TCF SERVICES PTY LTD

Submission to the Treasury in response to the New Research & Development Tax Incentive Consultation Paper – October 2009

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A – Background to TCF Services Pty Ltd & Declaration of Interest

TCF Services Pty Ltd welcomes the opportunity to provide comments on the new research and development tax incentive consultation paper. The comments below reflect both a thorough reading of the consultation paper itself, as well as our attendance at public consultation hearings held in Sydney.

TCF Services Pty Ltd is Australia's largest private deliverer of advisory and technical support services to firms participating in the Textile, Clothing & Footwear (TCF) Strategic Investment Program (SIP), and the Automotive Competitiveness Incentive scheme (ACIS).

We have been involved in the delivery of Australian Government industry assistance programs for these two industries for over 20 years, beginning with the imposition of tariff-based Quantitative Import Restrictions (ie: Quotas), the creation of the TCF Import Credits Scheme (an export incentive) in 1991, and the latter introduction of the post-2000 & 2005 TCF&L and ACIS automotive assistance packages.

As part of its delivery of SIP and ACIS advisory services, TCF Services staff are regularly required to deal with complex investment expenditure proposals by firms in relation to new capital equipment and the employment of supporting tools such as software, business expertise, process methodologies, warehousing and logistics.

In the main, the majority of these activities are driven by research and development (R&D) efforts related to firm-based innovation aimed at yielding a flow of new products and services to underpin long-term corporate viability and sustainment. As a result, TCF Services maintains a strong interest and involvement in debate over new measures to assist economy-wide innovation and new product development.

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B – New R&D Tax Incentive Policy Development

TCF Services notes the new R&D Tax Incentive Consultation (RTIC) paper's statement of government intent to move to a tax credit structure in regards to ongoing support for research and development (R&D) in Australia that is consistent with the recommendations of the National Innovation Strategy (NIS) review.

Further, access under the new program to the proposed 45% 'refundable' R&D tax credit is to be focused on Australian incorporated firms with grouped turnover of less than $20 million. Similarly, firms with grouped turnover in excess of $20 million, are proposed to be eligible for the 40% 'standard' (non-refundable) R&D tax credit.

We further note the new RTIC paper's introduction of new R&D tax incentive concepts not canvassed in the Government's original 2009/10 Budget announcements, as well as acknowledgement the consultation paper does not cover every detail that stakeholders may be interested in.

- **TCF Services looks forward to release of the Exposure draft legislation for further analysis and comment later in the year, and hopes adequate time will be afforded to stakeholders to review the document and provide additional commentary.**

C – The Case for Reform – Observations & Response

TCF Services notes the new RTIC paper's statement of Government policy intent – 'to achieve an effective R&D tax incentive that results in firms conducting R&D that they would otherwise not perform, because they cannot capture sufficient benefits from the activity to justify the investment'.

Whilst recognition of the need for ongoing government support to address market failure in the generation of innovation outcomes is welcome, the RTIC paper nevertheless goes on to advise that establishment of the new R&D tax incentive can only be funded by:

- Abolishing the current scheme - thus requiring new legislation with the practical effect of expunging the whole knowledge base and body of accumulated legal precedent relating to the administration of Federal Government support for innovation in Australia;

- Tightening eligibility – in terms of the promulgation of a new 'dual test' to govern access to the R&D tax incentive which industry will have to expend scarce time and money coming to grips with, all within the context of the RTIC paper's forewarning of a coming rationing of government innovation support for a wide range of industry players; and

- A requirement for the new scheme to be revenue neutral over its first four years of operation – corresponding exactly with a period when Australian industry needs to boost its innovative effort in response to falling tariff levels, a rapidly appreciated local currency, and a raft of previously not experienced (in contemporary history) commercial challenges courtesy of the global financial crisis (GFC).

