

Deloitte Touche Tohmatsu FMCG Industry Group consultative submission to:

General Manager  
Business Tax Division  
The Treasury  
Langton Crescent  
PARKES ACT 2600  
[rdtaxcredit@treasury.gov.au](mailto:rdtaxcredit@treasury.gov.au)

26 October 2009

Dear Sir/Madam

Re: The New Research and Development Tax Incentive

We, together with the listed submission participants, appreciate the opportunity to respond to “The new research and development tax incentive Consultation Paper September 2009” (The Paper) as developed by the Department of the Treasury (Treasury).

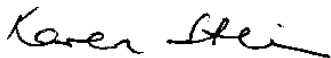
Overall, we are supportive of the development of The New Research and Development Tax Incentive to replace the existing research and development (R&D) tax concession with a new, more streamlined R&D tax incentive from 1 July 2010.

However, we do have a number of comments and concerns in relation to the effectiveness of the Paper presented, particularly in relation to the impact on the Fast Moving Consumer Goods (FMCG) Industry which we set out below.

On behalf of the participants to our submission, we thank you for Treasury’s input to and participation in the consultation.

Should you wish to discuss our submission in greater detail, please do not hesitate to contact me on (02) 9322 7387.

Yours sincerely,



**Karen Stein**  
Partner | Tax | Sydney

# The new research and development tax incentive consultation paper

**Deloitte Touche Tohmatsu Fast Moving Consumer Goods (FMCG) Industry Group**

## List of Submission Participants

Blackmores Limited	McWilliam's Wines Group Ltd
Casella Wines Ltd	Ridley Agriproducts Pty Ltd
CCA Bayswater Pty Ltd	Rivalea (Australia) Pty Ltd
Cheetham Salt Limited	SPC Ardmona Operations Limited
Chilled Foods McK Pty Ltd	Speciality Cereals Ltd
Competitive Foods Australia Pty Ltd	'Company A – A Coffee manufacturer'
Coca Cola Amatil (Aust) Pty Ltd	'Company B – A Food Manufacturer'
Comgroup Supplies Pty Limited	'Company C – A Personal & Household Products Manufacturer'
Convenience Foods Pty Ltd	'Company D – A Biscuits Manufacturer'
Freshpac Foods Pty Ltd	'Company E – A Snackfoods Manufacturer'
Givaudan Australia Pty Ltd	
Kellogg (Aust) Pty Ltd	
Lion Nathan Limited	
Mars Australia Pty Ltd	*Companies A-E are participating on an anonymous basis.

## Executive Summary

We welcome the opportunity to make a submission on the proposals contained in the Paper issued on 18 September 2009.

Deloitte Touche Tohmatsu together with the listed Participants is supportive of the introduction of a simplified tax credit program to replace the R&D Tax Concession, which has the objective of providing a broad based tax incentive to Australian businesses conducting R&D. However we have a number of concerns regarding the proposals detailed within the Paper.

Our key recommendations on the proposals contained in the Paper are summarised below:

### ***Question 1***

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

In order to extend access to overseas based R&D activities, we recommended that a further test be introduced which requires the results stemming from those overseas activities to be exploited to the benefit of the Australian economy. This will ensure that the new R&D tax credit reaps the benefits and spill-over resulting from such activities, within Australia. This will also reduce the need for a percentage cap against such overseas based expenditure.

### ***Principle 4***

*Legislation for the new R&D tax incentive will provide for support for the scheme's efficient and effective administration.*

We recommend that the proposed legislation does *not* require claimants to distinguish between core and supporting R&D, as such a requirement will detract from the scheme's efficient and effective administration.

It is recommended that further guidelines be provided with an industry focus to allow for greater clarity and certainty in relation to eligibility criteria.

### ***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.*

The preferred view is to remove the emphasis on additionality, and focus on the eligibility of the R&D activities. We recommend that the legislation and its stated objectives do not include the concept of additionality and spillovers, but rather focus on providing clarity in relation to the definition of R&D activities and associated expenditure.

## **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.*

We recommend that an eligible R&D activity should be defined as systematic, investigative and experimental activity that:

- (a) involves *either* innovation *or* high levels of technical risk ...

### **1.1 Question 4**

1.2 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 only a lower rate of assistance than core R&D?
  - (i) If so, what would the appropriate rate be?

We recognise that Treasury is seeking to limit the funding available under the new tax incentive to provide a program which is revenue neutral over the next four years. We recommend at first instance that economic modelling be undertaken to understand the impact of the elimination of the 175% R&D Tax Concession. Following this, should there be a further revenue need to extend the limitations to other expenditure categories, we recommend that Treasury restrict the inclusion of *indirectly related* supporting activities, rather than directly related supporting activities. We do not recommend the adoption of the suggested methodologies presented in Question 4 for directly related supporting activities.

Indirectly related supporting activities in the form of overheads, could be capped on an industry basis to effect this change. We recommend that further economic investigations be undertaken to analyse and understand the impact upon the differing industry groups within Australia, particularly in respect of the different cost structures and machinations of each industry. Following such analysis, Treasury will be better informed to determine the actual impact of possible capping, and then determine the possible percentage cap across particular industries. The application of a standard cap will not be equitable across all industry groups, and will create an unnecessary unfavourable bias against particular industries.

### **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 exclusions to the definition of core activities should be maintained and remain unchanged. The exclusion should not be extended to supporting activities.

Our analysis of each of the issues outlined above is detailed below.

## Section 1

### *“The Case for Reform*

8. *The new R&D tax incentive will be more effective in delivering support for business R&D and in targeting that support to where it is most likely to produce net-benefits for the Australian community.”*

### Response

We applaud the principle of targeting support for R&D to where the net-benefits are going to be of benefit to the Australian community. However based on the drafting of the Paper, we have concerns that this principle will not be achieved.

The proposed changes to the Research and Development Tax Incentive as described in the Paper will significantly dilute the amount of support which is currently available pursuant to the R&D Tax Concession program. Specifically with reference to the FMCG Industry, being an industry which provides considerable benefits to the Australian community, the recommendations and principles drafted in the Paper will impede R&D, rather than the support its continuation.

The basis for the dilution of the R&D funding support is set out below in our responses to the specific principles and questions contained in the Paper. **The proposed restrictions of the new tax incentive will more than outweigh the potential benefits that should flow from the new program as set out in the Paper.**

The tightening of the definition of R&D, coupled with the restrictions on eligible activities and associated expenditure will hamper the resulting support for R&D. This will be misaligned with the intention behind the change which, as stated at Paragraph 8 of the Paper, *will be more effective in delivering support for business R&D*. This is likely to arise from the associated impact of the increased AusIndustry compliance activity as well as potential claimants self selecting out of the system in the first instance due to the much higher compliance hurdle presented by the proposals as set out in the Paper. This will have a major negative impact on business expenditure on research and development (BERD).

