



3 June, 2010

File:

Senator Annette Hurley  
Chair  
Senate Economics Legislation Committee  
Parliament House  
Canberra ACT 2600

Dear Senator

**INQUIRY INTO TAX LAWS AMENDMENT (RESEARCH AND DEVELOPMENT) BILL 2010 AND INCOME TAX RATES AMENDMENT (RESEARCH AND DEVELOPMENT) BILL 2010**

At the public hearing in Canberra on 20 May 2010 I agreed to take several issues on notice.

First, in their evidence, Michael Johnson & Associates (MJA) suggested that 'the dominant purpose' test for certain supporting R&D activities should be replaced by 'a dominant purpose', on the basis that this was the way a similar definition operated already under Part IVA of the Income Tax Assessment Act 1936 (ITAA 1936). You asked (at p E 52 in the Hansard transcript) whether this could be done. Having consulted some experts on those matters I am able to advise that, contrary to the assertion by MJA, the test under Part IVA of the ITAA 1936 also uses the definite article, rather than the indefinite one. For this reason alone, MJA's suggestion is misguided. However, in case there is still an issue, I offer the following further comments.

The meaning of 'dominant purpose' has been held by the High Court to be the ruling, prevailing, or most influential purpose<sup>1</sup>. Changing the reference to 'a dominant purpose' would therefore lead to unfortunate consequences. When a taxpayer undertakes an activity for two or more purposes, as a matter of logic based on that judicial interpretation, only one of those can be dominant. Consequently, if 'the dominant purpose' were replaced with 'a dominant purpose' it would create much confusion.

Secondly, I agreed to further consider the 'conveyor belt' example. This is set out in more detail in Appendix A, but the short answer is that the Bill works effectively in this case and does not distort decision making in the manner claimed. Where there is a use of the conveyor belt in an activity that is for the dominant purpose of supporting core R&D (such as the production trial in question), the appropriate proportion of the depreciation deduction will be eligible for an R&D tax offset. The fact that the conveyor belt might have been purchased for production itself, or that the belt is more robust or expensive than would be required for R&D alone, does not affect this.

Thirdly, while Treasury agreed to Senator Cameron's request to review and comment on BDO's modelling, this has not been possible at this stage as it has not yet been made available to us.

I also wish to clarify that the Government has stated its intention to review the new tax incentive within three years. Since that intention is part of the normal post-implementation review process, the Bill does not contain a specific review clause (as was suggested by Mr Antioch).

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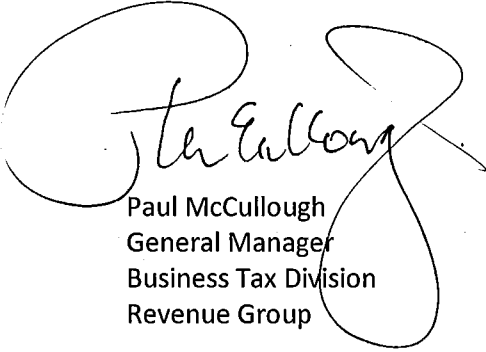
1. *Federal Commissioner of Taxation v Spotless Services Ltd* [1996] HCA 34; (1996) 186 CLR 404; (1996) 141 ALR 92; (1996) 71 ALJR 81 at CLR 416; ALR 98.

For the Committee's benefit, Appendix A includes Treasury's responses to some important contentions of other witnesses in their evidence to the committee, including the suggestions by some witnesses that that the feedstock provisions in the Bill have a much wider scope than the feedstock provisions in the existing law.

Appendix B contains a detailed statement of the actual changes made to the feedstock provision in the Bill and the reasons for them.

The Treasury stands ready to assist the Committee in any possible way.

Yours faithfully



Paul McCullough  
General Manager  
Business Tax Division  
Revenue Group

## TREASURY RESPONSES TO POINTS MADE BY OTHER WITNESSES

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### CORE R&D ACTIVITIES

Mr Duchini (Deloitte) proposed that the knowledge test in the definition of core R&D activities be amended in relation to development activities, such that it would be satisfied by the purpose of creating new products, processes [etc], rather than the purpose of generating new knowledge ... about the creation of new products etc [Transcript of 21 May 2010 at page E35].

We consider that the concern underlying this proposal is misplaced. The reference to knowledge does not imply a shift in focus to abstract R&D away from applied R&D. Rather, the overall 'purpose of knowledge' test has been worded so as to clarify that it is the knowledge bound up in the product, rather than the manufacture of the physical unit of production itself, that is intended to be assisted.

