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General Manager
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Dear Sir/Madam,

Re: New Research and Development Tax Incentive: Second Exposure Draft

The following is BDO's response to the second exposure draft (2nd ED) legislation and associated explanatory materials (EM) with respect to the new research and development (R&D) tax credit system.

The 2nd ED revises the first exposure draft, released on 18 December 2009. In light of the feedback received with respect to the first exposure draft, the Government has proposed a number of additional changes to ensure that the legislation is clearer, and to remove the potential for unintended consequences that could arise from the wording in the first draft. While BDO is supportive of the fact that the Government finally appears open to taking on board the opinion of companies and industry bodies, it appears that many of the changes and concessions made are with respect to some of the more extreme aspect of the initial exposure draft - particularly the augmented feedstock provision, at risk expenditure, restrictive provisions for software, etc. Whilst these changes are a step in the right direction, the 2nd ED still retains a restrictive object clause (legislating additionality and spillover), a requirement to identify and split core and supporting R&D activities and a wide-reaching dominant purpose test. In addition, new legal concepts (such as the term 'production') have been introduced into the legislation for the first time and there are a number of unresolved features of the draft legislation with key concepts (such as the feedstock expenditure provisions) still not available to stakeholders. In spite of the considerable uncertainty that surrounds the Government's proposed R&D tax credit legislation, Treasury is still pushing to have the 2nd ED in front of Parliament in less than a month.

Given the current state of the proposed legislation, BDO is of the opinion that the 2nd ED is still in a very draft format and has not been sufficiently analysed, modelled or developed (by either Treasury or the business community) in order to ensure this program provides the best possible incentive to encourage and reward companies undertaking R&D activities. Given these significant concerns and reservations, BDO strongly recommends that the Government does not sacrifice the opportunity to develop and implement a world-class R&D tax incentive program for the sake of simply meeting a deadline. The opportunity to shape Australia's future does not come around often and the Government should take sufficient time to fully consider the consequences of all aspects of the proposed legislation prior to presenting a final, well modelled version to Parliament for consideration. Such an approach will give more certainty to the Australian business community and will reduce the likelihood of many of the concepts and policies being challenged in the Australian judicial system.

The aspects of the 2nd ED that gives BDO the most concern are outlined below. Whilst BDO's preference was to undertake further additional analysis and examination of the new legislation,

this was not possible given that the Government only allowed 10 working ways in which to response to the extensive rewrite contained in the 2nd ED.

The concepts of additionality and spillover still remain

Despite a rewording of the object clause, without actually using the words, the 2nd ED still retains the concepts of additionality and spillover in its wording. As per Section 355-5:

> *(1) The object of this Division is to encourage industry to conduct research and development activities that might otherwise not be conducted because of:*
>
> *(a) the cost of the activities; or*
>
> *(b) an uncertain return from the activities;*
>
> *in cases where the knowledge gained is likely to benefit the wider Australian economy.*

While both the 2nd ED and the EM make it clear that the object clause is not an operative test that taxpayers will need to satisfy, it does provide important context.

It is BDO's strongly held opinion that a policy that aims to reward only those companies involved in R&D that is in addition to R&D they would otherwise have conducted is a massive restriction on the type of companies that the R&D tax incentive program should be designed to assist, including pharmaceuticals and small start up business.

All pharmaceuticals companies are created to develop drugs capable of successfully combating or controlling particular diseases or aliments. Given the current wording of the object clause, it would appear that the proposed R&D tax credit program should not support these types of companies. This is because the R&D undertaken by pharmaceutical companies would be undertaken **regardless of the existence of an R&D tax incentive program** (and hence such companies would fail the object clause). There are enormous costs associated with drug development (development costs are in the vicinity of $800 million) and enormous uncertainty in return for the activities (only 1 in 5000 compounds -or 0.0002%- will result in a saleable drug). With that said, the rewards for a successful drug are such that drug development companies would continue to undertake drug development in the absence of the 10c in the dollar incentive offered under the R&D tax incentive program.

Similarly, most small to medium enterprises (SMEs) are generally focused on the development of a singular start up product or technology. They have come into existence to further develop and exploit this single idea (an idea which is not additional to their normal activities as it is their core activity) in order to develop a commercial product or technology. Such SMEs do not have surplus resources (in terms of financial/people, etc) capable of being dedicated to additional R&D activities, despite the existence of an R&D incentive. As such, many SMEs would also fail the object clause, and thus (according the EM), would fall into the category of 'companies that should not receive support under the R&D tax incentive program'. This is of course, an outcome that BDO finds preposterous. It is, however, the result of the Government's insistence on retaining the concepts of additionality and spill over in the object clause of this proposed legislation.

