Dissenting Report by Coalition Senators

The Coalition supports increased business investment in research and development (R&D) and appropriate reforms to legislation to help achieve this outcome. We also accept the general principle that changes to the current law may potentially help to achieve a higher R&D rate for a greater number of Australian businesses.

However, we will not be supporting the *Tax Laws Amendment (Research and Development) Bill 2010*; *Income Tax Rates Amendment (Research and Development) Bill 2010*. There are several shortcomings in the Bills that will be addressed in this report.

Consultation

Throughout this inquiry, there have been complaints about the failure of appropriate consultation associated with the legislation.

> In order to understand and apply these changes, the industry will need time to consult on the legal implications to ensure compliance, and individual companies will need to develop and implement new internal mechanisms to administer the scheme.[1]
>
> Consultation timelines have been highly condensed. The second exposure draft was released by Treasury on 31 March, with submissions from stakeholders due by 19 April, a total of only 10 working days. This is not sufficient time to digest 134 pages of legislation and provide substantive comments, particularly given that the second exposure draft incorporated a number of new concepts, including a completely new definition for core R&D. In addition, the tight timeframes meant that Treasury had not completed its redrafting in time for the 31 March release. As a result, the second exposure draft did not include redrafted feedstock provisions, and instead merely stated that "a feedstock adjustment rule is under consideration."[2]
>
> Stakeholders were not provided with an opportunity to comment on this aspect of the legislation until after it was introduced into Parliament, which is an unfortunate and disappointing outcome.[3]
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> Firstly, the Government has given itself an absurdly short timetable for community consultation and examination by the Parliament of what is a fundamentally new approach to the definition of eligible expenditure. The new approach would apply to all business R&D expenditure undertaken

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1 Caltex Australia, *Submission 3*, page 5.

2 Australian Treasury, Tax Laws Amendment (Research and Development) Bill 2010 – 2nd exposure draft, 31 March 2010, p. 26.

3 New South Wales Business Chamber, *Submission 10*, page 6.

> from 1 July 2010 and, under the timetable presented to us, business will have about two weeks to examine the new Act before R&D spending will come under the new regime. Putting aside the particular features of the proposed changes, this timetable for introducing a fundamentally new approach will increase the range of grey areas surrounding the tax incentive and the resulting uncertainty will see businesses scale back their expenditure. This outcome sits in stark contrast to the purpose of the R&D tax incentive – which is to encourage additional R&D expenditure by business.[4]
>
> …lament the missed opportunities to genuinely consult over the months before January 2010.[5]

This was arguably best highlighted in the submission from Michael Johnson Associates.

> A consistent theme of the submissions to the Committee's hearings was that there has been inadequate time to digest the key documents associated with the introduction of the Bills. The main causes of concerns are as follows:
>
> - The Second Exposure Draft (which was materially different to the First Exposure Draft in many aspects) only allowed 11 days (across the Easter and school holiday periods) for stakeholders to prepare responses and it omitted key provisions such as those relating to feedstock.
> - The feedstock provisions did not appear until the Bills were read in to Parliament. At the Committee hearings, Senator Back indicated that he was not aware that the provisions had been made available at all prior to the commencement of the Committee hearings.
> - The Committee hearings began within a week of the Bills being read into Parliament meaning that written submissions actually follow rather than precede the hearings and that many stakeholders were unaware of the hearings taking place.
> - The legislation will commence with no guidelines available to assist taxpayers and no transition process to allow taxpayers to make arrangements for the new legislative environment.
> - AusIndustry has indicated that it will be rolling out its first wave of program material in July/August 2010 and that this will not be developed in consultation with industry.
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> At the Committee hearings, even the Chair of the TCC conceded that the above timetable represented a "fairly rushed process". One consequence of the rushed approach is that the EM contains a number of mistakes in terms of references to the Bills (see Attachment A).

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4 Australian Industry Group, *Submission 19*, page 3.

5 Ernst and Young, *Submission 30*, page 9.

> Taken along with the wildly divergent views expressed at the Committee hearings, the timetable above has meant that the Bills and EM have been prepared in haste and are distinctly lacking in clarity and accuracy.
>
> MJA submits that the package is in poor shape and should not proceed to law in its proposed form on 1 July 2010.[6]

This was reflected in the committee hearings as well.

