



AUSTRALIAN BANKERS' ASSOCIATION INC.

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Mr Paul McCullough
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Dear Paul,

**Submission on Research and Development Tax Incentive
Consultation Paper**

The Australian Bankers' Association ("the ABA") appreciates the opportunity to comment on the Consultation Paper of September 2009 concerning the new Research and Development ("R&D") tax incentive.

The ABA works with its members to provide analysis, advice and advocacy and contributes to the development of public policy on banking and other financial services. It also works to ensure the banking system can continue to deliver the benefits of competition to Australian banking customers.

The ABA supports the reform objectives of making the new R&D tax incentive more effective in delivering support for business R&D and in targeting that support to where it is most likely to produce net-benefits for the Australian community.

In particular, the ABA welcomes the proposals in the Consultation Paper as to the recognition of the currently inequitable treatment of software development in R&D.

However, the ABA has some concerns with the practical application of some of the principles and design features of the new R&D tax incentive as outlined in the Consultation Paper, in particular, with regard to:

- the policy definition and practical issues in respect of quantifying additionality and/or spillover;

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- definitional issues arising from a move to dual criteria of innovation and high levels of technical risk;
- the potentially inequitable treatment of expenditure incurred in the development of software; and
- the practical issues surrounding restriction of eligibility for expenditure incurred in supporting activities.

Policy and spillover principles

Over the last 24 years the objectives of the R&D tax incentives have been to engender a culture of innovation and development in Australia and to create an environment that is conducive to increased commercialisation of new processes and product technologies. This should continue to be the driving principle behind the design rules for the new R&D tax incentive.

We do not necessarily disagree with 'additionality and spillover' being adopted as general and overarching design objectives for the new system but only from a macro economic and community perspective. In other words, the objective should be to create an overall environment which is conducive to greater and enhanced R&D activity, not penalise those who may currently conduct such activity. An approach to disallow what would otherwise qualify as R&D activity of a given enterprise, merely because of a perception that an enterprise may have been committed to that activity, regardless of any potential R&D incentive, is flawed.

An attempt to solely focus on new and incremental R&D will result in damage to the amount and type of Australia's R&D, particularly given the global nature of many R&D activities. Capital in our global economy is capable of flowing to or from countries; so too the decision to undertake R&D activity in a particular country will need to consider competing alternatives, including overseas jurisdictions if that alternative is available. Software development for example has many attributes that do not need to be necessarily tied to Australia.

Productivity Commission Reviews have confirmed that the R&D tax concession has resulted in net economic and social benefits. R&D undertaken by the ABA and its members benefits the Australian economy, as financial institutions make it their business to improve services to their customers, achieving this through the sophisticated development of in areas such as:

- Maintenance and security of customer data and identifying innovative ways of providing financial services to Australians that take advantage of the latest revolutionary technologies;
- Wrap platforms – managing investments securely online;
- Small business banking products – enabling efficient hedging, FX trading and import/export without the need for sophisticated accounting staff;

- Large business banking products – improving transaction capacity and capability as well financial risk management; and
- Efficacy of settlement and clearing processes – stabilising and enhancing counterparty transactions.

The innovation in banking technologies has changed the way in which all Australian customers and businesses conduct their banking. The spillover benefits, in terms of customer convenience, efficiency, and time savings, would be noticed and enjoyed by every business and household across Australia.

Consumers are now able to conduct their banking and investment activities in the comfort of their own home, at any time of the day. The time saved in having on-line services available in a secure and trusted environment would be immeasurable. Apart from telecommunication, innovation in financial services technology would probably have the widest spillover impact across the Australian economy, and by and large, the R&D tax concession is closely associated with the revolution in the banking industry.

Australia has, to a significant extent, avoided the worst of the GFC because of, and not in spite of, the robust banking risk management structure with which corporate Australia integrates its treasury systems.

However, incorporating “additionality and spillovers” in the legislation, even within an objects clause, will lead to confusion as to its application at a company level. Spillover benefits are extremely difficult to quantify, particularly at the commencement of R&D activities. Many of these benefits accrue from both small step changes and radical new development, and take many years to filter through the wider community. It is really only with the benefit of hindsight that one can determine if spillover has occurred.

