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General Manager
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Dear Sir/Madam

Submission to The Treasury
"The new research and development tax incentive" Consultation Paper

We are pleased to provide our submission in response to The Treasury's ("Treasury") Consultation Paper on "The new research and development tax incentive" ("the Consultation Paper").

We understand that Treasury is seeking feedback and comments on the principles and questions outlined in the Consultation Paper in relation to reform of the existing Research and Development ("R&D") tax concession program, and we appreciate the opportunity to contribute input on the Government's proposed approach for the new R&D tax incentive.

General Comments

Following our detailed review of the Consultation Paper, we understand that the case for R&D reform can be summarised as follows:

- The creation of an R&D tax incentive that is more targeted in support, particularly to those activities which would not otherwise be performed;
- The new R&D tax incentive should redistribute support to small and medium sized businesses (SMEs);
- The creation of a less complex and more predictable R&D tax credit system; and
- Narrowing the definition of R&D activities to exclude activities which are not in the public interest and which are of questionable merit.

Based on our analysis of the principles and conceptual options outlined in the Consultation Paper, we are sceptical as to whether the objectives of case reform will be achieved on the whole. We acknowledge that some initiatives and principles offer much needed change which is welcome, however other principles are arguably at odds with the objectives for R&D reform.

A detailed discussion relating to our findings and comments on the proposed principles and questions raised in the Consultation Paper is provided below.

Discussion

Principle 1

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

We agree with the concept of expanding the R&D tax incentive program to Australian companies undertaking R&D in Australia where resulting intellectual property ("IP") may ultimately be owned by organisations outside of Australia. We are aware that a New Zealand based company is considering the establishment of an R&D centre in Australia, as a result of New Zealand's repeal of its R&D tax credit/concession incentive.

We believe this principle has the potential to attract foreign investment for Australian R&D activities, particularly where R&D tax incentives in foreign jurisdictions may not be as attractive. Based on our research, there are a number of foreign R&D tax incentive programs which offer R&D tax incentives to companies on the same basis as what is proposed under Principle 1. It follows then that this initiative places Australia in a more competitive position globally for attracting foreign investment.

This initiative will also facilitate the dissemination of R&D knowledge and expertise.

Grouping rules

The Consultation Paper proposes that grouping rules in existence under the current R&D tax concession program will be the same under the new R&D tax incentive program. Whilst we believe the grouping rules are reasonable in the context of 'controlled' related entities, we believe the new R&D tax incentive program may benefit from clearer guidelines on the 'affiliate' relationships which are considered under the grouping rules.

Tax exempt entities

The proposal to expand access to the refundable R&D tax credit to include companies with up to 50 per cent ownership by tax exempt entities is a positive initiative, which will ensure that many R&D start-up companies with tax exempt investment will not be compromised under the new regime.

Many organisations are in joint venture R&D arrangements with Universities, and this proposed reform will ensure that Australia retains a competitive edge in regards to the quality of R&D activities on a global basis.

Question 1

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

In our opinion, a proposal to restrict R&D activity attracting R&D tax incentives under the new regime to only those activities that are conducted in Australia has the potential to severely compromise the quality of R&D projects conducted by Australian companies. In certain circumstances, this proposal would be unreasonable, particularly where the required R&D activity could not be performed in Australia.

The current rules relating to overseas R&D activities are already overly restrictive in that only 10% of claimed R&D expenditure for Australian based R&D activities is eligible for concessional treatment. In situations where the R&D activity in question cannot be performed in Australia due to a lack of expertise or resources, it is necessary for companies to utilise foreign service providers to ensure that the scope and objective of the project are not compromised. It is unreasonable to penalise companies by not providing for concessional treatment for these activities, which are only conducted overseas out of necessity.

Whilst we understand that a range of government incentives aim to support activities which provide for national benefit in terms of employment opportunities and the like, where the required level of expertise cannot be provided in Australia, exception should be made for companies to seek foreign assistance.

Furthermore, R&D tax incentives with regards to R&D activities necessarily conducted overseas should not be restricted by an expenditure cap. Assistance provided as part of the new R&D tax incentive should be uniform in the nature and level of benefits that it offers to different types of R&D expenditure, regardless of the *necessary* location of R&D activities.

