



ASSOCIATION OF CONSULTING
ENGINEERS AUSTRALIA

THE NEW RESEARCH AND DEVELOPMENT TAX INCENTIVE

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The Treasury Consultation Paper

ACEA SUBMISSION

Enquiries |

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INTRODUCTION

ABOUT THE ACEA

The Association of Consulting Engineers Australia (ACEA) is an industry body representing the business interests of firms providing engineering, technology and management consultancy services.

There are over 270 firms, from large multidisciplinary corporations to small niche practices, across a range of engineering fields represented by the ACEA with a total of over 50,000 employees.

The ACEA presents a unified voice for the industry and supports the profession by upholding a professional code of ethics and enhancing the commercial environment in which firms operate through strong representation and influential lobbying activities. The ACEA also supports members in all aspects of their business including risk management, contractual issues, professional indemnity insurance, occupational health and safety, procurement practices, workplace/industrial relations, client relations, marketing, education, sustainability and business development.

SUMMARY

Section 39AA of the *Industry Research and Development Act 1986* provides that the object of the research and development tax concession is to provide a tax incentive, in the form of a deduction, to make eligible companies more internationally competitive by:

- a) encouraging the development by eligible companies of innovative products, processes and services;
- b) increasing investment by eligible companies in defined research and development activities;
- c) promoting the technological advancement of eligible companies through a focus on innovation or high risk in defined research and development activities;
- d) encouraging the use by eligible companies of strategic research and development planning; and

- e) creating an environment that is conducive to increased commercialisation of new processes and product technologies developed by eligible companies.

Consulting businesses working in the built and natural environment require the support of the Commonwealth Government in their efforts to achieve innovation and technically sound project outcomes through the most cost-efficient methods. The vast array of engineering and related disciplines, including biomedical, chemical, civil, mechanical, and many others; engage in research and development activities on an ongoing basis.

Consultants will invariably encounter technical aspects of the project that require innovation and new technologies to overcome the complexities being faced. In addition, consulting companies are required to operate in such a variety of location-types under a host of different conditions that are often unpredictable. This presents consistent complexities that ensure that innovation is absolutely pivotal to proficient and technically sound project outcomes.

There is too much focus on measures assisting the development of new technologies in the small high-tech segment of the economy and too little on fostering economy-wide innovation and technology diffusion.

According to Innovation Australia, to be eligible for the concession, all projects must contain at least one systematic, investigative and experimental activity (SIE). It is important to note that the term SIE comprises the following aspects: innovation or high levels of *technical risk*, which are carried on for the purpose of acquiring new knowledge or creating new or improved materials, products, devices, processes or services.

The ACEA would assert that there is most certainly considerable innovation and high levels of technical risk for consulting engineering firms engaging in R&D. There is a realistic possibility that technical complexities could lead to project failure. Therefore, support from the Government is welcomed by the ACEA and its members as they strive to acquire new knowledge and formulate new processes in the delivery of their services.

The Government's support in the area of R&D is critical to the success of not only the consulting industry, but a host of other industry sectors that fundamentally depend upon innovation.

Summary of the ACEA's response to the consultation paper:

- Question 1: a) The new R&D incentive should retain the existing exceptions to the general rule that eligible R&D activity must be conducted in Australia, where the activity benefits Australia.
- b) The new R&D incentive should not consider whether Intellectual Property from an eligible activity is owned in Australia.
- c) The 'on own behalf' rules should be retained. It is recommended that the Guide to the R&D Tax Concession be clarified to express more clearly that contractual transfer of IP rights does not affect the eligibility of companies to apply for the incentive.
- Question 2: The ACEA has no objection to the proposal to allow companies to access a non-refundable tax credit on the eligible expenditures at the prevailing company tax rate (currently 30 per cent).
- Question 3: Accrual payments to associate entities should be retained under the new system.

Question 4: The contribution of 'supporting' R&D activities or that of dual role activities should not be capped. If some restriction is required, this could be achieved through a change in the current definition so that the supporting activity must be 'predominately' for the purpose of supporting a core R&D activity.

Question 5: The ACEA supports the current list of excluded activities and does not believe that amendment is required.

Question 6: Innovations in ITC software that provide innovative solutions or adaptive processes should remain eligible for the incentive.

Additional: The ACEA recommends a Federal Government funded Education and Training Tax Concession to boost the incentive for employers to invest in the skills of their employees.

QUESTION 1

Should there be any exceptions to the general rule that eligible R&D activity must be conducted in Australia?