Further, the proposed changes fail to recognise the significant R&D programs necessarily undertaken with the FMCG industry which currently and continuously provide net-benefits for the Australian community, which are supported by the existing R&D Tax Concession program.

### Background to the industry

The Australian FMCG industry includes a multitude of Australian based manufacturing companies varying in size from small start-up companies to the major multinational corporations. The industry provides for the manufacture of food, beverage, household and personal-use products and forms a major portion of the resulting gross domestic product within Australia. Notably;

- The food, beverage and grocery sector is the largest manufacturing sector accounting for close to 22 per cent of all manufacturing within Australia<sup>1</sup>
- It employs over 206,000 Australians and contributes approximately 2.5 per cent of GDP<sup>2</sup>

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<sup>1</sup> *Australian Food Statistics 2008* (Australian Food Statistics 2008 Food Policy Section, Australian Government Department of Agriculture, Fisheries and Forestry GPO Box 858 Canberra ACT 2601, at page 9

<sup>2</sup> *Australian Food Statistics 2008* (Australian Food Statistics 2008 Food Policy Section, Australian Government Department of Agriculture, Fisheries and Forestry GPO Box 858 Canberra ACT 2601, at page 2.

- The sector also consistently accounts for more than 18 per cent of the Australian manufacturing sector employment<sup>3</sup>
- It is a net exporter of food, with exports of \$23.4 billion<sup>4</sup>
- Australia's total consumer expenditure on food continued its rising trend in 2007-08, increasing by 6 per cent to around \$113 billion<sup>5</sup>
- Food manufacturing costs increased by 20% in 2008
- Beverage exports continue to rise in the beverage and malt category with the value of exports increasing by 6 per cent to \$3.3 billion in 2006-07<sup>6</sup>.
- The value of wine exports for 2008/09 was \$2.4 billion. The wine industry has been a strong contributor to the growth in the value of Australian beverage exports, with the value of wine exports increasing in real dollars from \$267 million in 1990-91 to \$2.4 billion in 2008-09<sup>7</sup>.
- The value of beer and malt exports rose by 23 per cent to \$335 million<sup>8</sup>.

These strong growth patterns offer major spin-off benefits to the Australian economy in terms of horizontal and vertical integration within and across industry segments, employment, development of a range of skills, and the development and sharing of new knowledge. The FMCG industry's developments impact other industries including the supply chain industry, media and telecommunications, packaging, and engineering.

### **The need for R&D in the FMCG industry – producing net benefits for the Australian community**

Whilst the FMCG industry continues to grow, it requires continued R&D programs. Such programs have been supported by the R&D Tax Concession since 1986 and have readily assisted many organisations with advancing both their product and process developments.

With a highly competitive industry, impacted by global and domestic advances, R&D is an essential requirement for the continued growth and success of this sector. As recently stated by the Hon Tony Burke MP, Minister for Agriculture, Fisheries and Forestry; *"Of course, it is not enough to produce more food—we must create an environment in which Australian produced food can move more freely to where it is wanted and needed, so work to access, establish and maintain overseas markets continues to be a high priority for the Australian Government. By aiming for product excellence and **promoting a culture of innovation** (emphasis added) and customer focus, Australia continues to consolidate its reputation as a world-leading provider of high quality food."*<sup>9</sup>

There are many influences which will impact the industry and drive its continued programs of R&D. "Overall the outlook for the Australian food industry for the next two to three years is one of growing complexity and volatility as a number of major drivers of the world economy influence food supply and demand.

Tight world market conditions in some major commodity groups are likely to result in higher food prices and costs over the medium term. Greater consumer awareness of environmental effects and the benefits of healthy lifestyles will continue to provide opportunities and challenges for food producers and marketers."<sup>10</sup>

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<sup>3</sup> Australian Food and Grocery Council, Fast Facts

<sup>4</sup> *Australian Food Statistics 2008* (Australian Food Statistics 2008 Food Policy Section, Australian Government Department of Agriculture, Fisheries and Forestry GPO Box 858 Canberra ACT 2601, at page 12.

<sup>5</sup> *Australian Food Statistics 2008*, (Australian Food Statistics 2008 Food Policy Section, Australian Government Department of Agriculture, Fisheries and Forestry GPO Box 858 Canberra ACT 2601, at p1

<sup>6</sup> Australian Food Statistics 2006, Food and Agriculture Division Australian Government Department of Agriculture, Fisheries and Forestry GPO Box 858 Canberra 2601 at page 6

<sup>7</sup> Ibid

<sup>8</sup> *Wine Export Approval Report June 2009*, Australian Wine and Brandy Corporation, p1

<sup>9</sup> *Australian Food Statistics 2008* Food Policy Section, Australian Government Department of Agriculture, Fisheries and Forestry GPO Box 858 Canberra ACT 2601, at the Forward to the report July 2009.

<sup>10</sup> *Australian Food Statistics 2008* Food Policy Section, Australian Government Department of Agriculture, Fisheries and Forestry GPO Box 858 Canberra ACT 2601, at page 38



What is clear is that in order for the Australian FMCG industry to remain a functional and competitive player in the global market, it is essential that it continues to undertake R&D activities. In order to maintain a respective position in the global and domestic market, the FMCG industry relies upon the funding programs which are offered by the Government in relation to the progression of R&D.

The resulting spin-off benefits for the Australian community stemming from the FMCG industry's R&D activities are many and include;

- The dissemination of new knowledge in relation to product and process development
- The introduction of new products into the market which respond to an array of consumer requirements including gluten-free, dairy-free, allergen protected, skin sensitive, an aging population, Halal certified, Kosher certified, fat free, organic, diabetic and vegetarian.
- Improved consumer health and safety requirements in relation to product quality and shelf life
- Positive environmental impacts including use of recyclable packaging, programs to reduce waste and energy consumption, increased water recycling
- Improved occupational health and safety outcomes for employees in the manufacturing environment, and the end users of the developed products (e.g. improved packaging including the use of easy to open bottles, jars and packages, resealable technology, smaller dimensioned packages reducing the net weight of products (e.g. smaller sized washing detergent boxes which house products which have double the concentration as the original product, yet half the content and associated weight)
- Collaboration between food service sectors including cold chain management and packaging<sup>11</sup>
- Developing solutions to harness the potential that exists in the fresh, ready meals category that is currently underdone in grocery retail outlets — these solutions are aimed at overcoming the cost–time tradeoffs made by consumers while also addressing quality and variety demands<sup>12</sup>.
- Seeking and finding ways to add value in more than the supply of product — that is, in logistics or shared R&D<sup>13</sup>.
- The development of export markets
- Employment within manufacturing facilities within the rural and urban communities within Australia
- An increased resulting retail sector with flow on employment opportunities
- contract R&D opportunities
- Development of markets to service the FMCG industry and beyond, e.g. development of the flavour and fragrance market, development of the packaging market, development of the supply chain industry etc.