> Cutler reviewed the PC report and came up with the polar opposite: increase the base and scrap the incremental. We then went on to a consultative process where we got that consistency of viewpoint, and then the rather unfortunately timed Christmas package, which arrived just before Christmas, did not take that consultation into any real account at all, and put forward a definition that virtually word-for-word mirrored what was in the Productivity Commission report. We then got 131 submissions over the Christmas period. Again, the almost unanimous tenet was, 'Do not make these changes.' This has not happened, and I do feel that in the very specific consultations we had that we did get an opportunity to express our views but we were essentially being prescribed, 'This is what we are doing; what do you think?' rather than being asked: 'How would you tackle these issues?' For example, we were not asked about the suggestions we have about how we could deal with large claims under the existing definition of putting too much strain on revenue.[7]
>
> Normally there is adequate time to examine these things, to consult with them and to provide scope and opportunities for things to be adjusted before they are taken to the parliament, but not in this case.[8]
>
> From my perspective, having been engaged in this process since it started, this all points to the haste with which we are trying to nail this so that it can apply from 1 July. The second exposure draft was completely different from the first exposure draft. I speak openly when I say that the first exposure draft we got just before Christmas was a dog's breakfast. From my perspective, only then did real consultation start. We had a wasted opportunity from the time we had the Cutler report, to the consultation paper, to the first exposure draft. That time should have been used, I think, working on what we have as the second exposure draft, which was somewhat of an improvement, and then even the bill. On the second exposure draft I think we had 11 business days to consult. The bill came out last Thursday and we are here today talking about it. It is rushed and you will have a suboptimal outcome because it is rushed. I think you need to think about it.[9]

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6 Michael Johnson Associates Pty Ltd, *Submission 5*, pp 14 – 15.

7 Mr Kris Gale, Managing Director, Michael Johnson Associates Pty Ltd, *Proof Committee Hansard*, 20 May 2010, page 30.

8 Dr Peter Burn, Director, Public Policy, Australian Industry Group, *Proof Committee Hansard*, 21 May 2010, page 5.

9 Mr Sergio Duchini, Partner and Research and Development and Tax Incentives Practice Leader, Deloitte, *Proof Committee Hansard*, 21 May 2010, page 35.

This is a reflection of the overall approach of the Rudd Government, which continues to rush legislation into Parliament without due consultation and consideration. Additionally, the Committee has not been given sufficient time to consider the Bills – another trademark of the Rudd Government's approach to legislation and policy making.

Proper consultation with all relevant industry stakeholders over an extended period of time would have prevented the numerous problems identified in this report.

Stakeholders are consistently urging the Government to at least delay the introduction of the Bills. Given the Government's failure to consult appropriately, this is an eminently sensible suggestion; indeed, it is entirely prudent for these bills to have their start dates deferred. This was supported both in submissions and in evidence given to the Committee.

> I would suggest that the prudent thing to do would be to delay the implementation date to 1 July 2011. Let us use the next 12 months to tweak this, to get it right, and then pass it as the law.[10]
>
> We submit that the introduction of the Bills be deferred to 1 July 2011, to enable appropriate consultation and clarification on the changes and related guidelines. Companies require additional notice to consider the new rules and adjust their business plans accordingly. The proposed passing of the Bill in the last week of June, for application on 1 July 2010, without guidelines, will create confusion and are unlikely achieve the desired changes in levels of R&D activity for 2010/11income year.[11]
>
> The radical nature of the shift in innovation policy cannot be easily assessed and applied in practice by taxpayers. Therefore the Minerals Council of Australia recommends the Bill be delayed for at least one year (to 1 July 2011) until more detailed consideration can be undertaken.[12]

Further to this, it was pointed out that there is no evidence of any supporting documentation, rulings, regulations, guidelines or forms for the new legislation.[13] This is concerning, particularly if the Bills are to take effect from 1 July 2010.

> I was a bit shocked that in July there will be a road show around the guidelines and they have not engaged with industry on those guidelines. How effective will they be?[14]

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10 Mr Sergio Duchini, Partner and Research and Development and Tax Incentives Practice Leader, Deloitte, *Proof Committee Hansard*, 21 May 2010, page 35.