A further point which should be considered in the context of Principle 1 is that the seeking of expert R&D services overseas may be beneficial long term in that:

- Information and findings resulting from the overseas R&D activity is knowledge that could be disseminated in Australia, thereby adding to our local knowledge-base; and

- Where there is a consistent pattern of companies seeking overseas R&D services for a particular R&D activity, it may be the case that a local services provider will consider the level of demand for the service in question sufficient to warrant the development of that service line locally.

Our recommendation would be to continue to allow overseas R&D activities to be considered for concessional treatment under the new R&D tax incentive program, where companies could demonstrate that the service could not be provided within Australia. In addition, we would recommend lifting the current expenditure cap to allow all legitimate overseas R&D expenditure to be claimable under the new R&D tax incentive.

Of course this recommendation would require the development of an acceptable means for companies to demonstrate that the service could not be provided locally, and in this situation we would recommend a system similar to that employed by applicants under the *Enhanced Project Bylaw Scheme* (where it is required to demonstrate the inability of local industry to supply certain goods).

Finally, we recommend the abolishment of the existing requirement for companies to obtain a provisional certificate in respect of overseas R&D activities. In our experience, the process for making an application for a provisional certificate for overseas R&D activities is overly burdensome on claimant companies, for what is mostly insufficient reward based on the current 10% limitation.

Principle 2

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

Principle 3

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

We believe that the 'standard R&D tax credit' and 'refundable R&D tax credit' initiatives, and the proposed carry forward treatment where a company has no tax liability, are positive proposals for reform for R&D tax incentives.

Many R&D companies require funding at each stage of the research, development and commercialisation phases of an R&D project. It would therefore be inequitable and defeat the purpose of encouraging R&D activities in Australia if R&D tax credits were to be subject to the 'same business' or 'continuity of ownership' tests.

Question 2

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

The Consultation Paper discusses two possible approaches for R&D expenditure currently attracting 'non-enhanced' deductions of 100%, such as interest, residual feedstock expenditure, core technology amounts and expenditure that is not 'at risk'. These include:

1. allowing all eligible companies (accessing the 'standard R&D tax credit' or 'refundable R&D tax credit') to access a non-refundable tax credit on these expenditure items at the prevailing company tax rate; or

2. excluding these expenditure items from benefit under the new R&D tax incentive program and leaving these items to be deducted under the normal tax provisions.

Whilst we acknowledge that expansion of the benefits available under the new R&D tax incentive program will require limitations being imposed on elements of the existing R&D tax concession program, we would question whether there would be significant gain to be realised in the adoption of either of the above proposed approaches.

Based on our experience, expenditure items such as interest, residual feedstock expenditure and core technology amounts do not represent a significant proportion of many R&D claims. In addition, claimable core technology amounts are already limited based on levels of other "R&D expenditure".

Furthermore, we find that many core technology acquisitions are sourced from overseas, and are therefore largely ineligible based on the current R&D tax concession program.

Accordingly, our opinion is such that removing access to the R&D tax incentive for these items, or removing the ability to 'cash out' benefits in respect of these items, may not provide significant savings in funding under the new program.

If Treasury determined it was necessary for reform with regards to these expenditure items, we would suggest possibly limiting the reform to 'residual feedstock expenditure' on the basis that:

1. this expenditure item is arguably more common, and of a larger value than interest expenditure and core technology amounts; and

2. presumably companies will be receiving some cash benefit associated with this expenditure item anyway by way of sales proceeds (or possible future sales proceeds) in respect of outputs produced as part of related R&D activities.

Expenditure 'not at risk'

With regards to the proposed approaches for non-enhanced deductions in respect of expenditure items which are considered 'not at risk', we consider our comments above applicable to this item also based on the limited application of the 'not at risk' provisions as outlined in section 73CA of the *Income Tax Assessment Act 1936*.

We understand that the scope of application of the section 73CA provisions was considered in consultation in 2008, and is the subject of a draft public ruling which has not been released. Without knowing the progress of the Commissioner's view with regards to expenditure 'not at risk' (as would be outlined in this draft ruling), it is difficult to add further comment on the proposed approaches for treatment of this type of expenditure.

In the event that expenditure items which are considered 'not at risk' received further clarification in the proposed draft legislation for the new R&D tax incentive program, then further comment could be provided on Treasury's proposed treatment of this item under the new regime.