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<sup>11</sup> Australian Food Statistics 2006, Food and Agriculture Division Australian Government Department of Agriculture, Fisheries and Forestry GPO Box 858 Canberra 2601 at page 24

<sup>12</sup> Australian Food Statistics 2006, Food and Agriculture Division Australian Government Department of Agriculture, Fisheries and Forestry GPO Box 858 Canberra 2601 at page 29-30

<sup>13</sup> Australian Food Statistics 2006 at page 29-30, Food and Agriculture Division Australian Government Department of Agriculture, Fisheries and Forestry GPO Box 858 Canberra 2601 at page 29-30

## Section 2

### Question 1

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

### Response

Yes, there should be exceptions to the general rule that R&D activity must be conducted in Australia.

It is important to recognise that Australia plays on a global stage. The global participants themselves will make advancements and undertake R&D programs which result in varying bodies of knowledge and technology. In many cases, the global developments may not extend directly into Australia, however allowing for their access, and inclusion within an eligible Australian R&D project, may assist with the development and advancement of the R&D and new knowledge within Australia.

In those cases where technology or know-how is unavailable within Australia, yet the access to such information, processes, or skills is essential for the progression of the R&D activities within Australia, it is imperative to include these activities as eligible R&D activities. By doing so, a number of spill-over benefits will be generated into the Australian community, through the inception of new knowledge and developmental work.

In particular situations, there will be limitations in respect of the facilities and know-how existing within Australia. Allowing for the incorporation of overseas activities in such circumstances will secure the advancement of Australian based R&D projects.

By way of example, in the FMCG industry it is possible that particular countries may utilise manufacturing processes which are unique to their location. Processes are often developed to respond to the availability and quality of raw ingredients, environmental constraints and impacts, water conditioning, energy supplies and packaging. Access to such technology may be limited within Australia, however advancements in the field can arise where experimental activities take place utilising the processes established in another jurisdiction. By trialling Australian raw materials and formulations on particular processes which are designed to manufacture differing quality and functioning ingredients, it may be possible to introduce new processing techniques into Australia, and resulting new or improved localised products.

Capital constraints prohibit the acquisition of such processes for trial purposes only. Hence, there is a need to identify and utilise existing global processes to trial novel methods of manufacture using Australian specific ingredients and formulations.

Providing an *exception to the general rule that eligible R&D activity must be conducted in Australia* will also recognise the many multinational corporations within the FMCG industry who may be able to exploit the use of their overseas based facilities for the benefit of Australian R&D projects. Ease of access to such overseas facilities and related bodies of knowledge can further develop the breadth of skills, knowledge and resulting R&D within Australia.

By way of example, Foster's, a major FMCG manufacturer within Australia and overseas, noted its involvement on a global scale in its *Review of the National Innovation System – Submission*.<sup>14</sup>

"Foster's is actively removing any divides between business groups both locally and globally. This allows for the cross fertilisation of innovative ideas; resulting in, for example, the

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<sup>14</sup> Review of the National Innovation System – Submission, 30 April 2008, page 4,  
[http://www.innovation.gov.au/innovationreview/Documents/589-Fosters\\_Group.pdf](http://www.innovation.gov.au/innovationreview/Documents/589-Fosters_Group.pdf)

development of Pepperjack Handcrafted Ale from a collaboration between our Saltram Winery and Matilda Bay Brewery.

As a leading multi-national beverage group, Foster's has extensive operations around the globe. In relation to our R&D effort, it is likely that our activities will become increasingly globally networked. For example, innovations in our state-of-the-art bottling facility at Nuriootpa in the Barossa Valley have already been reviewed and applied in the Napa Valley in California.

To support the extension of our innovation network, Foster's would like to see the Government recognise the global environment in which our and other companies' innovation takes place. To that end, Foster's encourages the Expert Panel to consider altering the requirement that the vast majority of eligible R&D activities to be conducted in Australia. Instead, allow R&D activities to be conducted overseas and still qualify for the R&D Tax Concession in recognition of the wealth creation arising from the generation of intellectual property and tax revenue generated from the profitable operation of the intellectual property owners in Australia. Foster's believes that such a move represents the next phase in the Government's support of innovation by Australian companies.

## **Recommendation**

In order to extend access to overseas based R&D activities, we recommended that a further test be introduced which requires the results stemming from those overseas activities to be exploited to the benefit of the Australian economy. This will ensure that the new R&D tax credit reaps the benefits and spill-over resulting from such activities, within Australia. This will also reduce the need for a percentage cap against such overseas based expenditure.

## Section 3

### Principle 4

*Legislation for the new R&D tax incentive will provide for support for the scheme's efficient and effective administration.*

*Para 47 - The new R&D tax incentive will require companies to distinguish between core and supporting R&D. However, companies also will be able to draw on more extensive guidance material (from both the new legislation and guidance issued by the administrators) than is currently available.*

### Response

The Paper as drafted does not sustain the premise that the R&D Tax Incentive will provide support for the scheme's efficient and effective administration. The distinction between core and supporting activities will add a further layer of compliance and complexity to the R&D Tax Incentive. For a program to be effective, it needs to moderate the additional compliance costs which result from its application.

The concepts of *core and supporting activities* are concepts which are unique to R&D tax funding programs. These concepts are not widely used terms throughout industry. Certainly within the FMCG industry, the concept of *core and supporting activities* is not commonly understood outside of the use of the R&D Tax Concession program.

Record keeping systems and accounts are not maintained in such a manner as to readily identify the incurrence and cost of core and supporting activities. Much information which is utilised to form the basis of R&D tax claims stems from detailed profit and loss accounts, expense accounts, invoice details and payroll information. Such accounting records are not prepared in such a manner as to differentiate between expenditure on core and supporting R&D activities. In fact, as these terms are specific to the R&D Tax concession program, it would require an inordinate misallocation of resources to develop accounting system to identify expenditure in such a manner. The cost of compliance would be significant.

Similarly from a technical point of view, R&D gating documentation, which houses the projected life story of an R&D project, is not isolated into core or supporting activities. Typically within the FMCG Industry, R&D is reported by reference to concept briefs, technical investigations, risk analyses, gannt charts, formulation and recipe developments, process development specifications, laboratory and bench-scale trials, pilot trials, full scale trials, transport trials, consumer and sensory testing, feedback R&D, packaging development, process improvement etc. These activities are a blend of core and supporting activities, depending on the nature of the project.

