Review of the R&D Tax Credit Legislation: Submission of the Australian Manufacturing Workers Union April 19

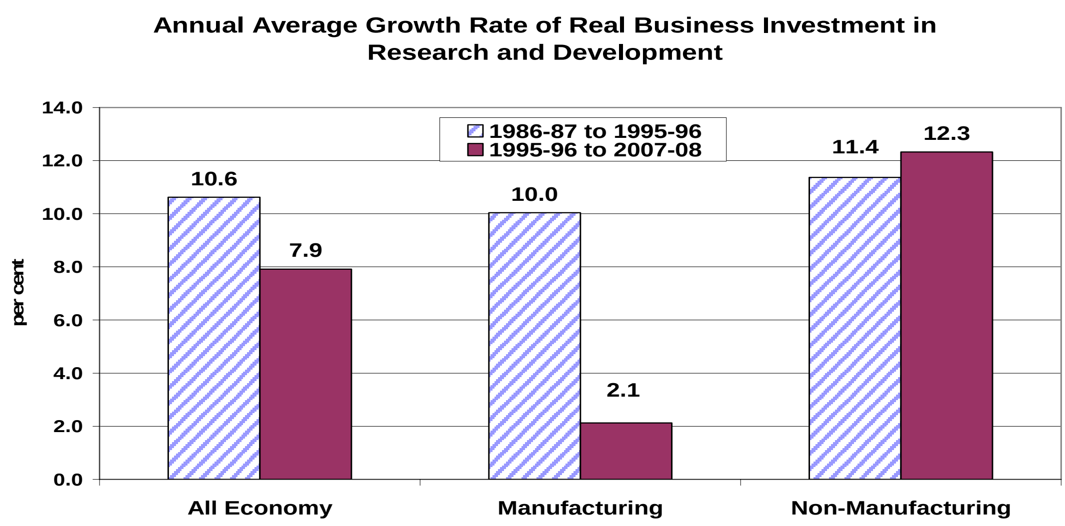
Introduction

The Australian Manufacturing Workers Union was part of a coalition with leading manufacturing CEO's that put together the submission to Minister Carr from the Future Manufacturing Industry innovation Council (FMIIC) on the first exposure draft of the tax credits legislation. That submission put issues such as software, IT services and the augumented feedstock provisions to one side and focused on three core issues.

1) The objects clause of the legislation
2) The definition of eligible R&D
3) The dominant purpose test and the split between core and supporting R&D.

It is therefore appropriate as we head towards a Senate Inquiry into the second draft exposure legislation for the AMWU to review its position in relation to these three issues. That is the purpose of this submission. Our main concern is the impact of the proposed draft legislation on manufacturing R&D.

As we stated in the FMIIC submission to Minister Carr, the last major changes to R&D in the mid 1990's that cut the 150% R&D Tax Concession to 125% and abolished Syndication were major contributing factors to the collapse in manufacturing R&D highlighted in the table below



The AMWU concurs with the views put by the FMIIC to Minister Carr in the following terms

> *"The FMIIC understands all too well what would happen to manufacturing in general and advanced manufacturing in particular if manufacturing had another decade of 2 % real annual R&D growth instead of 10%.*
>
> *Over the course of the second decade of the 21st century 10% growth would see manufacturers invest a cumulative total of more than $80 billion in R&D while 2% growth would result in just over $50 billion of R&D investment. The difference of $30 billion is the difference between Australia having a prosperous, thriving and innovative world competitive manufacturing industry as opposed to one that struggles to survive "*

We turn now to consider the second draft exposure Legislation on the R&D Tax Credit System[1]

AMWU Response to the Second Draft of the R&D Tax Credit Legislation

The AMWU notes that Ceramic Fuel Cells Ltd (a cleantech SME headquartered in Australia), in its submission in 2009 on the first exposure draft of the new R&D Tax Credit legislation summarised the view of almost every participant when it said:

