

Submission - Tax Laws Amendment (Research and Development) Bill 2010

1. We would disagree that the new R&D tax incentive represents a streamlined tax incentive as promised. The proposals are clunky and serve to penalise the very companies that are most likely to successfully undertake and commercialise R&D in favour of those that are less likely to do so.

Incentivising companies that are less likely to successfully complete or commercialise R&D is not in line with the desire to create spill over benefits.

The proposals can be expected to result in the start of a drop in the amount of successful R&D undertaken in Australia, which cannot be value for money for taxpayers.

2. Not only does the new R&D tax incentive not cut red tape it should increase it significantly thanks to the introduction of phrases like "considerable novelty", "dominant purpose", and "market value". Such phrases will no doubt bring with them for a period of time complexity, uncertainty and an increase in the cost of compliance.
3. The proposed new definition of R&D activities must be the most restrictive definition anywhere in the world. Logic suggests that the more restrictive the definition is the more exclusive it is in terms of eligible activities. All other things being equal, the new definition will likely cause the general level of R&D undertaken to decrease.

Core R&D activities are, by definition, experimental activities that, amongst other things, involve "considerable novelty" and "high levels of technical risk". It is accepted at paragraph 2.10 of the explanatory materials that core activities can be "more typically a set of related activities". The number of instances where a set of related activities will involve all of the terms in the definition will likely be significantly less than is currently the case.

4. Supporting activities are inextricably linked to the success of any program of R&D. To make companies establish whether every supporting activity is undertaken for the dominant purpose of supporting core R&D activities is too onerous in terms of the likely compliance burden. The current test requiring such activities to be "directly related to the carrying on of" core R&D activities is quite sufficient to distinguish between those activities that do and do not properly support core R&D activities.
5. The exclusion for "in-house" software makes no sense in today's technological environment. A company developing a tool for use in its own business is not penalised unless that tool is a software tool. Few business operations do not depend to some extent on software and few R&D projects do not involve some form of software control. Software development can be undertaken anywhere using equipment located

anywhere else. Software development requires an intelligent, highly skilled, and highly moveable work force. This being the case, there are very low barriers to software development expertise leaving Australia. The exclusions around in-house software make no commercial sense and should be scrapped.

The proposal for in-house software requires a commercial return to be made directly from the supply of the software. Software should be expressly excluded from the augmented feedstock provisions, which if taken together with the software rules would virtually guarantee some level of clawback.

6. The exclusion for "computer services not otherwise covered" by the software provisions should be removed. Such a provision excludes all desirable future services as well as those presumably undesirable services.
7. A market valuation is to be applied in connection with feedstock outputs yet a "commercial return" is required for software. Such requirements are inconsistent with the desire to streamline and cut red tape.
8. The feedstock rules do little to streamline or cut red tape, nor do they seem to offer any spill over benefits. They do however seem to reward failure whilst penalising excellence. By way of example: suppose Company A and Company B are both in the race to develop the new widget X. Company A is not applying very good thinking or processes to its R&D and the outcomes of its experiments are scrapped. Company A will receive the full tax credit incentive. Company B on the other hand applies best practice throughout the R&D process and is able to produce prototype widgets that it can sell to subsidise the further refinement of its successful R&D. Company B will not receive the full tax credit incentive.

Surely, we should be encouraging success in R&D and getting things right first time, as much as possible, through the application of best practice approaches. Success means quicker to market, quicker to profitability, and quicker to paying more federal taxes than failure. R&D by its nature is risky and failure is to be expected but lets not penalise success.

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Addendum:

Core activities that involve both considerable innovation and high levels of technical risk will be rare and likely only towards the end of a program of R&D activities. This is so because R&D is, by its very nature, risky and tends to follow a path of failure before it yields success.

Moreover, the principal objective or hypothesis of an R&D project is more likely to be tested over several smaller more manageable core activities than in one single core activity. This being the case, a project that exhibits considerable innovation overall may well not involve that level of innovation at each separate core activity. This is likely the case even where each separate core activity produces some level of success (e.g. the hypothesis under investigation is proven partially).

Successful core activities (i.e. those that prove the hypothesis under investigation) are more likely, if at all, to involve considerable innovation. From a practical perspective, it will be extremely difficult, if not practically impossible, to show (as the law will require) that a failure to prove a hypothesis did in fact involve considerable innovation.

Such a definition will not achieve the policy intent of the Government and is at odds with the technically risky nature of attempting to prove a hypothesis for the first time.

Moreover, to the extent that a core activity produces something with a positive market value, the augmented feedstock proposals work to reduce the benefit that would otherwise be available. The net effect of the proposed definition and augmented feedstock rules is to largely render the tax credit system ineffective.

The only logical solution, insofar as the definition of R&D activities is concerned, is to require core activities to involve innovation *OR* technical risk at desirable levels.

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