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

Dear Sir/Madam,

Re: Consultation Paper – “The new research and development tax incentive”

The following is the Australian Postal Corporation's ("Australia Post") response to the paper titled, "The new research and development tax incentive".

Australia Post has been a significant claimant under the Research & Development Tax Concession regime since it became a tax paying entity in 1991 and expects to continue to participate as a claimant under the new R&D tax incentive.

In this submission Australia Post will attempt to establish a case for the simplification of the regime consistent with the objective of the Consultation Paper and as would be necessary to allow small to medium taxpayers to access the incentive without undue cost constraints and without the uncertainty prevalent in the existing scheme while retaining essential features of the existing scheme.

Key elements of Australia Post's response will be:

1. Scope of the incentive to extend to all entities treated as a company in the tax laws, specifically including entities like Australia Post,
2. Retention of the availability of the incentive for certain R&D conducted overseas,
3. Maintenance of the single rate for the incentive for all claimants and for all activities,
4. Significant improvements to the administration of the incentive,
5. Reduced (as opposed to the proposal to increase) reliance on the identification and characterisation of activities as Core and/or Support Activities, and
6. Removal of the limitations currently placed on expenditure on software under the multiple sale test.

Principle 1 – The new R&D incentive will be available to companies incorporated in Australia for R&D conducted in Australia. Location of ownership of the resulting IP will not be relevant.

Status of Australia Post

The Australian Postal Corporation is a statutory corporation incorporated in Australia under the Postal Services Act 1975 (Cth) and continued in existence as a statutory corporation under the Australian

Postal Corporation Act 1989¹.

Australia Post is subject to taxation under the laws of the Commonwealth and the States and Territories² and conforms to all taxation laws on the basis that it is a company incorporated in Australia. Australia Post does not have a share capital and as a consequence submits that in defining the scope of the new tax incentive care should be taken to ensure that the definition of Company should include entities such as Australia Post which are incorporated under specific Acts of Parliament and which do not have a share capital.

In the event that changes to the eligibility to the R&D incentive are made Australia Post submits that, as an entity that is treated as a company in the tax law, it should continue also be treated as a company for the purposes of the new tax incentive.

The existing definition in Section 73B(1) meets this requirement.

Eligibility for other entities

While the extension of the incentive to other entities creates some complexity, failure to do so will preclude access to the incentive by many small and medium enterprises. Given the express objective of the proposed changes to redistribute support in favour of small and medium sized businesses the decision to limit the scope appears to be contrary to the intent of the changes.

Ownership of the resulting IP

Australia Post supports the proposal that ownership of the resulting IP should not be relevant provided that there is an identifiable connection with commercial activities in Australia.

Question 1 – Should there be any exceptions to the general rule that eligible R&D activity must be conducted in Australia?

Australia Post strongly supports the retention of eligibility in respect of the conduct of limited R&D activities overseas. The view is based on the critical nature of certain activities which, either due to the lack of expertise available in Australia or the lack of available research facilities cannot be conducted in Australia.

In the particular environment that Australia Post operates, the expertise, facilities and resources required to support R&D activities may only exist overseas due to the specific nature of Post's activities and the lack of providers of similar services in Australia. Notwithstanding, that research carried out by or in conjunction with other Postal Administrations may form a critical element of research activities carried out by Post, it should be noted that as a result of Australia Post's strong commitment to R&D it frequently leads its foreign counterparts in the development of technology and the implementation of enhanced practices. The existing R&D incentive and access to the incentive in respect of activities carried out overseas has, in no small part, contributed to Post's position in postal technology and accordingly has provided considerable spillover benefits in Australia.

In the event that some or all of the existing rules relating to foreign eligibility are retained, Australia Post submits that the current requirement to obtain a Provisional Certificate is unduly cumbersome and ineffective in providing an incentive to businesses to commit to R&D activities. The requirements placed on claimants to obtain the certificate result in delays to the project and in practice project timelines rarely allow the extensive delays that are experienced in the Provisional Certificate application process. Delays in obtaining the certificate have on occasions exceeded 12 months and in some cases the required certificate is not received prior to the overseas research being completed.

As a result of the delays the incentive is frequently ignored in the commitment process or if the R&D is

¹ Australian Postal Corporation Act 1989, Section 12 and 13

² Australian Postal Corporation Act 1989, section 63

contingent on the tax incentive to proceed – which is likely to be the case particularly for small to medium organisations that have tax losses – the activity is likely to be deferred or abandoned.

The Provisional Certification process results in the project being subject to up to three separate reviews by AusIndustry (2) and the ATO (1). The risk of exposure to the cost of these three reviews will in some cases result in a decision either to not carry out the R&D or to do so without seeking access to the tax incentive.

