COMMONWEALTH OF AUSTRALIA

Official Committee Hansard

SENATE

ECONOMICS LEGISLATION COMMITTEE

Reference: Tax Laws Amendment (Research and Development) Bill 2010

THURSDAY, 20 MAY 2010

CANBERRA

BY AUTHORITY OF THE SENATE

INTERNET

Hansard transcripts of public hearings are made available on the internet when authorised by the committee.

The internet address is:

http://www.aph.gov.au/hansard

To search the parliamentary database, go to:
http://parlinfo.aph.gov.au

SENATE ECONOMICS

LEGISLATION COMMITTEE

Thursday, 20 May 2010

Members: Senator Hurley *(Chair)*, Senator Eggleston *(Deputy Chair)*, Senators Cameron, Joyce, Pratt and Xenophon

Participating members: Senators Abetz, Adams, Back, Barnett, Bernardi, Bilyk, Birmingham, Mark Bishop, Boswell, Boyce, Brandis, Bob Brown, Carol Brown, Bushby, Cash, Colbeck, Jacinta Collins, Coonan, Cormann, Crossin, Farrell, Feeney, Ferguson, Fielding, Fierravanti-Wells, Fifield, Fisher, Forshaw, Furner, Hanson-Young, Heffernan, Humphries, Hutchins, Johnston, Kroger, Ludlam, Lundy, Ian Macdonald, McEwen, McGauran, McLucas, Marshall, Mason, Milne, Minchin, Moore, Nash, O'Brien, Parry, Payne, Polley, Ronaldson, Ryan, Scullion, Siewert, Sterle, Troeth, Trood, Williams and Wortley

Senators in attendance: Senators Back, Bushby, Cameron, Colbeck, Eggleston, Hurley, Pratt and Xenophon

Terms of reference for the inquiry:

To inquire into and report on:

Tax Laws Amendment (Research and Development) Bill 2010

WITNESSES

Committee met at 9.15 am

CHAIR (Senator Hurley)—I declare open this first hearing of the Senate Economics Legislation Committee's inquiry into the Tax Laws Amendment (Research and Development) Bill 2010 and to the Income Tax Rates Amendment (Research and Development) Bill 2010. These are public proceedings, although the committee may agree to a request to have evidence heard in camera or may determine that certain evidence should be heard in camera.

I remind all witnesses that in giving evidence to the committee they are protected by parliamentary privilege. It is unlawful for anyone to threaten or disadvantage a witness on account of evidence given to a committee and such action may be treated by the Senate as a contempt. It is also a contempt to give false or misleading evidence to a committee.

If a witness objects to answering a question, the witness should state the ground upon which the objection is taken and the committee will determine whether it will insist on an answer, having regard to the ground which is claimed. If the committee determines to insist on an answer, a witness may request that the answer be given in camera.

[9.16 am]

MONK, Ms Deborah, Director, Innovation and Industry Policy, Medicines Australia

SHAW, Dr Brendan, Chief Executive Officer, Medicines Australia

CHAIR—I welcome representatives from Medicines Australia. Would you like to make an opening statement?

Dr Shaw—Thank you for the opportunity to address the committee. It is a privilege today to appear before the committee on behalf of Australia's innovative medicines industry to discuss an issue that is extremely important to ensuring the continued growth of investment in innovation in prescription medicines in Australia.

Medicines Australia represents the collective interests of the research based medicines industry in Australia. Our membership comprises some 50 companies. Medicines Australia members bring new medicines, vaccines and health services to the Australian community and help generate over $4 billion worth of exports of medicinal and pharmaceutical products per annum.

Our sector invests hundreds of millions of dollars each year in research and development in Australia. In 2009, for example, our industry invested over $930 million in R&D in Australia. Regrettably, however, maintaining this significant investment in Australia is becoming increasingly difficult. We all know that Australia is home to some of the world's best medical researchers and healthcare professionals. We know that it has world-class research infrastructure, a stable socioeconomic environment, a strong intellectual property system and an efficient regulatory system. All of these factors have in the past contributed to the strong growth of R&D investment by the pharmaceutical and medical biotechnology sectors in Australia.

But these factors alone are no longer sufficient to stimulate investment growth. There are several reasons for this. The most important among them is the rapid transformation of developing nations in Asia, South America and Eastern Europe as viable destinations for long-term investment in research and development. As recently as the early part of this decade these regions were largely ignored as potential candidates for world-class clinical research. Most of them did not have the necessary infrastructure and their intellectual property laws were not strong enough. Whatever the reasons, Australia had far fewer competitors for investment dollars then, but circumstances have changed and they have changed quite dramatically.

We all know that India and China have made incredible progress in the past 10 years, not only in terms of their economic development but also as locations for clinical research. We know that countries like Poland, Hungary and even Russia have rapidly emerged from the shadows of the Cold War to become vibrant and progressive members of the world community. While we may marvel at the speed of their success, we should also be worried about the impact this has on Australia, and be particularly worried because, while Australia remains an attractive location for R&D investment for our industry, other countries are now looking even more attractive.

Australia is already beginning to attract less biopharmaceutical industry investment in clinical research. This has a variety of negative consequences, beginning with fewer Australian patients having access to experimental therapies for conditions where nothing already available seems to have worked. We should not allow this to happen. Be assured that, without business investment coming to Australia, it will happen.

