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GST • FUEL CREDITS
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PAYROLL TAXES

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General Manager
Business Tax Division
The Treasury

By email: rdtaxcredit@treasury.gov.au

Dear Sir

SUBMISSION ON THE NEW R&D TAX INCENTIVE

Please find our firm's submission below on the new R&D tax incentive, including our commentary on a number of issues and proposed recommendations.

INTRODUCTION

Our firm has been involved in providing advice and also in the preparation and lodgement of R&D tax concession claims for in excess of 15 years. We have advised businesses from the micro level all the way up to claimants with R&D expenditure in excess of $40M each year. We therefore have an appreciation of the scheme and issues across the whole spectrum of business.

In addition, our firm was involved with the New Zealand R&D tax credit scheme, both at the time it was being formulated and also in the claim preparation and lodgement phase. We therefore have an understanding of the NZ R&D model, although you may be aware that is only operative for the 2009/10 financial year.

The comments and views expressed in this submission do not relate to any specific client or clients, but are based on our experience in dealing in this discipline over a long period of time. We have tried to be positive in our remarks by making constructive comments and recommendations, rather than just highlighting a potential problem without providing some sort of solution.

Our submission identifies each of the 13 items that we wish to raise and there is also a corresponding recommendation(s) against each one of them. The items are not ranked in any particular order of priority or importance.

Issues and Recommendations

1. Overseas Performed R&D

Issue:
We note that one of the main tests under the new scheme for eligibility is now based on where the R&D is conducted, in that overseas ownership of intellectual property (IP) is no longer a detrimental factor. The

issue of proving where the R&D is conducted existed under the "old" (current) scheme, but was not usually a matter of contention. This location test is now much more likely to be a relevant factor under the proposed scheme in proving where the R&D is conducted.

Quite often proving where a sub-contracted R&D activity, or work performed by an overseas parent company can be quite difficult and onerous. It may not be sufficient simply to show, for example that the charges for the work are rendered on an Australian generated invoice. It is also possible that a claimant company may not be aware of where the R&D is conducted. This burden of proof in showing where R&D is conducted of course can to some extent be mitigated under the current scheme by gaining prior approval for overseas R&D from AusIndustry.

Recommendation:
Clear guidelines will need to be issued to indicate what documentation and onus of proof will be required of claimants to prove that the claimed R&D was performed in Australia. This is especially the case where even though the subcontracted work or work is performed by a parent (overseas) entity it may be performed either locally or overseas with little or no reference back to the principal.

We presume that simply having an invoice issued by an Australian entity may not be sufficient proof and perhaps some type of certification by the contractor or overseas head office may be acceptable, if it is accepted in good faith and the claimant does not have reasonable grounds to doubt its authenticity.

2. Conducting Overseas R&D

Issue:
It is a fact of business life that not all R&D can be performed in Australia, due to factors such as the availability of test equipment, qualified personnel and access to intellectual know-how etc. For example, there may be only a certain number of test facilities in the world and the local Australian market would not support such a facility and therefore local companies must go to these sites to complete their R&D by using the facility, the qualified personnel and intellectual know-how of the provider.

Situations such as the above were adequately covered under the old scheme where prior approval to perform and claim overseas R&D could be sought and obtained through AusIndustry. These activities are integral to the successful completion of the R&D and its commercial exploitation. We believe in cases where the access to and availability of such facilities is critical to the completion of the R&D that expenditure incurred in this overseas activity should be eligible for the new R&D tax credit.

We note that one possible outcome under the new scheme may be to deny all overseas R&D activity without exceptions. These activities and costs are critical to the completion of the R&D and to deny claimants such expenditure would create an unfair advantage for those claimants who may be competitors that do not need to use such overseas facilities.

Recommendations:
We strongly recommend that expenditure for overseas R&D activities described above be eligible for the concession. It should be pointed out that claimants will have to prove that such facilities, personnel and know-how are not available in Australia. It will not be sufficient simply to state that to use the overseas facility, personnel etc., is more cost effective over local providers.

We also recommend that, as with the old scheme, prior approval be obtained for overseas R&D activities.

We do not believe that there should be any expenditure limit imposed on this overseas R&D, because by its very (usually unique) nature this activity can be quite expensive.

We also recommend that the current 10% limitation test be removed and that one specific application can cover more than one financial year, without the need for annual (sometimes multiple) applications. This will streamline the process and reduce time and paperwork.

3. Exploitation of Foreign Owned IP

Issue:
The new R&D tax incentive places emphasis on where the R&D is conducted and not so much on the IP ownership. In fact, it is accepted that the IP ownership can reside with an overseas entity. There will still be a requirement that the results of the R&D (IP) are exploited on normal commercial terms.

