

16 February 2010

General Manager
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The Treasury
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**FEDERAL CHAMBER
OF AUTOMOTIVE
INDUSTRIES**

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Dear Sir/Madam

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

The Federal Chamber of Automotive Industries (FCAI) welcomes the opportunity to provide comments on the Exposure Draft. Our comments should be read in conjunction with our submission of 27 October 2009 (*copy enclosed*) in response to 'The new research and development tax incentive: Consultation paper'.

As outlined in our previous submission, the FCAI supports the objective of making the new R&D tax incentive more effective in delivering support for business R&D and targeting that support to produce enhanced net-benefits for the Australian community. We also support the intent to make the rules governing this key incentive less complex and more predictable in their application.

However, the proposed legislation goes too far in a number of the aspects. In particular, we are concerned that proposed changes in the definition of R&D and the treatment of supporting R&D activities will lead to a significant narrowing of eligibility and could potentially undermine the future attractiveness of Australia as a location for international R&D investment.

On balance, we are concerned that the negative impact of changes to restrict the scope of the R&D incentive will substantially outweigh the positive impact of the replacement of the tax concession with the new tax offset and the increase in the 'headline' rate of support.

Accordingly, we urge the Australian Government to reconsider these aspects of the proposed legislation and to work with Australian industry to identify better options to achieve the intended policy outcomes.

Change of R&D definition

As a key point, the FCAI firmly opposes the proposed changes to the current R&D definition.

In the absence of a compelling rationale there is a real risk that the proposed change in definition will generate unwarranted confusion and uncertainty.

The new definition would be one of the most restrictive definitions in the world including the USA, Canada and that contained in the OECD Frascati Manual which provides at paragraph 84, as follows:

"The basic criterion for distinguishing R&D from related activities is the presence in R&D of an appreciable element of novelty and the resolution of scientific and/or technological uncertainty"

In addition, there is no requirement that the novelty test needs to be met on a "worldwide basis" as is the pre-requisite in the proposed legislation. This additional requirement will add a considerable compliance burden and excessively restrict future access to the incentive.

In particular, these changes are likely to adversely impact the capacity of locally-based subsidiaries to secure investment to adapt new technologies, which may have been developed overseas, into Australian-made automotive products and vehicles.

The FCAI contends that a key objective of the new R&D incentive should be to encourage R&D activities within Australia and to make Australia an attractive location for R&D investment which is internationally mobile.

The automotive industry competes locally and internationally in a highly competitive market and seeks to incorporate leading safety and environmental technologies into vehicles that are designed, engineered and manufactured in Australia. Adapting global technologies to locally manufactured vehicles and conditions can require significant R&D investment. Without effective and accessible support there is a real risk that the level of automotive R&D undertaken in Australia will be substantially diminished.

Since the inception of the R&D tax concession, a body of case law and numerous guidelines issued by AusIndustry and the Australian Taxation Office have provided companies with a clear understanding of the key terms and the parameters under which the legislation operates. The proposed definition change would undermine these established interpretations.

By way of comparison, Canada has maintained consistent eligibility criteria since the 1980's.

Supporting R&D

The inclusion of the so called 'dominant purpose test' in the definition of eligible supporting R&D activities will add further complexity, compliance costs and result in additional disputes in the audit context.

As mentioned in our earlier submission, supporting activities are intrinsic to all core R&D activity and are required in order to bring about a successful conclusion to any project. While reasonable boundaries for eligible supporting expenses need to be defined, the proposed approach appears to be unnecessarily restrictive.

Accordingly, we urge the Australian Government to consider a more flexible and more realistic alternative criteria.

R&D activities conducted for foreign operations

We welcome the continuation of the current exception to the 'on own behalf' rule for R&D activities undertaken on behalf of foreign companies (e.g. where the intellectual property is held offshore). During the consultation process it was understood that the principles applicable to the current International Premium R&D Tax Concession would be retained, although the benefit is to be reduced from a 175 per cent deduction to the 40 per cent non-refundable tax offset.

However, we seek clarification as to whether an Australian company that is reimbursed for the R&D expenditure that it incurs on behalf of a foreign related company, would be able to obtain the R&D tax offset. The draft Integrity Rules (Subdivision 355-F of the Exposure Draft) appear to deny such claims. According to the draft legislation, if the Australian company is reimbursed for the R&D expenditure that it incurs on behalf of a foreign related company, it may not be able to obtain the R&D tax offset.

Furthermore, these integrity provisions are at odds with the current provisions contained in section 73CA of the Income Tax Assessment Act 1936, which were drafted to address syndicated R&D arrangements and they were never intended to apply to R&D activities such as those contemplated by the introduction of the exception to the 'on own behalf' rule. Furthermore, the Australian Taxation Office has still not issued a ruling on Section 73CA and the Explanatory Materials which accompany the draft legislation provide little additional guidance.

Denying such claims will diminish the exception to the 'on own behalf' rule. This would appear to be contrary to the intended policy outcome. According to paragraph 1.20 of the Explanatory Materials:

"R&D entities will be able to claim the new R&D tax incentive for their expenditure on eligible R&D activities regardless of where the resulting intellectual property is held. This will strengthen the case for companies to conduct their R&D activities in Australia."

However, in commercial practice, an Australian company that does not own the intellectual property attaching to the results of R&D activities would rarely if ever conduct an R&D program on behalf of its foreign affiliate without recompense for its efforts. This could create transfer pricing issues.

We seek clarification of the intended interpretation of these provisions.

Other Issues

We support the proposed repeal of the current provisions to amend assessments relating to previous R&D claims extending back over an unlimited period. It is noted that the introduction of the proposed four year limit for review is in line with other amending provisions in the Income Tax Assessment Act. Notwithstanding the concerns and issues for clarification highlighted above, this change should provide companies with greater 'certainty' in respect of future R&D claims.

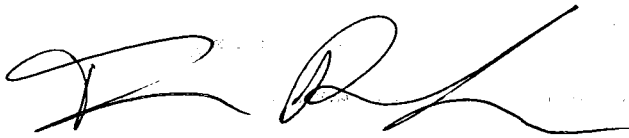
Conclusion

FCAI maintains that there is a role for Government to encourage greater investment in R&D which involves some level of technical and commercial risk, as well as supporting ongoing improvements in business processes, products and services to underpin future productivity growth.

While the FCAI endorses the policy objectives underpinning the new R&D incentive, we are concerned that the adverse impact of measures to restrict eligible activities will substantially outweigh the benefits of other reforms, including the inception of the proposed tax offset.

Accordingly, we urge the Government not to introduce the legislation in its current form but instead seek to resolve a better way forward with industry and other stakeholders.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Tim Reardon', with a stylized, cursive script.

Tim Reardon
Director Government Policy