PRICEWATERHOUSECOOPERS

PricewaterhouseCoopers
ABN 52 780 433 757

Darling Park Tower 2
201 Sussex Street
GPO BOX 2650
SYDNEY NSW 1171
DX 77 Sydney
Australia
Telephone +61 2 8266 0000
Facsimile +61 2 8266 9999
Direct Phone +61 2 8266 0470
Direct Fax +61 2 8286 0470
www.pwc.com/au

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

rdtaxcredit@treasury.gov.au

19 April 2010

On behalf of PricewaterhouseCoopers I welcome this opportunity to provide feedback on the second exposure draft of the *Tax Laws Amendment (Research and Development) Bill 2010* released 31 March 2010 ("the second exposure draft").

You will appreciate that as we have had only a limited time to review the draft we may not have identified all potential issues. In this respect we may bring issues to the attention of Treasury and the Government in the future.

We make the following points and recommendations:

1. The dominant purpose test is too broad and is an additional layer of complexity which will reduce support for innovation in Australian industry. We would be happy to work with you to establish a test for supporting activities which supports commercially focussed R&D. We again request that the dominant purpose test be removed

2. The exclusions list is unnecessary and does not give effect to any stated policy. We therefore request that the exclusions list should be removed from the second exposure draft.

3. In our view the examples relating to the definition of R&D activities contained within the explanatory memorandum (EM) are too complex and inconsistent – both between themselves and also with the Exposure Draft legislation. The examples require further consultation before being finalised. We suggest that the examples are released at a later date and are not codified within the legislative materials at this time. We note that the information contained within an EM is difficult, if not impossible, to change. In summary, the definition examples should be removed from the EM.

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4. We note that the feedstock provisions have not been released. We request that the provisions be released for comment before the bill is tabled in Parliament.

5. We note there is an outstanding issue in respect of franking accounts. The franking account issue should be addressed in the legislation.

6. The greater than 50% grouping test for aggregate turnover purposes for qualification for the offset should be carried forward into the new legislation.

7. The proposed objects clause as drafted is too narrow and should be replaced with one which reflects the incentive nature of the New R&D Tax Credit.

8. The outright exclusion of building expenditure is inequitable and excludes otherwise eligible programs of activity from the new program. The building expenditure exclusion should be redrafted to ensure R&D activities related to buildings are supported under the new program.

Should you wish to discuss any of the matters outlined in this submission please do not hesitate to contact me on (02) 8266 0470.

Yours sincerely

Sandra Mason
National R&D leader
Tax and Legal Services

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1. Dominant Purpose Test

It is our view that the dominant purpose test as still contained in the second exposure draft remains too broad and too subjective. We reiterate our previous comments on this matter as they remain relevant. In particular, where an activity has two or more purposes (which will be the case in most commercial R&D settings), determination of the dominant purpose will be problematic. In fact an activity may have no "dominant" purpose, all purposes may be equally important. It will be a complex and subjective exercise to determine the application of the dominant purpose test.

The classification of activities as core or supporting will be required under the new program given the requirement to register activities as either core or supporting and the power of Innovation Australia to make its own assessment of activities and to breakdown registered activities into smaller subsets. As a result of the dominant purpose test remaining in the new program there is a risk that audits of R&D claims will become bogged down in the detail of individual activities and whether a particular activity was experimental and whether another particular activity was carried out for the dominant purpose of supporting another activity. Such a granular program is not commercial and imposes an unnecessary administrative burden on companies.

As per our previous submissions we do not support the inclusion of a dominant purpose test. It is our view that a more commercially focussed test should be introduced in order to enable the support of commercially based R&D otherwise this test will significantly limit the scope of R&D that will be eligible for support under the new program.

We concur with the Government that some action at the margins is required to prevent a minority of claims which are, in the Government's view, excessive. However, examples of excessive claims have only been sparingly provided to illustrate the areas where the Government is concerned about the current program. Further consultation is required to precisely identify the concerns of the Government and suggestions can then be made that can address these issues ensuring that changes do not limit support for the vast majority of claims which warrant Government support.

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2. Exclusions list

As has been put forward previously, the exclusions list is unnecessary and creates an unwarranted level of complexity particularly when applied to supporting activities. Whilst we commend the removal of the all-encompassing exclusion list from the second draft, we note that no evidence has been provided to date of the particular need for the exclusions list (other than in the case of computer software). The EM states that "As a matter of policy, certain activities are excluded from being considered as core R&D", however we cannot identify any commentary on this policy stance.