This raises the issue that Australian claimants may not have access to the relevant documentation demonstrating normal commercial exploitation, due to a variety of reasons including, commercial confidentiality, access to sales and profit data etc. There could be either a high burden of proof on the Australian company, or its lack of control over the commercial exploitation, or a denial of access to an overseas company's records and documentation in being able to prove that the Australian developed IP has been exploited on normal commercial terms.

Recommendation
The published guidelines will need to be quite specific in defining what proof must be produced to satisfy the commercial exploitation requirement. These will need to take into account that Australian companies may have difficulty in being able to access documentation etc. to prove this point. It will make matters easier for the claimant to know in advance of conducting the R&D what it will require and will be requested from the overseas company in this matter.

4. Use of R&D Credits for Large Companies in Tax Loss

Issue:
We are aware that the ability of large companies to access the tax credits when they are in tax loss is a major issue and potential deterrent in claiming R&D tax credits. We are also aware that submissions have been made that the R&D credits in these circumstances can be used to offset other (current) tax liabilities egs. GST, FBT, PAYG etc. It would seem that these submissions have not found favour, although once again we raise this issue, because we have clients in the large business category (in excess of $20M turnover) and we know that they will not prepare and lodge R&D claims simply to accumulate and carry forward R&D tax credits.

In the past under the “old” scheme, some of these companies would not consider making claims for eligible activities unless expenditure met certain thresholds e.g., in excess of $1M per project, believing it was not time and cost effective to do so. In addition, other clients in tax loss declined making R&D claims even though eligible activities were being performed, because the benefit in accumulating more carry forward losses through the R&D concession was not considered time and cost effective.

We appreciate that the decision to make or not make an R&D claim is ultimately the decision of the claimant company, but we do not believe it is in the interests of the country or business to not make claims when they are entitled to, simply because of a lack of incentive.

Recommendation:
It would seem, based on the earlier submissions that we are aware have been lodged and the current Consultation paper, that any request for offsetting R&D credits against other tax liabilities will not be entertained. In order to ensure that there is some equity between small and large businesses claiming the R&D tax credit and to eliminate any unfair competitive advantages perhaps a hybrid solution could be applied. It is recommended that large businesses in tax loss can claim R&D tax credits up to the limit of small businesses, but only at the 40% credit rate. This should overcome any potential competitive

disadvantage against small companies. The balance of the credit rate above this threshold would then be treated in the proposed manner, being, carried forward until the company has an income tax liability.

5. Treatment of Core Technology Expenses

Issue:
We note that one of the proposed treatments for non-enhanced deductions is for such expenditure to be deducted under the normal tax rules. The problem is that deductibility for core technology expenses is generally not allowable, either through a straight out deduction (expensed), or through a gradual write-off (depreciation or amortisation). In relation to core technology there would be a double loss if some relief is not available for core technology expenses through the R&D tax incentive, or under the normal tax rules.

Recommendation:
Any non-enhanced expenditure where relief is not available under the normal tax rules, such as core technology, should receive some concession under the R&D tax credit scheme, even if it is at the 100% rate or equivalent.

6. Payments to Associates

Issue:
It is important to understand why most associated entities "fund" R&D and why this is done on an accruals basis. In the vast majority of cases it is not done to simply derive a tax benefit, but for sound commercial reasons. Quite often the entity conducting the R&D can have great difficulty in obtaining finance to fund its activities on what a lender might see as a highly speculative venture and/or where the return is very doubtful. As a result, lenders in these circumstances most commonly charge a much higher rate of interest and require greater security, resulting in a facility and associated costs that can be prohibitive.

R&D claimants requiring finance can turn to their associated entities for funds where the speculative nature of the project and the chances of it being commercially successful may not be determining factors in whether the funds are provided and therefore whether the R&D is performed. These funds are generally made available by the associated entity and charges incurred by it are journalled to the associated entity.

In addition, the repayment terms to associates can be favourable and over a longer period of time and commonly can be linked in to the exploitation of the R&D results. In cases where the company performing the R&D has no tangible assets it is not in a position to repay any loans, without taking out further financing.

Recommendation:
If it is accepted that the main reason for payments to associated entities is for sound commercial reasons that enables the R&D to be performed, then this practice should not be discontinued. A problem can arise when a debt between associated entities may be forgiven, discounted or written off quite some time after the R&D claim has been lodged and "paid". It is recommended that the practice of payments to associates on an accruals basis be continued, but new requirements be introduced. These requirements could include a mandatory and formal loan agreement, a prohibition to forgive or write-off a debt or else the R&D claw back provisions will apply, a belated claw back provision of any R&D benefit which could apply for a stipulated period, e.g., for 5 years after the R&D claim has been lodged.