From a compliance point of view, it may be an arduous task to distinguish the above as core and supporting R&D activities. In fact, it may result in the need for a further allocation of resources (away from the base of R&D work to be undertaken); just to ensure that there is a level of compliance with the new R&D Tax Incentive. In an environment of cost constraints and limited funding, it is questionable whether this would provide a benefit to the regulators comparable with the consumption of additional resourcing by industry for this purpose. Certainly it would detract from the ease of application of the new R&D Tax Incentive and in some cases be a deterrent to applicants who do not have the record keeping systems, nor the available resources to comply with such a requirement.

These additional compliance costs will be passed on to consumers, with consequent impact on prices and inflation. As currently designed, the new record keeping requirements will not result in cutting red tape, which the Treasurer has stated will be an outcome of the simplified R&D tax credit. [see release 102/09 18.9.09]

Note further that as the new R&D Tax Incentive will be set at a particular rate of credit based upon company (group) turnover, with no distinction between the rates applicable to core and supporting activities, there is no

apparent justification for the delineation of core and supporting activities, and the incurrence of additional compliance costs.

Finally, the FMCG industry is in favour of additional guidance materials to assist with an understanding of the breadth and operation of the new R&D Tax Incentive. It is recommended that reference be made to the Canadian model which provides detailed guidance in relation to industry specific issues associated with their R&D tax credit program.<sup>15</sup> Industry specific issues relevant to the FMCG industry appear to be well understood in this regard and are sure to benefit all eligible participants as well as the regulators with the determining the general basis of R&D tax credit claims.

## **Recommendation**

We recommend that the proposed legislation does *not* require claimants to distinguish between core and supporting R&D, as such a requirement will detract from the scheme's efficient and effective administration.

It is recommended that further guidelines be provided with an industry focus to allow for greater clarity and certainty in relation to eligibility criteria.

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<sup>15</sup> Food and Consumer Packaged Goods Sector SR&ED Guidance Document, Prepared by Food and Consumer Products Manufacturers of Canada (FCPMC) and Canada Revenue Agency (CRA), Canada Revenue Agency, [www.cra.gc.ca](http://www.cra.gc.ca), <http://www.cra-arc.gc.ca/txcrdt/sred-rsde/pblctns/fd-eng.html>, Date Modified: 2002-02-07

## Section 4

### Principle 5

*The new R&D tax incentive should target R&D that:*

*(b) 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.*

*48. A public subsidy for R&D should generate additional R&D activity with benefits that spillover to other firms and the community. This ‘additionality and spillovers’ test applies to the new R&D tax incentive as a whole, rather than individual R&D activities.*

*49. In a broad-based entitlement scheme that allows claimants to self-assess, administrators cannot practically assess whether individual activities provide spillovers and whether the R&D would have occurred in the absence of a subsidy. However, the principle of additionality and spillovers will underpin the design of the rules for what activities will be eligible for the new R&D tax incentive.*

*50. The Government appreciates that previous attempts at tightening the definition of eligible R&D activity under the current scheme were contentious and that some stakeholders are satisfied with the current definition. However, a new definition of eligible R&D activity is an essential component of the new R&D tax incentive package. Without it, the Government cannot afford to proceed with the incentive at the current rates and turnover threshold and would continue to leave the Budget exposed to lower value-add claims.*

### Response:

We disagree with this principle. Although the FMCG Industry generates spillover benefits as a result of its R&D activities for the Australian community (refer to section 1 above), Principle 5 of the Paper introduces a further concept which makes the assumption that there is a base level of R&D which will be undertaken irrespective of the availability of Government support for R&D in the form of the R&D Tax Incentive. It also makes the assumption that the base level of R&D can be well understood and measured. Yet in reality, this is not a simple task and introduces a layer of subjectivity.

In the FMCG industry, there is a constant need to innovate and develop new and improved products and processes. However determining what “would otherwise have occurred” and what is in addition to this, is a subjective test prone to both individual taxpayer and regulator interpretation. The concept of ‘additionality’ requires an understanding of what occurred, where it took place, when it took place, and on what scale it took place. All of this is subject to interpretation. A subjective approach to public policy introduces irregularities and inconsistencies, and may impede the effectiveness of the intended policy. It is imperative that this does not form a part of the ‘objectives’ to the new tax credit, nor a part of the resulting legislation.

The preferred view however, is to remove the emphasis on additionality, and to focus on the eligibility of the R&D activities. This would acknowledge that the FMCG Industry is faced with real pressures and concerns regarding its ability to remain competitive on a global scale. The provision of support via the new R&D Tax Incentive would assist the industry with promoting the culture of innovation which it needs to survive.

With the cost of food manufacturing increasing by 20% in 2008, and the global financial crisis impacting the path of innovation for FMCG manufacturers, it is arguable that programs of R&D will not be undertaken without Government support for funding R&D. Limited internal cash flows, tightening of capital funding and balance sheets, and a review of current spending means that many R&D projects will be shelved until such time as funding becomes available.

For innovation and R&D to prosper, there is a need to financially support Australian based developments. Overseas studies have shown that “food processing establishments’ ability to innovate is impeded by several factors. Those food processing establishments surveyed reported that the major impediment to innovation in food processing is lack of internally generated cash flow. Firms overcome some of their impediments through government support and collaboration. The most important sources of government support are R&D tax credits and R&D grants.”<sup>16</sup>

The Australian FMCG industry is no different to that found overseas. It too is hamstrung by available internally generated cash, and access to further funding for R&D is essential. With the cessation of the *Food Industry Grants* program, and the limited *Regional Food Producers Innovation Productivity Program*, FMCG corporations within Australia are seeking further Government support through the new R&D Tax Incentive program. The current R&D Tax Concession has assisted many corporations within the Australian FMCG industry with pursuing R&D. In *The R&D Tax Concession - impact on the Firm*, it was identified just how effective the program had been for a FMCG manufacturer; “the R&D Tax Concession has, however, encouraged the company (Mildura Fruit Juices Australia Pty Ltd) to undertake more R&D.”<sup>17</sup> The new R&D Tax Incentive should also be focussed on this outcome.