The ability of a company to determine potential broader benefits of its R&D program beyond the impact to its own business should not be a criterion for access to the R&D tax incentive.

We also note that the Consultation Paper suggests that such spillover effects are more associated with SMEs than with larger enterprises. Given the well-established benefits listed above, and the magnitude of the associated spillover benefits to the Australian economy and skills-base, the ABA considers that this assertion is not supported by the evidence.

Definitional issues – Innovation and High Levels of Technical Risk

The proposed changes to the definition of core R&D activities will now require those activities to exhibit both innovation and high levels of technical risk, whereas the current requirement is for the activities to exhibit only one of these characteristics.

The ABA is of the view that the change in definition would have a significant limitation on the class of “activity” eligible for the credit. Further, the term “activity” is not currently defined. It is conceivable that if the scope of an activity

is defined too narrowly, it may be difficult to identify elements of both innovation and high levels of technical risk.

The ABA believes that there is no basis for the proposed change to the definition, as the Frascati manual does not require R&D activities to contain the presence of both innovation and high levels of technical risk.

The Frascati Manual 2002, which is universally accepted for the measure of R&D activities, defines R&D as:

"comprising 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."

However, the ABA appreciates that simply localising software developed overseas for Australian use without developing new or improved products, processes or knowledge is no justification for government assistance. Most banking R&D projects are not merely localising software but involve complex development of integrated banking systems that provide many benefits for the bank, customers and the economy.

If the proposed tightening of the definition of eligible R&D to require both innovation and high technical risk is to be implemented, the ABA considers industry or sector-specific definitions of software development should not be required. Given its involvement across all industry sectors and the direct and indirect nexus to economic spillovers, we submit that software development should be afforded the same treatment as other core R&D activities. Accordingly, we would submit that the optimal approach would be to avoid prescriptive rules for software-associated R&D activity wherever possible.

We note with concern a desire to limit "supporting activities". In the context of large complex projects, it is practically impossible to isolate a supporting activity. For example, testing is usually characterised as a supporting activity. However, in complex projects, testing activities require the development of sub-hypotheses to support the major hypothesis. A move to differentiating support from core activities would necessarily and significantly increase uncertainty.

For this reason, the ABA would prefer a model based on internationally recognised definitional criteria around:

- nature of "experimental development";
- a defined scope of what constitutes innovation; and
- the purpose of improvement or new knowledge from a technology perspective.

Whilst, of itself, such a requirement for satisfaction of dual criteria should not necessarily preclude the appropriate characterisation of the activities in question, in practice, this will largely depend on the definition of "innovation", and how that definition is interpreted in practice by the Government authorities.

The ABA would therefore stress the importance of the definition of innovation being commercially practicable with regard to the stated policy intention. Were "innovation" to be defined too narrowly, this could restrict the eligibility of the tax incentive beyond that intended by Government policy.

Narrowing the definition would also appear to be at odds with current Government policy in relation to initiatives such as the Carbon Pollution Reduction Scheme (CPRS) and the proposed and heavily promoted Australian National Broadband Network, both of which will require much experimental development work to meet the ambitious targets being set.

In particular, regard should be had to the practical nature of commercial R&D activities, with the definition containing an appropriate level of tolerance for elements of existing technology, through and upon which nevertheless, eligible innovative R&D activities result in the creation of new technologies.

Given the complexities of each industry's context, the ABA considers that the provision of industry-specific guidelines by AusIndustry, in consultation with representatives from the relevant industry (similar to the comprehensive guidelines issued by the Canadian tax authority, in conjunction with the local software industry association for software projects, and other guidances issued for specific industry sectors), would serve to:

- give effect to Government's policy intention;
- provide corporate taxpayers with an appropriate level of certainty and guidance as to their activities' eligibility; and,
- provide guidance to the relevant officials examining these claims.

Examples

As far as we can understand, the rationale for making the change to the definition is firstly based upon a series of examples, such as the three provided in the Consultation Paper, purporting to demonstrate how, under the current definition, disproportionately large unjustifiable expenditures qualify for the concession.

