ADVANCED MANUFACTURING COALITION (AMC) SUBMISSION TO THE SENATE COMMITTEE INQUIRY INTO THE R&D TAX CREDIT DRAFT LEGISLATION

INTRODUCTION

In late 2009 a group of manufacturing industry leaders participated in a Roundtable discussion in Canberra on the future of Australian manufacturing over the 2010-2020 decade. The leaders included CEO's from companies such as Cochlear, Thales, Varian and Hofmann Engineering, union leaders from the two major manufacturing Unions (the AMWU and the AWU) as well as representatives of industry associations, academics, analysts, public servants and other industry experts who have dealt with manufacturing issues for a number of years.

One of the issues identified at the Roundtable as critical to the future of manufacturing was the new legislation being developed to introduce the R&D tax credit system advocated by the Cutler Review and announced in the 2009-2010 budget. The participants accepted the Government had determined as a policy objective to make the new R&D incentive more advantageous to SME's (defined as firms with turnover of less than $20 million).

However, there was considerable concern that larger firms (with turnover of more than $20 million) who account for more than 70% of Australia's R&D could be disadvantaged by the approach Treasury was developing. It was subsequently agreed by Roundtable participants that efforts should be mounted to ensure the interests of manufacturers in general and advanced manufacturing firms in particular were taken into account in the drafting of the new legislation.

To this end, and because many of the firms and union leaders were also members of the Future Manufacturing Industry Innovation Council (FMIIC), a submission was prepared on behalf of the Council and given to the Minister for Industry Innovation Science and Research advising the Minister of the concerns of manufacturers with the direction of change being proposed.

Subsequently various organisations who attended the Roundtable or who were members of FMIIC made submissions on various drafts of the R&D tax credit legislation.

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

That is the origin of this submission. For completeness we refer to this group as The Advanced Manufacturing Coalition (AMC). The group includes AMWU, Cochlear, Marand Precision, Hofmann Engineering, Varian Australia, and Thales Australia.

We thank the Senate Committee and it's supporting Secretariat for affording us this opportunity to make a presentation to the Committee. This short paper is a background to the issues we will discuss.

Besides identifying our concerns with the legislation and its consequences for manufacturing R&D over the 2010-2020 decade we also recommend a broad set of changes for the Senate Committee to consider to improve the legislation. These changes involve the following:

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

Specific AMC Concerns with the Tax Credit Legislation

Since the September 2009 Treasury Consultation Paper, and through the first and second exposure drafts of the R&D tax credit legislation, organizations comprising the AMC have had three fundamental concerns.

1) The objects clause of the draft legislation was too narrow and restrictive and implicitly or explicitly accorded greater emphasis to research rather than development. It changed the emphasis that has been in the objects clause one way or another since the inception of the R&D tax concession in the mid 1980's. That emphasis that has always been central to the objectives of an R&D tax incentive focused on increasing investment in R&D in Australia and to help Australian industry become more internationally competitive, export oriented and innovative

2) The changed definitions of research and development in the draft legislation impose too severe a test for various elements of a firms R&D investment to qualify as eligible expenditure. Initially this was done by requiring the R&D to satisfy **both** a test of high technical risk and considerable novelty. Under current arrangements the tests require satisfying one or the other (**either** innovation or high technical risk).In the draft before the Senate Committee the definitions of R&D have been radically altered again with “core R&D” defined in terms of “experimental activities” As might be expected this has given rise to concerns that the bar has been raised too high for many types of R&D activities to qualify as eligible expenditure.
3) The draft legislation has created complex and confusing distinctions between core and supporting R&D and imposed a dominant purpose test. In practical terms the consequences of this, particularly for manufacturing firms and others who undertake their R&D in a production environment will be to render a significant proportion of expenditure ineligible for the tax credit. This is particularly the case for development expenditures such as trials, testing, prototype development, and trouble shooting during new process improvements. The other consequence of the distinctions drawn between core and supporting R&D and the imposition of a dominant purpose test is a very large, costly unnecessary and unhelpful increase in red tape that will significantly increase the time and cost of compliance in planning, documenting and registering a firms R&D activities for tax purposes.

In their individual submissions since October 2009, the various organizations that have come together under the banner of the AMC for this submission have focused on a range of other issues including the treatment of software, feedstock provisions and transitional arrangements to the new system. However, the three issues noted above have been and remain substantial concerns. Since the tabling of the legislation, the feedstock provisions are now an addition to our list of concerns.