As an alternative to the Provisional Certificate process clear guidelines should be produced as to when foreign expenditure is eligible and any additional information required to assess the eligibility should be provided by the claimant at the time the claim is lodged. These guidelines should not be limited by the cost of the activity or the proportion of the project expenditure but should be limited to discrete activities where the claimant is able to demonstrate by reasonable means that the specific activity cannot be performed in Australia or cannot be performed in Australia at a cost which would be viable.

If further limits are to be placed on overseas expenditure (which Australia Post does not support) Post suggests that these limits may exclude from the claim certain defined Support Activities.

Principle 2 – The Standard R&D credit will be available at a rate of 40 per cent for eligible R&D expenditure and can be carried forward where a company's income tax liability is zero.

Australia Post generally supports this proposal however we believe that there is a case for redefining the new R&D tax incentive in a manner which allows for the treatment of the benefit “above the line”. Post understands that other parties will make submissions on how this may be achieved.

In relation to the rate, the uplift of 10% above the tax rate fails to adequately compensate for the removal of the 175% rate and exposes the economy to a reduction in R&D at the critical “large business” end of the economy. Small and medium claimants, who may access the 45% refundable Tax Credit, may be less able to fund the commercialisation of their R&D and as a result of biasing the new R&D tax incentive towards the small and medium claimants a hiatus may occur in the commercialisation of R&D and in the gaining of economic benefits from that commercialisation.

Principle 3 – the refundable R&D Tax Credit will be available to companies with a turnover of less than \$20 million at a rate of 45 per cent for eligible R&D expenditure.

The provision of a “split” incentive introduces a level of unnecessary complexity.

While Australia Post is not impacted by the complexity small and/or medium claimants which have turnovers of approximately \$20 million will be unable to accurately predict which level of benefit they will be entitled to. To the extent that the requirements differ between the two schemes impacted taxpayers will be required to adopt the processes and procedures that require the maximum level of substantiation while they will only be able to anticipate the minimum level of benefit in making their decision to commit to the expenditure.

To assist in removing uncertainty the Refundable Tax Credit regime should be available to taxpayers with a turnover of less than the applicable threshold in the prior year.

Question 2 – How should the new R&D tax incentive treat R&D expenditure that is currently deductible at 100 per cent?

Australia Post does not wish to comment on this aspect of the paper.

Question 3 – Should expenditure incurred to associate entities only be eligible for the new R&D tax incentive where paid in cash?

Australia Post does not wish to comment on this aspect of the paper.

Principle 4 – Legislation for the new R&D tax incentive will provide for the scheme’s efficient and effective administration.

The current split of the administration of the tax incentive creates uncertainty and can lead to a duplication of costs where each of AusIndustry and the Australian Taxation Office each exercise their right to review a particular Project.

While the administrative scheme that applies at present generally defines the role of AusIndustry to be for the review of the eligibility of the Project activities and the ATO for the eligibility of the expenditure, in our experience AusIndustry take an active interest in the expenditure in making their assessments and the ATO critically reviews the activities.

This duplication of administration is needless and should be eliminated in the revised scheme by either :

- (1) centralising the administration – probably to the ATO,
- (2) removing all requirements for costing in the AusIndustry reviews and requiring the ATO accept project activities as identified on review by AusIndustry or
- (3) by AusIndustry and the ATO conducting joint reviews with the result of the review being binding on both authorities.

The revised administrative arrangements must also place defined limits on the administering authority in making their determinations. The current process is slow and prone to resulting in the taxpayer dealing with multiple officers due to officers being redeployed during the extensive delays and the taxpayer being required to repeat programs designed to inform the officer on the particular Project.

The effectiveness of the split administration process applicable in Australia was noted by the New Zealand government when introducing their (now abolished) incentive and the decision was made to centralise the in administration within Inland Revenue. Australia Post supports adopting this model in the new R&D tax incentive.

Principle 5 – the new R&D tax incentive should target R&D that:

- a) **Is in addition to what otherwise would have occurred; and**
- b) **Provides spillovers – benefits that are shared by other firms and the community – that are large relative to the associated subsidy**

Australia Post does not support this proposal which requires claimants to determine:

- a) A split between R&D that would be carried out regardless of the new tax incentive and R&D that is reliant on the new tax incentive for support, and
- b) The relative level of spillover benefit that is likely to occur from the expenditure.

Research & Development activities occur as a regular and necessary element of business activity. Whilst not all R&D would be undertaken in the absence of programs such as the new R&D tax incentive business practice would dictate that some R&D (Base R&D) occur to ensure there are improvements to its materials, products, processes or services. Where incentives exist businesses will factor the incentives into their overall plans and in many situations extend their expenditures (Additional R&D). The level of benefit on the Base R&D will provide the incentive for extending the expenditure to Additional R&D.

In practice it will be virtually impossible to differentiate between R&D that would be committed to in the absence of an incentive and that which would not.