The assertion is that those expenditures relate to activities that, in substance, do not constitute "genuine" R&D, under more universally accepted norms and conventions and, therefore, do not have *"a strong rationale for public support."*

It has not been demonstrated in the Consultation Paper as to how the change from "innovation or high levels of technical risk" to "innovation **and** high levels of technical risk" in definition will impact on the three examples given. It would appear that the examples are more concerned with the distinction between "core" and "supporting" activities than with whether or not the activities would satisfy the new definition of R&D activities.

There is no evidence that activities involving only innovation or high levels of technical risk have a lesser impact in regard to spill over or additional benefits to Australia.

Software

We note that the paper has also expressed concern with respect to the application of the R&D definition to the development of software and welcome the invitation to provide specific comment as to alternative approaches in this regard.

The ABA concurs with the view expressed in the Consultation Paper as to the multiple sales test's irrelevance in today's R&D context, and the almost ubiquitous presence of software development in current economic endeavours, given the World Wide Web.

Given its involvement across all industry sectors and the direct and indirect nexus to economic spillovers, we submit that software development should be afforded the same treatment as other core R&D activities. Accordingly, we would submit that the optimal approach would be to avoid prescriptive rules for software-associated R&D activity wherever possible.

We also note that software development by its nature can be transformational, creating new industries without need for national expenditure on new infrastructure.

Large complex software projects are found most frequently in the financial services arena. These projects employ large amounts of highly skilled and highly educated Australian workforce who, in turn, develop technology and knowledge, thereby making them an enabler. These skilled professionals will continue to use their knowledge and skills gained from working on such complex projects in their future endeavours in Australia.

It should be emphasised that the banking sector, like other industries, is constantly under cost pressure as investors demand greater efficiency gains and cost reduction. Without the support of the R&D tax concession, it is possible that a larger proportion of technology development could be undertaken in offshore locations with more favourable cost structures, including more favourable R&D incentives and operating costs. This would result in a reduction of work opportunities for Australian workers in these types of projects.

The level of finance related R&D conducted within Australia, typically on complex software projects, has resulted in Australia having a real competitive advantage when compared with many overseas countries, and Australian institutions, particularly as we emerge from the GFC, now leading the world on many indicators.

The more costly, insecure and inefficient that financial intermediation is within an economy, the greater the waste and inefficient use of resources. The Government's stated objective is to make Australia a regional financial services centre, and R&D in the Australian financial services sector should be seen as essential enabler to keep Australia's competitive advantage, to the benefit of all Australians in providing:

- employment;

- market efficiencies; and
- retention of intellectual property in Australia.

In Australia the telecommunications industry is the only other major source of high-end technical software development. Without large complex projects, cutting-edge skill sets cannot be created.

For completeness, we also note that the definitions of software in R&D at paragraphs 135-142 of the Frascati Manual are notable for both their breadth and lack of reference to any motive or purpose test as to future commercial exploitation.

Software example

Example 3, in the Consultation Paper states:

"A company in the finance industry undertakes to provide customers with an enhanced online experience and more simple use of the company's products. The business solution will provide customers with access to an extensive range of on-line facilities. The project provides a common platform for delivery of software-based services over the internet. The project involves internal software development and the integration of a number of existing on-line services with single customer sign-in.

All activities are claimed to involve both innovation and technical risk. The existing multiple sale test provision for software is deemed satisfied, because customers are 'licensed' to access a single sign-on integrated on-line environment. The claim is expected to be in the order of \$15 million over the 4 year life of the project.

This claim illustrates the weakness of the current multiple sale test and the high level of taxpayer subsidy available to activities which largely involve customisation and/or integration of existing systems."

The ABA would submit that this example does not provide sufficient information about the relevant activities as to make any proper determination. In addition, it is not clear how any proposed changes to the R&D definition would be intended to apply any differently to this type of R&D. For example, in relation to R&D associated with software development such as this, the respected Frascati Manual states:

"For a software development project to be classified as R&D, its completion must be dependent on the development of a scientific and/or technological uncertainty on a systematic basis...Therefore, an upgrade, addition or change to an existing program or system may be classified as R&D if it embodies scientific or technological advances which result in an increase in the stock of knowledge."