Concomitant with the above concerns, the new RTIC paper goes on to canvass an unprecedented massive compliance burden increase in the form of requiring applicants to split claims into 'core' R&D and 'supporting' R&D categories, whilst at the same time proclaiming government intent is being satisfied in terms of delivering a "more streamlined" R&D tax credit from 1 July 2010.

In short, the Treasury's proposals outlined in the RTIC paper, if fully implemented, run the risk of an even more complicated program rising out of the ashes of the existing IR&D tax concession scheme, whilst also likely having the effect of severely curtailing R&D support in Australia at a most inopportune time – when industrial activities and basic manufacturing are facing a raft of domestic and international challenges arising from the GFC and shift to economy-wide 'climate friendly' activities.

TCF Services disturbingly notes a lack of innovation on the Government's part in developing the new R&D tax incentive, in terms of its all too ready willingness to fall back on traditional guidance documents - such as the Frascati Manual – in framing principles for the new R&D tax incentive, without acknowledging the generic guidance provided by such documents has been substantially amended by lead global industrial nations when developing their own R&D incentive schemes.

Further, we note an all too ready willingness has been displayed by government in drawing upon the rules and regulations adopted by leading global industrial nations for drafting essential details of the new R&D tax incentive, without sufficient recognition being given to the substantial differences in the width and depth of Australia's industrial structure – and hence, opportunity to advance innovation - compared with countries such as the USA and the United Kingdom.

In short, appropriate recognition of the above influences, would point to a requirement for domestic policy development that went out of its way to ensure proposals for a new R&D tax incentive were struck on the back of an intimate acceptance of the limitations of the local industrial environment, and thus demand real innovation in the development of policy responses – not an all too apparent readiness to fall back on international conventions to justify a tightening of R&D eligibility in the absence of hard data to support more informed policy options in relation to the worthiness of providing government assistance for 'core', as against 'supporting' R&D activities.

- **In the responses outlined below, TCF Services has not attempted to address in detail all RTIC paper sections, as much of the document can be taken as read when compared to the long history of government assistance for the conduct of R&D activity in Australia.**

D – R&D to be conducted in Australia

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

The provisions contained within the current IR&D Scheme - that no more than 10% of R&D project expenditure should relate to overseas activities that cannot be conducted domestically (along with the approval requirement) - should be based on total R&D expenditure.

Through being able to claim the 10% across all projects, this approach will ensure continued encouragement for accumulating development of the Australian skills base from frequent exposure to international collaboration.

TCF Services also proposes that a higher (or no) limit be applied when the research is conducted though an internationally recognised NGO, University or Government research body, given such overseas activity requires pre-approval (in terms of the formation of an agreed position) on the overseas entity's eligibility.

- **TCF Services agrees that the emphasis in the new R&D tax incentive should be changed from the ownership of IP, to "on own behalf" rules as currently framed.**

E – Non-enhanced deductions

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

Given Government policy intent to reduce R&D tax incentive complexity – but confusion on how companies derive benefits from tax deductions included in the R&D system - we see merit in having non-enhanced deductions excluded entirely, if such treatment is limited to those items currently treated in this manner.

Deductions could then be progressed under normal tax rules, with the exception that rules on 'core technology' be retained for small- to medium-sized enterprises (SMEs) to encourage faster development paths from their R&D investment activities.

While many of these items are also treated as part of Business Expenditure on Research & Development (BERD), we believe determination of the BERD calculation should remain the responsibility of the Australian Bureau of Statistics (ABS) and its data collection principles to calculate overall IR&D expenditure, with AusIndustry only helping to facilitate the process through its role in extending the availability of R&D registration.

F – Payments to Associates

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

TCF Services believes this proposal will introduce an unnecessary level of complexity and inequity into the new R&D tax incentive, with separate rules and requirements for additional record keeping acting to compound the existing burden of claim compilation, as well as raising accounting issues in terms of the determination of timing for what amounts to being a compliance management issue.

