



ASSOCIATION OF CONSULTING
ENGINEERS AUSTRALIA

TAX LAWS AMENDMENT (RESEARCH AND DEVELOPMENT) BILL 2010

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Exposure Draft and Explanatory Memorandum

ACEA SUBMISSION

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The Association of Consulting Engineers Australia (ACEA) is an industry body representing the business interests of firms providing engineering, technology and management consultancy services.

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ABOUT THE ACEA

The Association of Consulting Engineers Australia (ACEA) is an industry body representing the business interests of firms providing engineering, technology and management consultancy services to individual consumers in the community and major clients in the private sector and local, state and the Federal governments.

There are over 270 firms, from large multidisciplinary corporations to small niche practices, across a range of engineering fields represented by the ACEA with a total of over 50,000 employees.

The ACEA presents a unified voice for the industry and supports the profession by upholding a professional code of ethics and enhancing the commercial environment in which firms operate through strong representation and influential lobbying activities. The ACEA also supports members in all aspects of their business including risk management, contractual issues, professional indemnity insurance, occupational health and safety, procurement practices, workplace/industrial relations, client relations, marketing, education, sustainability and business development.

SUMMARY

The ACEA estimates that in 2008/09 there were some 17,000 firms in the consulting engineering industry, employing 130,000 people, generating revenues of around \$23.2 billion, and earning pre-tax profits of \$3.3 billion.

The twelve largest firms in the industry generated revenues of \$13.05 billion in 2008/09, up 23 per cent on the previous year.

The industry's contribution to gross domestic product in 2008/09 is estimated to have been \$12.9 billion, or 1 per cent of GDP: up from 0.75 per cent in 2001/02.

The ABS has reported (ABS 8104.0, September 2009) that in 2007–08 Australian businesses spent some \$14,400 million on research and development. The main fields of research were Engineering (\$7,921 million or 55%) and Information and computing sciences (\$3,678 million or 26%).

The main industry contributors to this research and development effort were Manufacturing (\$4,305 million or 30%), Mining (\$3,283 million or 23%) and Professional, scientific and technical services (\$2,230 million or 16%).

The industry group 'Professional, scientific and technical services' includes engineering consulting, which makes up the great bulk of the industry group.

Engineering skills are also a key element of job creation. In the transport sector for example, some 84 jobs are created and supported by one professional engineer's design and project management role.¹

It is clear therefore, that by both type of research and by industry; engineers make a major contribution to Australian business research and development.

The R&D Tax Concession has contributed to the industry's substantial growth in productivity. Australian consulting engineers are in high demand here in Australia (evidenced by the ongoing skills shortage) but also internationally, as their expertise and knowledge is highly sought after. It can be said that the Government's return on investment is high and that the gain in productivity and overall benefit to Australia far outweighs the cost of the scheme to Government.

The professional services provided by consulting engineering companies involve high levels of technical risk. There is a realistic possibility that the technical complexities associated with engineering and related disciplines could lead to project failure.

The ACEA welcomed the Australian Government's statements confirming the Government's intention to support research and development (R&D) in Australia. In the joint media release published by The Hon Wayne Swan MP and Senator The Hon Kim Carr on 12 May 2009 it was stated that,

"The Rudd Government will simplify and enhance the Research and Development (R&D) Tax Concession so that it provides better incentives and more support for Australian jobs in the face of the global recession.

The new R&D Tax Credit is the biggest reform to business innovation support for more than a decade. It will boost investment, support jobs and strengthen Australian companies so they can take full advantage of new opportunities as the economy recovers.

From 2010-11, the Government will replace the complex and outdated R&D Tax Concession with a simplified R&D Tax Credit which cuts red tape and provides a better incentive for business to invest in research and innovation."

Given these statements, it is disappointing to note that the Exposure Draft does not reflect the policy intentions contained therein.

The ACEA, which comprises small, medium and large consulting firms, is concerned that rather than cutting red tape and providing a better incentive for business to invest in research and innovation the proposed legislation will have the opposite effect. This is not a desirable outcome, particularly at a time when the economy is only in the early stages of recovery.

