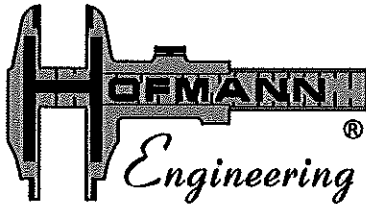


# Hofmann Engineering Pty. Ltd.



3 ALICE ST, BASSENDEAN, PERTH  
WESTERN AUSTRALIA 6054

A.C.N. 114 806 969 A.B.N. 39 114 806 969  
TELEPHONE: (+61 8) 9279 5522  
FAX: (+61 8) 9279 9386

EMAIL: [mail@hofmann.net.au](mailto:mail@hofmann.net.au)  
<http://www.hofmann.net.au>



5 February 2010  
General Manager  
Business Tax Division  
The Treasury  
Langton Crescent  
PARKES ACT 2600  
By email: [rdtaxcredit@treasury.gov.au](mailto:rdtaxcredit@treasury.gov.au)

## **Submission on the Exposure Draft Tax Laws Amendment (Research and Development) Bill 2010**

Hofmann Engineering Pty Ltd appreciates the opportunity to lodge a submission toward the Treasury's Exposure Draft on the "Tax Laws Amendment (Research and Development) Bill 2010".

### **About Us**

As an Australian private business established in 1969 Hofmann Engineering provides specialist engineering products and services to world industry leading companies. Innovation is the cornerstone of our success as it has been since inception. Innovation and development of processes and products has resulted in company growth to one of the largest Australian private engineering firms in Australia with 450 staff, 5 offices and facilities in 4 States in Australia and exporting 56% of sales to overseas markets.

Innovation has delivered premium products to a highly competitive world market, improved productivity, increased customer base and strengthened customer loyalty but this alone cannot support industry. The staff, customers and local industry have benefited from Hofmann Engineering's Directors' visionary and altruistic leadership in maintaining a long term view for the company. Innovation requires high risk and cost so Directors have never taken a dividend in the company's 40 year history and draw a minimal income, choosing instead to reinvest all profits toward capital investment. In return the company has grown exponentially, as have the total staff and apprentices, and the company has a proud record of never retrenching a staff member and employing one of the largest Australian in-house apprentice programs at 10% of total staff.

Hofmann Engineering fights for survival in a constant battle to retain in-house trained highly skilled employees from high-paying mining companies and overseas competitors. The company must achieve price premiums to retain highly paid skilled staff in order to redress the labour pull to lucrative opposition and customers.

Exponential growth, international market penetration, secure employment and up skilling would not have been achievable without Director altruism and government support provided through R&D and associated government bodies.

Westpac Bank – Perth WA  
Account # 186715  
BSB 036 033  
SWIFT WPACAU2S

Priority Account  
Commonwealth Bank – Perth WA  
Account # 11039022  
BSB 066 000  
SWIFT CTBAU2S

## Introduction

Treasury stated in the Research and Development Tax Incentive Consultation Paper that the intention was to “deliver a more generous...tax incentive” and so “...lift Australia’s innovation capacity and performance”.

Consultation with industry advisers and associated experts (including Ernst and Young, PriceWaterhouse Coopers, Michael Johnson Associates, CPA Australia and KPMG) suggests Hofmann Engineering will be materially detrimentally impacted by this radical legislation change. The resultant Hofmann Engineering investment reduction will consequently produce significantly less employment growth and heavily reduced expenditure with reliant Australian industries and workers.

Hofmann Engineering encourages and supports a streamlined, efficient and equitable R&D program intending to drive innovation as the key to medium and long term Australian economic growth for ours and our children’s future. Economic growth is primarily driven by innovation that ultimately improves Australian productivity in comparison to developing countries so fuelling associated spillover benefits. Therefore such a program should always maintain at its heart support for organisations that have a proven track record of strong employment growth, export market development and capital reinvestment of profits because these organisations will provide higher net government revenues and overall productivity gains that increase Gross Domestic Product (GDP).

## New Tax Credit Intent

Industry Minister Kim Carr said he intended providing a “better targeted, more generous, more predictable and less complex” R&D program with revenue neutrality a key element of the new legislation. “To enable the enhanced benefits to be paid there will be some tightening to lift the integrity of the scheme and ensure the government expenditure is generating new R&D activity”.

Hofmann Engineering management attended the October briefing in Perth for the Consultative Paper and were reassured by Tony Webber of the Innovation Division that “Hofmann Engineering would not be adversely impacted by legislative changes because a fast growing medium sized Australian owned and operated international manufacturer, providing enormous spillover benefits to Australia is what the government intends to support”.

Senator Button’s Research and Development Bill introduced in 1986 intended to develop internationally competitive, export orientated, and innovative industries with investment improving as a result to the current modest 1.15% of GDP (or half the level of leading nations according to PWC). The Exposure Draft has radically redefined the objectives of R&D by proposing an incentive for technical uncertainty, encouraging spillover activity, and not subsidising R&D investments that would have happened without government support.

