

Australian Manufacturing Workers Union (AMWU) Submission to the Senate Committee Inquiry into the R&D Tax Credit legislation

INTRODUCTION

The AMWU is already part of the Advanced Manufacturing Coalition (AMC) submission to this inquiry and we thank the Senate Committee and the Secretariat for affording us the opportunity to lodge a submission and make a presentation to the Committee on Friday May 21st. The AMC is made up of the AMWU, Cochlear, Thales, Varian, Hofmann Engineering and Marand Precision.

As pointed out in the AMC submission:

“It was agreed that this group who had been involved in the lengthy process of discussions over the legislation would join together and respond jointly to the Senate Committee that was expected to be established once the R&D legislation was introduced into the Parliament. It was also understood that each of the participants had the option of making representations to the Senate Inquiry from the perspective of their own organisation.”

This AMWU submission deals with the R&D tax credit legislation and its impact on the cleantech sector in general, and energy efficiency related experimental development R&D by manufacturers in particular.

Our submission remains consistent with the AMC submission in identifying the following as key problems with the proposed draft legislation that will impact cleantech firms undertaking R&D as well as the energy efficiency applications R&D undertaken for process and product improvements by manufacturers.

- A) The objects clause of the legislation is too narrow
- B) The new definitions of R&D are overly restrictive in terms of what will qualify as eligible expenditure
- C) The distinctions between core and supporting R&D will create unnecessary compliance and reporting issues for both large and small firms
- D) The dominant purpose test will severely restrict genuine manufacturing R&D carried out in a production environment
- E) The new feedstock provisions will not assist manufacturing firms
- F) The draft legislation is draft three and there are yet more changes. There are too many unknowns and unknown unknowns to proceed with haste in implementing it and that includes the Explanatory Memorandum that will provide a context for the courts and the audit assessment process in the years ahead.

This submission also remains consistent with what Cochlear and AMC put to the Senate Inquiry in terms of a way forward and we expand briefly on this in our short conclusion.

R&D LEGISLATION, CLEANTECH AND ENERGY EFFICIENCY R&D BY MANUFACTURERS

The AMWU is particularly concerned with the potential implications of the draft tax credit legislation on the cleantech sector in general and on the eligibility of manufacturers R&D to qualify as eligible expenditure for energy efficiency process and product improvement investments in particular.

Similar concerns were registered with Treasury in April 2010 by the Clean Energy Council (CEC) in its submission on the second draft exposure legislation in these terms:

“Specifically, the CEC wishes to express its concerns with a number of aspects of the proposed legislation. In particular, the CEC believes that the dominant purpose rule and the lack of recognition of either applied research or experimental development as a core R&D activity will be of particular detriment to Australian clean technology companies, by significantly narrowing the definition of R&D.

Large grant programs, such as Solar Flagships whilst welcomed, do not incentivise SME clean technology companies to undertake risky R&D, thereby threatening the intellectual capability of the Australian clean technology industry. The CEC also has concerns that these changes will increase complexity and result in uncertainty for claimants, particularly those in the SME market. The CEC also considers the new legislation will put Australian firms at a competitive disadvantage, and will de-incentivise multinational companies’ R&D expenditure in Australian clean technology, at a time of increased tax competition – contrary to the stated objective of attracting spill over benefits from R&D activity in Australia.”

The Future Manufacturing Industry innovation Council had similar concerns and wrote a submission to Minister Carr highlighting them in the following terms:

While definitions vary, there is a boom underway in R&D investments related to the climate change and cleantech agendas. In 2007, more than \$55 billion of R&D was undertaken in cleantech by governments and corporations globally, and more than \$6 billion of venture capital was invested in new cleantech firms.. The opportunities have only just begun to emerge which is reflected in the fact that between 2000-2006 only 2.15% of total patents applied for worldwide were environment related.¹

One of the submissions to the R&D Tax Consultation in October 2009 suggested that there was considerable potential for low emission technology R&D to be undertaken in Australia.