The ACEA asks that the following issues are addressed in the Exposure Draft before it is submitted to Parliament to better reflect the policy intention.

¹ Australian National Engineering Taskforce www.anet.org.au

EXPENDITURE NOT AT RISK AND AMENDMENTS TO FEEDSTOCK RULE

The 'expenditure not at risk' provisions are a change from the current 'guaranteed returns to investors' provisions. It is the ACEA's understanding that the impact of this change is that companies will not be eligible if, when the expenditure is incurred, the company received, or could reasonably have expected to receive, consideration as a direct or indirect result of the R&D expenditure where that consideration is equal to or greater than the expenditure, i.e. where the money received is greater than what is spent on R&D activities.

This provision will impact the majority of ACEA members. This is because the majority of R&D undertaken by a consulting engineer is within the framework of a contract. The contract that they enter into with their client will be, for example to provide an engineering design for a project. The contract is not for R&D, nor does the contract typically include consideration for any R&D undertaken by the consultant. Consulting engineers are innovators, and while the contract is consideration of applying traditional engineering methodologies, consultants will seek to exceed those expectations by undertaking R&D activities in order facilitate the optimum project outcome. It is 'self-incentive' that drives the innovation.

The ATO Interpretive Decision ATO ID 2009/09 is pertinent here. The Decision looks at whether a company is 'not at risk' if it can expect to recover its R&D because of the technical prospects of its activities rather than merely because of the terms of the relevant arrangement. The ACEA believes that the decision was sound and endorses the findings. The example given of a company engaged to provide a project for a fixed fee, and incurs R&D expenditure in order to meet its contractual obligations but does not receive consideration for it, is applicable to the consulting engineering industry (it would in fact be a fairly typical example of how the contractual relationship operates).

The potential impact of the change is that consulting firms will only be able to claim the loss that is made on projects that are fixed price contracts. If a loss is not made, no claim will be allowed.

This approach which works in concert with the new approach to the feedstock rules distorts the purpose of the R&D tax credit from an incentive to a compensation scheme. This appears at odds with the Object of the legislation, which is to benefit the wider Australian economy.

Economic benefit will flow when the R&D and the company is successful. Where a company makes a profit as a spillover from the R&D this has a net benefit to productivity. The resulting profit allows the company to invest in further R&D activities, staff training and recruitment and growth. The Government spending on R&D will soon be recovered through the increased productivity, which is evident in the performance of the consulting engineering industry.

This change will also greatly increase compliance costs and time. For example, if there is a R&D project that has originated as a result of a fixed price contract with a client and the project is not completed in year one, the company will have to lodge the project and claim an amount as being R&D expenditure, due to there being doubt that the project will be profitable. If the project is completed in the second year and it makes a profit, the company would have to amend the prior year's R&D Tax Concession Schedule, the company's income tax return and possibly the prior year's Application for Registration of R&D Activities document as well.

Additionally, a comparison between the revenue earned and the base salary amounts instead of a charge out rate may need to be done. This is not workable and goes against Government's policy objective, i.e. to decrease compliance burden.

Requested amendment:

The ATO Interpretive Decision ATO ID 2009/09 should be adopted in the legislation and the tax credit should be available irrespective of whether a profit or a loss is made where the company is bearing the financial risk of the project at the time the activities are undertaken.

EXCLUSION FOR ITC

The ACEA believes that the Government should not undervalue the role that ITC software innovation plays in enhancing productivity and our way of life and is very disappointed to see it excluded from eligibility. For example, in building and construction the introduction of Building Information Modelling (BIM) has allowed the creation and use of coordinated, consistent, computable information about a building project in design. The information is used for production of high-quality construction documents, predicting performance, cost estimating, construction planning, and, eventually, for managing and operating the facility. This has had substantial benefits for building design in Australia, which has direct benefit to the end users.

Requested amendment:

The exclusion for ITC be removed from the Exposure Draft before it is submitted to Parliament.

CONSIDERABLE NOVELTY

The Object of the Act states that the experimental activities must involve "considerable" novelty. The ACEA believes that this sets an unreasonably high bar and creates substantial uncertainty. The R&D is either novel or it is not, 'considerable novelty' is in effect meaningless until interpretations are given through the approval process. This approach will be very subjective and will result in important R&D activities falling outside the incentive.

