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3 February 2010

Dear Sir/Madam,

On behalf of PricewaterhouseCoopers, I welcome this opportunity to provide feedback on the exposure draft of the Tax Laws Amendment (Research and Development) Bill 2010 released 18 December 2009 ("the exposure draft").

We applaud the Government's stated objectives in developing a "more generous, more predictable, and less complex tax incentive" however we have major concerns about the practical implementation of these objectives via the draft legislation in its present form.

Our submission is split into three sections, firstly we comment on the underlying policy behind the drafting of the exposure draft. The second section explores the major technical areas of concern in detail, and presents suggested solutions on how the legislation may be clarified. Our last section deals with the challenge of transitioning into the new program.

I am happy to discuss any of the comments made in this submission. Please feel free to contact me on (02) 8266 0470.

Yours sincerely



Sandra Mason
National R&D Leader
Tax and Legal Services

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Section One

Underlying Policy of the Exposure Draft

We believe that the changes outlined in the exposure draft lessen the attractiveness of the R&D Tax Incentive to local and multinational businesses of all sizes, and will result in significantly less R&D being undertaken in Australia when compared with R&D generated under the existing program.

An underlying fundamental principle of R&D Tax Incentives worldwide is that innovation is positive for the economy. The fundamental relationship between innovation, productivity and growth has been established across OECD countries¹ and in a local context².

We believe that the compounding effect of the multiple new restrictions on the R&D tax incentive for certain activities contained in the exposure draft, and the introduction of a broad “net expenditure rule” will result in Australia becoming a less competitive location for foreign investment in locally based industries. The proposed changes will also lessen incentives for local business to innovate and take risks in creating new products and more productive business processes.

Our review of the exposure draft reveals a number of consequences and repercussions (possibly unintended) which, if left in present form, will lead to confusion, high compliance costs and a drastic reduction in the efficacy, perceived value and uptake of the R&D Tax Incentive.

We do not believe that the exposure draft in its current state will achieve the Government’s stated aims without significant amendment. Our suggested amendments are outlined in Section 2 of this submission.

¹ Rao, S. Ahmad, A., Horsman, W. and Kaptein-Russell, P. (2001) “The Importance of Innovation for Productivity” *International Productivity Monitor*, Number 2, Spring 2001.

² Smith, K. and West, J. (2007) “Innovation Policy, Productivity, and the Reform Agenda in Australia: A Framework for Analysis”, Australian Innovation Research Centre, January 2007.

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Generosity

The Government has stated that it seeks to make the new R&D tax credit more generous for business. We welcome the increased base incentives available to both small to medium enterprises (“SMEs”) and larger companies and we recognise that this increase in base benefit will come at a cost to government revenue. However, we believe that this additional cost is significantly outweighed and clawed back by the accompanying changes that were announced as part of the launch of the new tax credit program which in our view will deliver significant savings as less support will be available across all industries and not meet the revenue neutrality aim of the new program.

These savings will in essence be delivered by the following:

- the abolition of the 175% Premium R&D Tax Concession (which saw 22% of R&D registrants claim 54% of all R&D expenditure in 2007-08³) and the International Premium Concession;
- the tightening of the definition of what constitutes core R&D activities (i.e. the “and” test for considerable novelty and high levels of technical risk);
- the adoption of a “dominant purpose” test for supporting activities to be eligible;
- the arbitrary exclusion of a large number of activities from being either core or supporting activities, via expanding the former s73B(2C) of the ITAA 1936;
- the inclusion of a net expenditure system in the form of the augmented feedstock provisions which aims to deny R&D benefits to those companies that are successful in their endeavours; and
- the specific exclusion of many aspects of computer software development from the incentive scheme.

We note that the majority of the restrictions floated in the consultation paper “The New Research and Development Tax Incentive” released 18 September 2009 (the “consultation paper”) have *all* been implemented in the exposure draft.