11 KPMG, *Submission 9*, page 4.

12 Minerals Council of Australia, *Submission 11*, page 13.

13 Aditus Consulting, *Submission 16*, page 2.

14 Mr Sergio Duchini, Partner and Research and Development and Tax Incentives Practice Leader, Deloitte, *Proof Committee Hansard*, 21 May 2010, page 35.

It was stated in the hearings that the educational material was still being developed by AusIndustry.

> However I can say that it is our intention to produce sectoral guidelines as educational material for different industry sectors, but neither of us, unfortunately, could comment on the policy deliberations.[15]

The fact of the matter is that the legislation is being unnecessarily rushed through the Parliament, leaving the Department of Innovation, Industry, Science and Research to prepare education campaigns, regulations and guidelines that have not yet been adequately tested with industry and stakeholders. This is an inappropriate state of affairs when industry is recovering from the global financial crisis and facing a second potential downturn in the economy, if current media speculation in Europe and the United States is to be believed.

Recommendation 1:

The Coalition recommends that the start date for these Bills be amended to 1 July 2011.

An additional result of the hasty development of the Bills was numerous drafting errors, as well as inconsistencies between the Explanatory Memorandum and the Bills, as identified in several submissions.[16] The Coalition continues to be alarmed at the regular drafting errors that keep arising in legislation under the Rudd Government – although it is hardly a surprising outcome given there is often such limited time between drafting and introduction. All drafting errors must be eradicated before the legislation's enactment.

Recommendation 2:

The Coalition recommends that the passage of the Bills be delayed in order to rectify the issue of drafting errors.

Definitions of 'core' and 'supporting' R&D

The Bill substantially alters the definitions of 'core' and 'supporting' R&D. In narrowing the definition of what constitutes genuine R&D, the Bill will disqualify from assistance many forms of R&D undertaken by Australian businesses. In turn, the overwhelming expectation of those groups who have lodged submissions on the

15 Dr Russell Edwards, Ex officio member, Tax Concession Committee, Innovation Australia, *Proof Committee Hansard*, 21 May 2010, page 52.

16 Michael Johnsons Associates Pty Ltd, *Submission 5 – Attachment 1*, pp 10 – 12; KPMG, *Submission 9*, page 10; Deloitte, *Submission 22*, page 12, Document tabled by Mr Serg Duchini (Deloitte) at a public hearing in Sydney on 21 May 2010: "Incorrect bill references in the explanatory memorandum", *Additional Information Received*; Ernst and Young, *Submission 30*, page 10.

exposure drafts is that the Government's changes will reduce the number of firms qualified for the concession. There will be particularly grave consequences for firms focused on industrial R&D and other 'non-lab/white coat' activities, including those involved in manufacturing, prototyping and process development.

The problem with the new definition was outlined as:

> The new definition of R&D is not better aligned with the Frascati Manual definition as had previously been contended by Treasury. In fact, the eligibility of the third limb of the Frascati definition – experimental development – is in real doubt.[17]
>
> There is a very narrow definition of a core activity—experimental work, unknown outcomes, new knowledge—and then there are a range of choices as to what a supporting activity might be, with a strong flavour that anything in a production environment is in danger of not being eligible. It is those trials that could be unable to be claimed.[18]
>
> Certain companies look at this definition and they believe that the majority of what they do is 'core' and that their claims might be able to be sustained in this environment. Equally, other companies look at this definition and say: 'A lot of what we do is in a production context.[19]

The definition of R&D in the Frascati model, as developed under the auspices of the OECD is:

> Research and experimental development (R&D) comprise creative work undertaken on a systematic basis in order to increase the stock of knowledge, including knowledge of man, culture and society, and the use of this stock of knowledge to devise new applications.[20]

This is a well recognised definition and several witnesses pointed out that this had been the model they had worked with for quite some time and the new definitions that were being pushed by Treasury and the Department of Innovation, Industry, Science and Research could cause problems.

> On the need to bring the definition into better alignment with the internationally accepted Frascati Manual definition of R&D: I think they are no longer maintaining that. I think that the proposed definition in this bill recognises the first two elements of Frascati being basic and applied

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17 Michael Johnson Associates Pty Ltd, *Submission 5*, page 3.