Clawback Expenditure

We note that the Consultation Paper does not discuss expenditure subject to clawback under the existing section 73C of the *Income Tax Assessment Act 1936*, which also attracts a 'non-enhanced' deduction under the current R&D tax concession program. Clawed back expenditure amounts are also able to be 'cashed out' under the existing R&D tax offset provisions.

In the event that Treasury considered that clawed back expenditure would be subject to limited deductibility or not qualify for a refundable R&D tax credit, then we would argue that the proposed approaches would compromise the claims of relevant companies on the basis that:

1. many companies subject to the clawback provisions are small and medium sized enterprises (SMEs) in receipt of government grant funding for R&D activities. These companies have a need for grant funding in order for the project to proceed (this is a common merit criteria for government R&D grant funding programs); and

2. limiting the ability of these SME companies to access R&D tax incentives (refundable and otherwise) could significantly compromise the claims of these companies, and would not be consistent with one of the objectives of R&D reform, being to "redistribute support in favour of small and medium sized businesses…" (paragraph 10 of the Consultation Paper).

Question 3

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

The Consultation Paper highlights an issue with the operation of the existing R&D tax offset in which companies incurring non-cash expenditure in respect of supplies made by associates can access cash refunds, whilst the taxable receipts associated with these supplies may not be reported for some years.

To address this issue, it is proposed that government could mandate that expenditure to associates can only be claimed where paid in cash. An alternative proposal that is suggested by the Consultation Paper is for the amount to be claimed in a later period when paid, with claimant companies having the option of making an election to forgo the R&D tax incentive and then claiming the amount upfront in accordance with normal tax rules.

The Consultation Paper also provides that integrity rules will still apply to ensure that such expenditures are genuinely incurred.

Our initial thought with regards to the commentary on this issue is that the mismatch of amounts refunded in respect of non-cash expenditure items, and amounts not being brought to account as revenue by an associate supplier in the same income period (ie. not brought to account until received), would only be an issue where the supplier brings the income to account on a cash basis.

This is not the case in 100% of cases, yet the proposed options would penalise 100% of cases (through inability to claim at all or deductibility only under normal tax rules) where non-cash expenditure was incurred in respect of R&D supplies made by an associate.

It seems unreasonable that the SME (ie. those with turnover of less than $2 million per annum) should be receiving *more* 'support' under the new R&D tax incentive program, is being penalised for non-cash expenditure. Meanwhile, the government would be potentially benefitting from situations where the supply by the associate would be brought to account as an income item on the accruals basis, where tax is paid in the year in which the supply was provided.

Secondly, if integrity rules will still apply, then concern by government should only be with regards to the timing of the non-cash expense and corresponding receipt. If the expense item is 'genuine', then would it not be more supportive of government to bear the costs associated with the 'mismatch' of the expenditure item and taxable receipt, rather than the SME for which the R&D tax incentive program is intended to assist?

Perhaps an alternative that may be considered by Treasury in this situation, would be to impose a time limit on the debt associated with the expenditure to the associate, which could be supported by an agreement between the two parties.

Principle 4

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

We support the Consultation Paper's proposal for more appropriate levels of guidance and certainty with regards to R&D tax incentive claims, particularly in areas which are currently lacking under the current R&D tax concession regime.

Furthermore, we would also recognise the benefit in having areas of the proposed R&D tax incentive program examined in more detail under the public rulings system, as was the case under the R&D tax concession program until recent times.

Distinguishing between 'core' and 'supporting' R&D activities

We note that the new R&D tax incentive will require companies to distinguish between 'core' and 'supporting' R&D activities, and that the new legislation and further guidance to be issued by the administrators (Innovation Australia and the Australian Taxation Office), will provide for more appropriate guidance material in this area.

With regards to distinguishing between 'core' and 'supporting' R&D activities, we would encourage the administrators to provide guidelines which consider that the scope of, and distinction between 'core' or 'supporting' activities can vary from one industry to another. Obviously, the differentiation between 'core' and 'supporting' activities becomes critical depending on how (or if), Treasury decides to limit the scope or claimability of 'supporting' activities (as proposed in Principle 7 and Question 4).

Based on the existing guidelines for what constitutes 'core' R&D activities as opposed to 'supporting' R&D activities (refer to Part B, sections 3.1.3 and 3.1.4 of the existing *Guide to the R&D Tax Concession*), it seems that the definition of 'core' R&D activities could be overly narrower than what it should be. As a result, the ability to claim legitimate R&D activities under a new R&D tax incentive could be significantly compromised.