We believe the new R&D tax credit program will result in a significant decrease in the total value of the incentive to industry, which is not in line with the Government’s previously stated aim of

³ Innovation Australia Annual Report 2007-08, (2009) Commonwealth of Australia

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revenue neutrality. Such changes in essence lead to a program which is inherently less generous and will drive innovation offshore and in the long term decrease productivity in Australia.

Complexity

Whilst the Government is seeking less complexity for the new program, we are concerned that the new law as presently drafted will greatly increase complexity, uncertainty and compliance costs for companies, particularly SMEs. For example (and as covered in more detail in Section 2):

- the augmented feedstock rule will require multiple, complex valuations of the “products of R&D activities”, which will be a significant cost for claimants particularly in the SME sector. It will also strongly favour failed R&D and “penalise” those companies that take on risky and new R&D activities within Australia. It will also introduce a situation where an R&D Tax Incentive claimant must carry forward a potential liability, in anticipation of the possible sale of such products at some future date. The effect of these provisions is to restrict the R&D Tax Incentive to unsuccessful projects, an inappropriate outcome in our opinion;
- the requirement for registrants to differentiate between core and supporting activities, and to tie supporting activities to the relevant core activity *across income years* is both complex and subjective. Our industry research suggests that the understanding and interpretation of core versus supporting activities varies greatly between companies, even within the same industry. We anticipate that Innovation Australia and the Australian Taxation Office (“ATO”) will similarly arrive at other conflicting interpretations of the law leading to greater uncertainty for companies wishing to access the new R&D tax incentive;
- the inclusion of a new term – “considerable novelty” – creates confusion. While we have acknowledged in previous submissions that the inclusion of an “and” test to tie the element of “newness” with high levels of technical risk is necessary to achieve the Government’s policy objectives, we believe that substituting “considerable novelty” in place of the well defined and understood term “innovation”, apart from being perhaps an unnecessary tautology (is it possible for something to be *considerably* new or unusual?), introduces significant uncertainty. Over 20 years worth of administrative experience and judicial interpretation regarding the meaning of that term will be rendered obsolete, leading to an inevitable, costly and potentially painful period as administrators, advisors, industry and the courts come to grips with the precise meanings and boundaries set by the new terms.

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Accordingly, to the extent that such changes are not required to implement policy intent, we recommend against their inclusion.

Predictability

The Treasurer has stated that “under the new R&D Tax Credit, companies can invest with certainty knowing they can claim a tax offset”⁴, the third underlying policy intent of the new program. However, the exposure draft in its current form does not provide certainty that industry requires when making investment decisions.

As described above the augmented feedstock rule effectively means that successful projects will be more expensive for companies to undertake than unsuccessful ones. Further the actual impact of the R&D tax credit will not be known until the completion of the project (at best) or the eventual sale of some or all of the results, potentially some years later. This degree of complexity will result in less R&D being undertaken by Australian companies given the high eligibility barriers in the new R&D tax credit program and the counterintuitive tax law.

When coupled with the increased complexity and uncertainty discussed above, we believe industry will not be able to use the R&D Tax Credit as intended – i.e. to undertake technically risky and novel activities that otherwise would not be undertaken.

Therefore in our view the Government’s policy objectives of an R&D Tax Incentive that is more generous, predictable and less complex will not be achieved if the exposure draft remains as currently drafted. We request that the Government re-assess the detail of the exposure draft to achieve the stated policy aims as outlined above.

⁴ Australian Government News (2009) Press Release : “Australian Commonwealth Treasurer released draft legislation to deliver less complex tax incentive”, 21 December 2009.

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Section Two Technical Issues

This section deals with three major specific technical areas in the exposure draft that in our view require clarification and modification in order for the correct policy intent to be implemented. We have made these three areas the focus of our submission due to their significant impact on the overall program.