In our presentation to the Committee we will elaborate on these concerns and highlight examples where they will disadvantage manufacturing businesses investing in R&D. We also draw the Committees attention to the following April 2010 submissions on the second draft exposure legislation that give emphasis to these three concerns that we have highlighted. These submissions include:

Cochlear
AMWU
Ernst and Young
Michael Johnson Associates
KPMG
Deloitte
PricewaterhouseCoopers

The concerns we have raised above will have the effect of substantially reducing the quantum of eligible R&D activities across all claimants in the future. We do not believe that the increased value of the tax offset would compensate for this reduction. It therefore follows that, contrary to the announcement in the 2009/10 Federal Budget that these measures will be revenue neutral, this change is likely to represent a net gain to the Commonwealth revenues.

Consequences of the Proposed R&D Taxation Regime for Manufacturers: 2010-2020

According to Innovation Australia's 2008-09 report, there were 3,188 manufacturing firms registered for the R&D tax concession in 2007-08 which accounted for more than 40% of all registered firms. These manufacturers undertook more than $4.6 billion of R &D. In addition, according to ABS, almost 70% of manufacturing R&D is experimental development, (most undertaken in a production environment), and 75% of all investment in R&D by manufacturers is undertaken by medium to large firms employing more than 200 people.

Investing in R&D is not the only driver of innovation in manufacturing firms. Nevertheless, within an increasingly competitive global economy successful R&D investments will be critical to a firms success, its prosperity and that of its shareholders, and to the job and income security of manufacturing workers across the country.

There is considerable uncertainty about how developments in the global economy will evolve over the second decade of the 21st century. However with the emergence of China and the rapid development and urbanization of emerging economies Australia can expect its terms of trade to stay stronger for longer. This in turn suggests that despite the continuing volatility, the Australian dollar is likely to remain higher over the 2010-2020 decade than its average value over the period since the early 1980's.[1]

For many manufacturing firms this global context and the imperative to remain internationally competitive will put a premium on reducing the time, cost and risk of their R&D investments as well as other measures to lift productivity and improve the firms management systems and organizational capabilities.

[1] The 2010-2011 Federal Budget papers use a projection for the exchange rate of 90 cents US and 70 on the TWI for the period through 2013-2014. During the 1983-2009 period the Australian dollar averaged 60 on the TWI and 73cents US. To the extent that the Budget projections represent the reality for the coming decade then manufacturers will need to address the consequences of an Australian dollar 17% (against the TWI) to 23% (against the greenback) above the long term trend and the implications this has for competitiveness. In such an environment R&D will be critical to move firm's products higher up the value chain where they are likely to have more sustainable competitive advantages.

The AMC participants remain concerned that the draft legislation now before the Senate Committee will increase the time, cost and risk of undertaking R&D in Australia.

While it is appreciated that the periodic determination of "core" and "supporting" activities throughout a project's life is fundamental to correct assessment of eligibility, we believe the requirement for separate reporting and costing of these activities will increase compliance effort and cost with no value adding purpose to many organisations.

To report and cost separately will require all of the known activities in a project to be tracked in detail so that costs can be apportioned and activity descriptions recorded. In our view, once "core" and "supporting" activities have been identified it should only be necessary to confirm for registration purposes that the activities had actually been performed without having to quantify the relationships through separate costing.

The new process to identify core and supporting activities would involve the following process:

- Is the activity a core R&D activity?
- If not, is it a supporting activity directly related to a core R&D activity?
- Is it an excluded activity and if so, is it undertaken for the dominant purpose of supporting a core R&D activity?
- Is it an activity that is the production of a good or service?
- Is it directly related to a good or service?
- Is it for the dominant purpose of supporting core R&D activities?[2]

This will constitute a significant increase in red tape and will seriously stretch the resources of many manufacturers, particularly SME's

It will increase the risk of undertaking R&D in Australia because of, amongst other things, the restrictive and narrow definition of core R&D, the uncertainty of whether a firms R&D will qualify as core R&D, and whether and what components of their R&D will qualify as eligible expenditure (even with the benefit of advance rulings as proposed). Given the significant role of global manufacturing businesses in Australia the proposed new legislation may also, over time, increase the attractiveness of other locations where the time cost and risk of undertaking R&D is more favourable.