It should also be noted that, the Frascati Manual, in para 142, states that in the systems software area, which are projects that the financial sectors often engage

in, individual projects or components may not be considered as R&D, but their aggregation into a larger project may qualify for inclusion. For example, changes in file structure and user interfaces in a fourth-generation language processor may be made necessary by the introduction of relational technology. The individual changes may not be considered R&D in their own right, but the entire modification project may result in the resolution of scientific and/or technological uncertainty and thus classified as R&D.

Therefore, it is universally accepted that R&D is often found in projects undertaken by the financial sector where the overall project, including integration of various components, could involve the resolution of technical uncertainty and technological innovation, while some of the individual components may not themselves be regarded as R&D.

That would appear to be the case under the current definition and we would hope that there is no intention to depart from this general approach. As for Example 3, the question is whether the claims made about the activities (that they "involved innovation and technical risk") are founded in fact – or whether they involved no more than mere customisation or integration of existing systems, without the necessary innovation or technical risk. If the activities satisfy the normal eligibility requirements, they should be supported and encouraged.

Supporting Activities

As an overarching comment, the ABA's view is that, from a policy perspective, the distinction between core and supporting activities is essentially artificial. That is, provided the activity is necessary for the successful pursuit of the R&D project, it should be supported by the tax concession.

This principle is recognised internationally, where there is no differential treatment of expenditure incurred in core or supporting activities. As with the current Australian system, where there is no differential treatment, there is no tension as to characterisation of activities.

In practice, it appears that the changes proposed as options in the Consultation Paper do not represent the embodiment of any principle as to which activities should receive government support, but rather, a variety of means for the revenue cost of that support to be restricted.

However, the mere fact that the cost of these activities may be high does not make their contribution to the R&D activity any less valuable than "core" activities. Indeed they are likely to be fundamental to success or failure of the R&D project.

Whilst we comment below on each of the methodologies proposed in the Consultation Paper for the restriction of claims for supporting activities, from a practical legal and operational perspective, we note that, any such restriction places significant stress on the definitions of core and supporting activities, with a characterisation of activities as core being preferable, since there would be no such restriction.

To implement the changes as proposed will create a significant and onerous compliance and administrative burden on potential R&D claimants and a significant likely source of future disputes. This will not only waste Government and claimant resources, but may also lead to a level of disillusionment with the R&D system given the level of uncertainty and the costs of making an R&D claim.

The suggestions to restrict supporting activities seems to be based on the premise that supporting activities contribute less in terms of public good, however they do currently require a nexus to the core activities in order to be eligible.

Options proposed in the Consultation Paper

Capped as a proportion of Core R&D

We note the Consultation Paper suggests that capping eligible supporting activity at a percentage of core R&D expenditure would address concerns regarding the relative size of claims for supporting and core R&D activity.

However, our members' R&D projects may have differing ratios of expenditure with regard to core and supporting activities, and as this form of fixed cap would create an arbitrarily fixed relationship between core and supporting R&D claims, we consider it is likely to be inequitable in the majority of cases.

Sole purpose

The ABA submits that a "sole purpose" test would not be practical, given that almost all bona fide supporting activities will have some element of incidental benefit for the claimant taxpayer. Accordingly, such an approach is likely to lead to the ineligibility of the majority of otherwise eligible expenditure incurred in supporting activities.

The suggested variation that the activity be "predominantly" for the purpose of supporting a core R&D activity may be a workable compromise in this regard, provided that practical guidelines are given to both assessors and taxpayers as to a certain threshold tolerance of incidental benefit.

For completeness, we note that any approach based on a purpose test will, almost by definition, require an objective decision to be made as to the claimant's motive for such expenditure, in addition to the assessment of value attributed to any incidental benefit. Accordingly, such an approach introduces not only uncertainty but also the potential for widely differing interpretation by assessors and claimants. This is especially true given that industry R&D should focus on achieving a commercial outcome, albeit that this is achieved through the development of technology.