The ACEA agrees that the general rule should be that the eligible R&D activity must be conducted in Australia, but the two limited exceptions that apply under the current scheme should be retained. Specifically, the following two separate rules should be maintained:

1. The "de minimus" exemption contained in *Section 4* of the Industry Research and Development Board (Overseas Research and Development Activities) Guidelines 2004; meaning that the Commissioner of Taxation should maintain the practice of accepting minor amounts of expenditure (that are incidental to or de minimus of an Australian project) on overseas R&D activities as being deductible/included in the credit.
2. The exception contained in *Section 5* of the Industry Research and Development Board (Overseas Research and Development Activities) Guidelines 2004, on the basis of the following criteria:
 - a) the applicant must demonstrate that the proposed overseas R&D activities cannot be carried on in Australia or in the external Territories;
 - b) the applicant must demonstrate that the R&D activities undertaken overseas will form part of a larger R&D project in Australia and the results of the overseas R&D activities will be exploited by the applicant for the benefit of the Australian economy;
 - c) the applicant must demonstrate that the expenditure on overseas R&D activities for which the applicant proposes to claim a deduction under section 73B, 73BA, 73BH or 73Y, or a tax offset under section 73I, of the Tax Act, will not exceed 10% of the total expenditure that the applicant has incurred or proposes to incur on the project.

The ACEA believes that there should be an exception to the general rule that eligible R&D activity must be conducted in Australia.

Firstly, this is because there has been substantial growth of outsourcing by Australian service industries. The ACEA has observed this in the consulting and engineering industry. Consulting firms are outsourcing work overseas to tap local design skills (for example: India, the Philippines, and Bangladesh). Basic and routine work is done offshore then transferred to Australia for final and more complex design onshore. The SIE activity is being conducted in Australia with minor directly related activities, due to efficiencies, being conducted overseas. Although outsourced, the work is for and benefits Australia.

Secondly, the ACEA supports Senator Carr's Innovation Agenda to 2020 (announced 12th May 2009), which states that Australia can do better in building innovation skills, supporting research to create new knowledge, increasing business innovation and boosting collaboration. A key way in which to build innovation skills is to encourage knowledge transfer from overseas into Australia. The Australian Government should support knowledge transfer which benefits Australia through developing the skills of our workforce. For example, this can be done through the R&D tax concession where business sends its staff overseas to view different methodologies.

Location of IP

The ACEA supports the approach that the new R&D tax incentive will not consider whether Intellectual Property (IP) from an eligible R&D activity is owned in Australia or overseas.

The 'on own behalf' rules'

The ACEA also supports retention of the 'on own behalf' rules, however does have concerns regarding the ownership test.

It is noted in Part C of the Guide to the R&D Tax Concession (Section 2.2.3) that the company seeking to claim the concession must have effective ownership of the results of those activities. It goes on to say that,

"This does not necessarily mean that the company must be the proprietor of a piece of intellectual property in any formal sense."

"There might be pre-arrangements between companies seeking to claim deductions under section 73B and other parties involving a sale, option, or irrevocable and exclusive commercial licence of the results of a program of R&D activities, entered into before those results are known."

This situation can arise for consulting firms, particularly where their client is a government entity, because under the Copyright Act 1968 (Part VI Division 1) any intellectual property created under the direction of the Commonwealth, a state or territory government vests in the Crown.

There is a perception in the industry that the transfer of a consultant's intellectual property (IP) of the final design means the consultant is not eligible for the R&D tax concession because of the ownership test. This perception is contrary to the guidance, which appears to suggest that a pre-arrangement between parties to transfer IP, which would include a contractual agreement, should have no impact on the ability of the creator of the IP from applying for the concession. This suggests that there is a difference between what happens in practice and the terms of the guidance.

The ACEA agrees with Part C of the Guide, in that the contract has little relevance to R&D. Typically the contract between consultant and client does not refer to R&D in any way. A contract will refer to ownership of intellectual property, but this only relates to the deliverables (e.g. the engineering design). It does not relate to the intellectual know-how or R&D that has gone into the creation of that deliverable. Therefore the consultant will not be remunerated for the inclusion of R&D in the deliverable.

The ACEA believes that there would be value in clarifying the provisions in the Guide to express more clearly that contractual transfer of IP rights does not affect the eligibility of companies to apply for the incentive.

The ACEA notes the ATO Interpretive Decision ATO ID 2009/09. This looks at whether a company is 'not at risk' if it can expect to recover its R&D because of the technical prospects of its activities rather than merely because of the terms of the relevant arrangement. The ACEA welcomes the decision and endorses the findings. The example given of a company engaged to provide a project for a fixed fee, and incurs R&D expenditure in order to meet its contractual obligations but does not receive consideration for it, is applicable to the consulting engineering industry (it would in fact be a fairly typical example of how the contractual relationship operates).

QUESTION 2

How should the new R&D tax incentive treat R&D expenditure that is currently deductible at 100 per cent?

At this time the ACEA has no objection to the proposal to allow companies to access a non-refundable tax credit on the eligible expenditures at the prevailing company tax rate (currently 30 per cent).

QUESTION 3

Should expenditure incurred to associate entities only be eligible for the new R&D tax incentive where paid in cash?