**Does paragraph 2.16 of the Explanatory Memorandum (EM) say that the 'new knowledge' test will not be satisfied where 'experimental activities merely confirm what is already known — even though that knowhow might not exist within the company' (KPMG p.13)?**

The EM to the bill clarifies the issue, in response to submissions to the Exposure Drafts. (The words quoted by KPMG appear to have been carried over in error from their submission to one of the Exposure Drafts.) Paragraph 2.16 now states: "'New knowledge" in this context means knowledge not already available in the public arena at the time the activities are conducted, in the relevant technology, on a reasonably accessible world wide basis.' This is consistent with the guidance provided by AusIndustry in relation to the current R&D Tax Concession: 'To establish whether something is new or different, the Board compares it with what was already available in the public arena at the time, in that technology, on a reasonably accessible world wide basis.' (Guide to the R&D Tax Concession, Part B, p.16)

**The EM fails to acknowledge that the application of existing knowledge in a sufficiently novel context can represent the generation of new knowledge (KPMG p.14)**

The EM *does* recognise that the application of existing knowledge in a novel context can represent the generation of new knowledge. Examples 2.1 (EcoStartup I), 2.4 (Boulevard Mining I), 2.7 (Boulevard Mining III), 2.9 (Grandheap Mining), 2.10 (Matryosh-Koala I), 2.12 (Matryosh-Koala III), 2.13 (Hayk Hockey Stix) and 2.16 (Tabby Marine III) all entail experiments that apply existing knowledge in new ways.

## Relationship between the scope of core R&D and the need for the scientific method

KPMG stated (p.16):

'...the EM should not use language and terminology which is defined in a particular way in the ED, in a contrary or confusing manner. For instance, the definition of core activities includes the phrase "hypothesis to experiment, observation and evaluation, and leads to logical conclusion". The definition clearly implies that an experiment is part of the core activities. However the EM continually implies that an "experiment" is the whole of a core activity.

In particular at paragraphs 2.11 and 2.19, the EM describes the core activities as being part of an experiment. The use of the term "experiment" in the EM in this manner, and as a subset of core activities within the definition does not aid in the interpretative clarity of the Bill.

It appears that, the EM is using the term 'experiment' instead of the term "experimental activities".'

The interpretation of 'experimental activities' adopted by the EM reflects the existing AusIndustry guidance (Guide to the R&D Tax Concession, Part B, pp.15–17). Although the definition of core activities does 'include' the quoted phrase (about the scientific method), it does not do so in relation to determining the *scope* of core R&D. The requirement to apply the scientific method is an attribute of an eligible core R&D activity, which establishes a threshold test for the knowledge gap and associated step in knowledge. This is explained at paragraphs 2.13, 2.14 and 2.18 of the EM.

**The Australian Industry Group said that the new definition of R&D activities is inconsistent with the Frascati Manual in that it excludes 'experimental development'** [Transcript of 21 May 2010 at page E3]

The Frascati manual is a document setting forth the methodology for collecting statistics about research and development, it is not a definitive guide for whether activities warrant government assistance. That said, the Frascati manual explains that the basic criterion for R&D activities is an appreciable element of novelty and the resolution of scientific and /or technological uncertainty.

The definition proposed in the Bill is consistent with this, as it requires the generation of new knowledge (novelty) and that experimental activities are conducted where the outcome cannot be known in advance (scientific and/or technological uncertainty).

**Mr Duchini (Deloitte) proposed that the knowledge test in the definition of core R&D activities be amended in relation to development activities, such that it would be satisfied by the purpose of creating new products, processes [etc], rather than the purpose of generating new knowledge ... about the creation of new products etc** [Transcript of 21 May 2010 at page E35].

The concern underlying this proposal is misplaced. The reference to knowledge does not imply a shift in focus to abstract R&D away from applied R&D. Rather, the overall 'purpose of knowledge' test has been worded so as to clarify that it is the knowledge bound up in the product, rather than the manufacture of the physical unit of production itself, that is intended to be assisted.

## SUPPORTING R&D ACTIVITIES (INCLUDING THE DOMINANT PURPOSE TEST)

**Are production trials excluded from the definition of R&D activities, because they will only ever be supporting activities and will always fail the dominant purpose test?**

Some witnesses incorrectly said that production-related R&D activities can never satisfy the dominant purpose test for supporting R&D activities.