Section 3.1.3 of the *Guide to the R&D Tax Concession* ("the Guide") provides that the following points should be considered in determining whether activities are 'core' R&D activities or "systematic, investigative and experimental activities" ("SIE activities"):

- the activities should have the attributes or character of systematic, investigative and experimental activities;
- important to establish that 'experimental' activities have been undertaken;
- evidence should be able to be produced which indicates that the activities were experimental, and that tests were undertaken to discover something unknown, to test a hypothesis or discover something previously unknown;
- companies should be able to provide documentary or physical evidence of the experimental activities, including records of hypothesis and outcomes and evaluation of the experiments.

What could be interpreted from existing guidelines in relation to 'core' R&D activities, is that they are the 'experimental' activities or 'experimental' process associated with an R&D project. In the event that we were required to distinguish between 'core' and 'supporting' R&D activities under existing guidelines, one could conclude that all activities which constitute the 'experimental process' would be 'core' R&D activities.

'Supporting' R&D activities or "directly related activities" are described in section 73B(1) of the *Income Tax Assessment Act 1936* to include "other activities which have been undertaken for a purpose which is directly related to the carrying on of SIE activities".

Section 3.1.4 of the Guide includes a number of examples of activities that are likely to be considered 'directly related activities', such as literature searches, preliminary investigatory work, development of software to be used in experimentation, etc. Two specific examples of particular interest in this list include:

- "design and construction of apparatus used directly for experiments, such as pilot plant"; and

- "design, construction and operation of prototypes used in experiments".

These activities are critical to the 'experimental' process, and arguably part of the experimentation conducted as part of an overall R&D project. Furthermore, if the subject of the R&D activity is the development of a fully-functional 'prototype' (in the case of a custom equipment manufacturer), fully-functional pilot scale plant *or* production scale plant, which are novel and innovative, then arguably these activities are more appropriately considered 'core' R&D activities as opposed to 'supporting' R&D activities as provided in the Guide.

On this basis, given that the distinction between 'core' and 'supporting' R&D activities could have a significant impact on the level of claims under the new R&D tax incentive program, we would recommend reform to the definition of 'core' and 'supporting' R&D activities to ensure that these terms accurately reflect what *is* the 'experimentation' activity ('core'), as opposed to what is a necessary activity for the experimentation activity to be performed ('supporting').

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.

With regards to Principle 5 regarding the concept of 'additionality and spillovers', it is perhaps important to firstly highlight the confusion with regards to whether this is a 'test' as described in paragraph 48 of the Consultation Paper, or a 'principle' as identified in paragraph 49 of the Consultation Paper.

Discussion in the Consultation meeting seemed to identify the concept as more of a 'principle' rather than a 'test'. Regardless of how it is ultimately described, what was evident from observation of the questions and feedback in that Consultation meeting, and from feedback from our clients, is that the concept is confusing and potentially difficult to demonstrate in reality.

The principle is also one which may be difficult to measure, and therefore difficulties arise in determining whether a claimant's R&D activities will qualify for the new R&D tax incentive.

In reviewing the Consultation Paper's case for R&D reform at paragraph 12, we also consider the statement that "an effective R&D tax incentive needs to result in firms conducting R&D that they would otherwise not perform because they cannot capture sufficient benefits from the activity to justify an investment".

To some extent, we are of the opinion that this principle conflicts with another intention of the reform as outlined at paragraph 10 of the Consultation Paper – being to "intentionally redistribute support in favour of small and medium sized businesses…".

If the new R&D tax incentive program is targeting support for SMEs, we are unsure how a requirement to satisfy the 'additionality and spillovers' principle will facilitate this. SMEs do not necessarily have surplus funds to carry on R&D activities that would otherwise not be performed. An example might be a situation where a start up company produces a simplified early version of a novel new product, for the purpose of generating a revenue stream to finance the R&D program required for further necessary development of the novel product.

A further point to consider with regards to the 'additionality and spillovers' principle, is that with the absence of any meaningful generic R&D grant funding programs (such as the historical 'Commercial Ready' program), it is unrealistic to expect SMEs to utilise limited funds for uncertain, technically-risky R&D activities, such as those R&D activities which are "in addition to what otherwise would have occurred" in a development sense, given the nature of a company's operations.