18 Mr Kris Gale, Managing Director, Michael Johnson Associates Pty Ltd, *Proof Committee Hansard*, 20 May 2010, page 28.

19 Mr Kris Gale, Managing Director, Michael Johnson Associates Pty Ltd, *Proof Committee Hansard*, 20 May 2010, page 28.

20 Organisation of Economic Co-operation and Development, *Frascati Manual – Proposed Standard Practice For Surveys on Research and Experimental Development*, OECD, 2002, page 30.

research, but query the applicability of the third limb, which is experimental development. This package seems to query the extent to which that work would be eligible.[21]

The second and central basis for our strong opposition to the new approach to defining eligible business R&D expenditure is that it is highly restrictive. For approximately 25 years, our R&D tax incentive has been based on what is known as the Frascati model, which has been developed under the auspices of the OECD over a number of decades. Under this model, R&D is defined as:

> … creative work undertaken on a systematic basis in order to increase the stock of knowledge, including knowledge of humanity, culture and society, and the use of this stock of knowledge to devise new applications.

The second part of the definition, 'the use of this stock of knowledge to devise new applications', is central to our objections to the new approach proposed by the government. The objects clause of the bill states:

> The object … is to encourage industry to conduct research and development activities … by providing a tax incentive for industry to conduct, in a scientific way, experimental activities for the purpose of generating new knowledge or information in either a general or applied form.

Critically, this clause omits the second critical element in the Frascati approach—'the use of this knowledge to devise new applications'.[22]

The new definition of 'core' R&D is:

> (1) ***Core R&D activities*** are experimental activities:
>
> (a) whose outcome cannot be known or determined in advance on the basis of current knowledge, information or experience, but can only be determined by applying a systematic progression of work that:
>
> (i) is based on principles of established science; and
>
> (ii) proceeds from hypothesis to experiment, observation and evaluation, and leads to logical conclusions; and
>
> (b) that are conducted for the purpose of generating new knowledge (including about the creation of new or improved materials, products, devices, processes or services).[23]

Several submissions were critical of this approach.

> The new definition of core R&D requires taxpayers to seek new, previously unknown or undiscovered information and carry out scientific experimentation to uncover that new knowledge. Claimants such as Caltex will need to prove in a retrospective assessment that the knowledge did not exist anywhere else, which will create additional administrative and

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21 Mr Kris Gale, Managing Director, Michael Johnson Associates Pty Ltd, *Proof Committee Hansard*, 20 May 2010, page 27.

22 Dr Peter Burn, Director, Public Policy, Australian Industry Group, *Proof Committee Hansard*, 21 May 2010, page 3.

23 Tax Laws Amendment (Research and Development) Bill 2010, section 355-25.

> operational burdens. This creates an innovation system which does not encourage industry to pursue innovation and development of processes and products.[24]
>
> The definition of core R&D activities in the bill confirms the research focus of the new approach to business R&D. The approach outlined in the bill leaves little room for the majority of what business R&D is actually about—what, in the Frascati model, is called 'experimental development'. Experimental development is defined as:
>
> … systematic work, drawing on existing knowledge gained from research and/or practical experience, which is directed to producing new materials, products or devices, to installing new processes, systems and services, or to improving substantially those already produced or installed.[25]

When it came to the hearings, the witnesses were strident in their view that the definition of core R&D was inappropriate and would add additional red tape issues.

> For example, the requirement that supporting R&D activities must be either directly related to or be conducted for the dominant purpose of supporting core R&D activities will add significantly to the compliance burden.[26]
>
> It splits off the development of new knowledge from the development of new or improved product processes, devices, materials and services. If you have a manufacturing process where you are trying to develop a new process, under the current scheme you will have a project that might be a certain size. The first 30 per cent of that might be the creation of new knowledge, and the remaining 70 per cent would be the development of the new process, which by this definition is R&D. It is that 70 per cent that will get lopped off by this legislation.[27]

Similarly, the new definition of 'supporting' R&D is:

> (1) ***Supporting R&D activities*** are activities directly related to *core R&D activities.
>
> (2) However, if an activity:
>
> (a) is an activity referred to in subsection 355-25(2); or
>
> (b) produces goods or services; or
>
> (c) is directly related to producing goods or services;

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24 Caltex, *Submission 3*, page 6.