The power of R&D Incentives in the current economic environment cannot be understated. Funding within FMCG organisations is stretched between differing department needs, and every opportunity to strengthen funding for R&D programs creates a further impetus to support the continued growth within an organisation. The R&D Tax Incentive can aid FMCG organisations with responding to the competing priorities faced by internal pressures. “When a firm allocates its total budget to its different departments (marketing, production, research...), the shares each department is awarded is the result of an internal “struggle” between departments. If, again, the R&D grant (incentive) acts as a stamp of approval, this might improve the research department’s bargaining power, resulting in a larger budget share than would otherwise have been attainable.”<sup>18</sup>

Further, additional support via the R&D Tax Incentive will aid the collaborative efforts of many FMCG organisations that are more frequently partnering with others within the industry to create joint developments, and shared R&D. Industry groups as the *National Food Manufacturing Innovation Network*, coupled with research organisations such as Werribee, Vic (CSIRO Food & Nutritional Sciences), The Grape and Wine Research Associations, The Pork Research Association, The Grain Research Association etc., will be better placed to couple with FMCG corporations who have additional funding available by virtue of the new R&D Tax Incentive.

## Recommendation

The preferred view is to remove the emphasis on additionality, and focus on the eligibility of the R&D activities. We recommend that the legislation and its stated objectives do not include the concept of additionality and spillovers, but rather focus on providing clarity in relation to the definition of R&D activities and associated expenditure.

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1.1 <sup>16</sup> *An Overview of the Canadian Agriculture and Agri-Food System*, May 2006, Agriculture and Agri-Food Canada  
<http://www4.agr.gc.ca/AAFC-AAC/display-afficher.do?id=1240581444184&lang=eng>

<sup>17</sup> R&D Tax Concession - impact on the Firm, Report of a survey of 116 Firms, Department of Industry, Tourism and Resources, Canberra, October 2005 at p 28

<sup>18</sup> *Input Additionality Effects of R&D Subsidies in Austria, Empirical Evidence from Firm-level Panel Data*, Gerhard Streicher Andreas Schibany, Nikolaus Gretzmacher, Institute of Technology and Regional Policy - Joanneum Research, March 2004, page 11

## Section 5

### 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.*

52. *The definition of core R&D will not alter the SIE or purpose requirements. However, the Government's current intention is that the definition of core R&D will require SIE activities to be both innovative and technically risky. These conditions go more to the heart of why a subsidy for R&D is warranted. The absence of either of these factors reduces the likelihood the activity will produce spillover benefits and be in addition to what would otherwise occur.*

53. *Innovation is one of the ways in which companies seek to differentiate themselves from their competitors and improve profitability. There is a level of innovation that will occur in the absence of a subsidy. Similarly, companies routinely make commercial judgements about undertaking activities that involve technical risk based on the probability of success, the benefits of success and the costs involved.*

54. *Subsidising an activity that is innovative but not risky may, at the margins, lead to additional R&D with benefits extending beyond an individual company. However, it is more likely to do no more than subsidise a company for doing what is already commercially sensible. Similarly, a subsidy for activities that involve high levels of technical risk but are not inherently innovative may lead to additional activity but is unlikely to deliver benefits beyond an individual company.*

55. *A definition which requires that core R&D activities involve both innovation and high levels of technical risk means that the new scheme will better align with the Frascati Manual and international practice. Currently Australia has one of the broadest definitions of R&D (when compared to the Frascati Manual). Many countries, including the United Kingdom and the United States, take a narrower approach.*

### Response

We disagree with this principle.

The current R&D Tax Concession has been effective in supporting, and creating additional R&D. Note that this Concession has been successful, albeit it provides an alternate test for innovation or high levels of technical risk.

*"The current system encompasses all innovation, not just invention. Most of the innovation in the dairy industry associated with bringing new products into the marketplace relies on systematic, investigative and experimental activities. Most of these activities involve some degree of technical risk and/or innovation. **Narrowing this definition would see a significant reduction in the eligibility of near-to-market development within dairy rendering any incentives for increasing new product developing marginal at best.**"<sup>19</sup>*

It is incorrect to suggest that a new program will only meet its aims of *being more effective in delivering support for business R&D, and deliver additional spillover to other firms and the community*, by tightening the definition of R&D as detailed above.

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<sup>19</sup> Review of the National Innovation System, A submission on behalf of innovators in the Australian Dairy Industry, Submission co-ordinators: Isabel MacNeill, David Nation, Dairy Australia, dnation@dairyaustralia.com.au Tel: 03 9694 3777



It seems an unnecessary requirement to tighten the definition of R&D in order to achieve this outcome. R&D activities can arise in those circumstances which involve either innovation or high levels of technical risk, with spillover benefits to the Australian community.

*“In the food sector, a number of significant innovations that were world firsts occurred. NFL was fortunate to launch a number of these products including Le Rice, Fruche, yogurts, milk in PET bottles. These products although traditional “comfort foods” required the development of new technologies and processes to deliver safe products to consumers. Each of these innovations required a significant investment in research and development capability within the Company often utilising basic research and development carried out in Australian and State universities and research institutions.*

*The R&D Tax Concession has been important to development of our business. The process has assisted the Company to develop an innovative culture at all levels of the business. The awareness of the high risks and associated costs of innovation in the provision of safe, nutritious food to our consumers has been further encouraged through the availability of the R&D Tax Concession.”<sup>20</sup>*

The above example illustrates the effectiveness of the current definition of R&D activities. Not only has the program supported the company in its efforts to innovate, but it has also allowed for the development of world firsts.

The premise at Paragraph 54 of the Paper that

*subsidising an activity that is innovative but not risky may, at the margins, lead to additional R&D with benefits extending beyond an individual company. However, it is more likely to do no more than subsidise a company for doing what is already commercially sensible,*

is not sound. It may be the case that an existing program of R&D may be followed, however the pace of development; the paths of possible investigations; and the potential results, may be limited without additional R&D funding within an organisation. There are many examples within the FMCG industry where resources are finite. As a result, although it may be commercially sensible to follow a path of R&D in order to seek market differentiation and the resulting market share, the realities of the economic climate, internal cost constraints and a squeeze on internal resources often dictate otherwise.

The application of the new R&D Tax Incentive will assist corporations with direct funding into the business in the form of cash offsets, and tax credits, which will assist the business with completing the program of R&D necessary to innovate. The spin-off benefits of doing so will have a real benefit for the Australian community; well beyond the individual company (refer to section 1 above).

Innovation in its purest form, whether it be the creation of new knowledge which has neither been contemplated, nor proven in any scientific or statistically valid manner in the past, may require an enormous financial commitment, with little short term gain. Research programs can take many years to reach viable outcomes. Commercial sensibilities in a highly competitive market environment do not usually provide for such investment. . The FMCG market is moving at a rapid pace with over 182,000 new products entering the global market each year<sup>21</sup>. This pace does not always allow for investment in innovation where it transgresses a timely research period. Innovation is certainly a driver of the FMCG industry, however pursuing innovation without Government assistance may not always be commercially sensible, nor commercially viable.