In our experience, it is often the case that where an associate company's experienced and qualified employees or assets/facilities are required to support R&D development activity that the principal entity does not posses, these are charged at 'arms length' as they are incurred, and thus recorded in the accounts under accrual accounting principles, where appropriate. As the debt is incurred, it becomes a legal liability of the principal entity.

Examples of this inequity would include: 1) Where the payment is made in the next period (according to the agreed terms of exchange between the two entities), this would see the supporting company treated unfairly due to its association, compared with using services provided by a non associate; and 2), in circumstances where the principal company has an accrued debt to the associate, there is also an offsetting creditor amount.

At times, these offsets – that is, between related entities - are treated in the accounts by way of group/inter-company loans, etc without any cash payments. In the same manner, this approach is also likely to be detrimental to start-up SMEs that are cash poor, and make use of related company loans as a means of securing injections of working capital.

TCF Services' experience with large numbers of government grant applications where a distinction is made between an incurred amount, and a paid amount, has ultimately manifested itself in a huge burden of tracking all elements of the payments chain - through to bank statements recording cheque presentation dates – in the absence of being able to rely on the applicant firm's own internal accounting systems.

- **To ensure integrity issues are properly addressed in the new R&D tax incentive, TCF Services believes consideration should be given to requiring that outstanding debt accumulated from R&D claimed expenses to a related company aged more than six months after the close of the financial year, must be accounted for by way of a binding loan agreement.**

- **Such an approach will reduce the compliance burden inherent in reliance upon cash based management of the claim, and will give the same effect to a practice the proposed change intends to target - encouraging a climate where the associate company makes a cash injection by way of a loan to prepay the outstanding debt.**

G – Administration

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

In response to paragraph 47, TCF Services supports the proposal to require companies to distinguish between 'core' and 'supporting' R&D to ultimately enable a greater understanding by all parties of where particular R&D expenditures are incurred. We also support the use of this information to underpin the development of suitable metrics to help gauge future program development.

- **TCF accordingly welcomes the development and dissemination of more extensive guidance material in the new R&D tax incentive than has been the case with previous schemes, including the preparation of instructive industry-specific (ie: mines & airports) 'example' sets to help guide firms in developing their R&D programs.**

H – Eligible R&D Activity

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.

While TCF Services accepts the concept of 'additionality' may be applied to assessing the worthiness of broad-based business incentives, we submit that organisation's committing to the undertaking of an R&D project exhibit a prima facie commitment to self-creating the required "something new and different", when compared to their peers.

- **The recognition of such commitment should accordingly be viewed as sufficient to satisfy the intent of Principle 5, and hence, the requirement upon applicants to substantiate addition metrics represents an unnecessary administrative burden.**

As a means of satisfying Government intent to substantiate 'spillover' effects, TCF Services believes the new R&D tax incentive should make provision for the definition of what a 'project' is, with an accompanying explanation of the aims it seeks to achieve.

Also, it is important that if the change sought through the nominated R&D activity is ultimately not achieved, the provisions of the new R&D tax incentive still recognise that substantive R&D effort has taken place.

- **TCF Services considers the RTIC paper's push for proof of the benefits of R&D activity being large relative to the associated subsidy, is very subjective, and impractical in its application when applied to intangible outcomes.**

I – What is R&D?

The term 'project' is not defined in the current IR&D legislation or guidelines, with the accepted definition more commonly being drawn from ISO 1006-2003, itself a guide to general project management. Further, it is important to note the UK approach adopts the 'whole of project' concept in determining R&D boundaries, as per:

> "A project consists of a number of activities conducted to a method or plans in order to achieve an advance in science or technology. It is important to get the boundaries of the project correct. It should encompass all the activities that collectively serve to resolve the scientific or technological uncertainty associated with achieving the advance, so it could include a number of different sub-projects. A project may itself be part of a larger commercial project, but that does not make the parts of the commercial project that do not address scientific or technological uncertainty into R&D."