The EM to the original tax concession legislation in 1986 made comments about how the "precise cut-off point" could not be given between R&D and normal production activities. Many activities on the list represent crucial steps in the R&D process and when coupled with the new dominant purpose test an unnecessary level of complexity is created. It requires companies to breakdown otherwise eligible R&D projects in a piecemeal fashion to determine if a particular activity was on the exclusions list and, if so, whether it was conducted for the dominant purpose of supporting core R&D activities.

We acknowledge that the Government has a stated policy for software development and accordingly the introduction of a specific exclusion gives effect to that policy.

We suggest that the exclusions list be re-examined. If it is to remain it should only apply to core activities and should not be combined with a dominant purpose test and applied to supporting activities.

3. Examples too complex for EM

We note that the EM contains extensive, detailed and complex examples of the application of the definition of R&D activities. We have set out in Appendix A numerous instances of where the examples are:

- inconsistent between separate examples in the current EM;
- inconsistent with examples in the EM to the first draft; and
- inconsistent with a reasonable interpretation of the law.

(N.B. Due to time constraints we have not commented on every example).

We note that in certain circumstances the EM to a bill is an "extrinsic material" of the type referred to in the Acts Interpretation Act 1901. As such it may be used by juridical and other authorities in forming a view as to the proper construction of the law. In addition we note that an EM is difficult, if not impossible, to change.

Accordingly, we recommend that the detailed examples be removed from the EM and released later in another form of guidance following further consultation to ensure that inconsistent, complex and confusing examples are not codified into the legal framework at this time. This step would not be inconsistent with the Government's stated intention to consult more with industry and claimants in relation to finalising its approach to the New R&D Tax Credit, and certainly not inconsistent with Innovation Australia's stated intentions to supply a more strong and rich source of information, documentation and guidance to R&D claimants.

4. Input into the feedstock provisions

We support the Government's decision to withdraw the augmented feedstock concept and retain the current feedstock provisions. We look forward to a draft consistent with the intent of the current feedstock provisions. We request an opportunity for comment on the rewritten prior to their introduction into Parliament.

5. Franking problem not resolved

We are concerned that the second exposure draft does not resolve an important timing issue for the Non-Refundable component of the program. In both cases (i.e. the Refundable and Non-Refundable components) a credit results in a debit to the franking account. The only difference in treatment (between the Refundable and Non-Refundable components) is that in the case of the Refundable credit, the franking debit is deferred until there is tax paid to offset against the debit (avoiding franking debits tax). We recommend the impact on the franking accounts of recipients of the Refundable credit should be extended to Non-refundable recipients. This will prevent instances where the R&D claim is prepared after franked dividends are paid potentially resulting in a franking deficit.

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We recommend the deferral of franking debits be extended to recipients of the Non-Refundable credit.

6. 50% Rule for Offset Qualification Grouping

We note that the "old" R&D offset grouping rules provided for in essence a greater than 50% grouping rule to apply in working out the group turnover. However in the current draft this has been changed to an at least 40% test. We cannot identify any clear policy intent for this change and as such we recommend the current greater than 50% grouping test be retained.

7. Objects Clause Too Narrow

It is our view that the proposed objects clause is too narrow. It was acknowledged during the Consultation Paper phase that it would be difficult for any particular company to show that its R&D program was likely to benefit the wider Australian economy. It is also difficult for a company to prove that activities would not have been carried out if not for the R&D incentive. A narrow objects clause is not required and does nothing to achieve the Government's stated policy objectives of incentivising companies to do more R&D in Australia. We therefore request that the objects clause be redrafted along the same principles as the current objects clause.

8. Building Expenditure

We note that as a result of the operation of proposed section 355-220(1)(a) expenditure on the development of an innovative building prototype which is not to be used by the developer in its business in the future will not be eligible for the new program. The reason for section 355-220(1)(a) appears to be to prevent double deductions for a building **which is a setting in which** a company undertakes R&D activities. Such expenditure may be deducted over time under modified capital allowance rules.