Rather than providing, *"better incentives and more support for Australian jobs in the face of the global recession"*, which was the policy objective specified by the Ministers, it will have the opposite effect of simply reducing the number of eligible activities. This would indicate that the changes are in fact to reduce the Government's support for R&D in Australia.

Requested amendment:

Remove the reference to "considerable" novelty from the Objects of the Act before it is submitted to Parliament.

CASE STUDY

This case study involves an Australian based consulting engineering company. Initially specialising in civil infrastructure, the company has progressively widened its expert capabilities to also include irrigation, environmental planning and management, rural, urban and social development, training and capacity building.

The company's services have expanded too. They extend through all stages of the project including, pre-feasibility and feasibility studies, field investigations, laboratory testing, computer modelling, design, preparation of tender and contract documents, tender evaluation, contract management and construction supervision, quality assurance, commissioning, operation and maintenance, training and overall project management.

With nearly 40 years' experience, over 3,000 staff, and offices throughout Australia and in 25 cities around the world, this company has an international reputation for excellence and a proud record of achievement. It has completed thousands of projects and delivered a vast range of services across Australia and in more than 80 other countries.

The R&D tax concession has in part contributed to the company's growth. The R&D concession enables the business to invest in capabilities which can generate new ideas and in systems which enable it to retain, rejuvenate and redeploy intellectual property into new projects.

The company's Intellectual Property (IP) generates new and interesting opportunities which enables the business to retain professional staff and provide cutting edge, on the job training to graduate engineers embarking on their careers.

R&D is an integral part of this company's business; the R&D tax concession made available by the Australian Government allows new cost effective solutions to be developed for projects in Australia and allows the company to export world class Australian expertise internationally.

A number of interesting and innovative projects have been realised in part as a result of this incentive. A few examples are as follows:

- Major road projects, in which the company had to address a number of design challenges including the design of wall and crash barriers within stringent design and safety constraint. The design and construction of rigid elements such as seamless pavement contained high technical risk due to the softness of ground and modularity of construction elements.
- Advanced work on protecting concrete structures from 'concrete cancer'. The techniques developed would in future allow the company to build structures in areas not previously thought viable for large construction works.

Technologies developed by the company are marketed in many locations around the world and enhance its international reputation as a leader in the field of engineering. The successful commercialisation of these technologies also provides ongoing employment opportunities for Australian engineers.

The new R&D tax credit

Under the proposed legislation, we understand the Core R&D activities must meet four tests:

1. Experimental activities must be systematic and investigative
2. The activities must be conducted for the purpose of acquiring new knowledge
3. The activities must involve considerable novelty; and
4. The activities must involve high levels of technical risk.

Due to the nature of the research and development activities carried out by the company, the new 'compound definition' of Core R&D activities, which requires a combination of both 'considerable novelty' AND 'high levels of technical risk', will represent a substantial reduction in the type of activity which is eligible for the incentive. Due to the commercial considerations the company and other consulting engineers must consider in undertaking a project, this compound test will be exceedingly difficult to satisfy. The opportunity for commercial success is a significant factor to be considered in undertaking any project, and exceedingly high levels of technical risk and considerable novelty will impact the commercial viability of a project. Consequently, this test will be satisfied by only a limited number of activities.

The restriction of the concession in this manner appears to compromise the policy intent of the incentive, which was introduced to incentivise Australian businesses and encourage the development and commercialisation of new technologies for the benefit of the Australian economy.

The proposed changes to the definition of Core R&D activities will limit the availability of the concession to more risky and therefore potentially unsuccessful activities, which will not result in long term commercial benefits to the Australian economy.

The amendment of the concession in this manner cannot be supported by reference to any policy intent the concession was designed to achieve.

Conclusion

The proposed legislation represents a setback in encouraging successful private-sector research and development in Australia. Limiting the scope of eligible research and development activities to those with a high level of novelty and technical risk will result in the encouragement of activities with a lower chance of commercial success. The benefit to the Australian economy of an incentive designed to encourage only this type of investment in research and development must be questioned.

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