- An extreme version of this view was put by Ms Murray (BDO Australia) [transcript for 20 May 2010 at page E41]:
  - ‘What does “dominant purpose” mean? If you look at the explanatory memorandum, in a production environment it is impossible to show dominant purpose. The reason it is impossible to show dominant purpose is that every proprietary limited company is established to deliver value to shareholders. Most companies are set up to exploit a single idea, a single product or a single process. So are they able to deal with some of these subjective terms, such as “dominant purpose”; to say that something is for the dominant purpose of supporting a core activity? The company’s dominant purpose is to make money, to produce something that is saleable and to commercialise it; that is their overarching purpose. Looking at the explanatory memorandums, if you have forward contracts or a sale or you have a hint that you might be selling something, or if you do something with a view to exploiting it in 10 years, that fails the dominant purpose test.’
- Similarly, Mr Ross-Gowan (MJA) stated [transcript for 20 May 2010 at page E29]:
  - ‘In the wording of the EM it says that if one of your objectives is production, then that is the dominant purpose.’

These assertions are incorrect. Production trials clearly *can* be core R&D activities or supporting R&D activities.

Example 2.12 (Matryosh-Koala III) and 2.13 (Hayk Hockey Stix) in the EM are clear examples of an experiment (core R&D) that is inherently a production activity and so would not be subjected to the dominant purpose test. As discussed by Mr Edwards (AusIndustry), the relevant issue in determining the scope of the experiment is the extent of production activity that is required to address the knowledge gap [transcript for 20 May 2010 at page E52].

Further,

- Paragraph 2.24 of the EM states: ‘Implicit in the dominant purpose test is the acknowledgment that activities can serve, or be conducted for, more than one purpose. Accordingly, the fact that an activity serves a commercial objective as well as being directly related to R&D does not preclude it from qualifying as supporting R&D.’
- Example 2.1 (EcoStartup I) states ‘It is not relevant [in determining whether supporting activities are production activities] that the activities contribute to experiments that, by their success, could lead to subsequent production.’
- Example 2.11 (Matryosh-Koala II) has eligible supporting R&D activities that are production activities for which the output had been pre-sold at a profit under a forward contract. Along with paragraph 2.27, this example discusses various factors that might be considered in determining the dominant purpose of a supporting production activity.

**What is the correct treatment of a conveyor belt in an example originally mentioned by BDO?** [Senator Colbeck at page E51 of the transcript for 20 May 2010]

The facts of the example were originally explained by Ms Murray of BDO as follows:

If you want to conduct R&D activities in a production environment, we have talked about having to demonstrate dominant purpose. If I need to purchase a conveyor for a production environment test, I could have an opportunity to spend \$2,000 and get a dodgy one that is only going to last the month in which the trials are conducted, or I could think a little bit more strategically and think, 'I hope this R&D is going to work and, if it does work, I am going to be able to manufacture the end product.' So instead of spending \$2,000 on a conveyor I might get one that is going to last a bit longer and spend \$4,000 on it. [Transcript for 20 May 2010 at page E42]

Where a company acquires a conveyor belt and uses it in producing goods or conducting research and development activities, the belt is a depreciating asset. A depreciating asset is an asset that has limited effective life and can reasonably be expected to decline in value over the time it used<sup>2</sup> (section 40-30 of the *Income Tax Assessment Act (ITAA) 1997*). In working out the company's entitlement to an R&D tax offset, it is necessary to apply the R&D depreciating asset rules in proposed Subdivision 355-E of the ITAA 1997, *not* the rules about expenditure on R&D activities in proposed Subdivision 355-D.

The key test then is: did the company use the asset during the income year for conducting R&D activities for which it is registered. For this test, the company's purpose in acquiring the belt is *not* relevant (contrary to the evidence of Ms Murray) – that is, buying a conveyor belt is not an R&D activity. Nor is the price paid for the belt relevant as such.

If the company did so use the asset, it works out a decline in value amount (under proposed sections 355-305 and 355-310) that is taken into account in working out its R&D tax offset entitlement. The first (and usually main) element of cost in working out the decline in value is the amount that the company paid for the belt<sup>3</sup>. Whether the company could have purchased a belt of a different quality at a different price is not relevant.