The objective of Australia’s R&D Tax legislation should remain to encourage innovation within Australia in order to improve international competitiveness, fuel economic growth and support Australian Jobs.



In providing this submission Hofmann Engineering would like to address the issues of primary concern, due to their significant detrimental impact on our business, as follows:

1. R&D Definition Narrowing  
Changing the test from “innovation or technical risk” to “**considerable novelty and high levels of technical risk**”
2. Feedstock Adjustments Definition Broadening  
Feedstock has broadened to only realise the net expenditure so limiting R&D performed with intent to ultimately sell new and improved products
3. Supporting R&D Dominant Purpose Test  
The change requires that Supporting R&D must be undertaken for the dominant purpose of supporting Core R&D activities
4. R&D tax credit now 10c per R&D \$1 from incremental 175%  
Reducing the R&D incentive from an incremental 175% or 22.5c per \$1 down to 10c per \$1 further marginalises high risk projects and reduces Australian commercial innovation

## 1. R&D Definition Narrowing

By changing the definition of core R&D to require “**considerable novelty and high levels of technical risk**”, the focus of eligible core activities will shift to the acquisition of new knowledge or information rather than the application of that knowledge.

The consultation paper stressed that the change in definition of core R&D was to align Australia’s R&D Tax Legislation with the Frascati Manual and international practice however the definition, “considerable novelty and high levels of technical risk”, is in fact different from those used in the Frascati Manual, and internationally, so would likely make Australia’s R&D definition amongst the most onerous in the world (Michael Johnson Associates).

The Explanatory Materials suggest that the acquisition of new knowledge will generate greater spillover benefits to the wider Australian Economy than the application of that knowledge. The Government has indicated its preference to support R&D that may not have proceeded otherwise, due to its technical uncertainty. In theory, this would seem to exclude operational R&D and instead target riskier projects so taxpayer dollars would be spent on “pie in the sky” projects with far inferior economic returns.

Hofmann Engineering’s R&D projects have, over several years, significantly altered and improved our final products. Hofmann Engineering’s project-based manufacture is in a continual state of evolution in order to stay ahead of overseas competitors, especially developing countries, by providing market leading technology. This has resulted in a 56% international export mix providing benefits including an Australian up skilled workforce (highly prized by mining companies) and tax revenues from exports that significantly underpin the Australian economy.

Industry and associated experts believe this legislation change is not revenue neutral but, according to Indirect Tax Consulting Group, “will probably eliminate 70% to 75% of all claims”. Not only will the narrowing of the definition drastically reduce claims but the spillover benefits will exponentially reduce because our company can attest that these commercial activities claimed would not have happened without government support. It is our opinion that the spillover benefits achieved by supporting marginal R&D expenditure will be far lower than the spillover benefits achieved by supporting R&D in the application of knowledge that will provide Australia skilled employment growth, technological advances and export earnings.

## **2. Feedstock Adjustments Definition Broadening**

The objective of tightening the criteria “seems mainly designed to bring about cost savings on support for large corporate R&D budgets”, says UTS Business Dean, Roy Green. The Amendment is not revenue neutral in supporting R&D that has a high probability of failure while denying R&D expenditure where there might be reasonable prospects of commercialisation. This is also contrary to the aim of the legislation’s intention of maximising spillover benefits because ultimately profitable new products borne from R&D far outweigh failed projects in terms of economic and innovative contributions to Australia and its economy.

By changing the legislation to focus on the conduct of “research” phase activities over “development” phase activities detrimentally impacts manufacturers such as Hofmann Engineering that are engaged in process technologies where downstream development costs and risks vastly outweigh the initial research effort involved. The drawing and design phase of complex machinery is the simplest, least intensive and least risky element of producing an innovative new product while testing, failure analysis and field assessment is the most expensive and consuming stage.

The Exposure Draft proposes that only net R&D expenditure can be claimed on the sale of a prototype that requires innovation and technical risk. New products are expensive to introduce and result in lagging costs of belated repairs and improvements that only become evident by field trials. Hofmann Engineering designed an upgraded hoist gearbox assembly for a dragline 5 years ago with the intention of reducing maintenance change-out times and improving lubrication. By providing a single assembly instead of multiple components the change-out time reduces on machines that cost millions of dollars a day in downtime and changing lubrication from grease to oil means less contaminant waste and longer product life due to sealed recirculation instead of regular grease application and gear exposure to dust. Repairs, improvements to the sealing mechanisms and re-design have been occurring to this day because the product is not yet commercially viable. These lead times are typical of our industry and the benefits are not accretive until potentially a decade after the first prototype is made.

To legislate such a Feedstock definition change will result in a dramatic decline in investment throughout the manufacturing sector as the marginal benefit is further eroded by removing financial assistance. Australian companies will not be subsidised for the enormous risk and cost of developing new products while overseas competitors not only receive tax incentives but also retain labour cost advantages in comparison to Australia. This will ultimately abrade Australian innovation such that our industries will be unsustainable in the future against intensely competitive overseas similar manufacturing industries.