“Based on what I am observing with my client group it is likely that an increasing number of low emission projects will be supported by the new (R&D Tax Credit) scheme. I am aware of a new, Australian low emission technology which will have more than 50 applications in transport, mining, agriculture and manufacture. Each application will involve developing an integrated solution specific for that application....My guesstimates of the proportion of R&D Tax Credit Scheme projects that will involve low emissions as a technical objective within about 5 years:

- *10-30% where low emissions is the primary objective;*
- *A further 20 to 50% where low emissions is a secondary objective.*

¹ Data sourced from P. Aghion et al Bruegal policy brief, Nov. 2009 : “No Green Growth Without Innovation” Cleantech group website (http://cleantech.com/about/press_release/20090106.cfm; Speech by Singapore’s Minister of State for Trade and Industry 20/08/2007)

Since the new (R&D Tax Credit) scheme will be a means for funding low emission projects and ones that address the various impacts of climate change it is recommended that revenue from ETS permits be used to fund part of the R&D Tax Credit scheme in proportion to the relative value of such projects supported and that eligibility (for the R&D Tax Credit) not be tightened.”²

(Dr. Terry Freund: Submission to the R&D Consultation paper, October 2009)

Unfortunately, that same submission, like the vast majority of the 197 submissions lodged with Treasury in the December Quarter 2009, suggested the changed eligibility arrangements for claimable R&D expenditure would substantially diminish the benefits to firms and the amount of R&D undertaken in Australia.

The concerns expressed previously in this submission apply as much to manufacturers focussed on cleantech R&D investments as they do to other manufacturing activities. This is especially the case with the impact the dominant purpose test for supporting activities would have on the capital intensive tooling up, trials, prototyping and other related activities that have to be undertaken in a production environment for much of cleantech experimental development.

FMIIC have a heightened concern about the impact in cleantech because it is a relatively new high growth “game changing” opportunity for Australian manufacturing where much of the opportunity is available for traditional manufacturers as opposed to simply being there for new start-up manufacturers.

As suggested in Appendix One, global competition to secure competitive advantage in cleantech is intense, with China, Japan and Korea increasingly challenging and moving ahead of the United States, particularly through government support.

*In Australia’s case that Government support exists in a range of programs but **not** through Australia’s main incentive for research and development (should the proposed changes for eligible R&D be legislated).*

The new arrangements proposed for R&D eligibility under the tax credit may encourage additional basic research in cleantech solutions to be undertaken in Australia. But other things being equal, overseas locations will be preferred for experimental development and tooling up and producing prototypes for manufacture. At the end of the day if the experimental development and prototype work is done offshore it is far more likely if not a certainty that the manufacturing will also be done offshore.”³

From the AMWU’s perspective it is not surprising that the submission by the FMIIC and Dr Terry Freund put so much emphasis on the fact that in the era of climate change mitigation policy an increasing proportion of business R&D will be committed to energy efficiency improvements in both product and process technology.

This will involve a considerable amount of experimental development to utilise existing process technologies with less energy, as well as lowering the carbon intensity of new and existing products as a response to a price being put on carbon, regulatory changes and as a requirement demanded by customers.

It is therefore particularly concerning that so much expert opinion suggests that the draft legislation may “crowd out” a significant amount of experimental development as eligible expenditure particularly where the legislation results in the R&D being reclassified as supporting rather than core R&D and occurs in a production

³ FMIIC submission to Minister for DIISR: January 2010

environment or is related to activities on the exclusion list such as “activities associated with complying with statutory requirements or standards” (Section 355-25(2) (f)).

A sample of this expert opinion from submissions on the second exposure draft legislation is provided in Appendix One attached to this submission. In simple terms a part of the problem that participants are highlighting, can be summarised in the following manner:

- The draft definition of R&D now before the Senate Committee focuses on experimental activities that are required to close a knowledge gap. The problem for a cleantech firm or a manufacturer doing R&D to improve energy efficiency is that considerable uncertainty exists over which group of experimental activities will be defined as core and which as supporting
- For every extra dollar spent on “experimental activities” that gets classified as supporting R&D in a production environment rather than core R&D, the dominant purpose test will come into play. In many cases this dominant purpose test will make some supporting R&D that is currently eligible expenditure under the existing system ineligible under the new system.
- It is far more likely that the basic research and applied research undertaken in a laboratory away from the production environment will qualify as core R&D. But once one is doing experimental R&D in a production environment (trials, testing, prototype development, and trouble shooting during new process improvements.etc), particularly where the output will/may be sold, the dominant purpose test is likely to render ineligible genuine R&D or at the very least give rise to considerable uncertainty about how such expenditure will be treated

It is also our assessment that a significant proportion of energy efficiency related R&D would, under the existing definitions of R&D satisfy either a test of considerable novelty, or a test of high levels of technical risk but not both. The new changed definition of R&D in the exposure draft legislation requires both as has been the case in each of the three drafts Treasury has produced.

In our assessment this raises the bar to high and will preclude as eligible expenditure much experimental R&D undertaken by cleantech firms and manufacturers doing R&D focused on more energy efficient products and processes.