1. Re-drafting the Augmented Feedstock Provisions

The augmented feedstock provisions as currently drafted in the exposure draft appear to take the form of the “net expenditure” position initially floated as one of the five options tabled in the consultation paper to curtail supporting activities. Now (as then) we disagree with this approach as we believe it will lead to an inappropriate outcome – i.e. an R&D Tax Incentive which does not subsidise otherwise profitable activities. In our view such a test implies that the only R&D activities worthy of R&D Tax Incentive support are *loss making* activities and a complicated methodology contained in the exposure draft will also have the effect of discouraging business from accessing the program.

Such an approach does not give effect to the stated principle that the R&D Tax Credit should encourage R&D spending above that which would have occurred in the absence of the support. In our opinion, we believe that such an approach will have the opposite effect. Companies will have no incentive to consider undertaking risky and novel activities or projects, and will more likely avoid such activities and expenditures.

There is a separation between benefits ultimately realised from an R&D investment and the initial decision to invest. The decision to commence, or not to commence, an R&D project is made before the outcome is known. It is at this time that any Government incentives to undertake a project will be considered and factored in to the anticipated cost.

Of course, at the time an R&D project is initially conceived it is implicit that there is uncertainty as to whether or not the project will be successful. This is as a result of high levels of technical risk present (by definition) in an R&D project. A company that is well managed will not embark on a project which is doomed to fail – thus the idea that only loss making activities are the types of

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activities that would not have been undertaken in the absence of the R&D Tax Incentive is a flawed assumption.

The consultation paper proposed 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."

We understand that the 'augmented feedstock' provisions relate to the policy intention of 'additionality' and the desire not to subsidise activities that are profitable.

However, we believe an important factor has been overlooked, i.e. when R&D activities are commenced there usually is uncertainty as to whether the activities will be successful. This uncertainty is due to the existence of technical risk and innovation present in the R&D activities. In these instances, the availability of an R&D incentive would encourage these activities to be undertaken, thereby supporting the 'additionality' principle. Viewing the R&D tax credit program as a means of underwriting R&D (i.e. a back-up to kick in in the event of failure) is in our view very short term.

Penalising companies that have overcome technical risk and have developed novel solutions and achieved successful (profitable) results is at odds with the policy intent of having an incentive scheme that is "more effective in delivering support for business R&D and in targeting that support where it is most likely to produce net-benefits for the Australian community".

It is the *successful* R&D activities that are most likely to produce net-benefits for the Australian community, through increased productivity and competitiveness. These successful Australian R&D companies will be penalised as funds will be redirected towards companies with failed R&D.

By restricting access to the incentive program by clawback provisions such as the proposed new feedstock rule, less financial support is made available to successfully innovative companies to allow them to continue to innovate in the future. We refer to this as a "culture of innovation" and it is also our view that penalising such companies by clawing back some of the "promised incentive" will stifle such culture and lead to less R&D being done in Australia, for the benefit of Australians.

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Our view is that an overall reduction in the pool of money available to innovative companies (via restrictive "feedstock" rules) will inevitably lead to the transfer of manufacturing, computing, engineering and other industries outside of Australia over time. It is important to consider the compounding effect - once the transfer of an industry begins it will accelerate at an increasing pace. It is for this reason we submit that support for innovation should not be contingent on the outcomes but should be contingent on the decision to commence innovation.

Augmented feedstock provisions will increase complexity

We believe that the 'augmented feedstock' methodology does not support Government policy intent of reducing complexity as it forces a company to undertake two valuations in every instance where R&D activities result in an output. We note that this is in contrast to the current 'net cost of raw materials' methodology that enables a company to make a high level observation about whether the value of its feedstock output would exceed its feedstock input. Where this occurs the company can choose not to claim (and therefore not calculate) the relevant feedstock expenditure as this expenditure would be deductible at 100% for income tax purposes.