Principle 6

Eligible R&D activity will be deemed 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 understand from the Consultation Paper, that Treasury's proposal to require that SIE or ('core') R&D activities involve both innovation **and** high levels of technical risk will create an R&D tax incentive regime which is more consistent with the *Frascati Manual 2002* ("the Frascati Manual"), and the criteria employed by other countries. However, it has the potential to prohibit any substantial increases in Australia's overall 'Business Expenditure on R&D' ("BERD").

In results released by the Australian Bureau of Statistics ("ABS") for the 2007/08 financial year, Australia's BERD is reported as 1.27% of 'Gross Domestic Product' ("GDP"). Whilst this BERD/GDP ratio represents growth of some 15% from the 2006/07 financial year, which could be argued is somewhat attributable to a 'booming' economic environment for the same period, it is still below the 'Organisation for Economic Co-operation and Development' ("OECD") country average of 1.59% for the same period.

It is interesting to note that the United Kingdom, which according to the Consultation Paper adopts a narrower approach in defining R&D activities, has a lesser BERD/GDP ratio than Australia at just 1.15%. With proposed changes to requirements for SIE activities as well as other limitations proposed by the Consultation Paper, it is entirely possible that Australia's BERD/GDP ratio could actually decrease.

Relative to other countries, Australia's existing R&D tax concession program is relatively generous. Although R&D tax credit rates will increase under the proposed R&D tax incentive, there will be less companies/activities qualifying for claim due to the proposed changes regarding SIE activities and other R&D reforms.

Based on the commentary in the Consultation Paper, it would seem that Treasury is likely to adopt the proposed reform that SIE activities involve both innovation and high levels of technical risk. In turn, this change is likely to have the desired effect of 'narrowing' the scope and value of activities being claimed as R&D, therefore providing funding to support the expansion of the new R&D tax incentive program in other areas.

On this basis, we would recommend is that Treasury consider the impact of this change on Australian BERD, and relax some of the other limitations proposed elsewhere in the Consultation Paper, particularly those proposed for 'SIE' and 'supporting' R&D activities.

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.

'Supporting' R&D activities play an important role in the R&D process and we agree that these activities should continue to be recognised under the new R&D tax incentive program.

We acknowledge that Treasury intends to limit the amount of ‘supporting’ R&D activities claimed by eligible R&D claimants based on:

- the size of claims in respect of ‘supporting’ activity expenditure relative to ‘core’ R&D expenditure; and
- given the requirement to create additional R&D funding to be available for expanded areas of the new R&D tax incentive program.

However, we would question the limitations proposed for ‘supporting’ activities, which are discussed below.

In addition, in determining the type of limitation to be introduced in respect of ‘supporting’ R&D activities, we would also expect Treasury to have regard for the need to more realistically define what constitutes ‘supporting’ R&D activities as opposed to ‘core’ R&D activities for particular industries. Further reform to the definition of these activities and proposed new guidelines may create different boundaries for each activity type, which in turn should influence any proposed ‘supporting’ activity limitation methodology.

Question 4

Should supporting activities:

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

  (i) If so, what would be the appropriate proportion (for example 1:1)?

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

(c) exclude production activities or dual role activities?

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

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

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

4.1 Should supporting activities be capped as a proportion of expenditure on core R&D?

The level of supporting activities expenditure that is incurred by R&D claimants as a proportion of core R&D expenditure can vary significantly from industry to industry, and from project to project. We do not believe there is a general ‘rule-of-thumb’ that can be applied as a ratio to determine what would be an acceptable level of supporting activity expenditure.

Based on our experience with claims for supporting activities in particular industries, a proposed ratio of 1:1 in respect supporting activity expenditure to core activity expenditure is unrealistic in terms of the level of supporting activity expenditure.

In addition, it is unreasonable to limit the amount of supporting activity expenditure that can be claimed, when supporting activities represent a legitimate part of the R&D process, which should receive support by way of incentive. The Frascati Manual also discusses the concept of some R&D activities being “borderline between R&D and other industrial activities”, but does not propose limitations in terms of the level of costs associated with these activities that should be included as part of an R&D claim.

For these reasons, we are of the view that this proposed supporting activity limitation technique is unreasonable.