7. Administrative Decisions

Issue:
It is a positive step to provide support for the scheme's efficient and effective administration and more particularly in the issuing of rulings, guidelines, etc. There has been a problem for a considerable period of time that due to manpower restrictions obtaining such rulings in the past has been a very slow process. It is one thing to espouse administrative changes to the scheme and the issuing of far more guidance material, but it is another thing having the manpower and the resources and experience to issue them in a timely manner.

Recommendation:
We strongly support the intention to issue far more guidance, guidelines, rulings etc., but we have reservations whether this can be done in a timely manner, given our past experience and the experience and manpower levels required. We note that there is an overall intention to reduce the cost of the scheme, but we would recommend that this is not done at the expense of reducing the level of competent officers.

8. Additionality and Spillovers Test

Issue:
Many aspects of the current and proposed R&D scheme have very subjective tests applied in determining eligibility. We see that the new additionality and spillover tests as being even more subjective in assessment than the concepts for example of "high technical risk" or "innovation". We appreciate that the Consultation paper is merely a brief summation of the proposed scheme and as a consequence these new terms were not explained in more detail.

There are a number of examples in the paper where the Government has areas of concern with the current scheme. It is from one point of view that these concerns have arisen because of defective or outdated law and rulings, but it is just as arguable that they have arisen as a result of the degree of subjectivity in interpreting some of the eligibility terms. We believe that similar problems are likely to arise in the new scheme in interpreting and satisfying the new tests surrounding the terms "additionality" and "spillover".

Recommendation:
There should be more than just a generic statement about the terms "additionality" and "spillover" in future guidelines, law etc. Furthermore, attempts to define them should not be made by reference to one or a series of simplistic examples. It is recommended that these terms be clearly defined, because based on the brief commentary in the Consultation paper of them it will only lead to more disputes concerning their interpretation, since they are very subjective terms.

9. Eligibility: High Technical Risk (HTR) AND Innovation

Issue:
As you would be aware, there was discussion on introducing this eligibility rule requiring R&D projects to contain both HTR and innovation some years ago. There were valid reasons put forward at that time why this would severely impact on the number and therefore value of R&D claims. It is difficult to place a figure on the impact of needing to satisfy both HTR and innovation, but based on claims that our firm has prepared it will probably eliminate around 70% to 75% of all claims. If additional tests of additionality and spillovers is also applied, then this number will only increase further.

We can see from the Consultation paper that there is a need to reduce the cost of the scheme and still remain within budget and therefore there is a need to somehow curtail the value of current claims. We do not agree that this is necessarily best achieved by tightening the eligibility so much that only a relatively small number of claims will be eligible. We believe that it is far more practicable to place monetary limits on either individual claims or the scheme in total, which is very similar to what has applied for many years in the area of Export Market Development Grants (EMDG). We see that this may not give total confidence to R&D claimants to know what benefit they may receive, but at least if they know there is an upper limit they can make business and investment decisions with prior knowledge.

Recommendation:
We recommend that the current either/or eligibility definition relating to HTR and innovation be maintained. We further recommend that claim limits be imposed to ensure the R&D scheme meets budgetary constraints. These claim limits can be announced in advance each year when the budget is being formulated. There will need to be a further consideration how this may apply to those entities that have substituted accounting periods.

10. Identifying Core and Supporting Expenditure

Issue:
The need to identify and separately cost core and supporting R&D activities and its related expenditure will add another level of complexity in the completion of an R&D application. There will be instances where the termination of an activity and its related expenditure could be very subjective in assessment. This determination of course will be on a self-assessing basis and clear guidelines will need to establish what activity and expenditure are considered to fall within each of them. It may not be as simple as providing a list of activities, because of the nature of an R&D project and what is performed. This additional requirement to separate expenditure will increase the time and cost in preparing R&D claims, possibly to the stage of being prohibitive to claimants.

Recommendation:
Clear guidelines will need to be issued for claimants to self-assess what activities and therefore expenditure is considered to be core and supporting. It could be misleading to try and explain this by way of examples, because in one project what is considered to be a supporting activity may very well be a core activity in another project.

11. Separating Core and Supporting Expenditure

Issue:
We can see under Principle 7 in the Consultation paper that there needs to be a reduction in the expenditure claims for supporting R&D. We can also see that there are some 5 or possibly more treatments of this expenditure. We believe that there are positive and negative aspects to all 5 treatments. It is not possible in this brief submission to outline all of the positives and negatives under each treatment, but we believe the most efficient method would be to cap the R&D as a proportion of core R&D expenditure.

It is very difficult to estimate what amount of total (current) R&D expenditure would meet the definition of being core and therefore estimate the value of the capped R&D, at whatever percentage is ultimately determined.

Recommendation:
As stated above, we recommend that a cap be applied to supporting R&D expenditure. It is very difficult to set a percentage, but 100% of the core R&D expenditure would appear to be reasonable.

