result in activities that are highly beneficial to the Australian economy.

  An example might be a manufacturing process has high levels of technical risk due to semi-automation, but is not considered to be innovative. The project itself might generate additional engineering positions as well as the subsequent Australia manufacturing activity if the project is successful.

  To require that eligible activities consist of both considerable novelty and high levels of technical risk would mean many projects would not qualify, despite having significant "spillover" benefits. To deny these projects eligibility is likely to result in either the projects potentially not being undertaken, or untaken in a jurisdiction where R&D incentives are available.

- The reference to "considerable novelty" rather than the existing "Innovation" reference also increases uncertainty and results in a more subjective definition. The existing reference to "innovation" should be retained as it is more widely understood and recognised than the proposed reference.

- The "Purpose, Knowledge and Improvements" test in subsection s355-25(c) excludes the most common form of commercial R&D involving the application of knowledge or information. This narrow approach fails to recognise that applying new knowledge is the most commercial common source of innovation and technical risk and will severely limit eligibility of R&D activities for the R&D tax incentive. It also largely recognises the "research" element and not the "development" element of R&D which is inconsistent with the overall purpose of the R&D tax incentive.

- ResMed also submits that for greater certainty, R&D activities that require regulatory approval (e.g. from the Food and Drug Administration) should be automatically considered eligible R&D. Any new product requiring regulatory approval will have "high-levels of technical risk" until regulatory approval is obtained.

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2. s355-35(1) Supporting R&D Activities

- The definition of supporting R&D activities has been limited to "activities undertaken for the dominant purpose of supporting core R&D activities". The proposed definition is significantly restrictive and increases uncertainty due to the subjective assessment required. The "dominant purpose" requirement is inconsistent with commercial R&D, particularly where an employee may have a number of similarly important roles, only one of which is to support core R&D activities.

- As an alternative approach, ResMed submits that a set level of core R&D expenditure to supporting R&D expenditure should be 1:1, regardless of actual supporting expenditure.

  This approach would provide a greater incentive for companies to invest in core R&D expenditure rather than reward excessive supporting expenditure. This also eliminates the significant administrative complexities involved in separately calculating supporting expenditure which is generally very time consuming for companies and the Australian Taxation Office in R&D audits and risk reviews.

3. s355-35(2) Supporting R&D Activities – Exclusions

- The transition of the "exclusions list" to supporting R&D activities represents a significant shift in the application of the "exclusions list". The exclusions list has a potentially much broader impact for both core and supporting activities.

- Activities associated with complying with statutory requirements or standards could have an extremely limiting effect for medical industries which are governed by the Therapeutic Goods Administration (TGA) in Australia and Food and Drug Administration (FDA) in the U.S. A large number of project activities could be interpreted as being for the purpose of complying with these statutory requirements. Further, clinical studies are often undertaken specifically to enable approval of a product by a governing body such as the TGA or FDA and therefore could potentially be excluded.

- Pre-production activities would also be excluded under the proposed "exclusions list". This is not reflective of commercial reality as any R&D that results in the development of a product needs to be tested to ensure it can be manufactured. Pre-production activities such as trial runs are an essential part of the overall R&D project.

- The proposed exclusion of computer software development from being an eligible R&D (except in limited circumstances such as making a commercial return directly from the supply of that software) will potentially exclude software which is embedded in a product. In practice, it is likely that only "shrink wrap" type software development will be eligible. This is a significant limitation of the application of R&D tax incentives to computer software development and this exclusion should be modified to avoid this adverse application.

- Further, the "commercial return" requirement for computer software does not reflect common situations where a software is provided to a customer at a subsidised cost which complements products that have been developed by the same company.

  An example would be computer software developed for the medical profession to monitor compliance of patients for a medical product. Given the developed software enhances product sales, it could be sold as a reduced or nominal cost and therefore may not be defined as a "commercial return" and therefore the software development is ineligible.

4. s355-405 Expenditure not at risk

- The proposed provisions stipulate that an R&D entity cannot deduct expenditure if it is expected to receive consideration as a result of the expenditure and the consideration is greater than the expenditure.

- The application of this provision results in R&D activities being ineligible where they are carried out for a foreign related party and arm's length consideration is necessary due to Australian Transfer Pricing provisions (e.g. on cost plus mark-up basis).

- The International Premium Concession was introduced in 2007 for this exact situation to encourage and incentive Australian R&D activities where the Intellectual Property is foreign owned.

- ResMed submits that the proposed "at risk" provision is inconsistent with the principle that Intellectual Property ownership is not essential to benefit from the R&D tax incentive program. The provision and "at risk" requirement should be removed or amended to mitigate ineligible of Australian contract R&D activities for foreign related parties.

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5. s355-450 Feedstock Adjustments

- Under the proposed amendment to the feedstock provisions, there will be further clawback of costs relating to the output of an R&D process against the entire cost of the actual R&D activities.

- Where outputs from an R&D process are successful and subsequently sold, then almost all costs in the R&D activity could be reduced by the consideration received. This results in an inequitable situation where unsuccessful projects are rewarded where as successful projects will miss out on R&D tax incentives. Further, the potential costs that would be reduced under the new rules is extremely broad and should exclude such costs as labour and depreciation incurred as a result of the R&D activity to result in a more equitable outcome.

ResMed would like to thank The Treasury for their consideration of ResMed's submission.

Robert Douglas
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Rob Douglas
Chief Operating Officer – Asia Pacific
ResMed Ltd