We propose that only expenditure by the claimant company which is incurred on a building which will be a setting for it to carry on its own business (or R&D activities) in the future should be excluded. The proposed rules would exclude, for example, a situation where a company conducts a destructive experimental program of testing on a new type of building material. A building is constructed of this material for the tests. The building is destroyed during testing. The company obtains no enduring benefit and may create significant new knowledge however it is denied a tax

offset by section 355-220(1)(a). We request that expenditure on R&D activities related to buildings be eligible offset under section 355-200.

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APPENDIX A – Comment on Examples Relating to the Definition of R&D Activities

Core Activities

We have considered the new definition of core activities. While we see the benefit of the removal of some subjective terms in the existing legislation, there will be some confusion while companies come to understand the new definition, so the use of examples and guidance is important in minimising this confusion.

We have noted some discrepancies in the guidance provided in the EM for the interpretation of the new definition.

- New Knowledge:

  We note that the new eligibility criteria points towards the existing requirement for innovation through identification of knowledge gaps or new knowledge. In this regard, Points 2.13 and 2.16 of the EM provide indications regarding the knowledge gap required to meet the new definition.

  Point 2.13 notes that core R&D activities must meet a test of "whether something is scientifically or technologically possible, or how to achieve it in practice, will not be deducible by a competent professional in the field on the basis of current knowledge, information or experience".

  However, Point 2.16 indicates that the new knowledge test "will not be satisfied by experimental activities that merely confirm what is already known — even though that knowhow might not exist within the firm conducting the activities." Accordingly, Point 2.16 implies that if anyone on a worldwide basis might know the outcome of the experiment, it would not pass the "new knowledge" test. This is a much higher requirement than the "competent professional" test outlined in Point 2.13.

  For the existing program, AusIndustry's *Guide to the R&D Tax Concession* notes that "to establish whether something is new or different, the Board compares it with what was already available in the public arena on a reasonably accessible world wide basis at the

time in that technology". We recommend that this test continue to apply, instead of the test at Point 2.16.

- Risk and Uncertainty of Outcome:

  The new definition of R&D activities denotes the requirement for technical uncertainty through the reference to activities "whose outcome cannot be known or determined in advance". Point 2.14 of the EM indicates that "there will be a significant risk that the outcome of eligible experiments will not be the desired one". While we acknowledge the Government's intent to limit eligibility where risk is limited, the use of a subjective term such as "significant risk" is not ideal, as it leaves scope for interpretation.

  We consider that R&D projects typically begin with considerable levels of uncertainty in the potential for, or manner of, success. Various approaches can be taken to mitigate risk during the project, for example companies can undertake a number of trials based on various hypotheses for success, to achieve the project's goals.

  Alternatively, companies may choose to undertake additional early stage work to mitigate risk which might be involved in later stages of the project. This may include extensive feasibility work, longer concept and early stage design work, and further desktop trials or computer modelling. For some projects, physical trials may be very expensive and involve significant capital investment, so failure has large financial consequences.

  In these circumstances, companies would wish to extend this early stage work so that by the time a prototype is designed and built, the risk of failure has now decreased (perhaps below "significant risk") due to the efforts undertaken earlier in the project. We do not consider that this approach should render certain project activities to be ineligible for R&D support.

  We also consider that experimental activities without any element of uncertainty would merely be confirming existing knowledge and accordingly, would not meet the "new knowledge" requirement. Accordingly, we believe that point 2.14 of the EM should be deleted.

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In addition to the above points regarding the interpretation of the legislation, we disagree with some of the conclusions drawn in the examples provided in the EM.

- Example 2.1: The supporting activities are described to include "mixing and measuring the ingredients for the test batches; constructing an apparatus to capture and record exhaust emissions". We believe that this example incorrectly applies the definition of supporting activities. We consider that these activities are eligible core activities because they are part of the experiment, and the experiment is itself a set of activities (including setting up the experiment). No single activity is going to be "experimental" – practically, groups of activities will be required to appropriately meet this new test. In administering the program, there can be a real danger of breaking down activities to such an extent that virtually nothing is eligible. The proposed legislation supports an approach of a broader interpretation of the term "activities", in its reference to a "systematic progression of work that proceeds from hypothesis to experiment, observation and evaluation, and leads to logical conclusions" in describing experimental activities.