12. Contributions to Co-operative Research Centres (CRCs)

Issue:
You may be aware that there are a considerable number of industry research bodies within Australia and most of these can be found at www.crc.gov.au. These CRCs rely heavily on contributions from the corporate sector and more specifically businesses that operate within each of the respective relevant

industries. It is well established that these bodies perform very valuable R&D, not only for their contributors, but also for their relevant industry and the country.

Traditionally, contributions made to CRCs automatically qualified as eligible R&D expenditure. This raises three questions about this type of expenditure in the future scheme from the donor's perspective.

The first issue is whether activities performed by a CRC satisfy all of the "new" definitions of eligible R&D, including all of the new tests. The subsequent implication is that if their activities do not satisfy the new test then contributions to CRCs would no longer qualify as eligible R&D expenditure.

The second issue is whether the contribution made to the CRC is only for supporting activities. This will be very difficult to determine, as CRCs generally do not advise what a contribution directly funds within its operations. This raises the question whether such contributions are for core or supporting activities conducted by the CRC, with the expected different treatment of core and supporting expenditure (see points 10 and 11).

Finally, assuming that contributions to CRCs are eligible for the R&D tax credit, then it raises the point whether this is core or supporting expenditure from the donor's perspective. We will assume that one of the 5 proposed treatments of supporting activities contained within Principle 7 is adopted.

Recommendations:
We strongly recommend that activities performed by CRCs be accepted as satisfying the new definition of eligible R&D activities. We further recommend that contributions made to such bodies be regarded or deemed to be core activity expenditure and full credit entitlements should be claimable.

Furthermore, we acknowledge the most important work performed by these bodies and their reliance on contributions from large corporate sponsors. In order to encourage these sponsors to maintain their financial assistance, we recommend that amounts given by large companies (above $20M turnover) where they are in tax loss qualify for a refund of the R&D tax credit for such expenditure. We are aware that some of the major sponsors to CRCs are in tax loss and to lose the benefit for funding vital CRC R&D projects could be jeopardised.

13. Software Claims

Issue:
There seems to be little doubt that an area of major concern under the "old" R&D scheme related to software based claims. This is especially shown in Example 3 in the Consultation paper. Apart from the additional multiple sale test, it is arguable that software based claims can be the most subjective to assess when matched against the various eligibility criteria. It is our experience that software claims comprise a significant number of the total claims, both in quantity and amount.

It is also fair to say that the legislation and rulings surrounding movements and advancements in this area of technology have not kept pace with technology. This may also be a message to ensure that any new legislation does not fall into this same trap. New legislation may reflect current technology, but what is likely to occur in the future may not, and as a consequence the same (to become outdated) law will not keep pace with future changes in technology.

The New Zealand experience with software claims may prove the easiest model to adopt. In that case, the multiple sale test did not apply, nor did internal software development, but a cap on software claims was set, along with grouping provisions. The definition of software subject to this cap does not apply:

- where it is permanently embodied in goods, i.e. it becomes firmware; or
- where it is developed clearly for sale, lease, licence etc. to multiple non-associated users.

Based on our experience, we believe that the New Zealand cap that was set for software expenditure claims of NZ$3M is probably too low in the Australian context and something approaching A$5M is more appropriate.

The other major issue surrounding software projects is in matching the activities performed against the various eligibility criteria and definitions. These matching processes we believe relies too heavily on a subjective assessment and firmly believe more objectivity needs to be included in assessing whether software development satisfies the R&D eligibility definitions.

We have considered the comments made at paragraphs 76 and 77 of the Consultation paper and believe that whilst they may be relevant now, using these potential criteria will soon become outdated in much the same way as the old law has for current software claims.

Recommendation:
We agree that the multiple sale concept is no longer valid and also that determination of eligibility for software claims presents real problems both for claimants and the administering authorities. Furthermore, we do not believe that in defining different types of software activities as contained in paragraphs 76 and 77 will meet the needs of determining eligibility for future claims.

Our experience has shown that the New Zealand model has proved successful, in that it incorporates an element of objectivity i.e., places an expenditure cap on software development expenditure, except where excluded. Software claims, like all other claims, will need to satisfy the basic eligibility criteria and far more specific guidelines will need to be provided for claimants to assess eligibility.

Our recommendation then is that software claims are capped, unless they meet one of the two exclusion criteria and this be set at $5M. We further recommend that defining eligible software projects based on current developments and activities in the industry will not assist in the future and the problems currently encountered with these types of claims will only occur again.

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We have tried to present our issues and recommendations as briefly as possible to at least give you some insight into our thinking on the above issues regarding the new law. It is not possible to explore every issue and explain it in detail, but if you believe any of the matters that we have raised warrant further explanation, then we are more than happy to meet with you or conduct phone conference(s) to expand on our comments.

Thank you for this opportunity to make this submission to you.

Yours sincerely

John Walden
Director