THE WAY AHEAD

Treasury officials, acknowledged that a 15% to 20% reduction in eligible R&D expenditure had been designed into the system as a result of “tightening” How much of this is the way the new definitions of R&D operate (effectively requiring both considerable novelty and high levels of technical risk) or how much will happen because of the dominant purpose test or other factors remains unclear.⁴ An attribution analysis has not been provided.

However, it is clear in the overwhelming majority of the 383 submissions recorded for this inquiry that participants do not support the introduction of the draft exposure legislation in its current form.

⁴ Senate Inquiry into R&D Transcript: Thursday May 20 pg 61 Statement by Mr Antioch

This is also the position of the trade union movement.

In May 2010 the Australian Council of Trade Unions (ACTU) in partnership with the AMWU, ANF, AWU, CFMEU, ETU and LHMU made a detailed submission to the Prime Minister's Task Group on Energy Efficiency rejecting key elements of the Treasury Exposure Draft Legislation in the following terms.

“Government has announced that it will introduce through legislation greater R&D incentives (through a system of tax credits), with its objective being to have the new legislation in place by July 2010. The scheme is likely to provide the equivalent of support costing \$1.4 billion in its first year of operation.

A good deal of controversy has been generated by the draft legislation to introduce the new system. From the perspective of unions it is imperative that the new legislation accomplishes two objectives that are both vital to the challenge of encouraging greater energy efficiency.

“First, the objects clause of the legislation should provide a clear signal of the goal of encouraging international competitiveness. The references to spillovers and additionality should be removed. The objectives clause should also state clearly that R&D focused on encouraging more energy efficient products and processes should be considered eligible expenditure, and in the 21st century be regarded as a key component of achieving international competitiveness....

Secondly, the existing definitions of eligible R&D activities should be retained as should the existing relationship between core and supporting R&D. Under current arrangements, ‘core R&D’ is eligible for the tax deduction if evidence can be shown that the R&D satisfies either a test of being innovative, or a test of high levels of technical risk. Similarly supporting R&D is eligible if it can be demonstrated that it is directly related to the core R&D.

Those tests are well understood by firms, administrators, regulators, and appeal bodies including the courts. They are also consistent with the way eligible R&D is operationalised for tax concession treatment in other OECD countries. Unions, therefore, advocate that the status quo be retained.

If there are any inappropriate claims or abuses of the system they should be managed through rigorous auditing process and specific mechanisms that only apply to the small number of firms that may pursue inappropriate claims. To do otherwise and impose new across-the-board demanding tests to ‘weed out’ such claims penalises the 8,000 registered firms with new and cumbersome R&D”⁵

This issue of inappropriate claims is really a core issue in this inquiry. We know the Government was concerned about the increasing cost pressures on the system because of the way that business as usual software was being claimed as eligible expenditure. It is now clear that there is a largely agreed amendment that could/will be made to the legislation to “fix” this software issue.

⁵ ACTU Submission to PM's Energy Efficiency Task Group May 2010 pp24-26

That leaves the” big elephant in the room” issue to be addressed which is so called whole of mine claims. The AMC described this issue in the following terms:

- 1) *During the consultation process it became clear to AMC participants that Government had an additional concern about the cost of the scheme, particularly how it might grow as economic recovery and increased investment occurred through the course of 2010 and beyond as a result of a small number of large “excessive claims”. This was covered off in the Cutler Report in the following terms:*

“In recent years several firms have been successful in the aggressive use of the R&D Tax Concession to make claims for very large share of expenditure in large one-off projects like mines and civil engineering. These claims have demonstrated that some aspect of the project is new and technically risky. This having been done it has been possible despite the efforts of the Australian Taxation Office, to claim as much as 80 per cent or more of all investment expenditures in the project.

The Panel appreciates that such ventures are both risky and innovative. At the same time it is clear that such ‘whole of mine’ claims are gaining for themselves a degree of assistance disproportionate to the benefits available to many other innovative projects. While they are also being undertaken by firms with very good access to capital, it is also true that capital markets are averse to risks in long term technology projects. This is an issue which needs to be addressed in its own right, and not by default through a general tax concession.”(Venturous Australia: opt cit, p. 109)

*So called “whole of mine” claims should be seen as a generic concept and could just as easily be referred to as “whole of factory”, “whole of construction site” or “whole of building”. The AMC participants in this inquiry have insufficient knowledge of such claims. However we strongly recommend that the Senate adopt the following principle in dealing with the issue. **Such claims, if they exist, should be dealt with by a separate mechanism (such as an expenditure cap, advance approval or specific regulation). Good policy does not impose a blunt instrument like a dominant purpose test or feedstock provisions on 8,000 firms in order to contain a handful of large claims that are perceived to be inappropriate.”***

The AMC proposed a simple solution to this problem. We know such claims are large multimillion dollar claims. We know that such claims often have supporting R&D which is 10 to 20 times or more then the dollar value of the core R&D.

