M SQUARED

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

Email: rdtaxcredit@treasury.gov.au

Dear Sir/Madam

Comment on the Consultation Paper for the new Research and Development Tax Incentive

M Squared & Associates Pty Ltd are a firm of accountants who regularly assist a variety of clients who operate in a number of fields to access the current R & D Tax Concession and R & D Tax Offset. For the 2007/ 08 financial year, we lodged in excess of 40 R & D Tax Concession registrations with AusIndustry, and anticipate lodging more than 50 registration claims for the 2008/09 financial year, hence we believe we have a keen interest in the proposed changes to the legislation pertaining to the proposed R & D tax incentive. We would like to take this opportunity to thank you for the ability to comment on the proposed changes to the R&D tax incentive scheme.

We strongly feel that some of the options outlined in the Consultation Paper will directly affect the ongoing research and development prospects and opportunities available to our clients and as such we provide the following comments on the principles and questions covered in your draft position:

Principle 1: Location of IP Ownership

We believe that the legislation should be drafted with a view to the long term benefits to Australia of undertaking R & D, and as such the location of the IP Ownership should remain tied to Australia. We are of the opinion that having the location of the ownership of the IP anywhere other than closely linked to Australia, results in only relatively short-term benefits to Australia, principally in the form of financial and knowledge gains arising from the R&D activities undertaken for the duration of the project. However, we believe that once a project is completed and the IP moves elsewhere, any royalties for the project will gravitate to the owner of the IP which is not in the long-term interests of Australia.

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

Agreed

Principle 3: The Refundable R & D Tax Credit will be available to companies with a turnover of less than $20 million at a rate of 45 per cent of eligible R & D expenditure.

Agreed

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

Agreed – one practical aspect that we believe needs attention is the interaction between the government agency reviewing and issuing registration numbers and the Australian Taxation Office who are tasked with the lodgement of the income tax returns. Currently, a taxpayer claimant has up to 10 months following their financial year end to register activities as R & D activities and thus make them eligible R & D activities. However, it is frequently the case that the Australian Taxation Office requires lodgement of the claimant's income tax return within that 10 month period. One response to this tension is to lodge a tax return without any R & D claim to accommodate the ATO lodgement requirement, and then seek an amendment to that return, once the R & D registration process is completed, however we believe this practice is highly inefficient. We would like to see a legislated period pertaining to the registration process and for this period to be accepted by the ATO when administering their lodgement program.

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

We agree with this principle to the extent it applies on an economy-wide basis. We believe that to apply this principle at an individual client basis would result in considerable confusion because it notionally requires a claimant to determine what would have ordinarily been undertaken, and then form a view as to what additionality may have occurred. Similarly, at the taxpayer level, one of the reasons for undertaking any R & D is the creation of new intellectual property with a view to deriving value from that new IP. That value usually arises by establishing and maintaining a monopoly right for a period of time (i.e. via a patent) which is counter to the creation of spillover benefits to be shared by other firms and the community. However, where the principle is viewed at an economy level, a view can be tested that the tax incentive results in additional R & D being undertaken and economy-wide spillover benefits are arising.

Principle 6: Eligible R & D activity will be defined as systematic, investigative and experimental that involves both innovation and high levels of technical risk and is for the purpose of producing new knowledge or improvements.

We believe that the requirement for eligibility that requires an activity achieve 6 different criteria (systematic, investigative, experimental, innovative, risky, and for the purpose of new knowledge or improvements) in order to be classed as R & D, will narrow the incentive scheme excessively and make it exceedingly difficult to access.

That is, we believe that a number of activities will be one "or" the other, but not "and", and the proposed legislative change will result in lost benefits to our R&D projects as a whole.