> *"Our company commends the Government's stated intent in delivering a 'more generous, more predictable. and less complex tax incentive', however we do not believe the legislation achieves this intent in its present form.*
>
> *Whilst we understand the Government's intention to tighten eligibility in order to focus incentives on worthy activities which will benefit the broader Australian economy, we believe the combination of the high number of tightening measures*

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[1] The two key drivers of non manufacturing R&D growth in the past decade were Finance & Insurance and the Mining Sector. Over the five years to 1996-97 theses two sectors share of total business R&D was 13.6%.and this increased to 26.1% in the five years through 2006-07. By 2007-08 this had increased to 32.7%.The strong R&D growth in these two sectors was facilitated by the strong growth in profitability they experienced. During the 1990's decade their combined gross operating surplus accounted for 12.9% of total industry gross operating surplus and that rose to 21.2% in the current decade. In the Mining sector the profit share of total factor income rose from 70.1% (1990's decade average) to 79.7% (2000-09 decade average).In the Finance and insurance sector the profit share of total factor income rose from 31.4% to 45.9% over the same two decades.

contained in the exposure draft serves to drastically reduce the generosity, accessibility and attractiveness of the R&D Tax Incentive program."

The AMWU believes that assessment is as relevant to the second exposure draft as it is to the first.

In responding to the second Exposure Draft of the R&D Legislation Michael Johnson and Associates had this to say:

> *"The current package leaves us back where we all were when the Treasury delivered its September 2009 paper – a restrictive Object clause legislating additionality and spillover (despite the original public assurances to the contrary); a first-time split between core and supporting R&D activities; a wide-reaching dominant purpose test. Remember, 162 of the 165 responses to the Treasury paper published last year opposed such changes. They were a bad idea then and they remain a bad idea now. Six months on and we have made little progress."*

Accordingly the AMWU will briefly note what we see as the main problems with the exposure draft legislation and where possible highlight changes and amendments that are required. We rely on the original submission of the Future Manufacturing Industry Council for the substance of our assessment about the impact of the legislation on manufacturing.

A) The objects clause of the new legislation is still fundamentally flawed. The AMWU reiterates the position we supported and the reasons given in the Future Manufacturing Industry Innovation Council submission to Minister Carr .We stated then and we reaffirm that direct or indirect references to spill overs and additionality is inappropriate in an objects clause that will provide the context for decisions by the Courts on the interpretation of the legislation.

It will also influence the"mindset" of those doing advanced findings and the audit process when the purpose of eligible R&D expenditure is assessed on a case by case basis either explicitly or implicitly. Additionality and spillovers might be dealt with through an objects clause in a small scale discretionary grants program, but it is inappropriate in a large scale general access program covering nearly 8,000 firms. Such an approach is yet another confirmation that this legislation is mainly about incentivising scientific research not experimental development and the later accounts for more than 70% of manufacturing R&D.

The objects clause in the existing legislation should remain largely as it is and read:

"The object of this legislation is to provide a tax incentive, in the form of a tax credit, to encourage research and development activities in Australia and make eligible companies more internationally competitive by:

(i) Encouraging the development by eligible companies of innovative products, processes and services: and
(ii) Increasing investment by eligible companies in defined research and development activities; and
(iii) Promoting the technological advancement of eligible companies through a focus on innovation or high technical risk in defined research and development activities; and
(iv) Encouraging the use by eligible companies of strategic research and development planning; and
(v) Creating an environment that is conducive to increased commercialisation of new processes and product technologies developed by eligible companies."

B) In supporting the Future Manufacturing Industry Innovation Council submission to Minister Carr the AMWU opposed the new legislative amendments that would require eligible R&D activities to entail **both** innovation **and** high levels of technical risk.