- **TCF Services would welcome the introduction of such an approach as outlined above into the new R&D tax incentive, with appropriate supporting guidelines to ensure a higher level of integrity can be assured in determining the extent of the subject project's claim.**

- **In satisfaction of the policy intent to provide more predictable, less complex support to business, TCF Services would submit there was a need for documentation supporting the new R&D tax incentive to more clearly provide a hierarchy of boundaries in relation to project inclusions (especially those known to have been contested in previous IR&D programs), as a means of making the new program easier to work with.**

J – Core R&D

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

(a) involves both innovation and high levels of technical risk; and
(b) is for the purpose of producing new knowledge or improvements.

While the United Kingdom and the United States make use of a 'core' activity definition as extracted from the Frascarti Manual, we submit consideration in determining the scope of eligible R&D activity for the new R&D tax incentive should be given to gauging the substantive differences in the width and depth of the Australian economy when compared to that of two of the world's largest industrial technology generators and manufactured product developers and exporters.

TCF Services' investigations have revealed the nature of grants paid on R&D expenditures differ somewhat between the two industrial leaders, with the United Kingdom adopting the Frascati-based Intramural Expenditures on R&D approach. For each industrial sector, this includes current costs (labour, materials, supplies, and equipment) and capital expenditures.

The latter inclusion is not a feature of the Australian IR&D support system, nor is their attitude to the payment of all R&D expenditure incurred overseas. The United States model could fairly be interpreted to include spending that leads to 'new or improved' products or processes, but without explicit 'novelty'. Progressing down the path of changing the definition of R&D will not thus automatically harmonise the view of Australian BERD, without an accompanying change to the same expenditure base as used by others.

Both countries also target their incentives "without borders on expenditure" to encourage multinational companies to conduct R&D within their home country. Hence, the tighter definition applied to companies with a high turnover and the ability to allocate funds to R&D intensive projects. Such features are not a part of the Australian industrial environment, which is instead dominated by the "small end of town", as noted by the Department of Innovation (formerly DITR) publication – 'Behavioural Additionality of Business R&D Grant Programs in Australia' (2005). According to this publication:

> "Overall, business expenditure on R&D lags that of our international competitors on a sectoral or global basis. There are a range of factors contributing to this situation. These include:
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> • Australian industry is dominated by small, less R&D-intensive companies. In 2004-05, approximately 82 per cent of registrations for the tax concession were from the SME sector - i.e. firms with up to 100 employees (this is up from about 72% in 1999-2000);"
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> **ALSO**
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> "Despite these impediments to the Australian innovative system, it should be pointed out that limitations can sometimes be turned to advantages. In the case of Australia, 'small' can mean 'quick moving'. Australian innovative businesses can succeed by moving quickly to bring innovative products to market and then aggressively seeking international partners who can market the products effectively. The Board is continuing to explore ways of accelerating this trend."

Another feature in the United Kingdom R&D incentives system concerns the higher level of certainty provided to applicants through the promulgation of regulations that prescribe - in greater detail than the supporting legislation - what activities that are, or are not, R&D for tax incentive eligibility purposes. Such administrative approaches are much more substantive than the approach taken in current Australian IR&D legislation and guidelines

While debate over proposals to advance a change of criteria is proposed in the RTIC paper as an attempt to address issues over the adjudication of "marginal or questionable" claims, the baseline approach brings with it potential to have severe negative effects on SMEs. TCF Services' experience within the SIP & ACIS programs is that upon the introduction of new criteria, a substantive period of uncertainty results.

This manifests itself in AusIndusty initially applying the new interpretation too conscientiously and thus denying practically compliant claims, whilst companies with projects of high merit end up too harshly questioning their validity (thus jeopardising their continuity), when assessed in response to uninformed interpretations of usually vague guidelines. At the end of the day, this denies worthy projects being properly advanced, while having no impact on curbing companies that pursue "aggressive claims". They will always continue to do so.