We would also like to see the testing done on a "project" basis not an activity basis. That is, we believe that the time is appropriate to formally incorporate the concept of a Project into the R & D landscape. A Project could be defined as a series of activities that are undertaken in a systematic, investigative and experimental manner. The Project itself could then involve aspects of both technical risk as well as innovation, with individual activities being either technically challenging or innovative. For example, an activity constituted by the completion of a testing program, within the context of an over-arching Project, may be technically risky, but is unlikely to be innovative. Similarly, an activity within a Project may contain a sufficiently appreciable element of novelty, but not be seen as technically risky. In both these instances, under the proposed legislation, both would fail the test propounded by Principle 6, however, both may be undertaken at differing stages of a single R & D Project, this is both innovative and contains high levels of technical risk. It is the undertaking of the Project, by an Australian company, that is what the tax incentive scheme should be seeking to support.

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

We believe that supporting R & D is an essential and fundamental component of any successful R & D project or activity, without which, the core R & D could not have been completed. We acknowledge that frequently the measurement and quantification of supporting R & D can be problematic and feel that the adoption of a prescriptive ratio or calculation regime will be counter-productive to the success of the scheme. Our preferred alternative is to require a claimant demonstrate the nexus between the incidence of an expense and the particular R & D activity being undertaken – this is identical to what is commonly required of a taxpayer in order to access a tax deduction for an expense and see no reason for not applying that principle to supporting R & D expenditure. We have elaborated more on this matter in question 4, below.

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

We believe that the requirement for R & D activities to be conducted in Australia will have a dramatic effect on the engineering, drilling and mining industries and the like, as it is not always possible to readily attain persons within Australia who have the skill required, or to locate the availability of specialised equipment, for some of the highly specialised R&D activities. Also a number of industries develop products for specific/different nations, and the ability to be able to test in environmental and climatic conditions specific to the different regions is imperative to the commercial success of our R&D projects. For example, it is very difficult to field test novel instrumentation designed for the Alaskan oilfields, anywhere other than the Alaskan oilfields.

In this regard we believe a better test would be one that ignored where the R&D activities were conducted, but required that the activities be directed, controlled and paid for directly from Australia. This test better reflects the underlying rationale for government support for R & D, as the increase in intellectual capital and associated technical transfer arising from and through the R & D activities, still come home to Australia, where the R & D that is undertaken, is undertaken at the direction and control of an Australian company. Furthermore, under this test, there would not be any requirement to pre-register overseas R&D activities, thus simplifying the incentive scheme.

Question 2: How should the new R&D Tax incentive treat R&D expenditure that is currently deductible at 100%?

We believe that the proposed new legislation in relation to R&D expenditure, covering core technology needs to be made clearer.

Given that core technology represents a genuine cash outflow and is just as an essential component of R & D projects and activities as core R & D expenditure, it is our view that such core technology that is inextricably linked with an R & D project or activity, should be fully deductible in the year of acquisition, giving rise to a 40% or 45% Tax Credit as part of the proposed provisions. Conversely, subsequent disposal of core technology should be on the revenue account.

Adoption of this opinion would remove the current layers of complexity surrounding core technology and more fully accord with the commercial reality, that sometimes it is more efficient to acquire an item of intellectual property, than to devote time and resources, 're-inventing the wheel'.

We believe that in relation to interest this should remain 100% deductible and be able to be included within the 40% or 45% Tax Credit calculation.

We believe the current format pertaining to feedstock to be horribly complex, and feel that the feedstock provisions should ultimately be scrapped, and feedstock should be claimable as per normal core R&D expenditure.

Question 3: Should payments made to associate entities only be eligible for the new R&D tax incentive where they are paid in cash?

We believe that bringing in a 'cash' requirement, where all else is prepared on an 'accruals' basis would be a retrograde step that would make accounting in this area horribly complex. Firstly, we question whether the number, or the value, of related party / associate transactions within the R & D arena are sufficiently large to warrant a discrete provision. Should the number or value of such transactions warrant it, we would suggest the introduction of a minor anti-avoidance provision requiring the discharge of the related party / associate debt within the time period allowed for registration following the end of the financial year (currently 10 months). In that way, a transaction entered into in June, of a tax year ended in June, may be accrued pursuant to normal concepts, but is only claimable under the new R & D provisions provided it is discharged within the 10 month R & D registration period.

Question 4: What should happen to supporting activities?