The ACEA notes and understands the concern that accrual payments to associate entities can result in tax offsets years before taxable receipts are reported. This will not be true in all cases. The question that needs to be addressed is to what extent it will affect the company's ongoing ability to support its R&D activities if it is only able to claim in later years when paid. If the purpose of the R&D is to incentivise R&D activity, then there should be no objection to continuing the system of accrual accounting.

QUESTION 4

Should supporting activities:

(a) be capped as a proportion of expenditure on core R&D?

(i) If so, what would be the appropriate proportion (for example, 1:1)?

(b) only be eligible where they are for the sole purpose of supporting core R&D activity?

(c) exclude production activities or dual role activities?

(d) only be eligible on a net expenditure basis?

(e) attract a lower rate of assistance than core R&D?

The ACEA does not support capping of 'supporting' R&D activities or exclusion of dual role activities. If supporting activities are not recognised in the building and construction sector, R&D will decrease and this will affect the quality of the output. At worse, it may not be possible to deliver the project.

Two-thirds of OECD production and 70 per cent of jobs are in services, whose nature is being transformed by information technologies, innovative efforts and upskilling. Most of employment growth is also in services. While manufacturing has declined in importance, its high-tech segment is very dynamic in terms of output and productivity, although less so in terms of jobs.

Service innovation is fundamentally different from technology R&D innovation and this should be recognised. In manufacturing it is typically clear who is in charge of the core R&D, however in service innovation there can be multiple parties contributing to the innovation in the project.

This is particularly true in the building and construction industry, where projects are delivered by teams working in different fields coming together to apply their expertise. This means that each company, which contributes supporting R&D, together creates the 'core'. It can also be the case that there may be more than one core SIE activity.

It is noted that eligible R&D activity is to involve both innovation and high levels of technical risk, but ultimately it is the outcome that is most important. Provided the outcome is new knowledge or improvements (achieved through innovation and technical risk) then the activity should be eligible regardless of its classification as 'core' or 'supportive'.

It is the ACEA's preferred position that the scheme for supporting activities remains the same. However, if there must be some restriction in light of budgetary constraints on the R&D incentive scheme, then the ACEA's preference would be a change to the current definition, i.e. that the supporting activity must be 'predominately' for the purpose of supporting a core R&D activity.

QUESTION 5

Should the current list of activities excluded from being considered core R&D be:

- (a) amended in any way?**
- (b) Extended to exclude certain activities from being considered supporting activities?**

The ACEA supports the current list of excluded activities and does not believe that amendment is required.

QUESTION 6

How should the new R&D tax incentive treat software R&D?

The ACEA believes that the Government should not undervalue the role that ITC software innovation plays in enhancing productivity and our way of life. In building and construction the introduction of Building Information Modelling (BIM) has allowed the creation and use of coordinated, consistent, computable information about a building project in design. The information is used for production of high-quality construction documents, predicting performance, cost estimating, construction planning, and, eventually, for managing and operating the facility.

It is for this reason that the ACEA believes that innovations in ITC software that provide innovative solutions or adaptive processes should remain eligible for the incentive.

ADDITIONAL RECOMMENDATION

The ACEA proposes a Commonwealth Government funded Education and Training Tax Concession to boost the incentive for employers to invest in the skills of their employees. A highly skilled and proficient workforce (particularly in the professional services sector) is essential to Australia's long term economic growth prospects and innovative capacity. Much of this up skilling is done via formalised on the job training, or industry based training not necessarily conducted through a Registered Training Organisation (RTO). For example, for a qualified engineer, other than perhaps completing a masters/doctorate, most of the continued education and training would either be in-house or through their professional or industry association, which generally would not be an RTO.

The OECD report published in June 2009, "*Policy Responses to the Economic Crisis: Investing in Innovation for Long-Term Growth*" highlights the importance of upgrading the skills of workers, particularly in light of the current economic downturn.

Whilst the parameters of the concession would need to be further explored (with budget considerations etc), the ACEA would propose a scheme as follows;

An Education and Training Tax Concession would provide a tax concession (or credit) for business when expenditure on education and training activities exceeded 2 per cent of payroll for the financial year. The concession would compensate business at a rate of 125 per cent of every dollar that exceeded the 2 per cent threshold. It would provide a direct financial reward to employers who invest in developing the skills of their employees above standard levels. This type of scheme would be based upon each company's desire to expand the skill sets of their existing employees. The scheme would also be optional, meaning it will not subject all firms to a compulsory training levy which has been previously proposed.

In order to claim the concession, the eligibility criteria must be broad-reaching, but simple for business to administer. The concession could be capped to manage the potential financial risk to the Government. Employers should only be able to claim the concession for applicable courses including, but not limited to, those of registered training organisations and other courses that meet prudential guidelines.

The ACEA believes that the concession would drive innovation and productivity in the workplace. It would complement the R&D Tax Credit by creating a significant commercial incentive to drive knowledge development, which is particularly critical if the services economies are to continue to thrive against increasing global competition. It would increase the level of support available for existing workers to update and upgrade skills that support productivity, innovation and growth within the Australian economy.

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