The New Research and Development Tax Incentive

Tax Law Amendments (Research and Development) Bill 2010

Submission by Ernst & Young

28 May 2010

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The Committee Secretary
Mr John Hawkins
Australian Senate Committees

Dear Sir

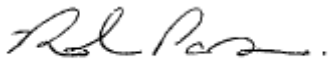
Response to Tax Laws Amendment (Research & Development) Bill 2010 ("the Bill")

Ernst & Young is pleased to make this submission in response to the above regarding the new research and development ("**R&D**") tax incentive to be introduced from 1 July 2010.

While it is pleasing to see that the Bill has addressed a number of industry concerns, there are 3 issues we wish to bring to the committee's attention as areas for more work, namely the difficulty a lack of modelling places on achieving policy objectives, possible alternatives to "dominant purpose" and detail on unintended consequences.

We set out our reasoning for our submission further in the attached paper. If you would like to discuss this submission in more detail please contact me on 08 9429 2251.

Yours faithfully



Robin Parsons
Partner

1. Introduction

Representations made 10am, Thursday 19 May 2010

Robin Parsons represented Ernst & Young at recent Senate estimates hearings. He has worked with the current Research and Development tax concessions for Ernst & Young since 1992. Ernst & Young is a global accounting firm and we service both the large and small companies of Australia.

We again re-affirm our overall comment that the Bill largely is achieving stated government objectives, that of re-directing assistance from larger corporate to the SME's. However, we do have the following reservations with the Bill as it is presented, namely:

- There appears a lack of modelling with respect to the Bill, and in particular, the stated objective of revenue neutrality at around $1.4 billion per year. It is our concern that the provisions are not as generous as the Government assumes (without the benefit of specific modelling), particularly with the use of the blunt "dominant purpose" test for supporting activities. It would be prudent to conduct detailed modelling of the Bill and to disclose this. With data on the cost of certain limitations to current law (such as dominant purpose) informed debate can be undertaken to ensure the measures around supporting activities have not been overly limiting;

- We do believe the Government has understated the adverse effect of the dominant purpose test. Dominant purpose is a high hurdle. We understand the governments concerns on the extent of support activities claimed in some specific cases, particularly production trials making up a disproportionate percentage of an R&D claim. Conversely, production trials do provide the valuable scaled-up development feedback important to product and process development. Manufacturers in particular use production trialling to verify and improve their R&D. They can also be characterised as a high turnover/low margin businesses often with turnovers in excess of $20 million, but still very thin profits (if at all). Manufacturers, by necessity, are ultra-efficient. There production trials are undertaken in a duel setting of production and R&D, because they are experts at undertaking multiple tasks with the same scarce resources. Production managers and R&D teams working in close collaboration. Dual purpose does not pass the dominant purpose test. Manufacturers in particular suffer under this principle based approach, and we believe they are unintended casualties of this Bill.

  There are alternatives to the principle based, dominate test to tackle specific areas of concern. We have already in written submission previously provided some alternatives, and we will provide more detail in this submission;

- We don't understand the need to extend the dominant purpose test to the non-production activities listed in the reduced exclusions list. Non-production related activities have not been identified as areas of excess; and

- Finally, there are unintented consequences in this Bill, as well as basic referencing errors in the EM (refer Appendix 1). We have provided in written submissions on these points before, but they include problems with:

  - SME Grouping;
  - Depreciable assets installed ready for R&D use;
  - Corporate Limited Partnerships; and
  - Disposal of part R&D asset.

We conclude that we have concerns that the risk is high that the Bill understates the adverse effects of such a limited application of certain supporting activities. We think this risk hasn't been tested due to the absence of financial modelling of the Bill, and as a consequence, the Bill could result in the under support of key sectors and not achieve the key Government objective of revenue neutrality. This risk is compounded when the unintended consequences outlined above are also taken into account, many of which could be easily remedied with appropriate consideration and consultation and do not represent any material cost to revenue.

Questions on notice:

1. Can you provide other legislation where there is preferential treatment to labour?

- France allows taxpayers to account twice the actual amount of salaries paid on certain labour costs.

2. Can you provide specific wording as an alternative to dominant purpose?
   - Refer to 2.3 of this paper.

2. Dominant Purpose Test Too Restrictive - Alternatives

Production trials are an important part of R&D activity, and we respectfully suggest the Government has confused "genuine R&D" with the need to limit the cost of R&D assistance for production trials to pay for higher R&D assistance in certain areas. We understand the conflict, and so production trials (although R&D) need to be limited to limit the costs to revenue and achieve Government policy. This is a more honest position to the debate, rather than demonising production trials (and certain industries that need to undertake them) to achieve the same objective.