Under the 'augmented feedstock' calculations, a company will be required to firstly undertake a valuation of an output produced by the R&D activities at the time of its production. Often the R&D activities will be occurring at a discrete point in the production process at which point the feedstock output is incomplete. The 'market value' process that will need to be undertaken (along with the inter-year application) will require additional analysis and as a result add complexity for business.

Secondly, a company will be required to identify expenditure that 'directly relates' to the particular feedstock output. Aside from the ambiguity that will arise as to what is meant by 'directly relates', additional analysis and evaluation will be required to work out the costs of production up to a discrete point of the production process – again adding complexity.

This complexity will be compounded for SMEs that may not have the resources and tools to accurately analyse the costing of discrete components of the production process.

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Augmented Feedstock Rule will reduce predictability

The proposed 'market value' approach to calculating feedstock output does not support the Government's policy intent of introducing predictability in instances where the output is incomplete.

The explanatory memorandum proposes two approaches to address the issue, each of which requires adjustment to the claim amount either through deferring the incentive until the market value can be determined or clawing back any adjustment from future claims.

Both of these adjustment approaches will introduce uncertainty in relation to the value of the incentive ultimately received and neither is an approach that would be welcomed by business.

Suggested Solution

For the reasons stated above, we do not believe the proposed 'augmented feedstock' approach is appropriate in achieving the policy intent. If it must be adopted, to improve the operation of the 'augmented feedstock' approach we make the following recommendations:

1. The list of 'quarantined costs' be expanded to include expenditure on:
 - a. 'detailed design'. The rationale for this is similar to that of quarantining 'conceptual design' as it is in the detailed design phase that new knowledge is developed that will deliver spillover benefits.
 - b. labour costs. As recognized by the Government when introducing the 175% premium concession, labour related costs of R&D provide the greatest economy-wide benefits. Further, we believe that a claimant takes on a real *opportunity cost* by diverting staff from normal duties to an R&D activity – this opportunity cost in lost productivity of normal business activities is in fact never fully recovered, even if the outputs of the R&D activities are sold. We believe that the current feedstock provisions of the R&D Tax Concession, which deal only with material inputs and energy, amply claw back incentives on profitable trial activities. Labour related costs should therefore be subject to the R&D tax incentive as they support the policy intent of promoting 'spillover' benefits. Furthermore, the inclusion of labour costs as 'quarantined costs' would promote the policy intent of delivering a less complex R&D tax incentive. This is

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because it will not require a company to devise an allocation strategy for labour costs to feedstock outputs, which may be arbitrary in any event.

- c. Plant depreciation – many R&D activities require the use of plant and equipment to undertake the experimentation and without that equipment the R&D could not be carried out. This inclusion would particularly assist the ability of the manufacturing industry to innovate.

2. Exclusions List Changes Required

We understand from consultation that it is the view of the Government that certain activities do not warrant support. These are activities whose:

"... primary objective ... is considered to be to develop markets, do preproduction planning or to get production or control systems working smoothly. As such, these activities do not add as much benefit for society as core R&D activities."

The mechanism chosen to achieve this objective has been to exclude all activities on the current core activities exclusion list from being eligible in any way for the R&D tax credit. It is our view that converting the current core exclusions list to a core and supporting exclusions list is too broad and will preclude major R&D activities that are at the core of every R&D project from being eligible and create significant unintended consequences.

It is our view that the Government's intent in this area (set out above) is already achieved by the exclusion of such activities by the introduction of the "dominant" purpose requirement for supporting activities. The dominant purpose requirement will mean that in many cases the development of markets, post-development activities such as pre-production planning or activities to get systems working smoothly will not be allowable as support activities. In addition, such activities will not be core activities in their own right. Accordingly the introduction of the dominant purpose test will restrict eligibility for the tax incentive to only those activities warranting support.

We raise in particular below significant concerns regarding the following exclusions:

Exclusion (a) rules out market research as a supporting activity, however it is arguable that without testing novel ideas in the market, the core activities of an R&D project will lack the

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feedback and direction required to result in a commercially relevant result, which is of interest to the market. We believe the dominant purpose test is sufficient to ensure that such activities are not subsidised wholesale, but only when appropriate.