The relative level of spillover benefit is also difficult to estimate. This will particularly be so in situations where the results of the R&D are applicable to more isolated activities – such as may be the case in businesses like Australia Post’s. The spillover benefits from Australia Post R&D may be represented by service performance benefits to its customers. Benefits may result from better, more frequent or timelier services or price benefits. In any case, the extent that the benefit results from R&D may be difficult or in

some cases impossible to ascertain.

Given the level of benefit (10 cents in the dollar above the current tax rate) Post is concerned that the imposition of additional levels of differentiation between various criteria (Core vs. Support Activities and Base R&D vs. Additional R&D) could result in such significant costs that the claiming of the new R&D tax incentive may be ineffective as the cost of compliance may approach or even exceed the benefit – resulting in a decision to forgo the new R&D tax incentive or to not proceed with the R&D.

Principle 6 – Eligible R&D activity will be defined as systematic, investigative and experimental activity that:

- a) Involves both innovation and high levels of technical risk; and
- b) Is for the purpose of producing new knowledge or improvements

Australia Post does not support the replacement of “or” with “and” in the R&D definition. This change will result in undue complexity and does not reflect the fundamental basis under which R&D is carried out.

While Post disagrees with the application of an “and” test to individual activities it is accepted that it is reasonable to require that the Project as a whole display both innovation and high levels of technical risk.

Australia Post also believes that the purpose test in the second limb of the existing definition should be retained. The existing test is well understood and enables an appropriate range of activities to be included in the incentive. Revision of the definition to remove the current level of understanding, as would be the case with the proposed wording, would be counterproductive and would lead to an extended period of uncertainty, again providing a disincentive for claimants, particularly small and medium claimants, who may be relying on the incentive for the funding of their project, to commit to R&D.

Principle 7 – Supporting R&D will continue to be recognised under the new R&D tax incentive but claims will be subject to new limitations.

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?*
 - i) *If so, what would the appropriate rate be?*

Australia Post does not support any broadening of the definition to place further emphasis on the identification of “core” and “support” activities. Such a broadening of the definition will make compliance with the legislation more difficult and costly for taxpayers and for small and medium taxpayers will require a level of analysis beyond their expertise.

Applying the proposed limitations would be extremely arbitrary and potentially discriminatory between industries and may also be discriminatory between taxpayers within the same industry.

If certain support activities are to be limited, which Post does not support, Post believes that a change which would result in expenditure *only being eligible on a net expenditure basis* would be preferable to each of the other alternatives as for these activities there is at least some productive benefit at the time the activity is carried out. Post’s concern with these proposals is that such a separation will create confusion in the identification of the activities and in determining the cost/benefits of the activity. Small to medium claimants will find compliance with the provisions difficult and projects that rely on full scale trials will be discriminated against.

The *exclusion of production activities or dual role activities* also recognises that some productive benefit

might be obtained however Australia Post does not support the complete removal of the activity on the basis that the return from the production activity may be seriously diminished by imposing the requirement to carry out R&D activities simultaneously with the production activities. In many cases full scale trials are the only option and the *net expenditure basis* option would adequately separate the expenditure loss on the activity.

The *capping of support activities as a proportion of core R&D* puts undue emphasis on the separation of activities between core and support. The distinction between core and support is poorly recognised even after the current incentive has been in operation for over 20 years. This lack of ability to differentiate is evidenced by the period of time taken by AusIndustry to conduct Section 39L Reviews and the difficulties taxpayers have in meeting the documentation requirements of the reviews. Any attempt to limit one class of activity by reference to others would be an “administrative nightmare”.

The exclusion of activities which are not for the *sole purpose of supporting core R&D activities* is not supported as this will introduce a factor that will result in difficulties reaching the level of certainty on whether the expenditure will be accepted as qualifying or not that many claimants will require to enable them to factor the incentive into their investment decision. A sole purpose test will create opportunities for AusIndustry/ATO challenge based on minor, irrelevant or incidental purposes to be identified and the benefit of the incentive lost.

Applying a lower rate of assistance to Support Activities than to Core activities once again creates a requirement to make definitive decisions on which activities fall into each category and as stated above Post believes that this distinction has not been capable of being made in the past and without clear guidelines will not be able to be made in the future, again, especially by small to medium claimants.

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 other activities from being considered supporting activities?*

Australia Post supports the retention of the existing list of activities excluded from being considered core R&D.

Question 6 – How should the new R&D tax incentive treat software R&D?

Australia Post supports the view that software development should be afforded the same treatment as other R&D activities.

The multiple sale test is no longer (arguably never was) a useful method to distinguish whether software displays the essential features necessary for support through the incentive. Software developed by commercial enterprises, such as Australia Post, are essential features of delivering enhanced products and services and allow the benefit of these enhancements to be incorporated into the client businesses and to the economy in general.

Australia Post would be prepared to provide further comment in relation to any aspect of this submission.

Yours faithfully
AUSTRALIAN POSTAL CORPORATION

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