**In evidence to the Committee on 20 May 2010 Mr Ross-Gowan of Michael Johnson and Associates Pty Ltd suggested that the words 'the dominant purpose' could be replaced by 'a dominant purpose'. He said that Part IVA (the general anti-avoidance provisions) of the *Income Tax Assessment Act 1936 (ITAA 1936)* only required 'a dominant purpose' [page E 29 of the transcript for 20 May 2010].**

This assertion is incorrect. Section 177D, the main operative section in Part IVA, relevantly says:

'... it would be concluded that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for *the purpose* of enabling the relevant taxpayer to obtain a tax benefit in connection with the scheme ...' (emphasis added)

Subsection 177A(5) is an interpretive provision which extends the meaning of 'purpose' in Part IVA

(5) A reference in this Part to a scheme or a part of a scheme being entered into or carried out by a person for a particular purpose shall be read as including a reference to the scheme or the part of the scheme being entered into or carried out by the person for 2 or more purposes of which that particular purpose is *the dominant purpose*. (emphasis added)

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2. There are a number of exceptions, such as trading stock, that are not relevant to the example.

3. There are special rules for cases such as non-arm's arm's length transactions and assets purchased for non-cash consideration that are not relevant here.

In *Federal Commissioner of Taxation v Spotless Services Ltd* [1996] HCA 34; (1996) 186 CLR 404; (1996) 141 ALR 92; (1996) 71 ALJR 81 the High Court considered the meaning of dominant purpose in Part IVA (3 December 1996). Brennan CJ; Dawson, Toohey, Gaudron, Gummow and Kirby JJ. said at ALR 95:

'Part IVA operates where (i) there is a "scheme" as defined in s 177A; (ii) there is a 'tax benefit' which, in relation to income amounts, is identified in par (a) of s 177C(1) as an amount not included in the assessable income of the taxpayer where that amount would have been included or might reasonably be expected to have been included in that assessable income for the relevant year of income if the scheme had not been entered into or carried out; (iii) having regard to the eight matters identified in par (b) of s 177D, it would be concluded that there was *the necessary dominant purpose* of enabling the taxpayer to obtain the tax benefit; and (iv) the Commissioner makes a determination that the whole or part of the amount of the tax benefit is to be included in the assessable income of the taxpayer (s 177F(1)(a)).' (emphasis added)

**Mr Duchini (Deloitte) proposed that in the definition of supporting R&D activities the dominant purpose test should be replaced by a test of a substantial purpose of supporting core R&D** [Transcript of 21 May 2010 at page E37].

The word 'substantial' should be avoided because in other contexts the courts have found the word to be imprecise and potentially ambiguous.

- For example, in *Tillmanns Butcheries Pty Ltd v Australasian Meat Industry Employees' Union* [1979] FCA 85; (1979) 42 FLR 331 (7 December 1979) Justice Deane said:
  - 'The word "substantial" is not only susceptible of ambiguity: it is a word calculated to conceal a lack of precision. In the phrase "substantial loss or damage", it can, in an appropriate context, mean real or of substance as distinct from ephemeral or nominal. It can also mean large, weighty or big. It can be used in a relative sense or can indicate an absolute significance, quantity or size.'

If 'substantial purpose' were used to mean 'not an insignificant or de minimis' purpose', as suggested by Mr Duchini, the existing low bar for supporting R&D activities would be retained.

**Does the dominant purpose test reflect a failure to recognise the manner in which R&D is undertaken by industrial-based businesses** (as suggested by Deloitte p.6)?

The Cutler Report (p.101) noted: 'In the 1980s and earlier, when these tax instruments were introduced, the prevailing model of business research centred around in-house corporate laboratories.' In such a context, supporting activities would generally have been for the dominant purpose of supporting core R&D. The dominant purpose test is therefore a response to changes in the nature of industrial R&D.

**Apportionment: Mr Parsons (Ernst & Young) proposed using apportionment instead of the dominant purpose test** [Transcript of 20 May 2010 at page E18]

Examples 2.3 (Smartread), 2.10 (Matryosh-Koala I), 2.12 (Matryosh-Koala III) and 2.13 (Hayk Hockey Stix) of the EM demonstrate how standard accounting principles would be used to apportion expenditures (or decline in value in the case of depreciating assets) across the various activities for which a firm's resources are used.

To further illustrate, a worker spending half their time on activity A and half their time on activity B would generally have half their labour cost included in the cost of activity A and half in the cost of activity B. This exercise (determining the full cost of an activity) is fundamentally different from determining the dominant purpose of activity A or activity B.

Subjectively apportioning an activity between an R&D purpose and a contemporaneous production purpose would not be workable in the context of the R&D tax incentive. Moreover, such an approach would be fundamentally inconsistent with the object that the R&D tax incentive should not go to activities that would clearly be undertaken in the absence of the incentive.

