



General Manager  
Business Tax Division  
The Treasury  
Langton Crescent  
PARKES ACT 2600

[rdtaxcredit@treasury.gov.au](mailto:rdtaxcredit@treasury.gov.au)

19<sup>th</sup> April, 2010

## Dear General Manager of the Business Tax Division

*Submission in response to 2<sup>nd</sup> Exposure Draft of the Tax Laws Amendment (Research and Development) Bill 2010, released 31<sup>st</sup> March, 2010.*

Please find herewith a submission by the Australian Dairy Products Federation on behalf of the dairy industry. This submission should be read as an update on the ADPF's submission (dated 5<sup>th</sup> February, 2010) to the first draft of the Bill.

## 1 Application of the definition of Core R&D Activities

The amended definition of Core R&D activities introduces new terms and concepts not utilised in the current, long-standing definition.

Concern arises when the commentary and examples in the EM are compared with this new definition in the draft legislation. Concern arises in respect of:

- The use of new terms and concepts which gives rise to uncertainty as to the meanings and boundaries of these terms particularly when applied to projects undertaken in commercially driven dairy manufacturing entities
- The distinction between “experimental activities” and “experiments” (if there is a distinction intended).
- Linked to the above point is the definition of “the scientific method” and how this is to be applied in a commercially driven dairy manufacturing entity

Specifically, we premise our comments on the basis that:

- “Core R&D activities are **experimental activities** .....” our emphasis - per section 355-25
- “**Experimental activities** ..... will employ a **systematic progression of work based on scientific principles and using an approach that proceeds from hypothesis to experiment, observation and evaluation and leads to logical conclusions** ..... generally known as the **scientific method**” our emphasis - per EM 2.12
- **scientific method** - a method of research in which the steps are identification of a problem, collection of relevant data, formulation of a hypothesis on the basis of this data, and, finally, empirical testing of the hypothesis to prove its validity. Per Macquarie Dictionary definition and discussion in the Frascati Manual

That is, the “experimental activities” required per the definition of core R&D includes identification of a problem, collection of relevant data, formulation of a hypothesis, empirical testing/experimentation of the hypothesis, observation, evaluation and development of logical conclusions.

Our concern arises where the EM contradicts this by (i) limiting most examples in the EM to discussion of the 'experiment' step only, to the exclusion of any discussion of the other elements of 'experimental activities' involved in the application of the scientific method, and (ii) the commentary at paragraph 2.22 which indicates that only the experiment will be a core R&D activity, directly conflicting both the draft legislation and other comments in the EM.

These contradictions give rise to significant uncertainty as to the intended scope of core R&D activities, which, on our reading of the EM, is in contrast with the draft legislation and appears to have been significantly narrowed when compared with the current definition.

The application of the proposed legislation to wide-ranging R&D conducted in the dairy industry becomes problematic based on the current draft in light of the conflicting EM. R&D in the dairy industry has such wide-ranging subject matter. Many different R&D outcomes are sought, for example new dairy products, new pharmaceutical applications of extracted milk factors and compounds, new processes and techniques to extract and process milk, milk by-products and fractions, environmental and sustainability driven developments, herd, pasture and on-farm development, including genomics.

This occurs across a range of products including commodity milk powder and cheese products, products such as infant formulas and specialised products including functional food products, nutraceutical and cosmeceutical products. These factors will complicate the application of new concepts, particularly where uncertainty exists.

If the EM is to prevail, the prospect of significantly limiting the scope of core R&D activities will deliver negative outcomes for the Australian Dairy Industry.

***We recommend that to avoid uncertainty, the term “an experiment” should be replaced with “experimental activities” or “scientific method” as appropriate in the above-mentioned, and other relevant EM examples.***

## **2 Production associated supporting activities - “Directly Related to” nexus required**

The second draft legislation introduces the terms “production of goods or services” and “directly related to production of goods or services” with regards to certain supporting activities.

While we recognise that this is an attempt to address concerns that have been raised in relation to production type R&D claims, we never-the-less remain concerned at the potential breadth of these provisions, and do not agree with the proposed exclusion for production related activities, nor these rules as drafted.