25 Dr Peter Burn, Director, Public Policy, Australian Industry Group, *Proof Committee Hansard*, 21 May 2010, pp 3 – 4.

26 Dr Brendan Shaw, Chief Executive Officer, Medicines Australia, *Proof Committee Hansard*, 20 May 2010, page 3.

27 Mr Ian Ross-Gowan, Manager, Michael Johnson Associates Pty Ltd, *Proof Committee Hansard*, 20 May 2010, page 29.

> the activity is a ***supporting R&D activity*** only if it is undertaken for the dominant purpose of supporting *core R&D activities.[28]

This has been of considerable concern in several submissions and followed up on during the hearings. The submissions and witnesses pointed out:

> By redefining supporting activities as proposed, incentives for R&D will move away from industrial R&D programs to laboratory-style programs. Caltex's industrial R&D occurs on a commercial scale, with improvements to processes and outputs trialled in live conditions rather than laboratory or theoretical conditions.[29]

> The whole concept of supporting and inducing additional R&D will be undermined by that uncertainty. Even if overall it worked out to be a fantastic new approach once the dust had settled, this problem would exist.[30]

> I think we agree entirely that, in the manufacturing or production environment, it will be an additional compliance because of the dominant purpose test, but there is still a significant compliance issue required in the non environment, where most of our R&D happens to be, in order to address the core and supporting activities.[31]

The Australian Industry Group pointed out two major concerns with the definition of supporting R&D.

> Firstly, supporting R&D expenditure is only eligible if it is ether "directly related to" core R&D activities or if it is "undertaken for the dominant purpose of supporting" core R&D activities. This means that businesses would have to be undertaking core R&D before *any* of its R&D expenditure could qualify as supporting R&D expenditure. If a business has no expenditure that qualifies as core R&D, it will have no eligible R&D expenditure.[32]

> Secondly, in any case much experimental development is neglected by the dominant purpose test in the definition of supporting R&D activities. In the Bill (s355-30), a supporting R&D activity is defined as an activity directly related to core R&D activities except if it is an activity that is: explicitly excluded, *or* if it is an activity that "produces goods or services", *or* if it is an activity "is directly related to producing goods or services". In any of these cases the expenditure needs to be undertaken for "the dominant purpose of" supporting core R&D activities.[33]

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28 Tax Laws Amendment (Research and Development) Bill 2010, section 355-30

29 Caltex, *Submission 3*, page 6.

30 Mr Innes Willox, Director, Government and International Relations, Australian Industry Group, *Proof Committee Hansard*, 21 May 2010, page 7.

31 Mr Gregory Oliver, Research and Development Analyst, Cochlear Ltd, *Proof Committee Hansard*, 21 May 2010, page 13.

32 Australian Industry Group, *Submission 19*, page 7.

33 Australian Industry Group, *Submission 19*, page 7.

> One of our advisors put it this way: "it is difficult to think of many supporting activities that don't fall into one of the three dominant purpose categories given that any activity directly related to production is captured."[34]
>
> Put simply, there are simply too many ways that supporting R&D activities will be excluded from eligibility for the proposed new R&D incentive for business to have any confidence that experimental development will continue to attract a tax incentive.[35]

Recommendation 3:

The Coalition recommends that the definitions of core and supporting R&D be reconsidered to be more closely aligned to the Frascati model of R&D.

Eligibility Criteria

The Government's changes to the eligibility requirements are sweeping, and threaten to significantly erode support for R&D investment in Australia. They are also fundamentally inconsistent with the Government's stated intent of making R&D tax support arrangements simpler, more predictable and more generous. Instead, they impose a series of barriers upon firms rather than offering encouragement for innovation.