The dominant purpose is overly restrictive for manufacturers in particular, and coupled with the lack of financial modelling of the Bill, the inappropriate outcome is that the dominant purpose test is unnecessarily harsh within the Government's policy framework. That is, the overall Bill provides unexpected revenue savings at the expense of (say) manufacturers. In addition, it has the following disadvantages:

- it is a subjective, decisive test that generously rewards production trials that pass the high hurdle but provides no reward for slightly less dominant (say dual) purposes;
- it fails to recognise business efficient approaches that is the reality of dual or multiple purpose activity; and
- it could promote inefficient behaviour that results in business altering their approach to production trials. Specifically, businesses halt normal production for specific trials or conduct trials on test beds so as to satisfy the high dominant purpose test. However, they ultimately need to test in real production environments, and will have to re-do work for real life scaled production testing.

We believe alternatives are available to dominant purpose, and we provide four, namely:

1. apportionment of expenditure;
2. dollar capping the extent of production trials;
3. more sympathetic language other than dominant; and
4. specific provisions to tackle specific excesses.

They each have advantages over dominant, but none are perfect. We would favour specific provisions for specific (extreme) concerns, or at least an apportionment methodology over the current dominant concepts.

2.1 Apportionment of Expenditure

An approach already evident in parts of the current R&D provisions and generally within the Act are the concepts of apportionment. That is, where dual or multiple purposes are evident in the one activity, an apportionment of expenditure relating to the R&D component is an allowable deduction. The advantages are:

- It is unlikely to alter efficient business behaviour, as opposed to dominant purpose, since proportionate reward would not form an artificial "hurdle" to overcome; and
- It naturally rewards the extent of R&D proportionate to effort. That is, a production trial with the dominant purpose to support R&D will be better rewarded than say dual purpose. Additionally, provisions could be included to fully exclude minor or incidental R&D purposes.

2.2 Dollar Capping of production trials

Simple cap limits could be an alternative, and example provisions are below:

- *Production trial expenditure, although eligible R&D activities, will be limited to $ X m per income year*

Advantages are:

- The vast majority of claimants are relatively small and would not breach modest caps;

- It is a revenue containment provision in keeping with Government policy of revenue neutrality. It is honest in this regard, unlike dominant. The cap amount may change to achieve the $1.4b – we are dependant around the absent modelling here;

- It specifically addresses the concerns of the Government around controlling the cost to revenue, and in particular areas; and

- It is a lot simpler than dominant.

There is an argument against caps – it punishes the bigger companies (the cap imposes a smaller percentage incentive for larger turnover companies) and who is to say the biggest companies are not doing the most important ("genuine") R&D.

We do not recommend the cap level be set until reliable modelling has been completed. It is the mechanism to manage revenue to a given figure, and it needs to be robustly understood what the extent of production trial claims currently cost.

Finally, the idea could be further modified to allow larger production trialling where advanced, discresionary approval is received from Government regulators. Advanced approval is a concept currently available in the current legislation. Despite the negative comments this Government has provided on production trials not being R&D, there are examples of significant, large scale production R&D being important to the Australian economy. It gives the Government the ability to manage and support worthy production trialling.

2.3. More sympathetic language other than dominant.

We do not favour different words, such as significant or substantial, because there is a risk the uncertainty and "hurdles" with dominant are simply moved to new uncertainties. However, we have been specifically asked for other alternatives, and our preference would be some form of quantification as described below.

- where the R&D constitutes 50% or more of the purpose of a production trial activity.

This language would support the dual purpose manufacturing examples we have explained previously. However, the disadvantage is the unknown effect on achieving revenue neutrality with the lower threshold, and this issue is again exacerbated with the lack of modelling.

2.4 Specific provisions for specific excesses.

An obvious approach to specific areas of concern is specific legislation to eliminate inappropriate use of the Bill. The advantage of this approach is it avoids the possible unintended consequences highlighted in our senate representations last week and in this paper, namely manufacturers and the like. The dominant purpose test in a more specific setting maybe appropriate for certain excesses the government is not keen to support.

It must be said that to date a comprehensive list of concerns has not been tabled by the Government, but rather a few (somewhat extreme and possibly currently ineligible) examples lacking context have been cited. This makes specific amendment proposals difficult to draft.

Indeed, one disadvantage we acknowledge with specific provisions is the difficulty in ensuring the specifics covers all activities not deserving of Government support.

2.5 Other Issues with dominant

Production of Goods and Services Not Defined

The Bill also introduces the terms "production of goods and services" and "directly related to production of goods or services" with regards to 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. The term "production of goods and services" is also not defined in the legislation, and the examples provided in the EM are often inconclusive due to the layers of caveats and restrictions.

