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The proposed new Research and Development tax incentive – Second Exposure Draft legislation

Caltex would like to make the following submission in relation to the second Exposure Draft legislation released on 31 March 2010.

This release has amended a number of the original provisions in the first Exposure Draft released on 18 December 2009, which we believe continues to considerably tighten the access to the R&D tax incentive. There is a fundamental departure from the existing R&D tax concession and the themes coming out of the Cutler review.

Caltex is disappointed that the concerns outlined in its submission to Treasury on the first Exposure Draft in February 2010 and the R&D Discussion Paper released in September 2009 appear to have been ignored in the second Exposure Draft. The proposed provisions significantly narrow the range of eligible activities and shift the focus from supporting corporate R&D to merely supporting pure research activities.

There has been no true consultation process and we have been provided with a tight response time. With incomplete draft legislation introduced, taxpayers have a limited time to understand, absorb and ensure smooth transition by 1 July 2010. There is simply insufficient time left to develop new plans and procedures to ensure all aspects of the legislation are addressed.

The proposed definitional changes are complex and cumbersome and present an additional compliance burden and cost in application.

Issues identified in the second Exposure Draft

1. New Core R&D activities definition

The definition of core R&D has been totally changed. It no longer refers to the terms "novelty" or "technical risk". It has added additional complexity by introducing new untested legal concepts.

From the first Exposure Draft, the amended definition of R&D was shifting the focus away from applied research or development towards research. This focus has not changed but has been reinforced in the second Exposure Draft. Once again Caltex is concerned that there is a real risk that the proposed rules will damage the innovation system in Australia by withdrawing critical support for commercially focused R&D. This is essentially where Australia is seen to fall behind its international competitors.

As discussed in our submission on the first exposure draft, it was strongly urged that the definition be reviewed to ensure that commercial scale R&D activities remain eligible for the R&D incentive. Caltex needs to be able to compete with the Asian refineries which employ more sophisticated refining technologies. We need to continuously evolve and adapt the processes we employ to keep pace and remain efficient. Such activities will not be supported by the definitional changes in the second Exposure Draft.

The new definition of core R&D requires taxpayers to seek new, previously unknown or undiscovered information and to carry out scientific experimentation to uncover that new knowledge. The eligible activities have been separated into core and supporting, with two separate qualification tests. This requires going further than what is already known and the knowledge gap needs to be significant to require adoption of the scientific method.

Claimants such as Caltex will need to be able to prove in a retrospective assessment that the knowledge did not exist anywhere else. This is impractical and creates an innovation system which does not encourage companies in an industry to pursue the development of new and improved products and processes autonomously

The examples in the EM highlight how difficult it is in business practice for the scientific method to translate to commercial or industrial R&D. The practical implications for Caltex to apply this new definition to the R&D activities are considerable.

Caltex is of the strong view that the definition of "core activities" needs to be amended to reflect support for application R&D explicitly so as to enable those activities that support development.

2. *Supporting R&D activities*

The second Exposure Draft has redefined supporting R&D activities as those that are directly related to core R&D activities. There is a dominant purpose test that needs to be applied to all supporting activities. This is viewed as a strict test and one which is left open for interpretation and once again will create a significant compliance burden for all claimants including Caltex.

To split the costs associated with R&D between supporting and non-supporting activities would be extremely difficult and unnecessarily impose a significant compliance burden. This goes against the focus of our R&D activities and will require significantly more resources to be spent on R&D administration and compliance.

Caltex completes its analysis, testing and implementation of its R&D activities on existing production processes. Caltex conducts R&D in the production environment for commercial reasons, as it reflects the tight margins under which we operate. For Caltex to set up new refinery units to accommodate pure R&D would be absurd. There is no commercial rationale to complete R&D in this way, it would be extremely prohibitive.

By redefining supporting activities as proposed, the support for R&D will move away from an industrial R&D program to one that is purely laboratory based which does not necessarily provide commercial outcomes. Support has now been removed from commercial scale activities, where real improvements to processes and output are trialled in real conditions and not purely laboratory or theoretical conditions.

Without the constant investment in R&D for business development, our refineries will become less efficient, more costly to run, unable to increase output to satisfy the country's energy requirements and less able to meet future fuel standards. Therefore we would need to consider importing product from our international competitors. This will be detrimental to the Australian economy.

The new proposal is narrowing any benefits that an R&D incentive program can provide to the Australian economy. As it currently stands the proposed R&D rules will deter any future investment and adversely impact a majority of corporate taxpayers that invest in Australian industry. Australian industry that is committed to driving change, evolving work practices and processes and increasing the productivity of its workforce and the future of the nation,

3. Feedstock

The introduction of the augmented feedstock rules is now excluded from the second Exposure Draft. However, the example given in the EM identifies a situation where R&D activities are conducted through production of a marketable product and these activities would not be seen as supporting a dominant purpose, hence excluded.

The second Exposure Draft does not include any provisions surrounding the feedstock rule. It remains unclear how the feedstock rules will interact with the requirement that production related activities be undertaken for the dominant purpose of supporting core activities. Until wording is provided in the proposed legislation, we are not able to comment on its impact and given the tight timeframes provided to comment we may not be able to provide any views in time for the introduction of the new rules.

However, it must be remembered that the costs of feedstock used in R&D activities would be quite prohibitive, if solely used to test research hypotheses.

Caltex is of the strong view that the feedstock rules should be widened to ensure that all genuine R&D related activities and costs are included regardless of whether a marketable product is produced.

Conclusion

Once again, Caltex strongly opposes the second Exposure Draft in its current form. The proposed measures will significantly impact on future R&D claims (Caltex expects there will be at least an 80% reduction in its R&D claims) and are supporting only the scientific, laboratory type R&D. This is very a very restrictive application of rules designed to make us an innovative nation.

The proposed rules will not support economic growth, development and increase in productivity that Australia needs to gain international competitiveness.

The timetable for introduction of the proposed rules is tight and the changes introduced in the second Exposure Draft are siubstantial to understand and apply. It is strongly recommended that the commencement date be deferred by one year, to enable taxpayers to understand and apply the changes effectively.

Caltex would welcome the opportunity to meet and discuss its concerns with the second Exposure Draft measures in more detail.

Yours sincerely,

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