Exclusion (l) has the potential to render R&D activities in the pharmaceutical industry ineligible. The pharmaceutical industry clearly undertakes R&D activities which are "associated" in some way to complying with statutory requirements, such as the conduct of clinical trials and the preparation of a regulatory package for the Therapeutic Goods Administration. In our opinion this is only one simple example of how this exclusion can have very wide unintended consequences.

Exclusion (h) also has wide ranging application. By excluding pre-production activities from the program entirely we believe that a great deal of activities will be excluded that are genuine R&D. It will be a subjective test and will be difficult to define as the term "including" is used in the law and therefore it will not be limited to the examples provided. An example of the confusing nature of this exclusion is set out in the explanatory memorandum itself. At example 2.14, it is proposed that a full scale experiment is not "pre-production" on the basis that:

"It is an experiment that needs to be run at full scale, rather than a trial or "shake down" run"

However, it can easily be argued that the experiment described in the example is a pre-production activity. After all if the trial is successful it immediately and directly precedes production.

Exclusion (i) is similarly wide reaching in its interpretation and should be revised to clarify its intent.

Software Development Exclusion

We are of the view that the incorporation of "developing computer software, except for the purposes of making a commercial return directly from the supply of that software" into the exclusions list will inappropriately exclude them from the benefits of the new program. This

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proposed change outlined in the exposure draft will ensure that, on the whole, computer software related R&D will not be eligible as either a supporting or core activity.

By also singling out the exclusion of "any other computer software services" many process improvement projects across all industries, will not be eligible R&D.

Commanding a commercial return (and not allowing licensing or nominal charges) will affect projects undertaken by service providers as a majority of their initiatives, which are licensed or supplied to the market using some form of "consideration" and web-based platforms, are only realised through technology development. Furthermore, the exposure draft does not adequately define what is meant by "commercial return". The EM to the exposure draft provides detail that stipulates "...zero or nominal charge", however the term "nominal" can vary significantly from company to company. What is nominal to one is perceived as significant to another, and thereby the use of subjective terminology creates yet further uncertainty.

We are concerned that the intended approach to software development targets this particular industry inappropriately and undermines the policy intent of the tax incentive.

Furthermore the approach excludes from being eligible any software development required for projects that are not predominately software development initiatives, but require software development as a mechanism to achieve its R&D outcomes. Many manufacturing, engineering, product development companies for example, rely heavily on software development as a platform for the R&D program of work, and for that reason the extension of the multiple sale argument is inappropriately broad. It essentially deems ineligible anything related to computer software if not for a direct commercial purpose.

The policy intent is to increase productivity, encourage economic growth, and thus create positive spillover effects for the wider economy. However in the current climate this can generally only be achieved via process improvement initiatives focused on the technology sector e.g. automation, improved communication links between buyers and sellers, reducing processing costs, improving speed, improving quality and robustness of data etc most of which is achieved via in-house development that is supplied to users via licensing arrangements or nominal charges.

We submit that there should be encouragement for companies to invest in development of innovative, secure, advanced technological developments that are substantial and economically

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significant. It is our belief that the exclusion of computer software as drafted in the exposure draft will in essence curb this type of R&D from being undertaken here in Australia. This comes, in our opinion, at a time when the industry is under its greatest threats from overseas suppliers.

Furthermore, the software industry, which by its nature is dynamic and cutting edge, is a sizeable exporter of products and services, and is strategically important to the competitiveness and sustainability of many other Australian industries. The benefits of supporting successful R&D outcomes in software dependent industries will lead to knowledge that is gained spilling over to the benefit of the wider Australian Economy.