Further, the premise in Paragraph 54 of the Paper, that

*a subsidy for activities that involve high levels of technical risk but are not inherently innovative may lead to additional activity but is unlikely to deliver benefits beyond an individual company,*

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<sup>20</sup> National Foods Limited, Submission to National Innovation Systems Review,  
30 April 2008, page 3

<sup>21</sup> Mintel Global New Products Database 2006

is also questionable. The FMCG industry is highly competitive. Information pertaining to the results of R&D within the industry, including formulation development and process specifications, is generally not made available on normal commercial terms. Hence although an FMCG corporation may develop a new product which may already exist in another form within the market, the corporation will face numerous technical uncertainties and high levels of technical risk in achieving the desired formulation which differentiates the product. The creation of a competing product provides additional benefit to the Australian community, in the form of price competition, product choice, employment, new knowledge disseminated via transfers of employees across an industry and so on. R&D activities which contain high levels of technical risk certainly provide benefits beyond an individual company.

The premise fails to understand the operation of the FMCG industry within Australia. With FMCG consisting of a range of technically sensitive products, there is a high level of technical risk associated with developing products and processes which do not create health and safety risks, which at its worst could result in the death of consumers. Ensuring that an FMCG corporation is able to develop new and improved products and processes which allow for products to meet shelf life requirements, comply with health and safety regulations, and provide a selection of dietary and health related choice, provides significant benefits beyond the individual company.

In addition, the concept of considering both innovation and high levels of technical risk to the definition of eligible activities requires this to be applied at the activity level, rather than at the project level. Applying this dual test to each activity will result in a dramatic reduction in eligibility, notwithstanding when considering the collection of activities innovation and high levels of technical risk may exist.

Lastly, Paragraph 55 refers to the broad nature of the definition of R&D in Australia, as justification for tightening the current definition, noting that *many countries, including the United Kingdom and the United States, take a narrower approach*. Although the United States has a higher level of BERD as a percentage of GDP than Australia, the United Kingdom is currently less than Australia<sup>22</sup>, which questions the implications and validity of narrowing the definition. Arguably, the breadth of the definition of R&D should not be considered in isolation when determining the effectiveness of the program.

In terms of the financial impact of the new program, with the removal of the 175% R&D concession and the possible recommendation by the Henry Review of a reduction to the corporate tax rate, the amount of expenditure to be claimed under the new R&D Tax Incentive and the financial impact on the Budget will be reduced. Further, a renewed program of technical assessments by AusIndustry and the Australian Taxation Office will better manage the interpretation of the definition of R&D and associated expenditure, eliminating the concerns as detailed in the examples within the Paper, e.g. the claiming of whole of mine claims. Without further detailed economic modelling, (following the institution of a renewed assessment program), it is assumed that there is no further basis to support the tightening of the definition of R&D.

## Recommendation

We recommend that an eligible R&D activity should be defined as systematic, investigative and experimental activity that:

(a) involves *either innovation or high levels of technical risk ...*

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<sup>22</sup> Australian Bureau of Statistics, Research and Experimental Development, Businesses, Australia, 2007-08

## Section 6

### Question 4

*Should supporting activities:*

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

### Response

No. Capping supporting activities fails to recognise the necessary undertaking of such activities to allow for the completion of an R&D project within the FMCG industry. FMCG corporations undertake a range of supporting activities which are unique to the FMCG industry. The cumulative relative cost of these activities may exceed the cost of the core activities. However, the pursuit of these activities is a necessary requirement to fulfilling the technical objective, which typically focuses on the development of new or improved products or processes, or the acquisition of new knowledge. Capping supporting activities as a proportion of the expenditure on core R&D will impede the continuation of the R&D project, and may limit the achievement of technical advancements within the industry.

Examples of supporting activities within the FMCG Industry which are necessary for the technical advancement of products and processes include;

- **Sensory & Consumer Research testing:**

The Canada Revenue Agency, in defining activities which characterize "Scientific Research and Experimental Development (SR&ED)" as described in sub-section 248(1) of the Canadian Income Tax Act, noted that

"consumer testing becomes eligible when it is used as an analytical tool in support of a SR&ED project. The science of consumer testing involves the use of sensory evaluation techniques, which have been researched and documented by scientists. Sensory evaluation is defined as the scientific discipline used to evoke, measure, analyze and interpret reactions to characteristics of food and consumer products as perceived through the senses of smell, sight, taste, touch and hearing. These techniques are quantifiable and have been correlated to instrumental analytical measurements e.g. rheological measurements, HPLC, NMR, NIR, texture analysis etc. Sensory characteristics of these products are considered as important as chemical, nutritional, physical or microbiological characteristics. The term "organoleptic properties" is sometimes used to describe the sensory characteristics of these products."<sup>23</sup>

Examples of the types of tests involving sensory testing which are often relied upon to evaluate experimental products during the experimental development process include:

1. Discrimination testing which would include both Triangle testing and Difference testing.
2. Sensory panel testing which could involve either a professional trained panel of experts or a semi-trained consumer group i.e. church group, scouts, guides, seniors etc.
3. Focus group testing or framework testing of experimental prototypes.
4. CLT (Central Location Test): pre-recruited personal interviews to evaluate experimental product prototypes.

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<sup>23</sup> Food and Consumer Packaged Goods Sector SR&ED Guidance Document, Prepared by Food and Consumer Products Manufacturers of Canada (FCPMC) and Canada Revenue Agency (CRA), Canada Revenue Agency, [www.cra.gc.ca](http://www.cra.gc.ca), <http://www.cra-arc.gc.ca/txcrdt/sred-rsde/pblctns/fd-eng.html>, Date Modified: 2002-02-07

5. HUT (Home Use Test): an in-home placement of experimental product prototypes generally with a questionnaire or other mechanisms to capture information related to the product design attributes.
6. In-Situ Test - End-use testing for service products used outside the home, in hospitals, food service operations, dental offices etc.<sup>24</sup>

The cost of such testing can easily outweigh the costs of the core activities which they support. However, their incurrence is essential to the completion of the R&D project.

- **Scale-up and Commercialisation**

The development of new or improved products or processes requires the translation of activities undertaken at the bench-scale in a laboratory, to a pilot and then production scale. The impacts of processing parameters on the ability to create a new or improved product are unable to be replicated in the laboratory. Whether it be heat transfer and temperature profiles, operating running speeds, throughput and the integration of technology, viscosities and stability of formulations, pasteurisation or retort processing, extrusion or moulded processing, hot filled or cold filled products, gaseous or aqueous processing; all such elements will impact on the ability to attain a product which can be developed on a commercial scale, in a repeatable, reliable and sustainable manner. Such attributes cannot be replicated on a bench scale, making R&D undertaken within the laboratory limited to the development of new or improved formulations, rather than the development of new or improved products (capable of being manufactured for commercial sale). To limit R&D funding to that undertaken in the laboratory results in programs which support R&D in a vacuum. The R&D will never be complete and will always remain speculative as to its success in a commercial environment.

