

Our Ref SD.nod
Contact Sarah Donovan



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Cardno Limited
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General Manager
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Dear Sir/Madam,

Phone: 61 7 3369 9822
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**RE: CARDNO LIMITED
SUBMISSION IN RESPONSE TO RESEARCH AND DEVELOPMENT
EXPOSURE DRAFT LEGISLATION**

www.cardno.com.au

Cardno Limited (Cardno) is pleased to have the opportunity to provide comments on the Research and Development (R&D) exposure draft legislation and associated Explanatory Memorandum (EM).

The R&D tax incentive has played a vital role at Cardno and has underpinned our company's world first innovation and ultimate growth to the internationally competitive multinational corporation it is today.

The Australian government has made a clear statement that it is seeking to:

- 1) target R&D that wouldn't have occurred in the absence of an incentive ("additionality");
- 2) target R&D more likely to result in spillovers (benefits beyond the R&D originally incentivised)

by:

- 1) increasing concessional rates, primarily in favour of SME's;
- 2) tightening the eligibility criteria for R&D tax incentives to maintain revenue neutrality; and
- 3) improving predictability and reducing complexity of the program.

Cardno supports the need for the R&D regime to better target those industries which will be incentivised to promote innovation in Australia. However, we believe that some of the proposed changes will not achieve the governments stated objective of incentivising innovation.

Cardno welcomes the opportunity to proactively engage with Treasury and the Government to demonstrate how the R&D benefit has been used to encourage the creation of knowledge and innovation within Cardno.

Cardno supports the need for change

Cardno supports the governments stated objective of making the R&D tax incentive more effective in delivering support for business while making the rules less complex and easier to apply.

We believe that the following changes contribute to the achievement of this objective while improving certainty for taxpayers.

- 1) The exposure draft includes a definitional change to "Core R&D activities" which must now involve considerable novelty AND high levels of technical risk.

While the "AND" test is not an unexpected change, including the "considerable" requirement, and effectively removing the well known, and understood requirement for "innovation" was not anticipated.

Although disappointing that the adoption of multiple limiting measures was not considered during consultation, through the provision of adequate guidance Cardno is willing to support this measure.

To achieve certainty would require the government to provide a more concise explanation of the "considerable" concept for without it the requirement creates a level of subjectivity which removes certainty for taxpayers;

- 2) Cardno supports the elimination of the open ended amendment review period by the ATO, with the rules now proposing a 4 year limitation which is in line with the broader tax legislation; and
- 3) Cardno supports the provision of eligibility review process and program guidance by Innovation Australia to ensure certainty for taxpayers around their R&D claim.

Changes which do not Incentivise Innovation

Cardno believes the changes identified below, defeat the governments stated policy intent of:

- 1) **Additionality** – the consultation paper released in September 2009 states 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" (emphasis added).
- 2) **Targeting spillovers** – the EM states that "the definition of R&D that is eligible for the tax incentive centres around the activities that are most likely to produce spillover benefits that, in the absence of the incentive, might not go ahead because of the technical uncertainty" (emphasis added).
- 3) **Increased predictability and reduced complexity** – the Government has stated their intent is for the benefit to be a more generous but targeted benefits to companies, and ultimately, more predicable for those companies that make a claim.

1. Augmented Feedstock Rules

The governments stated objective is to provide a tax incentive which results in firms conducting R&D that they would otherwise not because the Government believes there is no public support for R&D which would have been undertaken anyway.

Additionality

At the heart of the changes is the government stated objective to provide an incentive that will give rise to firms conducting R&D that they would otherwise not undertake (ie. additionality), because it believes this will result in greater "spillover" benefits to the community.

The rules do not achieve the stated policy objective for the following reasons:

- It is counter intuitive to expect “additional” activity to arise from the incentive when a taxpayer is unable to predict what the incentive will be with certainty, so is therefore unlikely to undertake R&D they otherwise wouldn’t have done.
- Certainty is the key to achieving additionality and therefore spillovers, however the rules in their current form are complex to apply and ultimately require a taxpayer to fail at an R&D activity (that is, incur a loss) before a claim can be made.
- The concept of additionality is impossible to measure and therefore legislate. By withdrawing the incentive for R&D that wouldn’t otherwise be done, it effectively withdraws the incentive for R&D that would be done because it removes any certainty for the taxpayers with regards to the availability or otherwise of the incentive.
- The rules remove all certainty for Cardno on the basis that it will no longer be practical to make an R&D claim until such time as a “failure” is encountered.
- Cardno would never undertake an activity with a plan to fail. A regime as proposed would not incentivise Cardno to undertake R&D they otherwise wouldn’t undertake because the best outcome from an R&D perspective would require them to fail.
- When Cardno makes an assessment to undertake a project they expect at the outset that some return will be derived in order to accept the project, not just to mitigate financial risk to a breakeven point. The absence of a predictable, easy to apply R&D regime, lowers the appetite for the acceptance of riskier, more ground breaking projects.
- The rules will reduce eligible claimants to those undertaking R&D in a non-commercial setting that is unlikely to be ultimately viable.
- For clarity, the practise of innovation and knowledge creation at Cardno is not about scientific experiments undertaken in a laboratory, rather it is about the practical application of novel solutions in a commercial, project driven environment.
- The Governments stated policy of this measure being revenue neutral will not come to pass as Cardno and a large number of other companies will be involved in less R&D therefore making less revenue and claiming a smaller tax concession from the R&D incentive.