From our exposure to different industries, we can state that the ratio between direct and indirect expenditure on R & D is subject to considerable variation. It is our experience that supporting activities are just as important as core activities to our research and development projects. Broadly, we estimate that for every $1 of core (directly related) R&D expenditure, at least another $3 of expenditure is incurred indirectly, without which, it is exceedingly unlikely that the R & D projects and activities could be been undertaken, let alone be undertaken successfully.

From our own perspective, we believe a minimum 3:1 cap at the same rate as core expenditure is required to reflect the reality of undertaking R & D in our organisation, however acknowledge that this ratio may not be typical of other organisations or industries.

However, one alternative not listed, but, we believe, worthy of consideration, is not placing any limit or creating any differentiating treatment for supporting activities, other than a requirement to demonstrate the nexus between the incidence of the expenditure and the undertaking of a particular activity – in this case termed 'carrying on research and development'. This particular treatment would then mirror many of the other tax provisions that require taxpayers to identify the relationship between an item of expenditure and an activity constituted by the derivation of income – see section 8-1 of the *Income Tax Assessment Act 1997* that grants deductibility only to the extent that losses or outgoings that are incurred in gaining or producing assessable income ....It is a common feature of tax legislation to require such an examination of the linkage between the purpose of incurring that expenditure and a taxpayer activity and would have the effect of making the R & D provisions easier to understand and administer by tax professionals within industry as well as within the regulatory organisations. It would also reflect reality, in that some expenditure items, in certain circumstances, would be justifiably regarded as too remote from the R & D activities, whilst in other circumstances, they would be justifiably regarded as being quite closely related to R & D activities and therefore capable of being considered as eligible supporting activities, or even core activities. Adoption of this position would remove the need for differentiating between core and supporting R & D activities, because what a claimant would need to do, is demonstrate how certain expenditure related to an R & D project, with the government regulator / judiciary, testing, evaluating and commenting on the proximity (or degree of remoteness) of the linkage.

With regard to the other opinions raised in the consultation paper, we believe that:

- The sole purpose test would result in considerable disputation between industry and the ATO, on a wholly in / wholly out basis;

- Similarly, the exclusion of production activities or dual role activities will result in demarcation disputes over the purpose or nature of undertaking the activity in question;
- The net expenditure basis would be problematic as it would start to bring the whole of R&D expenditure into question;
- Attracting a lower rate of assistance would also be problematic as classification as core versus supporting would be subject to considerable disputation between industry and the ATO.

Question 5: Should the current list of activities excluded from being considered core R&D be amended or extended to exclude certain activities from being considered supporting activities

In our view, the list of proscribed activities should be removed in entirety. The basis of this opinion is our suggestion that supporting activities be viewed in the context of their association with the conduct of the taxpayer's research and development. On this basis, any activity undertaken by a taxpayer could be potentially included within an R & D claim, subject to the taxpayer being able to demonstrate a suitably clear and distinct nexus between the undertaking of the activity and the research and development project or activities, with the onus on the taxpayer to demonstrate the relevant degree of association. We believe adoption of this position is warranted on the grounds of simplicity and would lead to a more efficient administration of the tax incentive scheme. It would also more closely mirror the general provisions and assumptions that commonly underpin most aspects of Australian taxation legislation.

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

We believe that software R & D should be treated no differently from any other type of R & D. That is, there should be a requirement placed on the claimant to demonstrate that what is being undertaken constitutes R & D (using the standard legislative provisions), and similarly there should be a requirement placed on the claimant to demonstrate any expenditure claimed, has the necessary connection to the activities that are classed as eligible R & D activities. To do otherwise, creates a level of complexity that we believe is unwarranted and will result in disputation as to whether an activity or project is in or out of the tax incentive, based on prescriptive legislation that may not adapt at the same speed software development is progressing.

We hope you find the above comments beneficial to your proposed approach forward with the new R&D Tax Incentives legislation. Should you wish to discuss any of these further, please do not hesitate to contact me via email (craig.miller@m-2.com.au) or telephone on (08) 6380 7800.

Thank you for your consideration in this matter.

Yours sincerely

Craig Miller
Director