Obviously, the costs of scale up and commercialisation can very quickly exceed the core R&D activities. Yet without the incurrence of such costs, the FMCG industry would stifle its program of R&D, and its ability to remain competitive on a global scale.

The necessity to undertake such scale up activity within the FMCG industry has been recognised as a necessary supporting activity by the Canada Revenue Agency.

“The progression of SR&ED from initial technological efforts at the bench level to a final commercial product or package requires the ability to prove that the initial SR&ED results can work on a larger process scale. In the food and consumer products industry, the normal approach is through an intermediate "scale-up process" in a pilot plant facility. Some companies may lack pilot plant facilities, or in some cases, the nature of their business dictates that experimentation needs to be conducted on a plant scale. Plant trials to resolve a scientific or technological uncertainty leading to technological advancement would meet the definition of a SR&ED project. As a project moves through various phases of development, frequent trials on a larger scale will be required. These experimental trials are often a critical part of a SR&ED project.”<sup>25</sup>

Capping supporting activities will create a significant bias against the manufacturing industry. It is within these industries that the bulk of production related activities are necessarily incurred.

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<sup>24</sup> Food and Consumer Packaged Goods Sector SR&ED Guidance Document, Prepared by Food and Consumer Products Manufacturers of Canada (FCPMC) and Canada Revenue Agency (CRA), Canada Revenue Agency, [www.cra.gc.ca](http://www.cra.gc.ca), <http://www.cra-arc.gc.ca/txcrdt/sred-rsde/pblctns/fd-eng.html>, Date Modified: 2002-02-07

<sup>25</sup> Food and Consumer Packaged Goods Sector SR&ED Guidance Document, Prepared by Food and Consumer Products Manufacturers of Canada (FCPMC) and Canada Revenue Agency (CRA), Canada Revenue Agency, [www.cra.gc.ca](http://www.cra.gc.ca), <http://www.cra-arc.gc.ca/txcrdt/sred-rsde/pblctns/fd-eng.html>, Date Modified: 2002-02-07

#### **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)?*

No. Further to the submission outlined with reference to Question 4 above, supporting activities should not be capped as a proportion of expenditure on core R&D.

## Section 7

### Question 4

*Should supporting activities:*

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

### Response

No. Supporting activities should not only be eligible where they are for the sole purpose of supporting core R&D activities.

R&D activities within the FMCG industry are typically undertaken by corporations who are manufacturing goods within their facilities within Australia. In order to remain competitive, the organisation will undertake R&D activities which result in the development of innovative or advanced products and processes. Many of these activities will necessarily be undertaken within the production environment, allowing for the development of a selection of products and associated processes which differentiate the corporation in the market, creating opportunities on a domestic and global scale.

It is unrealistic to surmise that supporting activities should only be eligible where they are for the sole or dominant purpose of supporting core R&D activities. Denying the eligibility of supporting activities which, due to the scale up required within the FMCG industry, are also undertaken whilst production activities occur, heightens the poor understanding of manner in which R&D activities are undertaken within the industry.

In order to prove the hypothesis, which is in some instances is tested within the laboratory, and move from objective to logical conclusions, it is essential that the R&D activities are extended into a production environment. To develop products which are able to be manufactured in a commercial environment, rather than be limited to the pure scientific development within a laboratory (with little comparative spin-off benefits), it is necessary to undertake production based activities. Similarly, the development and advancement of improved processes requires access to existing processes, which are constructed and utilised within a production environment.

Typically within the FMCG industry, the objective of an R&D project will be to develop sustainable, repeatable products which are differentiated within the market based on their functional characteristics. Excluding supporting activities unless they are solely or predominately undertaken for the purpose of supporting core activities, will significantly reduce the amount of funding for R&D in the FMCG industry which is provided by the new R&D Tax Incentive.

Further, as the current R&D tax concession utilises the ‘feedstock’ provisions to dilute the value of expenditure which can be claimed (including energy), where materials or goods are processed or transformed, Treasury is already provided with a mechanism to offset the cost of goods sold resulting from R&D activities. Hence the need to restrict the activities as suggested in Question 4 above has already been considered and effectively treated.

## Section 8

### Question 4

*Should supporting activities:*

- (c) exclude production activities or dual role activities?

### Response

No, supporting activities should not exclude production or dual role activities.

Following on from the discussion above, much of the supporting R&D activities undertaken by the FMCG industry include activities which are undertaken in the production environment. Few FMCG corporations operate pilot plants which replicate the scale and technical challenges associated with full scale production. Hence there is a very real need to utilise the production facilities to not only undertake production activities, but also undertake supporting R&D activities in the form of R&D trials.

As the intended definition of R&D under the new R&D Tax Incentive will refer to systematic, investigative and experimental activities undertaken for the *purpose of improvement*, it is necessary to recognise that *improvement* will extend to improvement of technical processes. Such processes which are located within a manufacturing environment are not operating in isolation, or for R&D sake alone. The recognition that processes can be developed and improved, and included as an eligible activity which is supported by an R&D funding mechanism, demonstrates that the program is an industrial R&D program, rather than a purely scientific program.

It is also uncompetitive and impairingly costly to halt production activities to undertake R&D trials where the processes which are the subject of the R&D are also production based processes. Further, it would be highly unlikely that the high levels of technical risk associated with improving the processes could be overcome without operating the processes at full operating speeds and throughput. This can be substantiated by the many FMCG manufacturers who are the participants of this submission.

The development of products for commercial scale need to be developed on processes which are designed and improved to allow for the same. The construction of pilot plants which mirror these requirements are cost prohibitive. Process improvements cannot result from activity concentrated within a non-production environment. An industrial R&D incentive stimulates the generation of competitive, advancing corporations. It is expected that to limit funding for such activities would more than halve the effectiveness of the suggested R&D program.

The Paper notes that the United Kingdom and Canada have adopted an approach where activities with a purpose other than R&D are excluded from their R&D incentive program. Both the United Kingdom and Canada rank below Australia with the current program of the R&D Tax Concession, in relation to the ratio of BERD as a percentage of GDP<sup>26</sup>. The Paper has highlighted that the new R&D Tax Incentive will be tightening the eligibility criteria, as well as creating a revenue neutral program over the first four years of operation.<sup>27</sup> Yet it also states that it will be more effective in delivering support for R&D<sup>28</sup>. If the program aims to mirror the definitions of the United Kingdom and Canada, it is possible that the objectives will not be met, and the BERD as a percentage of GDP will reduce within Australia, rather than move above the average of 1.59%<sup>29</sup>.