> Because of the operation of the dominant purpose test and the feedstock provisions, an eligible R&D activity may have no costs associated with it and therefore the customer or the client or the SME can go away from an AusIndustry meeting believing that they are eligible for the R&D tax credit program, only to have that eligibility wiped away because of the application of, for instance, the feedstock provisions or the eligibility of expenditure provisions.[36]
>
> While that requirement will not exist under the new legislation, there will nonetheless be a significant amount of additional planning required by companies so that they can reassess the eligibility under the new definition, on the one hand, and also, importantly, to predetermine, perhaps throughout the annual life of a project, what activities will now be core and what will be support.[37]
>
> However, there are a number of concerning implications which flow from what I refer to as the core building blocks of the proposed bill… the burden

34 Australian Industry Group, *Submission 19,* page 7.

35 Australian Industry Group, *Submission 19,* page 7.

36 Ms Tracey Murray, Partner, Research and Development, BDO Australia, *Proof Committee Hansard,* 20 May 2010, pp 39 – 40.

37 Mr Gregory Oliver, Research and Development Analyst, Cochlear Ltd, *Proof Committee Hansard,* 21 May 2010, page 12.

> of proof and evidence required to sustain eligibility by all claimants; and the compliance burden.[38]

'Dominant Purpose' Test

The major concern was the use of the term 'dominant purpose'. Several witnesses expressed concern as to what that term actually meant.

> The third tier comes about with what we still refer to as the exclusions list, although it is no longer called that in the bill. It says that a range of activities are defined as not being core activities. If you have an activity that comes under that list of exclusions then you have to jump over another hurdle. You have to show that that activity is for the dominant purpose of supporting a core activity. So I guess the issue is the complexity of having to define what are your core activities and you're supporting activities and justifying the fact that an activity has the dominant purpose of supporting a core activity. That is relatively complex. Also, companies are required to identify that upfront when they are registering their R&D activity to qualify for the tax credit. That is a relatively high compliance burden on our members and other companies. That is our concern.[39]

> In a manufacturing setting a company will come up with a process concept or a new product concept, but it will need to be tested in real life or at a scale-up version. Scale-up is a real challenge to successfully commercialising R&D, so it is important that the technical issues and problems are overcome. A production trial can be very small or very large, and it will depend on the particular facts. In manufacturing, typically, there will be a batch run of a new concept or product and there will be feedback R&D—invariably, the first trial will not be the final product. Feedback R&D highlighting shortcomings and failures within the system gives the R&D team the knowledge to further improve and create the product or process they are seeking. In a manufacturing setting this would be common.[40]

In submissions and during the hearings, there was evidence of continual and considerable confusion about what was meant by dominant purpose.

> The Easter draft persists with the notion of the need to introduce a dominant purpose test to qualify supporting R&D activities. Four categories of supporting activities have been identified and the taxpayer needs to identify which category its supporting activities belong to – if the activity is on the exclusions list, production or (somewhat bizarrely) directly related to production, the dominant purpose test applies; if not in any of these categories, then the directly related test applies. The introduction of

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38 Mr Sergio Duchini, Partner and Research and Development and Tax Incentives Practice Leader, Deloitte, *Proof Committee Hansard*, 21 May 2010, page 32.

39 Ms Deborah Monk, Director, Innovation and Industry Policy, Medicines Australia, *Proof Committee Hansard*, 20 May 2010, pp 4 – 5.

40 Mr Robin Parsons, Partner, Indirect Tax, Ernest and Young, *Proof Committee Hansard*, 20 May 2010, page 12.

> production is a first-time concept for the R&D tax incentive and has wide-ranging implications that the Easter draft does not fully explore.[41]
>
> Under the current definition of R&D activities, all activities qualify under the 'systematic, investigative and experimental' (SIE) test or the 'directly related' test. No distinction is made. Under the proposed Credit, the taxpayer needs to split activities into core or supporting and then establish which of four tests the supporting activities applies to. As discussed earlier, these decisions will be based on the overall circumstances of the activities without the EM providing any definitive guidance as to how circumstance relate to the law.[42]

The introduction of the dominant purpose test appears to be a large impost on businesses.