As stated at paragraph 2.22 of the EM: ‘...where supporting activities would have been undertaken anyway for normal operational reasons, they do not impose an additional cost on the company that arises from its R&D activities and so the R&D tax incentive is not intended for them. In particular, it is not intended that the R&D tax incentive cross-subsidise normal production activities.’



## OBJECTS CLAUSE

The objects clause is too narrow and should be amended to include a reference to 'encouraging industry to invest in R&D in Australia to help increase international competitiveness' [Submission of Australian Manufacturing Workers Union at pages 1 & 5]

The objects clause must actually reflect what the Bill is designed to do. The Bill is designed to encourage those R&D activities that are most likely to produce economy wide benefits that, in the absence of the incentive, might not go ahead because of uncertain returns.

To speak in terms of improving the international competitiveness of the whole of the economy would be such a vague notion as to obscure meaning. Furthermore, as the measure applies generally, it would not be appropriate to enshrine the notion of the measure increasing the international competitiveness of particular firms, since that may well come at the expense of the international competitiveness of other Australian firms.

## OTHER ISSUES

**In measuring the aggregated turnover of an R&D entity, should the 'grouping' rules be based on a 'control percentage' of 50%, rather than the standard 40%?** [Ernst & Young pages E11-12, E17 & E18 of the transcript for 20 May 2010]

As part of legislating the new incentive, the R&D provisions have been moved from the ITAA 1936 to the ITAA 1997. In the ITAA 1997 the concepts of *turnover* and *aggregated turnover* are defined in the small business entity provisions (see Subdivision 328-C of the ITAA 1997), but apply throughout the Act.

Small business entities are accustomed to using those tests because they use them in determining whether they are eligible for a dozen different tax concessions (listed in subsection 328-10(1)), such as simpler depreciation rules, simplified trading stock rules and the capital gains tax retirement exemption.

- It would be more complex and potentially confusing for small businesses if, in working out their aggregated turnover, they had to apply a test different from the one they normally use.

The 'grouping' rules that apply in working out the aggregated turnover of an entity under the ITAA 1997 are very similar to those in the existing R&D provisions. One difference is that in working out whether an entity is connected with another entity under the ITAA 1997 the 'control percentage' is 40%, rather than 50%.

- The control percentage of 40% reflects that in practice one entity can often control another while holding less than 50% of relevant interests (for example, shares in company).
- Where the control percentage is at least 40% but less than 50% the Commissioner of Taxation has a discretion to determine that an entity (the first entity) with the relevant control percentage does not control a second entity in which it holds that percentage, if he concludes that the second entity is controlled by one or more other entities (that is, other than the first entity and its affiliates) (subsection 328-125(6) of the ITAA 1997).

For consistency and simplicity the standard definition of *aggregated turnover* in the ITAA 1997 applies in working out whether an R&D entity has an aggregated turnover of less than \$20 million.

For an unincorporated joint venture (Mr Parsons referred to joint venturers at page E11<sup>4</sup>), the turnover of joint venturers would not be aggregated just because they were joint venturers. For a joint venture company owned by two or more entities, the standard rules apply in working out the aggregated turnover of the company.

**Is a specific transitional provision needed in relation to proposed section 355-410 (disposal of R&D results)?** [Deloitte's submission at pages 3 & 10]

The general savings provisions secure the intended result that an amount may be included in an eligible company's assessable income under the existing law for an income year commencing on or after 1 July 2010 if the company was entitled to deductions for R&D expenditure under section 73B of the ITAA 1936 in an income year commencing before 1 July 2010.

This result is expressly set out in the note to subitem 3(2) of Schedule 4 of the Tax Laws Amendment (Research and Development) Bill 2010 and is explained in paragraph 4.10 of the EM.

The continued application of the existing provisions in these circumstances is consistent with the general approach that the existing law applies in relation to expenditure incurred in the income year starting before 1 July 2010. This approach is appropriate because the proposed new law differs from the existing law as to the benefits available, the R&D activities that are eligible and the technical operation of the law.

**Clawback of grants: KPMG (page 24 of submission) proposes, in effect, that clawback only apply in relation to the R&D tax incentive that is received on 'government money'.**

This would be a more concessional treatment than under the existing R&D tax concession. The rationale for clawback is explained at paragraph 3.111 of the EM.