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<sup>26</sup> Australian Bureau of Statistics, Research and Experimental Development, Businesses, Australia, 2007-08

<sup>27</sup> Paragraph 14, The Paper

<sup>28</sup> Paragraph 8, The Paper

<sup>29</sup> Ibid 21

## Section 9

### Question 4

*Should supporting activities:*

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

No. Supporting activities should not only be eligible on a net expenditure basis.

Australian industry undertakes R&D in an industrial (commercial) environment. Similarly to overseas, in order for industry to develop and grow, it is imperative that Government support is provided to stimulate such growth and encourage further R&D within Australia

Providing a system which provides support on a net expenditure basis equates to providing highly limited, or in some cases no, support at all. The policy objective of the new R&D Tax Incentive is to *be more effective in delivering support for business R&D*. A net expenditure basis will not achieve this level of support, and may actually find Australian industry exiting Australia to jurisdictions where additional R&D funding and support is offered.

In considering how a net expenditure basis would operate, one needs to be mindful of the environment in which R&D is undertaken. Within the FMCG industry, R&D programs stem from the laboratories and production facilities. In both cases, it is not unusual to have a saleable product resulting from the R&D activities. However, presently the feedstock rules operate to effectively net off the cost of goods sold and profit element associated with the production process. The labour required to undertake the R&D in the production facility should however be included as a part of the cost of the R&D as it is necessarily incurred to continue the R&D, albeit it has a dual production purpose.

Care should be taken when considering a recoupment model in relation to core and/or supporting activities. Where corporations are relying on Government funding through the R&D tax incentive, they will more readily progress their R&D programs and advancements. It is evident that spill-over benefits result from these programs as detailed in the sections above.

Where however the corporation is required to offset the R&D tax incentive against activities which are profitable in their own right, it is possible that a number of outcomes may result:

- FMCG corporations may reduce the volume of R&D undertaken within Australia and further their developments offshore. This will reduce the direct spinoff benefits within Australia particularly in those cases where R&D is not correspondingly undertaken within Australia
- FMCG corporations may attempt to pass on the cost of R&D to the consumer in the form of price increases. In a market which impacts all Australians, such an outcome would cause concern. The market forces would then dictate how much R&D funding can be accommodated by the consumers. This has the potential to stifle R&D projects and reduce the spill-over benefits to the market in the form of product differentiation and price competitiveness
- A bias may result against the FMCG industry. This industry requires production based R&D activities in order to complete its R&D projects. Product and process developments cannot occur in this industry without the involvement of the full scale production facilities to trial new and improved formulations and resulting products. The process developments within the production environment complement the product developments, and assist with improving processes and technology.

This industry differs to other industries who already will gain the benefit of the changes mooted within the Paper. For instance, the computer software and finance industries do not ordinarily require production facilities to further their R&D. Hence, a net expenditure basis will have little impact on these industries.



The Paper indicates that current “on own behalf” rules will be maintained in the new tax incentive. These rules act to prevent corporations in any industry from claiming their R&D expenditure where they are reimbursed for the associated costs. In other words, where the financial risk is transferred to another, the R&D costs are unable to be claimed. These rules work effectively to reduce the funding which can be provided where a company is able to recover much or all of its R&D outlay directly from the R&D outputs of the R&D process itself.

This differs to the situation where a secondary outcome results, that being the creation of operating stock, or cost of goods sold. In this case, the value of the goods sold is determined by reference to a number of factors. However, the R&D Tax Concession already makes an allowance for this by effectively reducing the claim where the value of the output of materials or goods processed or transformed exceeds the value of the input of materials or goods processed or transformed. In other words, the feedstock rules operate to limit the expenditure in those instances where the corporation is able to sell the output from the production environment.

The combination of the current feedstock rules, plus the on own behalf rules are already effective in netting off expenditure incurred where the financial risk is transferred or eliminated through the sale of final goods.

A further netting off of expenditure will eliminate the benefit which results from the availability of the tax incentive. Although net impact on the Budget will be reduced, the program will become ineffective in supporting R&D within Australian FMCG corporations in particular.

## Section 10

### Question 4

*Should supporting activities:*

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

No. A two tiered program is unnecessary. Acknowledging that supporting activities within the FMCG industry are an essential element of eligible R&D projects lends itself to the conclusion that these activities are as important as the core R&D activities. Without their undertaking, R&D projects within the industry will come to a halt, and the level of advancement and progression within the industry will be impeded. Further, the application of two rates will create an administrative complexity for applicants and regulators.

For the new tax incentive to be “*more effective in delivering support for business R&D and in targeting that support to where it is most likely to produce net-benefits for the Australian community*”, it needs to be broad based and of application to all industries including FMCG. Should supporting activities attract a lower rate of assistance, the FMCG industry will be inequitably disadvantaged through the receipt of a lower base of Government support for R&D. Support for necessary sensory and consumer research as well as production based trials which are generally categorised as supporting activities, will be provided to a lesser extent.

### Recommendation *re* Question 4

We recognise that Treasury is seeking to limit the funding available under the new tax incentive to provide a program which is revenue neutral over the next four years. We recommend at first instance that economic modelling be undertaken to understand the impact of the elimination of the 175% R&D Tax Concession. Following this, should there be a further revenue need to extend the limitations to other expenditure categories, we recommend that Treasury restrict the inclusion of *indirectly related* supporting activities, rather than directly related supporting activities. We do not recommend the adoption of the suggested methodologies presented in Question 4 for directly related supporting activities.

Indirectly related supporting activities in the form of overheads, could be capped on an industry basis to effect this change. We recommend that further economic investigations be undertaken to analyse and understand the impact upon the differing industry groups within Australia, particularly in respect of the different cost structures and machinations of each industry. Following such analysis, Treasury will be better informed to determine the actual impact of possible capping, and then determine the possible percentage cap across particular industries. The application of a standard cap will not be equitable across all industry groups, and will create an unnecessary unfavourable bias against particular industries.

## Section 11

### Question 5

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

(a) amended in any way?

### Response

No. The list adequately excludes particular activities from being considered as core activities.

### Question 5

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

(b) extended to exclude certain activities from being considered supporting activities?

No. There is no practical basis for the exclusion of these activities as supporting activities. Many of these activities are necessarily incurred to progress the R&D projects being undertaken, and their exclusion will stifle the advancement of the project.

There are current safeguards preventing tax payers from including supporting activities on their own, in the absence of core activities. By way of example, where efficiency studies are necessarily incurred to progress a project, these are eligible supporting activities. However should the project not advance to include core activities, the claimant would be required to exclude the supporting activity from any earlier year claim. There is no mischief which results.

### Recommendation

The exclusions to the definition of core activities should be maintained and remain unchanged. The exclusion should not be extended to supporting activities.