While drug development companies and many SMEs would fail the Government's own object clause for the proposed legislation, they are the very type of business uniformally recognised as being engaged in R&D activities. The government's continual adherence to this object clause appears illogical to BDO. More concerning is that this concept has provided to be the catalyst for many of the changes to the current R&D tax incentive program, particularly those changes that target the eligibility of R&D activities conducted in a 'production' environment. As currently drafted, the R&D tax credit will allow many drug development companies to claim the entire costs associated with their program of R&D activities, even though such activities would have been undertaken in the

absence of such an incentive. On the other hand, the proposed R&D tax credit operates to deny R&D activities undertaken in a production environment (if the onerous dominant purpose test is not fulfilled) on the basis that such activities are 'business as usual'. In both instances, the activities would have been undertaken, regardless of the existence of an R&D incentive; however companies undertaking R&D activities are being denied access to such a program, due to ill conceived wording and the introduction of the term 'production'. Whilst it is clear that the provisions have been introduced to circumvent the ability for mining companies to access large R&D claims, the result, in BDO's view, discriminates against genuine R&D activities conducted within a production environment. The EM reasons this position away by stating that it is not the Government's intention to support or subsidise R&D that results in saleable goods. It is however difficult to reconcile why the Government would draft legislation that denies as R&D an activity conducted in a production environment (simply because it produces a product of value), yet fully supports drug development, which can produce multi million dollar patents and royalty flows. A robust R&D tax credit program should not discriminate against a company simply because the activities are conducted in a production environment. To do so would give an unfair financial advantage to some Australian businesses, at the expense of others.

If the Government were to analyse all projects registered under the R&D Tax Concession program for the 2009 income year, it is BDO's opinion that a significant proportion of these projects would likely have been undertaken in the absence of the R&D tax incentive program. R&D is undertaken by many businesses due to the fact that it provides companies with a competitive advantage, it assist companies become more profitable and enables companies to be more competitive. In a competitive, global business world, companies are forced to undertake R&D to survive. The rationale behind a decision to undertake or not to undertake R&D is so critical to a business that, in the vast majority of cases, the existence of an R&D Tax Incentive program is not a determining factor in whether an R&D project goes ahead. That being said, this type of R&D is critical to Australia's competitiveness in the global economy and is just as deserving of tax support. As such, BDO is strongly opposed to a restrictive and targeted R&D Incentives program that purports to only reward R&D activities that exhibit additionality and spillover benefits.

Balancing support for research, compared with, development

The changes proposed by the Government in the 2nd ED appears to discount the value of 'Development', when compared to 'Research' and in fact the 2nd ED effectively eliminates support for research and development conducted by companies and instead supports corporate research only.

Undertaking commercial R&D is a two step process, both of equal importance. Once a device or technology is developed, a manufacturer devises processes and techniques in order trial and test the success of the device, generally in a controlled trial run. If the device or technology is successful within this simplified environment, a broader, production style trial will also be required. Only through this larger scale trial can it be proven that hypothesised concepts have successfully translated into a commercial outcome, the objective of all R&D activities. Trials and tests in this manner may reveal that it is not possible to exploit such technology in a commercial environment or reveal what further developments are required in order to achieve a successful outcome. As applicable to a pharmaceutical company as to manufacturing company, these testing activities commonly need to be carried out in a 'real life' environment and are integral to determining the success or failure of the core R&D activities. In both industries the trialling and testing activities (supporting activities) can often be significantly more expensive than the conduct of core R&D activities.

Whether a company is in the pharmaceutical or manufacturing sectors, supporting activities need to be conducted within an environment that is able to replicate 'real life' test conditions in order to prove a successful outcome. As such, these development activities often produce something of value and/or something that is saleable. This can include products, technology, processes, know

how, waste, etc. However, the production of something of value should not be used as a road sign by the Government to conclude supporting activities are somehow less valuable within an R&D project than the core activities.

Under the 2nd ED, these types of supporting, development type activities will generate eligible R&D expenditure only if they are undertaken for the dominant purpose of supporting the core R&D activities. A literal interpretation of the phrase 'dominant purpose' (as it relates to the production of goods or services; or is directly related to the production of goods or services) will preclude a large proportion of most R&D projects, despite them being critical to determining the success or failure of the core R&D activities. This dominant purpose test fails to recognise or acknowledge the importance that supporting, development type activities play in the overall R&D process.