Directly Related to Production – Examples Required

The use of the term "directly related" is subjective, and potentially creates an extensive nexus. Much of the (successful) R&D undertaken will eventually lead to a viable commercial outcome, most likely in the form of a good or service at one stage or another. Often this will not be readily discernable at the time the early stage R&D activity is undertaken. How direct the connection with the production needs to be, in both time and the nature of the activity, is unclear and needs more clarity.

For example, there is potential that the early stage research and experimentation of a biotechnology company into microorganisms which will eventually produce a chemical product, could be considered "directly related" to the future production of that good, even though this may be many years away from happening. This could potentially become an area of controversy and dispute with 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 type of "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 from s 355-35(2), 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.

Dominant Test Should Not Apply to Old Exclusion List

As stated, we understand the Government's desire to limit certain excesses in production trials. We agree. However, the dominant purpose test has also been extended to non-production activities. We don't understand this in light of policy statements, we don't agree with this.

Although this list is reduced with the Bill, we would argue that none of the non-production activities listed in the excluded activities should be limited from the current law. In particular:

- Neither Dr Cutler or the Government highlighted the exclusions list as an area of concern or an area that would be reviewed;
- Although the regulator has been reluctant to provide specific examples of excessive claiming or "non-genuine" R&D, it has become apparent through the consultation process the concerns have mainly been around business as usual internal software development, production trials and the like. There has been no concerns raised with the exclusions list;
- At most of the public consultations last October, the exclusions list was highlighted as an area where genuine support was still required, due to the activities listed being an integral part of supporting R&D experimentation (such as data collection), and if anything, should be allowed to be considered in some form for core R&D activity eligibility; and
- The "directly related" test would continue to appear an appropriate threshold for this activity list, as with remainder of non-production supporting activities.

There would appear no rationale to exclude the exclusions list from the "directly related" test, or put another way, to adjust the current law in this regard. Rather, by requiring these excluded activities to pass the much higher test of dominant purpose, the new legislation would exclude legitimate data collection, analysis and review work typically undertaken to support experimental activity.

The dominant test adversely affects this group of activities more than others, because many of these activities are undertaken in a dual setting by businesses being as efficient as possible. In addition, the activities listed are typically modest in expenditure associated with them, generally being labour, consultant or minor consumables.

3. *Other Recommendations – Unintended Consequences*

Grouping Provisions – 40% vs. 50%

The Bill provisions have now been aligned with the small business entity provisions under Division 328, requiring the aggregate turnover of 'connected' entities be included when considering eligibility for the refundable R&D tax credit.

This changes the grouping requirement from a control test exceeding 50% ownership of an entity to being 'connected' and therefore grouped at 40%. Not only will this change exclude more small to medium enterprises from access to the Refundable Tax Credit, opposing the guiding policy objective of redistributing benefit towards SME entities, it also adds complexity to the legislation and critically can result in a company being connected with two entities who each control 40% or more of the entity. This is also a significant departure from existing provisions under which many SMEs that currently claim the R&D Tax Rebate have been set-up, and will result in some SME claimants being significantly worse off under the new legislation.

In line with the policy objective of providing benefits to SMEs, we recommend that grouping or 'connected' rules apply at greater than 50%, consistent with the treatment under the R&D Tax Concession. This could be achieved though extending the wording used at item 2 of s 355-100(1) (for exempt entities) to item 1.

Overseas Activity Cap

Under the existing R&D system, it is possible for amounts spent on overseas R&D to qualify for the R&D tax benefit, provided pre-

approval is obtained and certain other conditions are met. The overseas amounts are capped at 10% of the overall Australian R&D expenditure on the project (ie. the overseas component may exceed the 10% cap, but only amounts up to the 10% will be claimable). There are sound reasons why this exists- it is normally only applicable where the work done overseas is a critical part of the overall R&D effort, and that work (due to the expertise, equipment availability or otherwise) can only be conducted overseas.

The proposed new rules also recognise that in these limited circumstances overseas R&D activities should also be claimable. The Bill allows for these amounts to be claimed, provided that the new advance approval requirements of the Industry Research & Development Act 1986, are met. These new provisions, provide a clear link to the R&D activity and the role that the overseas R&D must play in the R&D project.

However, the new provisions leave uncertainty in relation to the extent that the expenditure may be claimable, and the EM provides no further guidance. It is stated the overseas expenditure must be less than the Australian expenditure, but it is unclear if this is a cap (like the existing provisions), or a requirement to qualify. That is, it is unclear whether only the amounts up to a cap of 50% of the total project costs are eligible, so that if, for example, the total overseas costs associated with the project where 51%, there is uncertainty as to whether the claim would be limited to the 50% of amount for overseas costs, or whether the entire overseas amount would not qualify. We would suggest that a cap approach is fairer, and consistent with the intent of the legislation in supporting R&D.

The legislation itself should be redrafted to expressly state that the advance registration approval will be capped at 50% of the overall (overseas and Australian) R&D project expenditure (even where the total amounts spent might be higher).