The use of the term “directly related” is ambiguous, and potentially creates an extensive nexus. Much of the (successful) R&D undertaken in the dairy industry will eventually lead to a viable commercial outcome, most likely in the form of a new or improved dairy product, or production process/technique that leads to improved dairy products, at some stage. Often this will not be readily discernable at the time of early stage R&D activities, (i.e. the results and/or likely success is not yet known). How direct the connection with the ultimate production needs to be is unclear and requires more clarity.

For example, there is potential that the early stage research and experimentation into the use of novel ingredients for a new dairy-based food that may eventually arise from the R&D could be considered “directly related” to the future production of that food product, even though this may be many years away from happening. This could potentially become an area of controversy and dispute with dairy industry claimants, where the

regulator seeks to establish a broad nexus with the relevant activity, even if the activity is at a very early stage. It also, (as with the augmented feedstock rules previously proposed), could act as a “penalty” on successful, commercially-orientated R&D, that leads to production.

***We recommend that the terms “directly related” [to production of goods or services] are removed, or at the very least limited to production of goods/services in that year of income. This would provide greater clarity, while still achieving the aims of restricting the R&D claims in an immediate production environment.***

### **3 Dominant Purpose for Certain Support Activities**

The exclusion list of activities (also currently used for the R&D Tax Concession) is likely to continue to only apply to supporting activities, not to core activities as proposed in the first ED. We note however, that for any of these excluded activities to qualify as supporting activities they will need to satisfy the dominant purpose test.

As an extension to point 2 above, if the support activity is “the production of goods or services” or “directly related to production of goods or services”, there is also a requirement that it be undertaken for the dominant purpose of supporting core R&D activities. If deemed not to have this dominant purpose, the activity will be ineligible.

The policy intent is to limit production type R&D claims where the production has little nexus with the R&D activities, and, whilst we agree with this concept, the current draft legislation has implications beyond this that will penalise applicants for conducting valid R&D production trials.

This stands to significantly adversely impact many R&D projects undertaken in the dairy industry, as it is necessary at some stage in the process to test hypotheses, developments and/or formulations at production scale. These production scale trials are undertaken for an R&D purpose, but will often produce output that can be sold (although often at downgraded prices). The fact that an R&D project has reached the stage of commercial scale trials indicates that it is more likely than not to ultimately be a successful project (i.e. most, but not all hurdles and technological uncertainty has been resolved). It is unclear why there is an intention to penalise this type of activity.

The current feedstock rules already apply to net off the trial output value before making a claim and we anticipate that new feedstock legislation will act in a similar fashion. As such, any output of value is already applied to reduce the value of trials that can be claimed.

***We accept that these types of activities should have a requirement for being “directly related to” core R&D activities, but not a “dominant purpose” and recommend that the legislation be amended to reflect this.***

### **4 R&D where not commercially available**

The definition of core R&D requires a purpose of “generating new knowledge”. This purpose test is applied to the various scenarios covered by the examples in the EM. The definition of core R&D applies equally to situations where the technology or know-how to resolve the problem has been developed elsewhere but is not commercially available, requiring a company to develop its own solution. The EM has not clarified eligibility of R&D activities in these situations.

For example, competing dairy companies may need to develop similar technologies (for example new cheese production techniques and formulations), but independently undertake their own set of experimental activities to achieve this. Both parties have no intention of making the technology commercially available to the other, and the information is not obtainable from any other source.

Another example is where a solution to a technical problem, such as a production sustainability issue, has been developed but is not commercially available. The company therefore needs to conduct experimental activities in a scientific way to resolve the problem, and generate “new” knowledge in the process.

It is clear that in both the above examples, there are real benefits to the wider Australian economy in supporting this type of R&D. This includes improved productivity across the economy, enhanced competition and efficiency, and recognition that it is experimental activities that are the key to the development of scientific knowledge across the economy, (thereby delivering high spillover benefits), across multiple companies that goes hand in hand with this.