BDO recommends that the Government returns to a program that encourages both R&D, not just research. While many institutions undertake research activities, it is the research **and** development activities conducted by Australian businesses that drive the success of the Australian economy.

The dominant purpose test

BDO also has a grave concern that, at Paragraph 2.20 of the EM, the Government states:

> *When applying the test, the 'purpose' of experimental activities means the dominant (or sole) purpose for which the activities are undertaken.*

The term dominant purpose is used in explaining concepts related to both core activities and supporting activities.

Dominant can be defined as, 'exercising the most influence or control/most prominent'. As such, it necessitates the contemplation of a number of options or outcomes, with one being stronger than the others. Contrast this with the definition of sole which is, 'being the only one'. The concept of sole is therefore completely different to dominant, as there is only one option or outcome in applying the term sole.

The requirement to demonstrate that an action is undertaken for a **sole purpose** is materially more difficult, and will preclude otherwise eligible activities from being able to claim the proposed R&D tax incentive, compared with demonstrating that something is undertaken for the **dominant purpose**. It is BDO's opinion that the proposed EM should be revised so as to not use the terms 'sole' and 'dominant' in an interchangeable fashion and, in fact, definitely state that a supporting R&D activities can be undertaken for a multiple competing purposes.

Taking into account the definitional differences between 'sole' and 'dominant', BDO is very concerned that the requirement (and associated compliance documentation) necessary to demonstrate that an activity been conducted for a dominant purpose to support a core R&D activity will lead to genuine R&D activities being denied access to the Government's proposed R&D tax incentive. This is due to the fact that it is arguable (and completely rational) to assert that the sole purpose of any company or business is to earn income in order to increase the wealth of their shareholders. Consequently, every activity conducted by a company has the dominant purpose of generating profit and wealth for its owners and/or shareholders. This is true, regardless of whether those activities are conducted on a company's factory floor or in a company's research laboratories. Scientists, engaged in early stage drug development activities, still have a dominant purpose that is related to production and the generation of revenue for the company's shareholders or owners. Most drug development companies have entered into agreements to further commercially exploit any developed drug at a very early stage in a program of research. In such circumstances, as all subsequent activities are related to trying to develop a product/line of research for commercial exploitation, the dominant purpose of all activities undertaken by a company are must therefore be

commercial. As all activities undertaken by companies relate to trying to increase profitability (through increased sales or reduced costs), then a liberal interpretation of Section 355-35(2)(b) operates to prevent **all** companies from being able to claim **any** eligible R&D expenditure. This is due to the fact that core R&D activity (which require a sole purpose) and supporting R&D activities (which would all somehow relate to production) would be ineligible as the dominate purpose of undertaking the activities would be the creation and generation of revenue streams for the company's shareholders.

While BDO may have used extreme examples, it is to demonstrate the concern associated with the use of a dominant purpose test. This concern is further borne out by that fact that, in most of the examples within the EM, if there is a commercial purpose to the R&D activities, Treasury's commentary indicates such activities would fail to meet the dominant purpose test. This test is subjective, onerous and has the potential to result in increased litigation. All parties have a vested interest in ensuring that the enacted legislation does not have these unintended consequences. This is why extensive analysis and modelling of all new concepts and sections of the R&D incentive program is required prior to it being placed before parliament.

Introduction of the term 'production'

Subsection 355-35 (2) introduces the term 'production' and states that:

> *"If an activity is the production of goods or services, the activity is a supporting R&D activity only if it is undertaken for the dominant purpose of supporting core R&D activities".*

It should be noted that this is the first time this concept has been include in the R&D tax incentive legislation. It should also be noted that there is no definition as to what the term 'production' means.

The 2nd ED states that the purpose of introducing a restriction on the eligibility of R&D activities conducted in a production environment is to divert government support away from activities that are 'business as usual' or are part of normal operational activities.