Rather than impose a substantial additional compliance burden on the 7,754 entities registered for the tax concession, the AMC proposed an approach that could, for example, operate in the following manner.

- A) The largest 100 to 200 claims in dollar value terms would be separated from the rest of the scheme and new regulations be applied to “weed out whole of mine claims”
- B) This would mean more than 97% of R&D applications would be processed under the existing system with the existing definitions and tests of eligible R&D and without the need of a dominant purpose test.
- C) The test for the 100 to 200 largest claims would be first, is the supporting R&D more than say three times as large as the core R&D? If it is less than that, the application would be treated under the same rules as all other applications. But if it was more then that and the company wanted to proceed, it would have to gain advanced approval from Innovation Australia on how much expenditure would constitute eligible expenditure. The rules to

determine this would be developed either via regulation or by legislating something similar to a dominant purpose test.

At the end of the day The AMWU and AMC approach to the way forward has the following benefits:

- 1) Almost 99% of R&D applicants will enjoy the certainty and knowledge of the existing system with the only change they may need to consider being for their R&D software claims.
- 2) Less than 1% of applicants are likely to be affected by the advanced ruling/approval processes required to “weed out” whole of mine claims.
- 3) Our approach represents the best way of preventing an unprecedented increase in compliance costs for thousands of SME’s and importantly preserves the integrity of the self assessment system
- 4) **Virtually 100% of all process and product development R&D that is energy efficiency related and qualifies as eligible expenditure under the existing system will qualify under the new system and much of it at a higher level of incentive. The same applies to the R&D of cleantech firms**

Most importantly we believe that this approach we are advocating is the only approach that can be fast tracked and gain approval from the Parliament in time for the legislation to come into effect on July 1 2010.

In this respect we state below what we stated previously in the AMWU’s April 2010 reply to the second exposure draft legislation

“The AMWU is firmly of the view that it is in the national interest for legislation giving effect to the new Tax Credit regime through the changes we have recommended to come into effect from July 1 2010.

We say this on the basis of discussions with a broad cross section of industry about the circumstances facing small innovative Australian companies with turnover of less than \$20 million who stand to benefit the most from a 45% refundable tax credit. The environment they currently face is characterised by the following conditions:

- *Access to bank finance for small innovative R&D intensive firms is even more constrained than usual.*
- *The global venture capital market in general and the Australian VC market in particular are under funded relative to the level of bankable deals. This is unlikely to change in the next 12 months.*
- *Given the high level of demand after Commercial Ready was closed down it is to be expected that the allocated funds for Commercialisation Australia in 2010-2011 will be seriously constrained relative to the number of seriously good claims*
- *While angel investors are back in the market they too have been impacted by the GFC.*
- *The bottom line is that both Federal and State funding for innovative companies is at capacity and unlikely to expand at the same time that access to different types of private sector risk capital is seriously constrained. This is occurring in an environment where small innovative firms were already short of working capital let alone funds for R&D.*

- *In such an environment there is a grave risk that an unnecessarily large number of small innovative Australian firms with smart IP and good global prospects will go to the wall or have to sell their IP off for a song and a prayer. This last resort sale of IP will in many cases be to offshore investors trawling for Australian IP that can be bought and sold on the cheap because of the financial squeeze.*

It is not in the national interest for Australian SME's in general and manufacturing SME's in particular to be disadvantaged by delaying the introduction of the tax credit system

If the legislation passes, the first SME's will receive their 45% refundable tax credits in August 2011. If it is delayed a year SME's will not be eligible to receive their refundable tax credits till August 2012.