Suggested Solution

Using the words of the old law, in this new context, is in our view not appropriate. We do not support the use of an exclusions list in this proposed manner as the majority of activities contained within the list (as it is contained in the exposure draft) should not be considered ineligible. We propose that any such exclusions only be excluded from being core activities and not supporting activities, as proposed.

If an exclusions list is to be included it should be significantly re-drafted to give effect to the policy intent. In particular we recommend that the specific exclusions listed above be reviewed to ensure that the exclusions list does not unfairly impact one sector or broadly misclassify eligible R&D.

In relation to the computer software exclusions we recommend the following:

1. Do not exclude in-house software development from being a "supporting" activity if it can demonstrate it satisfies the dominant purpose test. As the current provisions stand in the exposure draft, in-house software development is excluded from being a core R&D activity unless that software development is for "the purpose of supply" to at least two other entities;
2. Remove the "commercial" return requirement, and allow for other supply arrangements;
3. Allow in-house software development if it satisfies prescribed higher thresholds of innovation tests such as (i) a similar product is not commercially available; and (ii) the development involved significant financial risk.

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3. Replace the term Considerable Novelty

The introduction of the words 'considerable novelty' in place of 'innovation' will introduce ambiguity to the R&D tax incentive. The concept of 'Innovation' has been well established over 20 years of application, administration and case law. Changing the terminology will go against the policy intent of delivering a more 'predictable' incentive.

Furthermore, all innovation, whether radical or incremental, in the long run improves the productivity and competitiveness of the Australian economy⁵.

We note that throughout the consultation process to date there has been no discussion on changing what is meant by innovation and technical risk, only that an 'and' test requiring innovation *and* technical risk would be introduced. We believe the introduction of the word 'and' into the definition is sufficient to meet the desired policy intent of removing incremental advances that don't provide spillover benefits – a change in the definition of newness, i.e. innovation, is not necessary.

Suggested Solution

We therefore submit that considerable novelty is removed from the exposure draft and innovation is re-inserted into the definition of R&D.

⁵ Smith, K. and West, J. (2007) "Innovation Policy, Productivity, and the Reform Agenda in Australia: A Framework for Analysis", Australian Innovation Research Centre, January 2007.

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Section Three Transitional Provisions

We also believe that if the exposure draft is left in its current form, because the changes proposed are significantly different to those which are currently in operation, many companies will be disadvantaged because they made decisions to undertake innovative and/or technically risky activities based on the incentives on offer under the current 125%/175% R&D Tax Concession.

For this reason we believe that the exposure draft legislation should be amended to include transitional provisions "grandfathering" projects which commenced, or on which decisions were taken to commence, prior to the introduction of the exposure draft legislation into Parliament. In our opinion failure to insert such a provision will not only disadvantage and be unfair to many companies but is likely to dissuade companies from undertaking such innovative and technically risky activities in the future. In our opinion it will actually have an impact on the Government's ability to create a "culture of innovation", something which we believe is fundamental to the success of R&D in Australia and to the new R&D Tax Credit program itself.

Failure to provide for such transitional arrangements would also, in our opinion, be inconsistent with one of the major principles running through the new exposure draft legislation, that is, that any R&D incentive legislation influences company decision making when considering innovative and technically risky activities. To significantly change the R&D incentives legislation as currently proposed without providing for some transitional arrangement would be failing to recognise the influence that the existing legislation has on company decision making.

Suggested Solution

We submit as outlined above that "grandfathering" provisions be included in the new R&D tax credit program.

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Conclusion

We thank you for the opportunity to comment on the exposure draft and the underlying policy intent that was put forward in the public domain upon the release of the exposure draft.

Our submission has focused on the main areas of change that are needed in our view to ensure a more generous, more predictable and less complex program that will deliver additionalities and spillovers to the Australian economy whilst maintaining revenue neutrality.

We would be happy to participate in any further discussions with you to discuss our views contained in this submission. Please contact Sandra Mason on 02 8266 0470 with any queries or requests for further detail.