Depreciating Asset – Further clarity of key concepts needed in EM

The existing R&D tax benefit recognises that there are a number of small, but significant variations that are required to the standard tax rules that apply to depreciating assets, in order to provide an incentive to companies when utilising an asset for R&D purposes. This includes allowing the depreciation to be claimed from the point of being "installed ready for R&D purposes".

This is implied in the EM (e.g. at Para 3.83 and 3.84), but nowhere is it explicitly stated. It would be useful and provide certainty, if either the EM or the examples stated that the effective date to be used was the date it was "installed ready for R&D purposes" (or similar words).

Treatment of Corporate Limited Partnerships

The second exposure draft treats corporate limited partnerships differently from some other types of entities, and makes them ineligible to claim the R&D Tax Credit (refer to EM Para 3.20). We can see no reason why this should be the case, given that in all other respects under tax law this type of entity is treated as a company. Furthermore, many corporate limited partnerships contain partners that are only/ predominantly corporations (in contrast to the statement at 3.20). We suggest that this be changed accordingly to either allow these entities to claim, or allow corporate limited partnerships which have only/ predominantly corporate partners, to be treated as a company and hence be eligible.

Other Areas to Clarify

It would be useful to provide further clarification in the EM/ future guidance, including worked examples, in relation to the following areas:

1. The treatment of franking credits when a refundable tax offset is received- this is unclear from the existing information.

2. Further examples in relation to the disposal of assets and the impacts on the notional Div 40 deduction under s 355-310- especially where an asset is used for only part of the year and only in part for R&D.

4. Conclusion

The Bill is largely achieving stated government objectives, that of re-directing assistance from larger corporates to the SME's. We commend the recent changes between the first ED and this Bill, but lament the missed opportunities to genuinely consult over the months before January 2010.

However, we highlight 3 areas of concern still evident in the Bill, and with the benefit of detailed modelling we suspect the recommended changes will not be overly onerous to address, and importantly, will not significantly affect revenue. They will greatly eliminate unintended casualties and unintended consequences. Namely:

a) The dominant purpose is blunt and overly restrictive. There are alternatives to dominant purpose that will be less onerous on key sectors such as manufacturers.

   Key recommendation:
   Consider the 4 alternatives proposed to "dominant purpose", and in particular, specific provisions for specific concerns.

b) The tightening of certain non-production trial of supporting R&D activities through the dominant purpose test limits the positive spill-over benefits that the R&D tax credit is seeking to support;

   Key recommendation:
   Change to s 355-35(2)(a), to ensure all exclusions do not need to overcome the dominant test:

c) There are a number of unintended consequences listed above. We propose all the changes recommended be adopted.

   Key recommendation:
   Adopt all recommended changes given above, since they have little revenue impact and are genuinely unintended.

We welcome the opportunity to make this submission, and would be happy to provide any additional input should you wish to further discuss.

Appendix 1

Explanatory Memorandum - Incorrect Bill References

EM Paragraph	Incorrect Reference	Correct Reference
2.12	Schedule 1, item 1, paragraph 355–25(a)	Schedule 1, item, 1, paragraph 355-25 (1)(a)
2.16	Schedule 1, item 1, paragraph 355-25 (b)	Schedule 1,item 1, paragraph 355-25 (1) (b)
2.23	Schedule 1, item 1, paragraph 355-35 (2)(a)	Schedule 1, item 1, subsection 355-25 (2); paragraph 355-30(2)(a)
2.32	Schedule 1, item 1, paragraph 355-35 (2)(a)	Schedule 1, item 1, subsection 355-25 (2); paragraph 355-30(20(a)
3.3	Second reference to part 3 of schedule 3	Parts 2 to 6 of schedule 3
3.18	Schedule 1, item 1, section 355-40	Schedule 1, item 1, section 355-35
3.19	Schedule 1, item 1, section 355-40	Schedule 1, item 1, section 355-35
3.24	Schedule 1, item 1, section 355-40	Schedule 1, item 1, section 355-35
3.46	Schedule 1, item 1, section 355-115	Schedule 1, item 1, section 355-110
3.61	Schedule 1, item 1, subsection 355-20 (2)	Schedule 1, item 1, subsection 355-220 (2)
3.131	Schedule 1, item 54, section 4-25	Schedule 3, item 54, section 4-25
3.157	Schedule 3, item 44, subsection 136AB(2)	Schedule 3, item 47, subsection 136AB(2)
3.205	Schedule 1, item 1, section 355-699	Schedule 1, item 1, section 355-700
5.111	Schedule 2, item 1, subsection 27A(2)	Schedule 1, item 1, subsection 355-705(2)
5.151	Schedule 2, item 1 subsection 30C(3)	Schedule 2, item 1, subsection 30C(2) section 32