

19 April 2010

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

Dear Sir/Madam

**RE: R&D Tax Credit Draft 2<sup>nd</sup> Exposure Draft**

NOAH Consulting welcomes the opportunity to provide feedback on the 2<sup>nd</sup> Exposure Draft Legislation for the proposed R&D Tax Credit.

**About NOAH**

NOAH Consulting specializes in assisting organizations seeking to access Federal Government support for innovation, with a primary focus on the R&D Tax Concession. NOAH's Directors have in excess of 25 years experience in the R&D funding industry. Our client base ranges from small family run businesses to large global corporations across a wide variety of industries, including software development, tooling, mining and resources, manufacturing, medical and health care. As such, we feel well placed to assess the potential impact of the proposed new legislation on the wider innovation community, and industry in general.

**Our Feedback and Concerns**

NOAH commends the Federal Government for taking on board feedback from stakeholders on the 1st Exposure Draft Legislation and for making some common sense amendments such as:

- Lifting of the exclusions list on supporting R&D;
- Abandoning the augmented feedstock rules; and
- Abandoning broad based exclusions for software development.

Notwithstanding these changes for the better, NOAH still has a number of reservations about the extent to which the new legislation will truly deliver a more streamlined program that will encourage additional business expenditure on research and development (BERD).

These reservations can best be expressed as follows:

1. It is difficult to see how the jettisoning of the concepts of “innovation” and “technical risk”, which are internationally recognized, have been commented upon by the Courts and have been in the public arena for in excess of 25 years will provide greater certainty.

The proposed new definition of core R&D activities stipulates that these activities must be “experimental” and conducted for the purpose of “generating “new knowledge (including new knowledge about the creation of new or improved materials, products, processes, devices, or services.” Far from delivering clarity, we submit that the new definition contains greater ambiguity. This ambiguity seems to have been anticipated in the Explanatory Memorandum (EM) which, in paragraph 2.16, states that it may not be enough to be conducting experimental activities, if they “merely confirm what is already known.” But is this in respect of the claimant company or the industry at large?

In the example projects provided in the EM, the suggestion is that *the claimant* will need to be able to prove that the knowledge did not exist anywhere else. If this is the case, it is entirely at odds with commercial reality where IP is jealously guarded and companies may undertake research and development to arrive at a “me-too” product or process as part of a “stay in business” strategy. In this context, the activities conducted may well be experimental and deliver new knowledge, albeit new knowledge for the claimant company. Surely this type of research and development is still worthy of support, especially since it describes the vast majority of technical endeavour undertaken by Australian business.

2. We continue to have concerns about the introduction of a “dominant purpose” test for supporting activities. It is well-established principle that research and development does not take place in a commercial vacuum. It is critical that the nation’s flagship innovation program continues to support “development”, that occurs in a production or real-life environment, as well as “fundamental research”. This may not be the case under the proposed new definition.

Feedback from our client base indicates that a “dominant purpose” test will exclude a large proportion of production trial activity that is a necessary and legitimate part of the research, development and commercialization cycle. If the aim is to contain the cost to revenue associated with large and open-ended production trials, we continue to believe that the introduction of a cap on the value of supporting activities claimed as eligible project trial expenditure may more effectively achieve this objective.

It seems that the supporting activity limb is also not without ambiguity for, as the EM states in paragraph 2.32 that “it is possible that activities that are similar in appearance might qualify as supporting activities in one context but not in another.” We

understand that Government wants to preserve as much discretion as possible when it comes to assessing claims, but statements such as these suggest equally that project characterization will be as much an art as a science under the new scheme.

3. We continue to believe that the policy rationale for excluding what might broadly be called “in-house software development” from being a core R&D activity is poorly conceived. In today’s global marketplace, developing, modifying or customizing computer software to be used in internal administration can be a “stay in business” critical undertaking. If such an activity is undertaken in an experimental manner and for the purpose of generating new knowledge, why should it be denied government support?
4. We continue to believe that the changes proposed to the registration process and content will add complexity and increase the compliance burden for all claimants. Companies will be required to distinguish between core and supporting activities and explain the nexus between these activities. The draft legislation also holds out the prospect that Innovation Australia will request additional information as part of the registration process, adding further complexity and increasing the compliance burden for claimants.
5. The ‘expenditure not at risk’ provisions could be interpreted to limit claims to situations where the claimant has no reasonable expectation of obtaining consideration as a direct, or indirect, result of conducting the R&D. As a consequence, access to the R&D Tax Credit may be limited to entities conducting “blue sky” research.

## **Summation**

While the 2<sup>nd</sup> Exposure Draft Legislation does address some of the concerns raised during discussion of the 1st Draft, it does not go far enough. Under the 2<sup>nd</sup> Exposure Draft, the new program will still be much narrower in scope and no longer support industrial research and development. Instead, the scope of eligible R&D activities will be primarily aimed at supporting fundamental research conducted in a non-commercial context.

The changes will also add complexity to the process of project characterization, and the registration process, neither of which will support the stated policy aims of simplifying and streamlining applications.

Notwithstanding the amendments reflected in the 2<sup>nd</sup> Exposure Draft, an assessment of our own client base still suggests that the proposed R&D Tax Credit legislation has the potential to reduce support for R&D by as much as 70%. As our client base is representative of the existing R&D Tax constituency, there is every likelihood that a reduction of similar magnitude will be felt across the current 7,000 plus R&D Tax Concession registrants. If so, the results will be disastrous for Australia’s level of BERD, and contrary to the Government’s objective of maintaining revenue neutrality.

Given the Federal Government is a strong supporter of innovation and is actively seeking to improve the local environment for such activities, it would appear that the implementation of a broad based program that supports commercial R&D would better achieve these objectives. It is imperative that commercial R&D is given strong support, with the long-term objective of increasing investment in the Australian economy, generating new jobs, and boosting the profitability of Australian companies, directly resulting in increased corporate taxation revenue for the Federal Government.

NOAH would like to take this opportunity to thank the Minister and his Department for its consideration of the aforementioned comments.

Yours sincerely,

A handwritten signature in purple ink, appearing to read 'Andrew Hills'.

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