4.2 Sole purpose test

Adjusting the current definition of supporting R&D activities from:

- "other activities that are carried on for a purpose directly related to the carrying on of [core activities];

  to

- "other activities that are carried on for the sole purpose of supporting the carrying on of [core activities]";

also unnecessarily penalises claimant companies for undertaking supporting R&D activities which may also serve some other commercial or non-commercial purpose. For example, a supporting activity associated with gathering information or material for analysis as part of a program of R&D activities, may also provide information which may be stored and utilised for marketing purposes at a later date.

In this scenario it would be unfair to restrict access to incentives for supporting R&D activities simply due to the fact that the information provided by these activities could also be utilised for a non-R&D purpose at the end of the R&D program.

We would recommend that a more reasonable approach would be to:

- require that claimant companies pro-rate expenditure for supporting R&D activities according to the extent to which they are involved in the R&D program (where R&D is not the sole purpose); or

- pro-rate expenditure on the basis of the percentage of information produced by the supporting activity being attributable to the R&D activity, as opposed to a non-R&D activity.

4.3 Excluding production activities or dual role activities

For similar reasons to those discussed above at 4.2, we believe that the total exclusion of supporting activities on the basis that they have some other role in addition to a part in the R&D process is unreasonable, as it can still be argued that to some extent these activities are a necessary part of the R&D process.

Following on from 4.2 above, we believe that dual purpose supporting activities should be apportioned between R&D and non-R&D, possibly using a similar concept as that applied in administration overhead apportionment exercises.

With regards to production type supporting activities, the existing feedstock provisions are triggered in certain situations to limit the amounts claimed by companies where saleable outputs are produced. We believe this concept is adequate in its operation to restrict claims in respect of dual purpose activities (including production) for the most part, however, may warrant further review.

4.4 Net expenditure only or 'recoupment' approach

Based on the Consultation Paper's detail describing the proposed 'net expenditure only' method for limiting the claimability of supporting activities, it would seem that Treasury is seeking to expand operation of the existing feedstock-type provisions to encompass a broader range of activities including:

- Supporting activities where there is some recoupment from the claimant company – to be applied across all industry; and

- Supporting *and* core activities where there is some recoupment from the claimant company.

There are companies across a broad range of industries which are currently claiming R&D tax concessions in respect of R&D activities, which have the potential for significantly reduced claims on the basis of these proposed reforms to supporting activities.

Obviously it would be preferred if the existing treatment of supporting activities was retained to preserve the R&D claims of these companies. However if there was a more 'palatable' approach to restricting the level of supporting activities claimed, then this approach poses some merit on the basis that:

1. The R&D tax incentive support is still being offered to supporting activities without discrimination to activities or types of expenditure; and

2. A company's incentive is only reduced if the company receives additional reward by way of sales for any R&D output.

In the event that Treasury preferred this approach, we would recommend that sale proceeds (or potential sales value) be offset against only those inputs which have directly contributed to the resultant saleable R&D output (similar to operation of the existing feedstock provisions).

A further variation to the existing feedstock provisions that we believe results in a fairer approach or compromise for industry, may be to offset adjusted* sales proceeds (or saleable values) against product inputs. The variation would be that the sale/output amount to be offset is adjusted (reduced) by an amount which reflects a typical profit margin for the relevant industry. In this way, companies performing R&D activities which result in saleable end products can still be rewarded for levels of R&D expenditure on a net basis, without a reduction of R&D benefit in respect of standard profit margins (ie. some 'bonus' element is still retained from producing saleable output from R&D activities).

With regards to costs associated with the development of costly pilot plants or prototypes which are constructed for R&D and commercial purposes, the Frascati Manual suggests that only the 'additional costs due to the prototype nature of these products should be attributed to R&D' (paragraph 119).

The concept of only additional costs being attributable to R&D activity lends to the idea of claimant companies in relevant industries 'carving out' the R&D component associated with the project and prototype development.

This exercise would allow the companies to attract R&D tax incentives on the R&D components, similar to companies undertaking R&D where there is not saleable output produced from R&D activities. An exercise in measuring the R&D component may include comparing the activities and costs associated with the development of a commercial prototype, with other industry benchmark products which are produced in multiple volumes – for example it may be the case that R&D commercial prototypes are characterised by more design hours, construction hours and consumables used.

4.5 Lower rate of assistance for supporting activities

Application of a lower rate of assistance for supporting activities would provide for a simpler program for claimant companies than some of the hybrid methods above.