BDO is concerned at the impact of this stance and believe a number of points need to be made with respect to the introduction of the term 'production' and the reasons for introducing it:

a) Without an explicit definition, the term 'production' will be the subject of extensive audit and litigation activity, in much the same manner that the terms 'processing and transformation' are in the application of the feedstock provisions. The confusion caused in seeking to correctly apply this concept is borne out in the examples provided by the EM. In Example 2.2, the production of 'test batches would not (in the ordinary use of the term) ordinarily be viewed as 'production'. However the EM explains that it is Treasury's view that such an activity is 'production' and, to be eligible to claim the proposed R&D tax incentive, must evidence a dominant purpose. Conversely, Example 2.3 indicates the production of trial tyres in a normal production environment is not production, by virtue of the fact that the manufacture of the tyres does not have a prospect of producing commercial outputs (as they are to be used in a test). This example appears at odds with the normal concept of 'production' and it would appear that Treasury does not see the need to apply the dominant purpose test simply because no commercial outputs are produced. This does not appear a consistent application of the terms 'in the production of goods and services'. Example 2.4 gives further support for the fact that Treasury is seeking to disallow the 'output of production' rather than restrict the eligibility of activities associated with the production of goods and services. Example 2.4 requires the application of the dominant purpose test, not because the tunnelling activity is 'the production of goods or services', but because the tunnelling actively also produces coal (which is of value). It is arguable that the tunnelling activity is not a production activity, even though saleable coal is an output. The tunnelling activity (as described in the example) is not a 'normal' mining

activity and according to the example, was undertaken for no other purpose than to support the conduct of the core R&D activity. Yet because the activity produced an output of value, Treasury have, as a default position, assumed the activity is 'production' and must pass a dominant purpose test. This is an example of a scenario that is very subjective, contentious and likely to result in litigation, predominantly because the Government chooses not to define what 'production' means or cannot find another way to reduce claims made by mining companies.

b) The restriction on activities conducted within a production environment will not stop activities that are 'business as usual' being claimed as R&D activities. As previously noted, pharmaceutical companies conduct research activities that are 'business as usual' activities for such companies. Why does the government choose to support these 'business as usual activities' and not those conducted by, for example, manufacturing companies?

c) The requirement to evidence a dominant purpose introduces a level of compliance that will dissuade companies engaged in genuine R&D activities from claiming the proposed tax credit. Such evidence is simply not produced in the normal course of business and will need to be generated simply to evidence compliance with a subjective concept. This will be a significant impost on SMEs, most of whom are resource constrained and will not have the capacity to generate superfluous documentation that serve only a single purpose, which is unrelated to their commercial operations

d) If the term 'production' does remain in the final legislation, consideration should be given to allowing businesses to claim labour costs associated with such activities, rather than the use of a dominant purpose test. If all production related activities were disallowed with the exception of labour, Treasury could remove a subjective test (dominant purpose), whilst rewarding R&D activities that generates knowledge from people rather than assets. This would encourage SMEs to conduct R&D activities, as there would be certainty as to the eligibility of particular costs, rather than uncertainty as to the eligibility of some activities, (due to the use of subjective concepts) This would also effectively also address the concerns that started this entire redraft process - specifically - whole of mine or large, one-off infrastructure claims.

The requirement to classify R&D activities as core or supporting

The 2nd ED requires that all R&D activities be classified and registered as either core or supporting activities, with different qualifying tests for each. In addition, if a supporting activities involves the production of goods or services (or is directly related to the production of goods or services), a dominant purpose qualifying test also applies.

BDO's concern in that by including a requirement for companies to arbitrarily categorise and classify activities based on subjective and artificial concepts, many companies (particularly SMEs) will simply choose to forgo claiming the Government's R&D incentive. Whilst this may produce a desirable outcome for the Government (via reduced R&D claims), BDO believe this is not the intention of the legislation.

In terms of additional complexity, in order to make a claim under the proposed R&D tax incentive, the 2nd ED requires the taxpayer to determine:

- whether the outcome for an activity cannot be known or determined in advance on the basis of current knowledge, information or experience (and can only be determined by applying a systematic progression of work)
- whether the activity is conducted for the purpose of acquiring new knowledge (including knowledge or information concerning the creation of new or improved materials, products, devices, processes or services)

- whether the activity is core (undertaken for a sole purpose)
- whether an activity is supporting
- whether a supporting activity was the production of a good or service
- whether the production was undertaken for a dominant purpose of supporting a core activity
- etc,.

Given the flexibility associated with what constitutes an R&D activity and the subjectivity associated with this area, many large companies, their advisors and even the ATO and AusIndustry will struggle to distinguish between core and supporting activities. Requiring taxpayers to determine what is a core and supporting R&D activities (concepts that are highly subjective and open to interpretation) will most likely result in claims that are open to a significant level of interpretation and therefore a significant level of risk of rejection by AusIndustry, particularly with respect to SMEs who are less likely to have the resources to seek professional advice.