> The overwhelming feedback from our diverse client base indicates that a "dominant purpose" test will exclude a large proportion of production trial activity that is a necessary and legitimate part of the research and development cycle. If the aim is to contain the cost to revenue associated with large and open-ended production trials, the introduction of a cap on the total value of the group's R&D claim would better achieve this objective, whilst also providing clarity and simplicity for claimants.[43]
>
> The dominant purpose test should be removed as it imposes an unnecessarily high threshold as evidenced in the EM, and does not target the minority of excessive claims which the Government purports are occurring;[44]

It is concerning that many submissions were advocating for the removal of the dominant purpose test. Several alternative models were suggested, such as:

- 'A purpose directly related to' test[45]
- Substantial purpose[46]
- Apportionment of expenditure[47]
- Dollar capping the extent of production trials,[48] on the total value of the R&D claim for companies with group annual revenue exceeding $1 billion,[49] or on eligible R&D expenditure.[50]

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41 Michael Johnson Associates Pty Ltd, *Submission 5 – Attachment 2*, page 23.

42 Michael Johnson Associates Pty Ltd, *Submission 5 – Attachment 2*, page 23.

43 NOAH Consulting, *Submission 8*, page 3.

44 KPMG, *Submission 9*, page 7.

45 Deloitte, *Submission 22*, pages 2 and 7.

46 Property Council of Australia, *Submission 28*, page 7; Deloitte, *Submission 22*, page 7.

47 Ernst and Young, *Submission 30*, page 4.

- More sympathetic language[51]
- Specific provisions for specific excesses[52]
- Time limits for trials[53]
- Pre approvals for projects above certain values[54]

Recommendation 4:

The Coalition recommends that the dominant purpose test be removed and be reconsidered.

Object Clause

The object clause needs to be revised in respect of spillover and additionality benefits. The object clause currently reads:

> (1) The object of this Division is to encourage industry to conduct research and development activities that might otherwise not be conducted because of an uncertain return from the activities, in cases where the knowledge gained is likely to benefit the wider Australian economy.
>
> (2) This object is to be achieved by providing a tax incentive for industry to conduct, in a scientific way, experimental activities for the purpose of generating new knowledge or information in either a general or applied form.[55]

It was pointed out that this is a more restrictive term and could impact on Australian industry.

> During the course of the public consultation process last year the CTA and other external stakeholders urged the government not to include an objects clause that refers to R&D activities that would not otherwise occur and which are likely to involve spillover benefits for the broader community. We are disappointed this remains a feature of the Bill because we consider there is a risk that, at the margin, a court or tribunal might be guided by such language in resolving disputed claims.[56]

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48 Ernst and Young, *Submission 30*, pp 4 – 5.

49 NOAH Consulting, *Submission 8*, page 3; KPMG, *Submission 9*, page 7.

50 Corporate Tax Association, *Submission 14*, page 2.

51 Ernst and Young, *Submission 30*, page 5.

52 Ernst and Young, *Submission 30*, page 5.

53 KPMG, *Submission 9*, page 7.

54 KPMG, *Submission 9*, page 7.

55 Tax Laws Amendment (Research and Development) Bill 2010, section 355–5.

56 Corporate Tax Association, *Submission 14*, pp 1–2.

> While those concepts may be well and good, they are impossible to prove and therefore should not be part of the statutory framework – even as part of an objects clause. Such language might well be appropriate for a second reading speech but, in our view, does not belong in the law itself. We would much prefer the objects clause to make reference to increasing the efficiency and international competitiveness of Australian business, which reflects what we regard as the proper rationale for the incentive.[57]
>
> 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[58]
>
> But in a sense this restricts the eligible research and development to those circumstances where a company could perhaps be asked: 'Would you not have done this without the credit?' That is actually not a very sensible position because the credit should just be a cost-planning issue in a matrix where you make a decision about whether to do the work or not. I think one of the great concerns about the idea of conditionality is that people keep focusing on: 'Prove that we are only funding things that would never have been done.' That does not make sense to me.[59]

It is concerning that several witnesses suggested that the object clause concentrates more on research than development.

