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ASSOCIATION
of Australia Incorporated

General Manager
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The Treasury
Langton Crescent
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By email rdtaxcredit@treasury.gov.au

**SUBMISSION ON SECOND R&D EXPOSURE DRAFT**

The Corporate Tax Association (CTA), which represents the taxation interests of about 120 of Australia's largest companies, welcomes this opportunity to offer comments on the Exposure Draft (ED) released on 31 March 2010. This submission should be read in the context of the CTA's earlier submissions, including our submission dated 5 February 2010 in respect of the December 2009 Exposure draft.

While we appreciate the efforts being made to consult with stakeholders, we have concerns about the very short timeframe available to provide comments on what are very substantial changes to the existing R&D concession. We have received comments from a number of corporates, but with the Easter break and school holidays it is likely that many others have not yet had time to properly consider this new material. Our submission should be read in that context.

Although we can see that a number of the concerns we expressed in our earlier submission have been addressed in the revised Draft, we remain concerned about what we see as the re-orientation of the incentive away from experimental development and more towards basic and applied research. We believe this is likely to have an adverse impact on a critical element of business R&D in this country.

During the course of the public consultation process last year the CTA and other external stakeholders urged the government not to include an objects clause that refers to R&D activities that would not otherwise occur and which are likely to involve spill-over benefits for the broader community. We are disappointed this remains a feature of the latest ED because we consider there is a risk that, at the margin, a court or tribunal might be guided by such language in resolving disputed claims.

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While those concepts may be well and good, they are impossible to prove and therefore should not be part of the statutory framework – even as part of an objects clause. Such language might well be appropriate for a second reading speech but, in our view, does not belong in the law itself. We would much prefer the objects clause to make reference to increasing the efficiency and international competitiveness of Australian business, which reflects what we regard as the proper rationale for the incentive.

The September 2009 Discussion Paper indicated the definition of core R&D was to be brought more in line with the Frascati definition. We consider that, broadly speaking, the existing sec 79B definition already reflected the Frascati definition whereas the proposed new definition does not. The proposed new definition covers basic research and applied research, but omits experimental development – yet this is where much of the R&D undertaken by business takes place.

Removing the proposed augmented feedstock rule is positive in itself, but there is a risk that some of the remaining provisions will have much the same effect. The Exposure Draft still gets it wrong in trying to limit claims arising in an experimental production environment by introducing a dominant purpose test for supporting R&D activities that take place in such a setting. There is, in our view, a serious risk that much legitimate developmental research conducted by business and which contributes to making Australian business more efficient and competitive will be rendered ineligible by this measure – particularly when combined with a definition of core R&D that expresses a bias towards basic and applied research and looks for experiments using scientific methods.

We are concerned that the language used in the definition of core R&D will lead the agencies to look for a high degree of formality in precisely defining the knowledge gap, and that it will create unrealistic expectations about the kind of scientific experiments that characterise pure or basic research, but not necessarily applied or developmental research.

We have previously argued that the government's revenue neutrality objective could be more easily and transparently achieved by applying a cap on the amount of eligible R&D expenditure. Such a cap would apply to consolidated groups on a per annum basis. It would be accepted by most large corporates as equitable and at the same time avoid the compliance costs and uncertainty that would accompany the proposed regime.

On the question of new knowledge, a number of commentators have expressed concerns that the Exposure Draft imposes a "new to the world" test rather than a "new to the company" test, which was a feature of the existing regime. We are not sure whether raising the bar on newness in this way was, in fact, intended. If it was, we would strongly argue that a "new to the world" test would reflect a fundamental misunderstanding of how R&D works in a commercial environment.

Very few business R&D projects are aimed at making groundbreaking discoveries or winning Nobel prizes. Rather, they involve the more prosaic but nevertheless critical process of achieving step improvements in things as mundane as filling containers with food products while more efficiently minimising waste. Either way, the Exposure Draft needs to make it clear that seeking information or knowledge that is not reasonably available on commercial terms (excluding reverse engineering) is just as worthy a pursuit and should be supported by the incentive.

We welcome the revised approach to software in the current Exposure Draft – this should enable expenditure on software development that is integral to core R&D to qualify as eligible expenditure.

Finally, we note that no modelling on the revenue impact of these changes has been released. We remain of the view that the removal of the premium scheme (which we support) will in itself go a long way to recouping the cost of the various ways in which the incentive is to be improved. From what members have said to us, many corporates expect to see their claims reduced significantly, mainly as a result of the proposed dominant purpose test for supporting R&D activities in a production environment. In some cases, corporates may form the view that the compliance costs involved in working up a claim are not warranted, and will not register projects they might have under the existing rules.

If the law is to be changed on the basis of the recent Exposure Draft, we strongly urge the government to monitor the level of claims that are accepted on audit – particularly for large business. In the event that the level of claims drops in a way that was not anticipated the government should move quickly to fine tune the eligibility rules so that an appropriate level of industry support is restored.

Thank you again for setting up the various consultation meetings that have taken place and for this abbreviated opportunity to offer further comments.

Best regards,

Frank Drenth
Executive Director
Corporate Tax Association