**Did the Government indicate when it announced the R&D tax incentive in the 2009-10 Budget that it would change the definition of eligible R&D?** [Australian Industry Group in transcript of 21 May 2010 at page E7]

The joint Press Release of the Treasurer and the Minister for Innovation, Industry, Science and Research dated 12 May 2009 said:

'Under the new tax credit system, eligibility criteria will be tightened to make sure that our investment is getting the best result – supporting only genuine R&D.'

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<sup>4</sup> Mr Parsons did not elaborate as to whether he was referring to an unincorporated joint venture or a joint venture company.

## FEEDSTOCK

**MJA contend (p.11): 'The Treasury was adamant at the Committee hearings that the new feedstock provisions ... are a straightforward rewrite and consolidation of the existing feedstock provisions.'**

Treasury did not contend that the new provision is a 'straightforward rewrite'. Treasury stated:

'The effect of the existing feedstock provisions is retained in this bill. The feedstock provisions in the bill have the same scope as under the existing law. For ease-of-use, the bill consolidates all the existing feedstock rules in one subdivision and changes the form of the new feedstock adjustment to that of an increase in accessible income rather than a reduction in the R&D offset. The new mechanism overcomes several technical flaws in the existing rule that can disadvantage taxpayers and avoids the need to put a value on outputs at the end of each year that are not yet in a marketable state.' [Transcript p. E48]

**MJA contend (p.12): 'The proposed provisions potentially exclude many more types of costs than the current provisions. They can exclude goods and materials that are not currently considered to be feedstock inputs. These include consumables, process chemicals, maintenance materials, fixtures and fittings and capital assets. This is caused by the failure of the wording of the proposed legislation or the EM to limit feedstock inputs to being the raw materials made into feedstock outputs in line with the EM to the Taxation Laws Amendment Bill (No.1) 1996.'**

In relation to 'consumables' or 'process chemicals', the ATO advise that, under the current law, they regard expenditure on these goods or materials as 'feedstock expenditure' where they are in the nature of 'articles'. This is where they are physical objects on which the processing or transformation takes place, as distinct from items of plant which are used in carrying out the processing or transformation in question. They refer to the decisions in *Haigh v. Charles W Ireland Ltd* [1973] 3 All ER 1137 and *NZ Refining Co Ltd v. Commnr of Inland Revenue (NZ)* (1982) 5 TRNZ 402 in support of this distinction.

- The wording used by the bill does not impact on this issue.

The existing feedstock provision makes no reference to 'raw materials'. The term 'raw materials' only appears in the loosely worded 'Background to the legislation' section (which makes no reference to energy costs nor provides any real hint about the objective or impact of the feedstock provision). The term appears to be a shorthand attempt to avoid using technical terms not yet defined at that point, such as 'feedstock input'.

The text in the 'Background to the legislation' section is: 'The cost of raw materials fed into processes that qualify as 'R&D activities' as defined in subsection 73B(1), may qualify for deduction at the concessional rate of 150 per cent under subsection 73B(14). However, the value of resultant product that may be commercially valuable or useable in further processes does not affect the quantum of the deduction.' (sic)

- It is a matter for the ATO and ultimately the courts to determine whether the scope of goods or materials that are processed or transformed in R&D activities that produce outputs includes goods and materials that, as a result of the processing or transformation, do not 'feature' in the output.

**MJA contend (Attachment A p.2): 'what is meant by "the expenditure" in s 355-465(1)(b)(i) is unclear. It is unclear if this is all of the expenditure to obtain the resultant R&D product or just the expenditure on feedstock input.'**

Deloitte (p.8) made a similar claim:

... This is a clear extension of the costs to be swept up in this calculation and a departure from the existing practice as set out in the Commissioner of Taxation's fact sheet about the application of the

current feedstock provisions. The use of the word 'expenditure' in subparagraph 355-465(1)(b)(i) will arguably now require the inclusion of labour, and direct and indirect costs associated with the creation of the feedstock output.'

In subsection 355-465(1) the presence of the definite article in 'the expenditure' in paragraph (b) means the expenditure referred to can only logically be the paragraph (a) expenditure on feedstock inputs. As MJA acknowledge, the EM reinforces this.

It is therefore incorrect to say that the costs of transforming/processing feedstock inputs into feedstock outputs are exposed to the feedstock adjustment (with the exception of energy costs, which are treated the same as under the existing law).