## **3. Supporting R&D Dominant Purpose Test**

The Draft Exposure proposes that if a Supporting activity serves both an R&D and a commercial objective it will not be preclude as R&D but it must be undertaken for the primary purpose of supporting Core R&D activity. The dominant purpose test narrows the scope of R&D activities by requiring substantiation of the relevant R&D primary purpose of each individual activity at the time of undertaking the activity.



Ernst and Young have submitted that “accounting systems naturally report on costs in relation to projects for non-production activities. Capturing eligible R&D expenditure on a project basis sits naturally with this. Further dividing this expenditure into subtle and often complex divisions based on tax law does not. It is a practical complexity that is real, highly expensive and adds no benefit to the R&D output”.

Hofmann Engineering, or any commercial organisation, does not manage our projects according to core and supporting activities but according to objectives, tasks and milestones. Objectives set the framework of the project, tasks are the steps required to achieve an objective and milestones are the deliverable stages of project completion. Accounting for R&D expenditure according to core and supporting activities will impose a significant and unnecessary increased administrative and compliance burden including additional costs to project accounting systems, time sheets and record keeping systems, supplier invoicing systems and overall manufacturing systems.

Manufacturing R&D often requires tooling up, trialing and prototypes. These activities are essential to R&D and not of any less value than R&D carried out in a laboratory. To restrict claimable expenditure for essential R&D supporting activities will reduce legitimate R&D claims by Hofmann Engineering and consequently stifle further employment, investment in the development of new technology and export growth, so drastically reducing spillover benefits.

#### **4. R&D Credit now 10 cents Per R&D \$1 From Incremental 175%**

Hofmann Engineering compete internationally across over 25 product groups, many of which have no Australian competitors, as testament to the innovative market leading solutions we provide. R&D drives our expansion into highly skilled end markets for manufactured products including wind energy, wave energy and aerospace that are not native to Australia. Due to our technical innovation we can compete on an international stage under the existing financial, regulatory and industrial environment. Further marginalising the potential long-term financial returns and skilled employment resultant from these high-risk markets consequently compromises development of these fledgling Australian industries. Our overseas competitors and machinery suppliers are not supportive of our market penetration so fiercely protect know-how and intellectual property and provide no technical assistance. We must learn and grow by trial and error with as much support as possible needed for the benefit of local industry and ultimately Australia as a whole.

Reducing the tax credit for a company like Hofmann Engineering that is exponentially growing international revenues and skilled employment by continually reinvesting dividend-free profits, including any R&D tax benefits, into the business will not maximise Australian spillover benefits.



## Summary

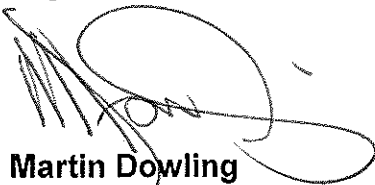
As Australia emerges tentatively from the worldwide financial crisis relatively unscathed, now is the time to encourage R&D investment by Australian owned and operated companies with proven R&D track records in order to generate the greatest spillover benefits for Australia at large. Hofmann Engineering has grown in over 40 years to become one of the largest private engineering firms in Australia, employing 450 highly skilled staff and generating 56% of revenues from exports. This is on the back of the altruistic long-term strategies of the Directors who have never taken a dividend and draw minimal wages but instead reinvest all profits toward sustaining international competitiveness in a continually improving world market and such growth would not have been achieved without existing R&D support from the government.

Mining companies are internationally outsourcing engineering and manufacturing that can be performed in Australia provided that innovation is supported in order to develop and retain international cost competitiveness. In addition these high-profit, low-risk miners poach highly skilled, in-house trained experts from us with remuneration packages that we cannot afford. Without innovation we rob our mineral reserves without investing any token proportion toward a sustainable resource-independent economy for our children. Australia needs expertise-driven innovation that fosters cutting-edge processes and products in order to compete with developing countries. Australian innovation must be nurtured and encouraged for the ultimate competitiveness of Australia. Promoting existing industry innovation is much less funding intensive than rebuilding industry after failure or off shoring so it is imperative this legislation doesn't break that nexus for Australian industry, the economy and our future prosperity.

Definition tightening for R&D and broadening for Feedstock as well as reducing the tax credit will drastically reduce claims making the change highly tax revenue positive but at Hofmann Engineering this R&D will not be otherwise spent. The overall revenue impacts will be significantly detrimental in years to come as risk aversion stifles Australian investment and ultimately reduces Australian competitive advantage in a cost-focused world market. Increased administration, both in upfront legislation training and ongoing additional compliance requirements, will further increase costs. We therefore recommend retaining existing legislation and instead more directly target the specific small proportion of claims causing treasury concerns to achieve the core intent more easily. To do otherwise will irreversibly damage the Australian manufacturing sector's ability to compete internationally with developing countries, develop new technologies, provide skilled employment growth and export worldwide.

Thank you again for the opportunity to make a submission. If you have any questions please do not hesitate to contact me at the above address.

Regards,



**Martin Dowling**  
Chief Financial Officer  
**Hofmann Engineering** Pty. Ltd.