***We suggest that an example is provided in the EM to clarify this situation.***

## **5 Reporting of Core and Supporting Activities**

Applicants are likely to need to classify activities as being either core or supporting when preparing their R&D applications.

Whilst there has always been a requirement to identify core as well as supporting activities when preparing a claim for the R&D Tax Concession, for many years there has not been a requirement to report R&D on the basis of a split between core and supporting activities and in particular to separately cost out core and supporting activities.

The new requirement to do so will impose a significantly increased compliance burden, as in most cases, companies do not naturally dissect a project into these classifications, but rather look at all activities necessary to achieve an objective. As such, R&D reporting systems do not presently provide this distinction for costing purposes. For example, a food technologist might record 20 hours of R&D time on a project during a week and for those 20 hours will be engaged in conducting both core and supporting activities. The split between time on core and supporting activities is not typically reported. This requirement imposes a significant additional compliance burden for no additional gain (i.e. there is no difference in the rate of benefit for core and support activities).

***We recommend that the current practice of reporting, but not costing, individual core and supporting activities remain, with the possible exception of those supporting activities that are required to have a dominant R&D purpose.*** This approach would serve to remove the administrative burden, (and confusion), that will come with the need to report and cost the many individual support activities that are directly connected with core activities and therefore unquestionably eligible. It would also provide Innovation Australia with the additional data it requires for the few remaining support activities that must pass the dominant purpose test.

This approach would appear to be a more practical solution that reduces the administrative burden back to more reasonable levels, whilst delivering the additional data for limited ‘dominant purpose’ support activities.

## 6 Administrative Power of the Board

The proposed R&D tax credit regime is to operate on a self assessment basis, however Innovation Australia now has increased autonomy to reject R&D Registrations of core and/or supporting activities or change the classification between core and supporting following lodgement of R&D Applications.

The Board may make findings about the R&D entity and the nature of the activities both before and after registration, and make these decisions without requesting further information from the client. These changes increase the uncertainty around self assessment as entities would have to wait until they are registered to be assured that no amendments have been made. This approach would be equivalent to a current section 39L assessment from AusIndustry, which is against the intended self assessment approach. Problems in interpretation by officers responsible for administering claims may be overcome by giving industry-specific training.

Additionally the draft legislation imposes no time limit upon Innovation Australia in regards to its findings about a particular registration. This further creates uncertainty for the Applicant, and most importantly, **will cause delays and complications in completing the company's tax return.**

There also remains uncertainty in relation to the 10 month time limit exclusions and whether this would continue to run once an R&D registration had been refused by Innovation Australia. This could act as a significant penalty to those who validly contest a decision by Innovation Australia to refuse to register a claimant. In some circumstances (eg. where the review goes past the 10 month registration deadline), this could indeed defeat the whole premise of making these decisions reviewable.

It should be made explicit that this will not be the case and words to this effect (eg. In s27A) should be inserted that for the avoidance of doubt, the 10 month period will run from the date of submission of the R&D registration and not the date of acceptance to register.

## 7 General Commentary

If not addressed the aforementioned issues implicitly have the potential to negatively and directly impact the investment in R&D by Australian dairy companies. Less obvious unintended and indirect impacts include:

- Encouraging dairy companies to conduct R&D overseas and discouraging smaller companies from doing R&D at all.
- Increasing the quantity and range of food imported into the country which, as a result of deficiencies in the Food Export Control Orders (Beale Report) will increase the likelihood of food safety incidents. This issue is related to the difficulty in ensuring quality assurance and traceability of imported food.
- Diminishing the industry support and delivery of extension of research results, compounding a deficiency that is already recognised as a major problem.

## **8 Conclusion**

On behalf of the Australian dairy industry the ADPF stresses the importance of tax concessions for R&D investment, and consequently ensuring the new legislation is clear and workable. We are of the opinion that unless the recommendations listed above are responded to, the legislation and its application will be ambiguous, and will detract from the intended purpose of encouraging R&D in Australia.

I would be pleased to respond to any queries you may have on this submission.

Yours sincerely

A handwritten signature in black ink, appearing to read 'P. Stahle'.

Dr Peter Stahle  
Executive Director