**MJA contend (Attachment A p.3: 'The Bills will move this [feedstock adjustment] calculation both in terms of where and when it will be measured. Instead of being measured at the point the feedstock output is produced by the R&D activity, it will be calculated at the point at which the final product(s) is (are) sold or used by the taxpayer for their own use. And the timing of that calculation will move to the year(s) that this sale occurs or when the product is used by the taxpayer.'**

Treasury considers this statement to be incorrect or misleading. The current valuation of feedstock output does not take place "at the point the feedstock output is produced by the R&D activity". Rather, feedstock output is, for the majority of cases (where the feedstock output is produced and sold in the same income year), the proceeds from the sale of the output, which can logically only be measured at the time of sale.

Output unsold at year end is valued at its 'sale value', which the 1996 EM (para 9.38) elaborates as follows:

'More particularly, it is the selling value of any such products sold during the year of income under arm's length transactions and the amount that could have been obtained if the remaining products were sold at the end of the year under arm's length transactions. If there is no ready market, that latter amount could be measured by reference to the arm's length price the taxpayer would be prepared to pay another person to obtain those products.'

Under the current feedstock provision, only output literally produced at the very end of the income year would be valued at the point it was produced.

Under the bill, for the majority of cases (where the feedstock output is produced and sold in the same income year), the point in time at which the valuation takes place will remain the point of sale. However, whereas the current feedstock rule uses the value of the output at its point of sale, the bill allows the firm to move the effective point of valuation back to 'the point the feedstock output is produced by the R&D activity'.

- Where the firm has added value or incurred holding costs subsequent to the output being produced, this will potentially reduce the size of the feedstock adjustment by reducing the deemed value of the output.

The income year in which the feedstock adjustment calculation occurs will only move for the minority of cases (where the feedstock output isn't produced and sold in the same income year).

Treasury considers this to be an improvement over the current requirement to make problematic year-end valuations on the 'sale value' of feedstock that might not be in a marketable form. It does not amount to introducing a 'multiyear application' of the feedstock rule, but rather a refined treatment of multiyear cases.

**MJA contend (Attachment A p.5, issue (c)(2)) that the bill's approach to using cost snapshots to scale back sale value to a deemed output value can 'eliminate genuine R&D costs'.**

This is incorrect. Cost absorbed into the output at the end of the final R&D activity can never be more than cost absorbed at the point of subsequent sale, and will generally be less. The deemed output value can therefore never be more than the sale value, and will generally be less.

The scaling back can therefore never increase the feedstock adjustment, and has the potential to reduce it.

**MJA contend (Attachment A p.3-4) that, for their example, the bill would require 44 different calculations rather than 2 calculations under the existing rule.**

This is incorrect. On a comparing 'like with like' basis, the existing provision would entail at least 6 calculations, as the purported 2 calculations each depend on calculations in relation to feedstock inputs and feedstock output.

The 44 calculations purported to occur under the bill's feedstock provision are based on an erroneous application of the provision to a sequence of activities. As stated at clause 355-465(3)(a) of the bill and reinforced at paragraph 3.151 of the EM (under the heading *Sequential R&D activities*), a feedstock adjustment will not arise where a feedstock output goes on to become a feedstock input for a subsequent experiment.

Rather, as acknowledged by MJA at issue 2(d) of Attachment A p.5 of their submission, a feedstock adjustment only arises in relation to the last activity in a chain of R&D activities. Consequently, the supposed calculations described at (a), (b) and (c), along with their related calculations at (f) and (g) for the carbon reduction experiment would not arise.

Further, the number of calculations said to be necessary under the existing provision implies that the intermediate and final outputs are homogeneous and are sold in the income year. Applying the same scenario for the bill's feedstock provision would, under the approach described in the EM under the heading *Multiple feedstock inputs and outputs*, result in 1 combined feedstock adjustment using the combined value of the 8 inputs to the water reduction experiment and the combined value of the 8 outputs.

**MJA contend (Attachment A p.4, issue (a)): 'Under the Concession, if tracking the feedstock adjustment becomes too complex, a taxpayer can choose to ignore just the adjustment and only forego part of their R&D claim. However, under the proposed legislation, this is not an option.'**

This is incorrect. Clause 355-465(1)(b) ensures that a feedstock adjustment can only arise where the firm actually obtains (not merely becomes entitled to) the related offset. Paragraph 3.136 of the EM reinforces this.

**MJA contend (Attachment A p.4, issue (c)(1)) that the feedstock adjustment incorrectly assumes a corporate tax rate of 30% and an R&D offset rate of 40%.**

Although the feedstock adjustment factor of  $\frac{1}{3}$  is derived from those rates, which will apply to most feedstock adjustments, paragraphs 3.144 and 3.146 acknowledge that the  $\frac{1}{3}$  factor will not achieve full clawback in all cases, but that a single factor was chosen for reasons of simplicity.