The new draft legislation changes the words and definitions but still comes out with a requirement to have both as a condition. This was summarised by Deloittes in the following terms:

"The Explanatory Memorandum states that the requirement to employ the scientific method reflects the threshold degree of novelty in the new ideas being tested. This requires going beyond the validation and implementation of existing knowledge in a different context or location

It must go beyond the confirmation of what is already known – even if this knowledge does not exist in the company carrying on the activities.

The knowledge gap needs to be of sufficient significance to require the adoption of the scientific method.

This is a high threshold indeed, as it extends knowledge and information beyond the confines of the company carrying on the *activities and as such sets the bar higher than the current innovation requirement.*

This new definition will require both high levels of technical risk "and" considerable novelty to be present for a core R&D activity to exist. As a consequence it is in substance the same as the definition contained in the first exposure draft. The widespread concern raised in response to Treasury's initial consultation paper issued on 18 September 2009 and the first exposure draft relating to the requirement of satisfying both tests is equally valid for the new definition."

This notion of a fundamental redefinition of eligible R&D expenditure is also argued by Michael Johnson and Associates in these terms:

As Treasury has indicated, the new definition of core R&D requires taxpayers to be seeking new information (to solve problems or develop new or improved products and processes) and to need an experiment to uncover that knowledge.

The concepts of systematic, investigative, innovation and technical risk have all been dispensed with. These are concepts that are useful to taxpayers in qualifying their R&D activities and are well understood as opposed to ambiguous. Ten of the current technical objectives – the creation of new or improved products, processes, devices, material and services – have been eliminated and subsumed into the new knowledge objective.

This is an unequivocal narrowing in the definition of core R&D compared to the current concession and, in fact, to the one contained in the Christmas package. Add the four new classifications of supporting R&D activities and the new restrictive Object clause and you end up with a very different definition of eligible business R&D The September 2009 Treasury Consultation Paper stated that the Government was altering the definition to bring it more in line with the Frascati definition. They could no longer credibly maintain that this is the case. The proposed definition reflects the first two elements of Frascati-basic and applied research-but not experimental development

The new proposed changes to eligibility which have a long history in this R&D debate should be disallowed. Under current arrangements, "core R&D" is eligible for the tax deduction if evidence can be shown that the R&D satisfies **either** a test of being innovative, **or** a test of high levels of technical risk. Those tests are well understood by firms, administrators, regulators, and appeal bodies including the courts. They are also consistent with the way eligible R&D is operationalised for tax concession treatment in other OECD countries. The status quo should be retained.

C) In supporting the Future Manufacturing Industry Innovation Council submission to Minister Carr the AMWU opposed the legislative amendments in the first draft that would institutionalise a split between core and supporting R&D and impose a dominant purpose test. As the FMIIC submission explained in relation to the first exposure draft legislation:

> *"Another difference between the existing incentives for R&D and the proposed new arrangements is the new emphasis on bureaucratic arrangements and rules for splitting R&D activities and costs between "core" and "supporting".*

Varian Australia Pty Ltd summarised the views of most participants in the inquiry process when it stated in its submission:

> *"We submit that the split between core and support R&D is a fiction created by the tax law and not reflected in commercial reality. We do not manage our projects according to core and supporting activities, so asking us to do so is a significant and unnecessary administrative and compliance burden. Such requirements divert effort away from and reduce the benefit of the R&D.*
>
> *We manage our projects according to objectives, tasks and milestones – objectives set the framework of the project, tasks are the effort required to achieve an objective and milestones are the deliverables. All tasks within the R&D phase of a project are necessary to bring that project to completion."* (Varian Submission: Submission: R&D Tax Credit Consultation, October 2009)

Marand Precision made the same point in their submission when they emphasised:

> *"We are especially concerned about the uncertainty and cost of defining and gathering data separately for the core and support activities, the distinction of which are extremely arbitrary and potentially discriminatory as between industry segments."* (Marand Submission: Submission: R&D Tax Credit Consultation, October 2009)