> The narrow coverage of the objects clause suggests to us that the government intends to pare back the role of the R&D tax incentive to fund, almost exclusively, research. It does not intend to include much of what business R&D is about—namely the development of existing knowledge to 'devise new applications'. Instead the government intends that the R&D tax incentive will apply to activities conducted for the purpose of producing new knowledge. It would be more straightforward to refer to it as the 'research tax credit'.[60]
>
> The new object clause (s355-5), when taken in conjunction with the new definition for core R&D, seems to reflect an intention to limit support to

57 Corporate Tax Association, *Submission 14*, page 2.

58 Advanced Manufacturing Coalition, *Submission 2*, page 2

59 Mr Kris Gale, Managing Director, Michael Johnson Associates Pty Ltd, *Proof Committee Hansard*, 20 May 2010, page 28.

60 Dr Peter Burn, Director, Public Policy, Australian Industry Group, *Proof Committee Hansard*, 21 May 2010, page 4.

> research and exclude development. This is despite the fact that development represents the largest and most important aspect of BERD.[61]
>
> The objects clause in the draft legislation definitely narrows the definition and has a much greater emphasis on the R rather than the D, compared to the existing situation.[62]
>
> The comment was made earlier that it is more about the 'R' and less about the 'D'. I think there is a conflict between this definition and the objects clause. I think the objects clause more eloquently and more directly says that the object of this section is to promote and support investments in R&D. But if you look at section 355-25(1)(b), I think you will find that the wording in that subparagraph could be improved pretty simply.[63]

This is not a positive sign for future research and development. While the Coalition does not believe that the balance should be tilted the other way, both research and development should receive equal footing within the taxation system.

Recommendation 5:

The Coalition recommends that the Object clause be amended to ensure that both research and development are given equal tax benefits.

Intellectual Property

There was concern by Cochlear Ltd about the ownership of intellectual property outside of Australia, as this may be disadvantageous to the Australian economy[64] and it was additionally suggested in evidence given to the Committee that the non-retention of intellectual property ownership within Australia be trialled for three years and then reassessed.

> I think, with care, that proposition could be accepted with the government reviewing it maybe after two or three years of activity to see exactly to what extent it has resulted in benefits domestically. It is a bit of a risk for us in public policy but I think, given the globalisation of R&D, it is something we should try out to see what the impact might be.[65]

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61 New South Wales Business Chamber, *Submission 10*, page 1.

62 Dr Christopher Roberts, Chief Executive Officer, Cochlear Ltd, *Proof Committee Hansard*, 21 May 2010, page 14.

63 Mr Sergio Duchini, Partner and Research and Development and Tax Incentives Practice Leader, Deloitte, *Proof Committee Hansard*, 21 May 2010, page 33.

64 Mr Andrew Chia, Group Tax Manager, Cochlear Ltd, *Proof Committee Hansard*, 21 May 2010, page 17.

65 Professor Roy Green, Dean, Faculty of Business, University of Technology Sydney, *Proof Committee Hansard*, 21 May 2010, page 20.

Conclusion

In short, the Bill radically alters a regime that has been operating effectively since the 1980s – and in a way that disadvantages a large number of Australian businesses. Where companies must currently demonstrate that their R&D activities are novel or have high technical risk, Labor essentially proposes to fund firms only in cases in which they can show they have introduced a wholly new technique, process or solution. Its effect is punitive on a number of large companies (whose best innovations are often based upon making refinements to existing practices) as well as the small business sector, given that approximately 60 per cent of current applicants are SMEs.

Together, the proposed changes to elements of the legislation such as the definition of R&D activities, the dominant purpose regarding supporting activities, the registration processes and feedstock rules will have the very opposite effect to the Government's stated intentions of providing greater generosity, predictability and simplicity. They will disadvantage rather than benefit most Australian companies intending to undertake R&D.

Unsurprisingly, the changes have therefore attracted substantial criticism from a wide diversity of stakeholders, including major organisations such as the Australian Industry Group, the Australian Chamber of Commerce and Industry, Ernst & Young and KPMG.

We also note that the Chair's report now implicitly acknowledges a number of potential problems with the legislation, including drafting errors and definitional concerns. We do not believe that it is appropriate that Bills be rushed through when they contain such errors and when they therefore give rise to considerable uncertainty. Reviewing elements of the Bills after three years is also not an appropriate means of addressing problems of the kind evident in this legislation – and a more practical step would be to make sure they are more appropriately drafted in the first place.

Increased innovation and productivity are both key factors in Australia's future economic success. But these Bills seek to gut an incentive that is integral to assisting and encouraging a diversity of companies to improve their business operations.

The Coalition will not be supporting these Bills.

Senator Alan Eggleston
Deputy Chair

Senator David Bushby