There is no legislative definition or guidance as to what constitutes an activity and the breadth of the activity as described can materially affect the eligibility of R&D expenditure. For example, one company may register "development of a prototype" as an activity, and if it is able to demonstrate all eligibility requirements have been met (in terms of an R&D activity), the expenditure on the entire prototype may be viewed as eligible. This needs to be compared with a company that, while developing the same prototype, registers the four main components of the prototype development instead of the entire prototype. If only one activity is assessed as fulfilling all the eligibility requirements (including correct classification as to whether the activity is core or supporting), then the expenditure associated with the activities could be considered ineligible or receive a lower level of support.

The complexity associated with identifying an activity that cannot be known or determined in advance on the basis of current knowledge, information or experience (i.e. technically risky) and an activity that is conducted for the purpose of acquiring new knowledge (i.e. innovative) could lead many businesses to either inadvertently misclassify activities or expend significant resources trying to justify why a specific activity is a core activity. This is not information generated as part of a business's normal commercial operations and, as such, this requirement will result in inefficiencies within a business, simply to comply with the Government's subjective eligibility criteria for claiming the proposed R&D incentive.

Due to the subjectivity of the underlying concepts, this is likely to be an area of increased ATO and AusIndustry attention and again, due to the subjective nature of the concepts, is likely to result in protracted engagement between Government agencies and Australian businesses, simply for the purpose of ensuring that an 'activity' has been correctly interpreted and classified. The resources required to assess, support, advocate and audit the correct interpretation of these subjective concepts is likely to be counter productive for little benefit, with the potential for significant consequences to SMEs (the target recipients of the incentive) in the event that the initial assessment is incorrect.

Conclusion

The R&D tax concession program has been the Federal Government's flagship R&D incentive program for the last 25 year. All going well, the new R&D Tax Credit program will last for a similar period of time. Consequently, BDO strongly urges the Government not to rush the consultative process (critical in achieving the strongest and best targeted R&D incentives program), and subsequent drafting of the legislation, in order to achieve an arbitrary deadline.

Since the May 2009 Budget announcement that the R&D tax concession program was to be replaced with a new R&D tax incentive program, Innovation Australia, the ATO and Treasury has been steadfast in its contention that the new R&D tax incentive will be available for income years

starting on or after 01 July 2010. It was acknowledge that, even if the entire process went smoothly, this would still be a tight timeframe to achieve.

In Easter 2010 (11 months into the process, and approximately one month prior to the legislation requiring submission to parliament) Treasury released its Second Exposure Draft - a piece of legislation that fundamentally changes the operation of the R&D tax incentive program. Not only has the eligibility requirements for core and supporting R&D activities have been completely redrafted, but new legal concepts (such as 'production') have been introduced for the first time. Furthermore, there are a number of unresolved features of the draft legislation and, critically, key concepts (such as the feedstock expenditure provisions) have still not been made available to stakeholders.

Government, industry bodies and individual companies all need to undertake a thorough review of the effect and application of this new legislation. Meticulous analysis and extensive modelling needs to occur, preferable based on real projects from actual companies, in order to ascertain the complete and true effect of the new program. By compete and true effect, BDO is not only recommending analysis and modelling of the actual financial benefit that various companies will receive, but also the extent to which the program encourages companies to undertake R&D activities.

It is the contention of BDO that the level of review that this legislation truly requires and deserves cannot be achieved in the current timeframes. The heat and soul of the R&D Tax incentive program is the definition of R&D activities - a definition drafted only a handful of weeks prior to submitting the bill to parliament and, in all likelihood, a definition that has not been modelled or analysed against a single 'real' project or company. Given that the second exposure draft introduces some first time concepts such as a new definition of core R&D activities and 'business as usual activities', there is simply insufficient time for a considered response.

Australia has traditionally lagged behind other developed nations with respect to its business expenditure on R&D. The unintended consequences that could potentially result from hurried and/or ill-conceived legislation could materially harm Australia's ability to remain competitive and to leverage off the advantages provided through its abundance of land and natural resources. As such, BDO strongly recommends that the Government does not sacrifice the opportunity to implement a world-class R&D Tax incentive program for the sake of meeting a deadline. The opportunity to shape Australia's future does not come around often.

BDO appreciates the opportunity to put forward its views on this issue. If further comment is required, please contact Tracey Murray on 07 3237 5832.

Yours sincerely
BDO (QLD) Pty Ltd

Tracey Murray
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