Hofmann Engineering provided a number of examples of how restricting supporting activities from qualifying as eligible expenditure would impact its business because of the extensive supporting role that design and draft work as well as testing plays in its R&D activities as a manufacturer, particularly for prototyping: (Hofmann Engineering: Submission: R&D Tax Credit Consultation, October 2009, p. 3)

On the issue of red tape and compliance costs, Cochlear made the point that splitting R&D activities and costs between core and supporting would require substantial additional costs to overhaul:

> *"I. Project Accounting Systems;*
> *II. Time-Sheeting and Record-Keeping Systems;*
> *III. Vendor and suppliers Invoicing Systems; and*
> *IV. Manufacturing Systems.*
>
> *These changes would mean that corporations would potentially need to invest millions of dollars into changing their current Business Systems and Business Intelligence applications to comply with the new proposed R&D Tax Incentive Scheme*." (Cochlear: Submission: R&D Tax Credit Consultation, October 2009, pp. 5-6)

Chevron Australia Pty Ltd made a similar point in its submission when it pointed out:

> *"Current accounting systems and procedures are created for project level reporting. To change to a system where the activity must be classified as core or supporting to the R&D objective will require each individual engaged in R&D activity, in addition to cost controllers and project administrators, to have in-depth knowledge of tax legislation to distinguish between core and supporting activities. As core and supporting activities vary dramatically from one project to another, significant education and training in regards to cost reporting would be required at the commencement of each R&D project, adding a significant financial and administrative burden to the R&D process*...(Chevron : Submission: R&D Tax Credit Consultation, October 2009, p. IV)

Ernst and Young, in their submission, made the same points as Chevron and Cochlear while adding that the consequences would likely be more severe for small and medium enterprises:

> *"Accounting systems naturally report on costs in relation to projects for non-production activities. Capturing eligible R&D expenditure on a project basis sits naturally with this. Further*

> *dividing this expenditure into subtle and often complex divisions based on tax law does not. It is a practical complexity that is real, highly expensive and adds no benefit to the R&D output.*
>
> *In addition to imposing additional expense upon large companies using sophisticated accounting systems, the requirement to account separately for core and supporting activity will create administrative and financial barriers to small companies. Companies who do not have the complex accounting systems and processes will find the changes necessary to allow this level of reporting to be cost prohibitive which may prove to be a deterrent to small to medium enterprises accessing the tax credit, possibly exponentially larger in effect than for larger companies.”*(Ernst and Young: Submission: R&D Tax Credit Consultation, October 2009, p. 14)

The September 2009 Treasury Consultation Paper canvassed a number of options for containing costs through a distinction being drawn between core and supporting R&D. The option chosen in the First Draft Exposure Legislation changes the existing requirement that supporting R&D must be carried on for a purpose **directly related to** the carrying on of core activities to the new arrangement where supporting R&D activities must be undertaken for **the dominant purpose** of supporting core R&D activities.

Criticism of this change in the early pre XMAS debate by Michael Johnson Associates was highlighted in the FMIIC submission because of its relevance to manufacturers in particular who carry out much of their R&D in a production environment

> *“..A dominant purpose test in respect of supporting activities is outlined in the following Objects clause: The Tax offset is also available for directly related activities that are conducted for the dominant purpose of supporting such core experimental activities rather than for broader commercial or other purpose.*
>
> *This myopic view of industry R&D will undermine any tax incentive for the conduct of applied research by Australian business. Essentially the program (tax credit) will focus on conduct of “research” phase activities and not development phase activities. This equates to a meaningless incentive for companies (large and small) engaged in process technologies where downstream development costs and risks vastly outweigh the initial research effort involved, especially in manufacturing and mining.”* (MJA website article Dec 2009).

