

26 May 2010

Mr. John Hawkins
Committee Secretary
Senate Standing Committee on Economics
Parliament House
Canberra ACT 2600
AUSTRALIA

Dear Mr Hawkins,

RE: Senate Standing Committee on Economics Inquiry into the Tax Laws Amendment (Research and Development) Bill 2010 and Income Tax Rates Amendment (Research and Development) Bill 2010.

NOAH Consulting welcomes the opportunity to submit comments and recommendations regarding the Committee's current inquiry into the aforementioned Bills.

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 30 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 has identified several issues regarding the extent to which the new legislation will achieve the objectives of a more streamlined incentive program that will encourage additional business expenditure on research and development (BERD). These issues are outlined below.

1. Definition of Research and Development

The terms "innovation" and "technical risk" have become clearly recognized and understood within the international research community, with a wealth of related Case Law and precedents now available regarding their application and interpretation. These precedents contribute greatly to

enabling a company to evaluate and assess their eligibility for an R&D incentive.

Removing the terms “innovation” and “technical risk” from the eligibility assessment process has the potential to create significant uncertainty regarding the eligibility of R&D activities for the Tax Credit. As such, we believe that this alteration will increase complexity and uncertainty surrounding eligibility assessments for companies, which is directly contrary to the Government’s objective to simplify the claim process.

The proposed new definition of core R&D activities stipulates that such activities must be “experimental” and conducted for the purpose of generating “new knowledge”, including knowledge about the creation of new or improved materials, products, processes, devices, or services.

The new definition will lead to greater ambiguity due to the introduction of the term “experimental activities”, which has not been clearly defined. It appears this ambiguity has 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.” However, there is no reference as to whether this is with respect to the claimant company, the local industry, globally, or otherwise. In the example projects provided in the EM, it is suggested that in order to meet the eligibility criteria, the claimant will need to prove that the knowledge did not exist anywhere else in the world prior to the commencement of the relevant R&D.

The aforementioned example is at odds with commercial reality where IP is jealously guarded, forcing companies to undertake their own research and development to arrive at a “me-too” product or process to remain competitive. In this context, the activities conducted may well be experimental and deliver new knowledge, albeit new knowledge for the claimant company. The lack of clarity regarding eligibility criteria could have a significant negative impact on the willingness of Australian companies to pursue local R&D efforts.

Recommendation: Maintain the current definition of eligible R&D activities.

2. Dominant Purpose

The introduction of a “dominant purpose” test for supporting activities has the potential to exclude the majority of research and development currently undertaken by leading innovative companies.

It has been well-established that research and development does not take place in a commercial vacuum, with the overwhelming majority of companies seeking to conduct R&D and profit from the results. Undertaking R&D in a production environment provides more accurate data, facilitates troubleshooting, and improves a company’s ability to progress a technology from idea to market.

It is critical that the nation's flagship innovation program continues to support "development" that occurs in a production environment, as well as "fundamental research". The proposed Bill will remove incentives for companies conducting R&D within their production environment.

The overwhelming feedback from our diverse 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 and development cycle. If the aim is to contain the cost to revenue associated with large and open-ended production trials, the introduction of a cap on the total value of the group's R&D claim would better achieve this objective, whilst also providing clarity and simplicity for claimants.

Recommendation: Introduce a cap on the total value of the R&D claim for companies with group annual revenue exceeding \$1 billion. This cap could be a prescribed dollar amount, or a percentage of the group's annual revenue.

3. Software Development

The policy rationale for excluding "in-house software development" from being a core R&D activity is contrary to the objective of promoting improved process efficiency and performance in Australian companies. The utilization of advanced software applications is becoming increasingly important in providing Australian companies with a competitive advantage in the global marketplace. It has been widely recognized that leading companies, across all industries, are increasing their focus and investment in software and IT, in an effort to further improve performance in all aspects of their business operations.

Specifically excluding in-house software development from core R&D activities will significantly discourage companies from adopting new software solutions, resulting in a direct negative impact on a company's performance and competitiveness. Such an exclusion will effectively encourage companies to maintain legacy systems which are inefficient and increasingly unreliable due to compatibility issues with advanced operating systems and IT infrastructure.

Assuming the development of an in-house software solution satisfies all other eligibility criteria, we cannot envisage any reason why such a project should not be entitled to R&D incentives under the proposed Tax Credit.

Recommendation: The development of in-house software solutions should not be subject to any special conditions or restrictions, other than the eligibility criteria applied to any other R&D project.

4. Registration Process

A key objective of the proposed Tax Credit is to simplify and provide greater certainty to companies with regard to the claim process. It is reasonable to expect that the proposed changes will add complexity and

require companies to invest greater internal resources to the claim process. In particular, the requirement for claimants to distinguish between core and supporting activities and explain the nexus between these activities has the potential to discourage companies from lodging an R&D Tax Credit claim.

Given the Tax Credit is intended to encourage more SMEs to lodge R&D claims, it is reasonable to expect that these companies will be discouraged from claiming given the substantial investment of resources required to compile an R&D claim. In particular, the increased reporting requirement will greatly discourage small companies from lodging R&D claims. These small companies have limited resources and are not able to invest the required time and/or funds required to ensure the R&D claim satisfies these additional reporting requirements.

Furthermore, the draft legislation also holds out the prospect that Innovation Australia will request additional information as part of the registration process, again adding further complexity and uncertainty to the R&D claim process.

Recommendation: Remove the requirement to distinguish between core and supporting R&D activities.

5. Expenditure Not at Risk

The 'expenditure not at risk' provisions would effectively exclude R&D projects undertaken with a reasonable expectation of generating revenue or some other 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.

The overwhelming majority of Australian companies undertaking R&D, do so with the objective of generating revenue and profits for their shareholders. It is unreasonable to expect a commercial organization to undertake R&D without a reasonable expectation to generate income from the resulting IP, whether directly or indirectly. Some of Australia's most internationally successful companies such as Cochlear, Foster's and Westfield, all undertake industry-leading R&D activities with the intention of generating value for their shareholders, a large proportion of which are Australian Superannuation Funds.

It is imperative that the Tax Credit encourages further R&D by SMEs seeking to build their companies into yet another successful internationally recognized Australian company. This can only be achieved by undertaking R&D that aims to boost revenue, and ultimately generate additional profits. These increased profits are then subject to Australian corporate taxation.

Recommendation: Remove the "expenditure not at risk" provisions.

Summation

The proposed Bill will drastically narrow the scope of activities eligible for R&D incentives, removing support for R&D conducted in a commercial environment. The scope of eligible R&D activities will be primarily aimed at supporting fundamental research conducted in a non-commercial context, with no clear objective of generating additional revenue or growth for the Australian economy. This will apply to companies of all sizes and across all industries.

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

Notwithstanding the amendments reflected in the 2nd 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, it is reasonable to expect a reduction of similar magnitude will be felt across the current 8,000 plus R&D Tax Concession registrants. Furthermore, we do not expect any significant increase in the number of claimants under the proposed Tax Credit, primarily due to increased complexity, a more narrow definition of R&D, and the explicit exclusion of activities undertaken with the objective of achieving a positive financial return.

Given the Federal Government is a vocal supporter of innovation, and is actively seeking to improve the local environment for such activities, the implementation of a broad based incentive program that supports commercial R&D would better achieve the objectives outlined. 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 Senate Economics Committee for its consideration of the aforementioned comments.

Yours sincerely,

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