Given the unfavourable environment described above considerable damage could occur through delay and delay is unnecessary if simple amendments proposed by the AMC are implemented. Those amendments include:

- 1. Redraft the objects clause of the legislation.**
- 2. Retain the existing definitions of R&D.**
- 3. Remove the dominant purpose test.**
- 4. Deal with excessively large/"inappropriate claims" using a separate mechanism, such as an expenditure cap, advance approval or specific regulation.**
- 5. Clarify the feedstock provisions so that:**
 - a. the feedstock clawback only claws back feedstock input and energy used to transform or process that feedstock input, and**
 - b. feedstock outputs are made from feedstock inputs in R&D activities that are also production activities.**
- 6. Establish a Government-Industry working party to help resolve these matters and clarify the Explanatory Memorandum**

The AMWU strongly urges this Senate Committee and the Parliament of Australia to adopt the simple set of changes we have recommended and that were recommended by the Advanced Manufacturing Coalition and have the legislation come into effect on July 1 2010. We also ask the Senate Committee and the Parliament a simple question about improving cash flow for knowledge intensive SME's in the current environment.:

- Suppose the legislation comes into effect from July 1 2010. What could Innovation Australia, Government officials and the Banks negotiate to securitise the 45% refundable tax credit for SME's such that rather than waiting till August 2011 an advance on the credit was available during 2010 for approved applicants.

Appendix One: Comments on why the new Tax Credit Legislation is more supportive of Research instead of Experimental Development

“The new draft clearly indicates a significant change in the policy mindset of the Federal Government as it relates to stimulating research and development in the economy. Contrary to its stated position in recent policy documents, such as the *Powering Ideas*, it is now apparent that the Government intends to pare back its role to fund, almost exclusively, research.

In fact, as it stands, the draft legislation would be better referred to as a Research Tax Credit given the narrow definition proposed for core R&D and the likelihood that most supporting developmental activity would be discounted under the new rules.”
(**Australian Industry Group** April 2010 Treasury website)

“The new definition of “core R&D activities” with strong emphasis on experimental activities is increasingly focused on the research component of R&D. The new definition seems to leave out essential development activities which bridge the gap between the research and the application of the new knowledge generated in real world situations.”(**Ernst and Young** April 2010 Treasury website)

“This (legislation), at best dilutes the eligibility of experimental development work necessary for the creation of new or improved products, processes, materials, etc. This experimental development is the fundamental method by which industry provides benefits to the wider Australian economy” (**KPMG** April 2009 Treasury website).

“We remain concerned about what we see as the re-orientation of the incentive away from experimental development and more towards basic and applied research. We believe this is likely to have an adverse impact on a critical element of business R&D in this country.”
(**Corporate Tax Association of Australia** April 19 Treasury website)

“The changes proposed by the Government in the 2nd ED appears to discount the value of “development” when compared to “Research” and in fact the 2nd ED effectively eliminates support for research and development conducted by companies and instead supports corporate research only”
(**BDO** April 2010 Treasury Website)

“*The object clause.* The new object clause (s355-5), when taken in conjunction with the new definition for core R&D (discussed below), appears to reflect an intention to limit support to research and exclude development. This is despite the fact that development represents the largest and most important aspect of business expenditure on research and development. Removing support for development would shift commercialisation activity overseas and undermine the capacity of the scheme to secure the benefits of R&D for the Australian economy.”
(**NSW Business Chamber** April 2010 Treasury Website)

“Subsection 355-25(b) significantly limits R&D activities to the generation of new knowledge and excludes the most common form of commercial R&D involving the application of knowledge or information. This narrow approach fails to recognise that applying new knowledge is the most commercial common source R&D and will

severely limit eligibility of R&D activities for the R&D tax incentive. It also largely recognises the research element and not the “development” element of R&D which is inconsistent with the overall purpose of the R&D tax incentive”
(**ResMed** April 2010 Treasury website)

“The EM appears to interpret the new dominant purpose test, in conjunction with the new core R&D definition, in a manner that could remove much of the existing support for development end activities conducted in the factory environment that are vital for productive commercialisation.”(**Institute of Chartered Accountants in Australia** April 2010 Treasury website)

“The Easter draft introduces new concepts and removes well understood criteria such as technical risk, innovation and novelty, thereby severely limiting the program to just supporting research. The new Object provision and the definition of Core R&D Activities (s 355-25) apply to only to the “Basic Research” and “Applied Research” parts of the OECD definition of R&D (the Frascati definition). This withdraws all encouragement and support for the largest and most critical aspect of BERD – the systematic work, drawing on the knowledge gained from the research that is directed at the production of new materials, products or devices, the installation of new processes, systems and services, and the improvement of those already produced or installed. This “Experimental Development” phase of R&D has long been recognised as the step that Australia is poor at and as being the critical phase insuring the benefits of R&D for the Australian economy.”(**Michael Johnson Associates** April 2010 Treasury website)