Criticism of a sole or dominant purpose test was also raised by KPMG in the following terms in their comments on the Draft Consultation Paper:

> *"KPMG submits that a sole purpose test would not be practical, given that almost all bona fide supporting activities will have some element of incidental benefit for the claimant taxpayer. Accordingly, such an approach is likely to lead to the ineligibility of the majority of otherwise eligible expenditure incurred in supporting activities…We note that any approach based on a purpose test will, almost by definition, require an objective decision to be made as to the claimants motive for such expenditure in addition to the assessment of value attributed to any incidental benefit. Accordingly, such an approach introduces not only uncertainty but also the potential for widely differing interpretation by assessors and claimants*". (KPMG submission to R&D Consultation Paper October 2009)

The last word on this matter and one that gets straight to the bottom line was put by Michael Johnson and Associates in these terms:

> *"Supporting activities customarily have more than one purpose as they are conducted by companies with commercial goals. Restrictions (on claimable expenditure under the tax credit) around purpose, particularly of a production nature stand to decimate claims."*

The assessment of MJA proved to be correct. The AMWU and several of Australia's advanced manufacturing firms commissioned MJA to assess two of these manufacturers R&D projects. The objective was to determine how much eligible R&D qualified under the existing tax concession arrangements compared to how much qualified in the arrangements proposed in the first exposure draft of the new legislation.

Even if we exclude the impact of the augumented feedstock provisions, the dominant purpose test made the vast majority of previously eligible R&D expenditure by these manufacturers ineligible under the first exposure draft legislation. It is our assessment that this will also be the case with the current provisions in the second draft of the legislation.

As KPMG has put the case in relation to the new second draft legislative provisions:

"Two of the main concerns with the 1st ED were the treatment of supporting activities and the introduction of an 'augmented feedstock rule'.

In the existing law, the criterion for eligibility of supporting activities requires that they be 'directly related' to the core R&D activities. The first ED proposed to alter this requirement of those activities being carried out for the "dominant purpose" of supporting the core activities.

This dominant purpose requirement has not only been retained for core activities in the second ED but also extended to exclude production costs from supporting activities. … In addition to the obvious narrowing of eligibility of costs incurred in supporting activities, this further test and substantiation requirement places additional compliance burdens on taxpayers as to its practical application in an industrial or commercial context.

Given the level of concern expressed by industry and practitioners during the consultation process, it is disappointing to see that the Government has chosen to ignore what, in our opinion, will be a further burden on taxpayers arising from increased uncertainty and compliance cost.

Whilst the 2nd ED and EM state that the current feedstock rules will now be retained, the government concedes that it will now achieve much the same outcome through the production-related qualifications to the eligibility of supporting activities.

The 2nd ED's definition of supporting activities requires that if an activity:

- *is included in the list of specific exclusions from Core R&D;*
- *is the production of goods or services; or*
- *is directly related to the production of goods or services*

then that activity can only be taken to be an eligible supporting activity where it is undertaken for the dominant purpose of supporting core R&D activities. Generally, if the associated goods or services produced are sold, then R&D is unlikely to be claimable.

As a result, companies engaged in eligible core R&D activities are likely to have the quantum of claims for costs incurred in *supporting activities reduced to the extent that there is any commercialisation of the resulting output from the R&D activity.*

The greater interpretative uncertainty arising from these new provisions is a poor outcome in a self-assessment environment for a government keen to encourage innovation. Indeed, overall, the dominant purpose test for production activities is arguably a worse outcome than the augmented feedstock provisions proposed in the first ED."

Accordingly the AMWU recommends that the existing arrangements for supporting R&D in the context of "directly related to" be retained and the provisions in draft two of the new legislation not be supported.

Conclusion

For some considerable time now the AMWU has been very clear in our discussions with Government, members of the legislative drafting team and in our consultations with R&D experts and manufacturing CEO's about the solution to appropriate legislation for the R&D tax credits.

That solution satisfies the Government's revenue neutral test and probably returns money to Government as against what the existing system costs now and on a forward estimates basis.