**MJA contend (Attachment A p.5, issue (d)) that the feedstock provision in the bill can duplicate deductions:**

This is incorrect. The bill's feedstock provision has no provision entitling firms to claim 'feedstock inputs' as such, on either a gross or net basis. Rather, the relevant expenditures will be claimed when incurred, along with other R&D expenditures.

## APPENDIX B: FEEDSTOCK PROVISION — CHANGES FROM CURRENT LAW

- As the R&D provisions have been moved from the ITAA36, to the ITAA97, the drafting style and conventions for the newer law have been adopted in the drafting of the feedstock provision. In this context, it should be noted that there is no literal 'feedstock provision' in the 1936 Act. Rather, the 'feedstock rule' is the outcome of five related (but not collocated) definitions.
- Machinery flaws meant the current law (if read literally) could allow firms to make multiple claims for 'net' feedstock cost, potentially leading to a claimed amount that was more than even the gross feedstock cost.
  - The new provision clarifies that the feedstock adjustment only takes place for the final R&D activity in a chain of R&D activities that use the feedstock.
- The current law did not work across income years, requiring instead that, multiyear cases, firms make problematic year-end valuations on the 'sale value' of feedstock that might not be in a marketable form.
  - This resulted in unequal treatment of firms whose feedstock was completely transformed and sold within an income year compared with those whose feedstock was work in progress at year end.
  - Cashflow issues could also arise, as the claim could be reduced by reference to 'sales value' of outputs that had not been sold and might not yet be in a marketable form.
  - The new provision avoids this by allowing firms to claim gross 'feedstock expenditure' in the same way as other R&D expenditures in the year they are incurred.
  - An adjustment is only made when the firm eventually sells the downstream output or applies it to its own use (ie, 'a dollar is made' by selling or 'a dollar is saved' by not needing to purchase an input).
  - The adjustment is concessional under the new law for small/medium firms eligible for the 45% refundable tax offset and/or in tax loss:
    - : The adjustment is based on a firm that only received the standard 40% non-refundable tax offset, so it will not claw back the full incentive on recouped feedstock costs for those receiving a 45% offset.
    - : The adjustment is made by increasing assessable income. Firms in tax loss will not 'feel' the adjustment until they become profitable and tax paying — they will retain the benefit of their original claim for gross feedstock expenditure where they received a refundable tax offset or were in tax profit when they originally claimed.
  - This approach avoided the need to include separate feedstock adjustment formula for the 45% and 40% offsets.
- Under the law concerns were raised that expenditure could 'fall within the cracks' and not be claimable where feedstock was purchased in one year with the intention of using it in the following year.

- The new provision does away with the distinction between ‘feedstock expenditure’ and ‘expenditure on feedstock inputs’ that gave rise to the concern.
- The current law could unfairly reduce claims for eligible feedstock where the firm added additional value to the feedstock output prior to sale, because the rule generally used ‘proceeds from sale’ rather than estimating the value of the feedstock output at the end of the R&D stage.
  - The new provision allows a firm the option to use ‘snapshots’ of its accounting cost data to pro-rata the downstream sale price back to a notional price at the earlier post-R&D stage.
  - As this adjustment is favourable to the taxpayer, we would expect the Tax Office to be relaxed about firms choosing to simply use the (arm’s length) selling price that the current feedstock rule requires them to use.
- The current law was unclear about whether depreciation relating the production of feedstock inputs was a part of feedstock expenditure.
  - The new provision explicitly says that such depreciation is part of the cost of producing feedstock inputs.
  - This ensures equal treatment between feedstock inputs that are produced and feedstock inputs that are acquired.
  - This clarification was requested in targeted consultations Treasury made with key accounting firms.
- The current law was unclear about how outputs needed to be aggregated.
  - It was put to Treasury by one firm that the existing feedstock rule often gave no recognition to the reduced profit that might arise from an experimental production run that resulted in output that was of variable quality but recovered overall costs.
  - The new provision ensures that the profit on successful units of output does not spill across to negate the claim for ‘dud’ units of output (while still allowing firms to claim on an aggregate basis if they choose).
- The current law was unclear about feedstock used in once-off production: the ATO advised that claimants were inconsistently applying the provision in this context (ie, some were, some weren’t).
  - The new provision makes it clear that feedstock used in once-off production is treated the same as in, e.g., mass production.