[2] Deloitte: Submission on Second ED bill pg 6

With these factors (and the global context described previously) in mind AMC participants are of the view that there is a serious risk that by the end of the 2010-2020 decade the manufacturing industry and Government will find:

- Manufacturing investment in R&D in Australia was less than was necessary to assist more firms to remain/become internationally competitive.
- Some manufacturing investment that would have been undertaken by existing firms was deferred/cancelled or was undertaken offshore instead
- Fewer new entrants chose Australia to establish their Asia-Pacific R&D headquarters and less new foreign investment in R&D than was expected was attracted to Australia.
- As a result of these developments and the increase in the time cost and risk of undertaking R&D in Australia the network of connections and collaborations between public/private research organizations, academic institutions, researchers, entrepreneurs and firms was less dynamic and beneficial than expected.

The Way Ahead: Concluding Remarks

Since the September 2009 Consultation Paper, the organizations who are today represented under the banner of the AMC have been part of a detailed consultation process. While each organization draws its own conclusions about the specific implications of the legislations impact on their own business, we have a shared interest in moving beyond what we regard as unsatisfactory legislation that will disadvantage manufacturing businesses, particularly those that undertake R&D in a production environment.

It is neither possible nor appropriate for a group such as this to provide detailed amendments to all the relevant clauses of the legislation. What we can do however is highlight certain issues and principles that may assist the Senate in making the legislation more efficient and effective in achieving its objectives.

1) The current objects clause should be retained. However if compromise is required then the proposed redrafting can easily accommodate the following: “(1)*The object of this Division is to encourage industry to invest in R&D in Australia to help increase international competitiveness as well as encouraging R&D activities that might otherwise not be conducted because of an uncertain return from the activities, particularly in cases where the knowledge gained is likely to benefit the wider Australian economy.”*
2) There have been specific concerns raised about the proposed new definitions of eligible R&D expenditure. We support the retention of the existing arrangements and strongly advocate the removal of the dominant purpose test

3) Throughout this inquiry a perception has emerged that Innovation Australia, Treasury and the Government more generally were concerned that too much "business as usual" software expenditure was qualifying as eligible R&D expenditure. It would appear that the parties to this consultation process have largely resolved the issue. We make no specific recommendation on this issue other than to say it is one that can be achieved by amending the existing legislation.
4) 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.**

We note this was the original intent of the AI Group in proposing the matter be referred to the Board of Taxation. We also note this view was supported by the ACTU in its submission to the Prime Minister's Task Group on Energy Efficiency in the following terms:

"If there are any inappropriate claims or abuses of the system they should be managed through a 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 definitions, excessive and unnecessary compliance requirements and a tightening of eligible R&D that is counterproductive."[3]

5) The feedstock provisions in the current law apply to exclude feedstock input costs from the benefit and only include any loss on feedstock output compared to its feedstock input costs. The new provisions require the feedstock input costs to be included in the benefit and then be clawed back by an increase in the taxable income by 10% (1/3rd of 30%) for the lower of either the cost of making the feedstock output or the revenue from the feedstock output. One objective of the Government was to make the new tax incentive independent of the corporate tax rate. The changes proposed here mean that this part of the law is no longer tax rate independent. In addition, the calculations required for anything other than a single product, single process manufacturing scheme also belie the Governments stated purpose of simplification, as multi-stage or non-linear processes will be virtually impossible to calculate.

   The current law now includes in the costs of production some expenditure that was not required to be included in feedstock offset calculations under the old provisions. In this way, labour and operating costs are also caught up in the clawback. The term "feedstock" is commonly accepted as meaning the raw materials fed into a process for conversion. It is therefore really a misnomer in this context, and as such the new provisions bear little resemblance to the current law.

   To remove any ambiguity in these provisions, we suggest a clarification of these 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

[3] ACTU Submission to the Prime Minister's Task Force on Energy Efficiency May 2010 pp25-26

6) Finally we recommend that the Committee in consultation with the major professional accountancy firms and R&D consultants itemize clarifications required in the existing Explanatory Memorandum and that the Senate Committee recommends that a Government-Industry working party resolve these and other matters.

The AMC participants believe that these six suggestions are practical, achievable and relevant. If adopted in the spirit in which they are intended:

- The legislation will provide Australia with a stronger, more internationally competitive R&D taxation regime than what is proposed in the draft legislation. It will also be one that maintains the budget outcomes the Government seeks over the course of the forward estimates.
- The legislation can meet the deadline of coming into effect on July 1.
- The legislation will impose less red tape and compliance costs on the overwhelming majority of participants compared to the proposed draft legislation.

From the perspective of AMC participants these outcomes would represent significant benefits to small, medium and large manufacturers undertaking R&D in Australia.