The AMWU solution takes the legislation that already exists and operates and then makes provision for 3 changes:

a) **Delete references to the previous system of tax deductions and insert the new 40% and refundable 45% R&D tax credits with a starting date of July 1 2010.**
b) **Accept the Commonwealths proposed changes to software and IT services as an appropriate amendment.**
c) **To the extent that the Commonwealth perceives so called "whole of mine" claims to be either inappropriate or unaffordable they should be dealt with separately. To do otherwise is to penalise 8,000 firms with cumbersome R&D definitions, excessive and unnecessary compliance requirements and a tightening of eligible R&D that is counterproductive. It appears that the additional concern about the cost of the scheme particularly how it might grow as economic recovery and increased investment occurred**

through the course of 2010 and beyond relates to what some regard as "excessive claims". This was covered off in the Cutler Report in the following terms:

> *"In recent years several firms have been successful in the aggressive use of the R&D Tax Concession to make claims for very large share of expenditure in large one-off projects like mines and civil engineering. These claims have demonstrated that some aspect of the project is new and technically risky. This having been done it has been possible despite the efforts of the Australian Taxation Office, to claim as much as 80 per cent or more of all investment expenditures in the project.*
>
> *The Panel appreciates that such ventures are both risky and innovative. At the same time it is clear that such 'whole of mine' claims are gaining for themselves a degree of assistance disproportionate to the benefits available to many other innovative projects. While they are also being undertaken by firms with very good access to capital, it is also true that capital markets are averse to risks in long term technology projects. This is an issue which needs to be addressed in its own right, and not by default through a general tax concession."(Venturous* Australia: pg109)

So called whole of mine claims can be dealt with in a number of ways including:

- **An expenditure cap on the existing feedstock provisions or**
- **By capping the size of any supporting R&D claim per company group or**
- **By requiring R&D investments over a specified dollar amount to follow a separate administrative path that requires a dominant purpose test or**
- **By some combination of the above.**
- **Alternatively one of the draft recommendations discussed by the Cutler review could be fine tuned that would require very large R&D projects to be approved on a case by case basis as to the dollar value of eligible expenditure.**

The Commonwealth should bring together the small group of firms affected and their advisors and work through the necessary amendments.

The AMWU is firmly of the view that it is in the national interest for legislation giving effect to the new Tax Credit regime through the changes we have recommended to come into effect from July 1 2010.

We say this on the basis of discussions with a broad cross section of industry about the circumstances facing small innovative Australian companies with turnover of less than $20 million who stand to benefit the most from a 45% refundable tax credit. The environment they currently face is characterised by the following conditions:

- Access to bank finance for small innovative R&D intensive firms is even more constrained then usual.
- The global venture capital market in general and the Australian VC market in particular are under funded relative to the level of bankable deals. This is unlikely to change in the next 12 months.
- Given the high level of demand after Commercial Ready was closed down it is to be expected that the allocated funds for Commercialisation Australia in 2010-2011 will be seriously constrained relative to the number of seriously good claims
- While angel investors are back in the market they too have been impacted by the GFC.
- The bottom line is that both Federal and State funding for innovative companies is at capacity and unlikely to expand at the same time that access to different types of private sector risk capital is seriously constrained. This is occurring in an environment where small innovative firms were already short of working capital let alone funds for R&D.
- In such an environment there is a grave risk that an unnecessarily large number of small innovative Australian firms with smart IP and good global prospects will go to the wall or have to sell their IP off for a song and a prayer. This last resort sale of IP will in many cases be to offshore investors trawling for Australian IP that can be bought and sold on the cheap because of the financial squeeze.

It is not in the national interest for Australian SME’s in general and manufacturing SME”s in particular to be disadvantaged by delaying the introduction of the tax credit system

Nor is it in the national for the second draft exposure legislation to be brought into effect. The changes proposed by the AMWU should be implemented and the new system commence from July 1, 2010.