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27th April 2010

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

Dear Sirs

RE: NEW RESEARCH & DEVELOPMENT TAX INCENTIVE – SECOND EXPOSURE DRAFT LEGISLATION AND EXPLANATORY MATERIALS: MARCH 2010

We responded in January to the first exposure draft of the proposed new R&D Tax Incentives and pointed out that there were numerous areas of concern and that the proposals were essentially very bad. We have been interested to see that you have now produced a second exposure draft just before Easter allowing very little time for a response. Unfortunately, it seems that while some words have been changed in the second exposure draft, the implications remain much the same as the first exposure draft and thus the proposals are almost as bad as the first draft.

The definition of core activities seems to be much the same as in the first draft and retains the same elements of grave concern, even though the wording has been changed. In the second exposure draft, the definition is just as bad as the first.

The definition of supporting R&D activities when they involve production and the requirement for a dominant purpose is of major concern. The requirement for the dominant purpose will lead to enormous scope for debate and uncertainty which is highly undesirable. It will lead to enormous complexity and uncertainty if implemented.

The proposed details of registration of core and supporting activities, together with suggestions for the need of costing of such, will add complexity and costs of administration to anyone who continues to seek to use the new R&D Tax Incentive.

The explanatory memorandum seems to suggest that the definition of ‘new’ means new to the world rather than new to the company. Thus, activities which may be new to the company would not be eligible if they were not new to the world even if the company knew nothing about them. It also indicates that companies must accurately self-assess their eligibility to the R&D. It seems impossible for companies to assess the newness if they do not know anything about work by others and at the same time achieve accurate self-assessment.

It is also often necessary for companies to undertake their own R&D even when others may have developed something similar when the means to obtain that development are not available in the

public domain. It is important that there is support for companies undertaking such R&D work and there are significant benefits to Australia if it is undertaken.

It appears that the existing feedstock definition in the old pre 2009 Legislation will be transferred into the new Legislation. That definition has always been unclear and there is a need to provide greater clarity in its scope and range of application. In the past, the Tax Guide to R&D has had an additional sentence providing an example which assists to partly clarify the definition. However, it is still not complete. Such examples should be included in any new definition and further clarity added. For example, a typical example involves equipment developed through an R&D process which is then tested in a mine to determine its effective functionality. The costs of the ore or coal processed through the equipment may then be considered likely to be R&D feedstock.

Further clarity should be added by stating that the costs of the experimental equipment or machinery including the cost of materials used to build it would be regarded as other R&D expenditure rather than feedstock. However, the costs of the coal or ore which are then processed through the experimental equipment might well be considered feedstock.

Throughout the explanatory memorandum for the second exposure draft of the proposed new R&D Tax Incentive, there are several areas of omission and/or conflict. There are also areas of the proposals which would appear to create an enormous and tedious administrative burden. For example, the apparent need to obtain pre-registration for any overseas expenditure. The need to obtain pre-authorisation for attendance at any overseas seminars seems tedious and involves unnecessary bureaucracy. Similarly, the need to obtain authorisation to visit overseas to establish any cause of problems in applications resulting from the R&D also seems to create an excessive administrative burden and costs.

Suggestions in the explanatory memorandum that individual activities need to be costed would suggest that companies would have to undertake activity costing to meet the needs of the proposed R&D Incentive Act. Again, this would require a huge overkill with regard to administrative burden.

There are several areas where the explanatory memorandum acknowledges the details are as yet incomplete which includes: paragraph 2.40 re feedstock; paragraph 4.32 regarding recoupment of deductible expenses; paragraph 3.155 regarding CRC's. There are also other areas of omission within the explanatory memorandum where, for example, there appears to be no details of what costs or expenses would be eligible under the Act. This is a major omission since it is critically important to any company seeking to claim the R&D Tax Incentive.

Overall, the proposed implementation timetable, to be implemented on 1st July 2010, for the 2010/11 financial year is far too early and the timetable leaves no room for meaningful appraisal or comment. Thus, the proposed introduction of "Legislation for the New Incentive to the next sittings of Parliament" (presumably May 2010) is far too early.

Furthermore, there continue to be significant areas of major concern within the proposed Legislation which make it totally unsuitable and unsatisfactory at the present time.

Some of the changes between the first and second exposure drafts are merely cosmetic rather than substantive. For example, initial reading suggests there is a change in definition for core

activities where, in the past, R&D has been defined as innovation **or** high levels of technical risks involving systematic investigative experimentation. While the consultation guide/second exposure draft suggests that the new definition of core R&D involves the seeking of new information (to solve a problem, develop a new product or improve a process), closer reading of the explanatory memorandum suggests that the definitions are much the same as in the past except that they effectively propose innovation **and** technical risk rather than innovation **or** technical risk. For example, paragraphs 2.11 to 2.21 in the new explanatory memorandum suggest that core R&D involves an experiment entailing investigation (2.11), employing a systematic progression of work (2.12). **Further**, there would be significant risk (2.14) and they will involve a purpose requiring **new** knowledge or information (2.16). It may involve information about the creation of **new** or improved materials, products, devices, processes or services (2.17).

The above suggests that the only difference between the proposed definition of core activities in the second exposure draft of 2010 and the old ongoing pre 2009 definition is the order in which the words are used. The new proposal seems to be a reverse order of those used in the past and the only difference is the use of the word “and or further” rather than “or” in the definition of innovation or high levels of technical risk. Thus, the changes made between the first and second exposure draft would appear to have little or no effect and the draft remains bad and detrimental to the support of R&D in Australia.

There are many other areas of concern and conflicting definitions within the second exposure draft of March 2010 that need to be addressed but little time is allowed for constructive comment.

Yours sincerely,

Geoff Stearn
Managing Director
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