

**Submission to Senate Enquiry
on
Tax Laws Amendment (Research and Development) Bill 2010
by
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Background

Associate Professor in Computer Systems Engineering UTS for 20 years.

I have been working professionally with the R&D Tax Concession since 1991 as

- IR&D Board Member
- Chair of Tax Concession Committee, then
- Director of Trilateral P/L doing tax concession advisory work

Concerns

I have great reservations about one section of the Tax Laws Amendment (Research and Development) Bill 2010, “Expenditure not at risk”. The problematic section is on page 21 lines 5 to 29:

355-405 Expenditure not at risk

(1) An R&D entity cannot deduct expenditure under section 355-205 or 355-480 if:

(a) when it incurs the expenditure, the R&D entity or its associate had received, or could reasonably be expected to receive, consideration:

(i) as a direct or indirect result of the expenditure being incurred; and

(ii) regardless of the results of the activities on which the expenditure is incurred; and

(b) that consideration is equal to or greater than the expenditure.

Note: Section 355-205 is about deductions for R&D expenditure.

Section 355-480 is about deductions for earlier year associate R&D expenditure.

... and ...

(b) that consideration is less the expenditure; the R&D entity cannot deduct under section 355-205 or 355-480 so much of the expenditure than as is equal to the consideration.

Class of Projects Adversely Affected

Many medium/large engineering projects are only undertaken by companies if they have a client who will pay for the result, generally a contract is signed before work commences. These projects can be undertaken either using proven conservative techniques, or undertaken by Research and Development of experimental approaches. The choice is with the company, the client pays for a usable result.

The current tax concession legislation encourages positive innovation irrespective of the terms of the contract so long as the company is undertaking the work on their own behalf (S39J: they are at financial risk if it fails, they directly manage the project and they can exploit successful results). The financial risk to the company for taking a chance on R&D is reduced by claiming the tax concession, the expenses incurred by the company for the core and supporting activities are eligible for the R&D Concession without consideration of any contract fee that could be reasonably expected to be received. If the R&D approach is a partial or complete failure the company may receive a reduced or no fee but the certainty of the current tax concession influences the decision to take the risk.

Section 355-405 of the proposed legislation discourages innovation, for if the commercial risk is taken to perform R&D to trial a new technique or technological approach, with the associated prospect of financial loss, then should it succeed then no tax offset can be claimed because the contractor will receive full payment for it which is then deducted from the R&D expenses. If the R&D does not succeed then either a greatly reduced, or zero, fee is received. A tax offset can be claimed but this only partly offsets the heavy

financial loss to the company. Faced with this no-win/lose situation for an innovative/risky R&D undertaking, a responsible engineering company will strongly prefer the traditional conservative approach with far less financial risk. As Section 355-405 is written it penalises successful R&D.

The Explanatory Memorandum discusses “Expenditure not at risk” but uses terms that do not correspond to the legislation. The EM states:

3.166 The inclusion of the requirement that the entity reasonably expects to receive the amount of consideration irrespective of the results of the activities on which the entity incurs the expenditure is consistent with the way the Commissioner has administered the existing law about expenditure not at risk.

The Bill uses the term ‘consideration’ whereas the EM uses the term “the amount”, which are very different terms. The Bill meaning appears to be, that if there is a reasonable expectation that a ‘consideration’ is expected to be received, whether it be a higher consideration (for a successful project) or a lesser consideration (for a failure or partial success), this ‘consideration’ is deducted from the actual spend when calculating the tax offset. The EM however uses the term “the amount” which leads the reader to understand that if the agreed full contract amount is not guaranteed to be payable (for instance some or all of this amount may not be paid if the R&D does not produce the desired result) then the full cost of the R&D spend is claimable (deductable) whatever the outcome of the project. Put another way, the EM is effectively saying that if there is the possibility that less than 100% of the amount could be paid then the expenditure is at risk and the company can deduct all of the expenditure as R&D expenditure, but this is not the wording of the new legislation.

This description in the EM is indeed how the Commissioner applies the existing law but does not appear to agree with the terms of the Bill.

The objective of the legislation is only referred to in the EM for the new legislation in the statement that the changes “will ensure that the incentive is available in circumstances consistent with the underlying rationale for government intervention” and they are “better targeted towards R&D that benefits Australia” A clearer purpose for the legislation is “to encourage innovation in Australian companies” (R&D Tax Incentive Handbook -Revised 1994, p. 11) and “to provide an incentive for greater levels of R&D in Australia (second reading speeches relating to the 1986 amending Act).

Section 355-405 of the new Bill does not appear to implement this legislative intention, further, it would discourage innovation in one of the very areas that provide the greatest national benefits: large risky undertakings.

Project Example

Many examples are in the field of engineering infrastructure, a field which is risk averse with high design and construct costs yet with significant economic benefits to Australia if reliable cheaper methods can be discovered. No infrastructure project is ever undertaken without a client agreeing to pay a contract fee, the client is most often a government body (roads, railway, ports etc)

For example, suppose a civil engineering motorway in a highly unstable geotechnical region that is liable to subsidence is to be constructed. The region is environmentally sensitive so terrain outside the motorway right of way must not be disturbed, a project with similar conditions has not been reported anywhere in the world. A design fee of some millions of dollars is agreed for the motorway to meet specific stability criteria for 100 years. The surface rock in this area is very highly horizontally stressed due to subsidence which renders it liable to sudden and catastrophic eruption when disturbed

('blowouts'). The conservative and very expensive means to stabilise the terrain is to fill all underground voids by pumping in a hardening agent, while an innovative approach is a combination of some type of stress measurement by proxy plus incline bored pilings and lifetime geotechnical sensors. The design choice is very difficult: either very expensive and proven; or risky and cheap (but with the potential for economic benefit by using the technique, if successful, on similar sites worldwide). The current legislation encourages innovation; the new legislation tips the balance against innovation.

Recommendation

That the wording of the legislation be changed to refer to a predetermined fixed consideration in S355-405(1)(a) and S355-405(2)(a).

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