Exclude production / dual purpose activities

With regard to the potential exclusion of activities with a purpose other than R&D, we would suggest that the key issue is that of whether the activities support, or are needed to support, the core R&D activities.

An approach based on exclusion of activities with a purpose other than R&D would seem to simply be a negative phrasing of the same question as that of sole purpose. However, we would submit that the key question should not be one of phrasing negative or positive limbs to the criteria but rather the recognition in legislation and practice of industry-specific norms as to at least some element of "dual purpose" or incidental benefit.

However it should be noted that trials to prove a process or product is viable should continue to be eligible.

Net expenditure only

Under the current rules, any proceeds received arising from the results of R&D are included in the claimant's assessable income under section 73B(27A) ITAA 1936. Were those proceeds to be netted off against associated R&D expenditure, this would of itself, reduce the effective tax concession available to "successful" R&D projects where proceeds exceeded costs. Furthermore, the effective tax concession would also be reduced where the claimant's project made a net economic loss.

Under this approach, net qualifying expenditure (and therefore, any effective tax concession) would only arise where, and to the extent that, the R&D was "unsuccessful".

For completeness, we also note there appear to be practical difficulties with this approach, including the valuation and timing of receipt and recoupment and the additional stress it would place on the nature of the nexus between proceeds and R&D results.

Lower rate of assistance

The ABA submits that the level of assistance granted to supporting activities should remain the same as that granted to core activities. As the supporting activity is required to properly enable the core activity, to the extent support was withdrawn from the former, it must of necessity indirectly reduce support for the latter.

In addition, as noted in our general comments above with regard to the introduction of differing treatment between supporting and core activities, such a differential will place significant stress on the interpretation of the associated definitions, leading to greater uncertainty and complexity for taxpayers.

For completeness, we note that this is likely to be the case regardless of the nature of that differential treatment – that is, whether by characterisation or by rate of concession.

Overseas activities

The present legislation, which extends the concession to 10 percent of project expenditure on overseas R&D activities, is, in our view, soundly based in policy and worthwhile retaining.

That policy is to assist and encourage Australian enterprises to continue to invest in innovation for the benefit of the Australian economy, even if that investment has to be outside Australia, but *only* where the R&D cannot otherwise be accessed from within Australia.

The ABA believes that the new R&D Tax Credit should adapt the current R&D Tax Concession program, under s39EC of the IR&D Act 1986, in allowing companies to claim project eligible expenditure on overseas R&D activities related to a larger R&D project conducted in Australia. For large software projects, with the internationalisation of workforce, it may be more expedient to have some of the supporting activities being carried out overseas due to limited resources in Australia, scheduling and particular skill sets available. We propose that the cap on eligible expenditure incurred on R&D activities undertaken overseas be raised to 25%, and that the resulting IP developed through this work must be located in Australia, to minimise the risk of purely foreign owned and conducted R&D being claimed under the Australian R&D Tax Credit.

Furthermore, the current requirement to certify overseas R&D activities prior to their conduct should be abolished and replaced with the same self assessment regime as R&D undertaken in Australia. The current 39EC/ED process often hinders the progress of the relevant R&D project, as the current requirement does not provide the necessary flexibility for scheduling activities for a development project. Moreover, this certification process introduces unnecessary complexity to the overall claim process for companies and the Government.

Additionally, the exclusion in whole or part, for overseas activities unrelated to a core R&D activity in Australia from being eligible to claim, also fails to recognise that Australia is part of a global economy where technical excellence is not constrained by geographical boundaries. To the extent that R&D is undertaken overseas but the IP is owned and exploited in and out of Australia, this gives rise to ongoing royalty and IP licensing income. In this instance, it is likely that the tax revenue created from this Australian income far outweighs the revenue foregone in providing a subsidy for this R&D undertaken offshore by Australian firms.

The ABA is grateful for the opportunity to provide input to the consultation process and trusts that the above comments are taken into consideration in further policy refinement and any draft legislation.

Yours sincerely

Tony Burke