- Example 2.9: The experimental activities are considered to include "incremental" building of the overburden heaps beyond the known safe slope angle. We believe the building of the entire overburden heap used in the experiment is an eligible core activity. This is the same point outlined above – setting up the experiment is part of the experimental activities.

- Example 2.14: The fabrication of the rudder-screw assembly is not considered to form part of the experimental activities. We believe the fabrication activities are eligible core activities because they are part of the experiment. This is the same point made above – setting up the experiment is part of the experiment. Further, these are exactly the same facts as Example 2.12 of the explanatory materials to the first exposure draft where the fabrication **was** considered to be an experimental activity. It is not clear why the change in proposed definition has altered the Government's interpretation.

These examples will play an important role in the interpretation of the new law by claimants and administrators. Accordingly, it is important that these examples are clear and are consistent with reasonable interpretation of the drafted legislation.

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Support activities

We have considered the modified definition of supporting activities. While we acknowledge that the second exposure draft more closely aligns the draft legislation with the stated policy intent, we disagree with some of the guidance given and some of the conclusions drawn in the examples provided in the EM.

As you are aware, the second exposure draft has brought in a "dominant purpose" test in relation to supporting R&D activities which are (or directly related to) the production of goods or services. This will operate to limit R&D eligibility for particular activities, in addition to the operation of the feedstock provisions (which we note were not included in the second exposure draft but we understand they will be included and will be similar to the existing feedstock provisions).

The operation of these two areas of the legislation can be problematic, as many R&D activities ultimately have a commercial aim. At Point 2.21, the EM acknowledges that "with very few exceptions, R&D undertaken by companies will have an ultimate commercial objective. This fact of itself does not affect a conclusion that particular experimental activities are conducted for the purpose of knowledge…"

Some examples in the EM look to exclude production activities due to the "dominant purpose" test. However, we note that in some circumstances, the basis for the outlined interpretation is not clear. In addition, as the feedstock provisions would apply to limit R&D benefits anyway, particular analysis of production processes may not be necessary, and may only confuse companies in trying to understand the operation of the new requirements.

We comment below on a couple of examples in the EM for which we query the outlined interpretation of the draft legislation.

- Example 2.10: this example outlines a circumstance where items are taken from a certain point in an existing process for trialling. The example outlines that the operation of the production line up to the point where the items are removed for trialling purposes is considered to be a supporting activity, but not for the dominant purpose of supporting the core activities, and therefore not eligible. We do not believe that this interpretation is correct, in that the existing process provides the items which are the subject of the trial. In addition, the example notes that these items will not be sold. Accordingly, it does not seem

reasonable to argue that the process which provides these items for trial purposes is for commercial reasons, rather than the dominant purpose of R&D. It would appear that the process solely operates to provide materials for the R&D trial – the fact that it was the same process that would otherwise occur in normal production is irrelevant.

- Example 2.12: this example outlines a circumstance where a company undertakes a full load production process with new process functionality for a section of the process. The example indicates that the operation of the section of the process with new functionality is a core R&D activity, while the preceding and subsequent processes are neither core nor supporting activities, regardless of the fact that "running the full production line is, to some extent, necessary for the experiment".

  We believe that selling the output of a process involving R&D activities does not necessarily mean that the process was not for the dominant purpose of R&D. Should the trial have been a failure and no saleable product was generated, it may follow from the example's interpretation that the entire process would be eligible. The purpose of activities should not be contingent upon their eventual commercial success.

  In practice, it would be difficult to apply the example's recommendations in the calculation of R&D expenditure. It would be difficult to segregate discrete elements of a process into either dominant R&D or other purposes. To take an extreme example, a production line could be completely redesigned and rebuilt. However, should any parts of the process be the same as the previous version (ie. pipework, utility lines, safety equipment) the example's interpretation may require that each component of the new process be analysed to see whether it is part of the trial, or merely the same as the previous process.

  We query whether the examples outline the correct interpretation of the proposed legislation. In addition, we query whether this discrete analysis of process components is required, as the feedstock rules may apply to limit R&D benefits available from the commercial process.

  However, should the feedstock provisions be applied to the trial section only, there may be a position where the output from the trial section is not saleable and accordingly there may not be a feedstock output. Regardless of the example's intention to limit R&D benefits in

relation to the trial, the effect on the feedstock calculation may actually increase the total R&D benefit available.