To minimise the impact of reforms to supporting activities on the claims of companies, perhaps the level of assistance afforded to supporting activities could remain at the equivalent of the existing 125% R&D tax concession deduction, ie. a non-refundable tax credit of 37.5%. In this way existing claimants that have historically claimed significant levels of supporting activities will not be severely impacted by the proposed reforms.

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?

With regards to the current list of activities excluded by from being considered core R&D activities, we do not believe the list warrants any inclusions of additional activities or exclusion of activities.

We do note however, that this exclusion list could be used as the mechanism to reduce R&D claims where it is the experience of the administrators that certain types of activities lead to claims in that may not be in the public interest, or may be of ‘questionable merit’.

Specific exclusion of targeted activities may more effectively ‘tighten’ claim eligibility and preserve funding, rather than the introduction of a magnitude of changes which cannot be uniformly applied on a fair and reasonable basis to industry as a whole.

Question 6

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

We agree with government and industry that the existing R&D provisions, as they relate to software development, are obsolete.

The first recommendation that we would suggest would be for the removal of the multiple sale/licence criteria, which at the moment can prevent genuine software R&D activity (which directly or indirectly has commercial exploitation potential) from being eligible for concessional treatment.

Secondly, we note that existing R&D activity definition presents difficulties with regards to software development projects. It is often difficult to determine when an eligible software development project begins and ends.

Whilst the United Kingdom system may provide some useful examples and guidelines as to those activities that constitute eligible software R&D, and those which do not, consideration should also be given to the relatively extensive list of examples provided by the Frascati Manual.

We also believe that further detailed comments should be sought from the Information Technology industry in this space, and that the guidelines with regards to eligible software development activities be reviewed and updated with some regularity to ensure that the list:

- Includes new areas for development with regards to software development activities; and
- Excludes those software development activities which have become less innovative and have lower levels of technical risk over time.

Conclusion

Having regard for the objectives for R&D tax reform as outlined in the Consultation Paper and earlier in this submission, we acknowledge that some of the principles and concepts raised in the Consultation Paper are likely to achieve their objective in:

- redistributing support for target companies, and genuine R&D activities beyond that which would otherwise occur (namely the introduction of the 45% refundable R&D tax credit for companies with a group turnover of less than $20 million);
- developing a new R&D tax incentive program which is less complex and provides for greater certainty for R&D claimants with regards to predictability of claims; and
- limiting the scope and value of R&D activities claimed by redefining the definition of R&D activities restricting the levels of R&D activity that can be claimed in certain areas.

However, our analysis of the proposals outlined in the Consultation Paper also leads us to conclude that many of the proposed changes will actually be detrimental for all R&D claimants (including the SMEs, which were the targets for reform), on the basis that:

- narrowing the scope of the definition of R&D activities to include innovation **and** high levels of technical risk will affect whole of industry not just larger corporate R&D claimants;
- the ‘additionality and spillovers’ principle will be difficult to demonstrate, and does the complete opposite of creating certainty or predictability with regards to company claims;
- the proposed exclusion of overseas R&D expenditure completely ignores the requirement for increased support in this area (where required services are not available locally), thereby compromising R&D activities and support for all claimants, including SMEs;
- requiring the distinction between ‘core’ and ‘supporting’ R&D activities will be a potentially difficult exercise, and will add to the administration burden associated with the program ;
- proposed methods to limit the value of ‘supporting R&D activities’ to be claimed will re-introduce complexity into the R&D tax incentive program; and
- the proposed ‘tightening’ and imposition of limitations of amounts/activities that can be claimed under the R&D tax incentive does little to foster an environment whereby Australia might significantly increase BERD above the OECD average.

We do not believe that a simplified uniform system can be created which will represent a fair and reasonable program for the whole of industry. We believe that the concepts and principles proposed in the Consultation Paper will need to be reviewed and adjusted to suit particular industry types, and with this a new level of complexity will enter the new R&D tax incentive program.

However, some level of complexity may be required to ensure that all claimants receive similar levels of benefit relative to the nature of activities undertaken, and the industry to which the claimant belongs.

We hope that you find our detailed comments and discussion helpful in your overall consideration of the proposed R&D tax incentive program (and elements of the historical R&D tax concession program), and would welcome the opportunity to discuss our comments and thoughts with you in more detail.

Should you have any queries in relation to the content of this submission, please contact Lisa Chamberlain on 08 9261 9507 or myself on 08 9261 9460.

Yours sincerely

Rami Brass
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