Spillovers

Innovation is one of the ways companies seek to differentiate themselves from competitors. Cardno has many examples of projects where a competitive tender against foreign firms was won by Cardno because of IP developed during a previous eligible R&D project.

A significant spillover of the existing program which is impossible to measure and quantify is the culture of innovation and knowledge seeking which is fostered as a result of the R&D incentive. As a result of the support provided on previous R&D projects, project managers, engineers and scientist are encouraged to develop new and innovative methods, and to invest in a model or platform where the result is uncertain.

The history of R&D activities at Cardno has shown that the current regime is front of mind for our engineering teams and as such the incentive creates a willingness to build on current knowledge by accepting implicitly risky and innovative project.

Increased Complexity and reduced predictability

While there are “feedstock” rules in the existing law, these limitations apply predominantly to manufacturing and mining claims and work to limited concessional claims in respect to raw material inputs used in R&D trials. These rules have previously not applied to Cardno. However, the new augmented feedstock rules require the theoretical valuation of a project output, which then is used to offset against the cost of any activities deemed to be eligible R&D expenditure to reduce the claim.

These rules defeat the government’s objective of making the rules less complex and more predictable in their application. The increased complexity of the expanded feedstock rules present another barrier to claiming.

Is this the right answer?

The proposed new rules are designed to redistribute the incentive away from successful companies to companies that fail. This is because the government does not want to subsidise companies that recover the cost of R&D even though this in the end is revenue and therefore tax generating. With this approach, the government is effectively underwriting non-productive R&D.

But is it the right answer to only reward companies that fail at their R&D by redistributing the incentive away from successful companies that use the incentive to drive the next innovative project? What’s wrong with subsidising successful R&D if it drives more innovation?

This approach is short sighted because it fails to recognise the benefits that R&D has created for the next project and the revenues generated from the next project.

Cardno believes that removing the incentive does not achieve the policy intent of encouraging the company to undertake R&D they wouldn’t normally do. In fact the reverse happens because it lowers the risk appetite to take on “considerably” innovative projects.

Desired outcome: The current feedstock rules are effective in preventing unwarranted claims for feedstock. Cardno’s view is that the expanded feedstock rules should be removed from the draft law but supports the existing feedstock rules as an effective measure.

2. Exclusion of certain Software Development activities

Cardno believes the exclusions proposed in the law, in particular the exclusion of software development activities, does not support the government’s own stated policy objectives.

The rules have been amended such that software development can only be claimed where it is for the purpose of making a commercial return directly from the supply of that software (ie. a tightening of the existing “multiple sale criteria”).

The changes do not support the stated policy objective:

- Software is prevalent in engineering and the computer software exclusions will apply broadly such that the incentive for business to create innovation through technological solutions will be removed.
- In many cases, software development is so integrated with the R&D Cardno conducts, it would be very difficult to specifically exclude software development activities from the claim, adding another level of complexity to accessing the program.
- Such an outcome falls short of delivering the government’s objective of fostering innovation because it fails to recognise and support that investment in software R&D is increasingly critical to growing business knowledge, innovation, and service delivery.

- Removing the incentive to increase innovation and create knowledge through hi-tech technological solutions also ignores the large commercial benefits that can be gained from the exploitation of the software in the provision of specialist engineering solution.
- Cardno has many examples where it has taken advantage of the R&D incentive to develop a software platform or model for the purpose of improving the provision of client services. For example, software was developed to simplify an onsite construction process to deliver a faster design solution allowing Cardno to successfully tender over foreign competitors and also reduce construction costs.

Desired outcome: The current tightened definition of core and supporting activities is sufficient to see the types of software development the Government dislikes excluded. Any form of multiple sale criteria is out of date and not in line with how business is now conducted. Cardno's view is that there should be no specific exclusions on software development.

Conclusion

The rules will result in a greatly reduced stimulus for R&D in Australia from what is currently offered. This is contrary to the governments promised revenue neutral outcome for the revised tax incentive.

The changes have the potential to undermine the entire R&D regime. The policy in its current form does nothing to assist companies working in a commercial environment that are seeking successful R&D outcomes.

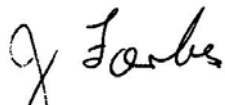
Cardno competes for projects against Australian and International firms around the world. In a number of instances the innovation which resulted from the R&D incentive was the differentiating feature which enabled Cardno to utilise its Australian based engineers and Australian owed intellectual property to be internationally competitive.

The proposed scheme will place Cardno and all Australian taxpayers at a competitive disadvantage in attracting R&D and will reduce its international competitiveness.

The rules will act as an incentive to only encourage companies to do R&D outside their normal operating environments, effectively rewarding failures that can only be determined after the fact.

Should you have any queries in relation to the above, please do not hesitate to contact our Group Tax Manager, Sarah Donovan on (07) 3139 2954.

Regards

A handwritten signature in black ink, appearing to read "Jeff Forbes".

Jeff Forbes
Public Officer
for **Cardno Limited**