- **TCF Services is concerned that while comparisons are drawn in the RTIC paper from the UK's approach in defining 'core' R&D, a different outcome to that presented in the discussion paper is evident from reviewing the fiscal outcome. In 2006/07, nearly 6,600 claims were made totaling £670m. We submit this is comparable to the current Australian experience when exchange rates are taken into account.**

- **Yet, the result is for a country that has a GPD two and a half times greater than Australia, with an R&D credit scheme that offers higher benefit (125% for large firms, and 150% for SMEs with a turnover of less than €50m). The application of the 'dual' test in the new R&D tax incentive thus risks an Australian contraction of R&D of the same order, that is, two and a half times. Government should therefore be cautious about proceeding with the stated intent to impose the concept of 'dual' test eligibility.**

K – Supporting R&D

TCF Services notes Principle 7 - Supporting R&D will continue to be recognised under the new R&D tax incentive, but claims will be subject to new limitations.

Question 4 - Should supporting activities:
(a) be capped as a proportion of expenditure on core R&D?
(i) If so, what would be the appropriate proportion (for example, 1:1)?
(b) only be eligible where they are for the sole purpose of supporting core R&D activity?
(c) exclude production activities or dual role activities?
(d) only be eligible on a net expenditure basis?
(e) attract a lower rate of assistance than core R&D?
(i) If so, what would be the appropriate rate be?

TCF Services does not favourably regard any of the above options. Instead, we would propose a hybrid approach to treating eligible apportionable overhead expenses whereby the current system - which is complex and dependant on the ability to alter the method to achieve a greater outcome - is replaced with an approach used by many other assistance programs, including the TCF-SIP and ACIS programs.

In short, their approach is to fix an administration percentage for application to salaries, in order to ameliorate the risk to revenue under this part of the claim value. Rates could be set at say, 50% for Direct/Core R&D staff, and at a lower rate - say, 25% - for direct support staff costs. Other eligible expenses that could be directly identified to fall within R&D boundaries of the project (and are consumed or purchased/commissioned for this purpose) would also be eligible, such as consumables parts & materials, energy, sub-contract expense, testing expense and similar expenses not specified in the list of R&D exclusions.

- **In regard to Options (a), (d) & e – TCF Services notes there is no extant data source that provides transparency as to the relative breakdown of costs associated with 'core' and 'support' activities. As such, any 'gut feel'-based resort to 'capping' may have unknown (and undesirable) effects, ultimately leading to a large reduction in the benefit, thus jeopardising the attractiveness of on-going R&D activity in Australia and defeating Government policy intent.**

- **For Options (b) & (c) – as the Government portends to be wanting to extend an incentive for companies to improve their products & processes with new innovative offerings and practices, these approaches would disadvantage both those new to introducing R&D activities, and to SMEs, as they do not have the capacity to resource a 'sole purpose role' or provide separate and dedicated resources. Over time, however, it could reasonably be expected they would accumulate such resources through being encouraged to participate in the new R&D tax credit incentive. Further, the exclusion of production activities would need to be carefully defined so as not to exclude development work that has to be trialed on production equipment, to test or prove a theory.**

- **Although TCF Services sees some merit in Option (d), it in turn raises its own difficulties. For example, while an item of feedstock is readily identifiable and any consequential recoupment easily accounted for, when applied to all R&D or Support activities, the implementation of the Option would add a substantial level of complexity in the calculation of claims, as well as compliance assessments. We are thus unable to see how the suggested option could be effectively applied in the new R&D tax incentive.**

L – Excluded activities

Question 5 - Should the current list of activities excluded from being considered core R&D be:
(a) amended in any way?
(b) extended to include certain activities from being considered supporting activities?

TCF Services considers that proposing a new R&D tax incentive, a serious effort should be taken by Government to review the current list of excluded activities, and update it for changes in contemporary industrial processes, as well as make amendments to ensure clarity moving forward.

- **In short, this means Government taking action – reflective of stated policy intent – to make it clearer by way of the Exclusions list what types of activities are preferred over those said in the RTIC paper as now viewed as representing "lower value-add claims."**

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