The introduction of the new R&D tax credit system is an important step in the right direction. It will replace an outdated system that is unpredictable, complicated and generally out of touch with the nature of modern commercial R&D, particularly in the pharmaceuticals and the medical biotechnology sectors. The existing system simply is not sufficiently effective.

Multinational companies, who account for the lion's share of total business investment in R&D in Australia, are only eligible for the 175 per cent international premium tax concession under the current system if they increase their R&D expenditure by approximately 20 per cent every year. This is an unrealistic expectation for any business, let alone for large multinational corporations, which spend billions of dollars on research and development already and for which a small increase means that hundreds of millions of dollars more will be spent.

The new R&D tax credit offers a benefit for all eligible R&D expenditure at a flat 40 or 45 per cent, depending on the size of the company. Not only does this remove the expectation of constant incrementalism; it also gives a degree of predictability to companies that count on stability to offset the inherent risks of investing in research and development. The proposed new system also extends the removal of the requirement

for intellectual property to be owned in Australia. This makes sense and ensures that Australia's R&D incentives are appropriate for a modern, globally integrated economy.

There has been a lot of criticism of the new R&D tax credit program. Some of it is well founded. 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. Medicines Australia believes that only one of the two requirements should be retained. It does not really matter which one.

However, a lot of criticism of the new program is simply not accurate. For example, some critics have said that the new program's definition of R&D is too restrictive. Medicines Australia does not agree with this. On the contrary, we believe that the new definition of R&D activities better reflects the real nature of commercial R&D, particular in the highly innovative pharmaceuticals and biotechnology sectors where research and development activities are designed to perform according to scientific method and undertaken to generate new knowledge which is then used to produce safe and effective medicines for human use.

In addition, the revised and contracted list of excluded activities which would only apply to core R&D activities and not to supporting R&D activities reinforces our position that the new definition of R&D is better. This will reduce the risk of certain critical activities undertaken during medical research, such as quality control on experimental medicines which are administered to patients in clinical trials, from being a priori declared ineligible for tax benefits.

Medicines Australia congratulates the government for taking the important step to improve and update Australia's tax based incentives to encourage private R&D investment. We are confident that the new system will make Australia a more competitive location for R&D investment. Medicines Australia strongly recommends that the new R&D tax credit system be implemented on time, on 1 July 2010. We are happy to take your questions now.

CHAIR—Thank you for that assessment. You made a submission to Treasury on the consultation paper and the exposure draft. In relation to the points you made in your submission, were any changes made to the bill?

Dr Shaw—I will defer to my colleague Deborah Monk in a second, but we went through several iterations of the legislation through various points. There were several submissions we made. Certainly our sense is that through that process a lot of the concerns we raised with the legislation, the particularities about it, were addressed. The consultation process was good for us because the legislation evolved to a point where we were comfortable with what was being put forward. I will defer to my colleague Deborah Monk to elaborate on the details of those.

Ms Monk—Substantial changes have been made through the different iterations of the legislation. There were quite a lot of changes that we were concerned about between the first exposure draft and the second exposure draft that have been addressed, such as the exclusions list. The matter of quality control has now been removed from the exclusions list. We had some concerns about the provisions related to expenditure not at risk and we believe that that was a drafting error in the first exposure draft that has been repaired in the second exposure draft and in the bill that has been tabled before parliament. So, yes, we have found that Treasury and the government have been responsive to our concerns with the draft legislation. There have been substantive changes that make us now satisfied that, whilst there are some aspects that could still be improved, the bill as it stands will benefit our industry in drawing R&D to Australia.

CHAIR—Could you just run through the one caveat you expressed in your opening statement about the compliance burden. It was dominant purpose, plus one other criteria.

Ms Monk—The way we have interpreted the structure of the legislation is that it has a hierarchical approach. There are core activities, and we believe that most of our members' activities would be core activities, such as researching and developing new medicines. The second tier is supporting activities, which support the core activities. 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 your 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.

CHAIR—You said use only one, but how would that work?

Ms Monk—At the moment you have two tests. There is the dominant purpose test, which is for that third tier. I will just refer to my papers.

CHAIR—I will explain my question while you are looking. I can see what you mean—that you make the application for the core R&D and you may not be aware of particular supporting activities. But I can quite see that the government may want to have a list of activities that are not for the core purpose of R&D but that you could make a case for if it did happen. It would seem to me that if you took away the exclusion list you would make it open slather for anything to be regarded as R&D.

Ms Monk—I found my notes. I am sorry for that delay. It is the concept of whether the activities are directly related to the core activities or whether they are for the dominant purpose. If you have both of those concepts working together, we feel that it is much more complex to show that they are both directly related and meet the dominant purpose test. The way that those two tests would work together is the complexity, and whether you could adequately justify that in qualifying for the R&D tax credit.

Dr Shaw—The other thing is to compare the compliance burden of the proposed new system with the one that is in place at the moment. Arguably the current system, with its rolling three-year average and having to account for growth above that average, is a compliance burden in itself, alongside the existing system of core and supporting R&D as well. My understanding is that the government has undertaken to have a preclaim approval process of some sort under the new system, which presumably would help overcome the compliance burden with the new system.

CHAIR—Yes, we have been briefed on that, and I do think that that might be of assistance.

Senator EGGLESTON—I was very interested in what you said about Australia having international competitors now for finance, research and development. I am therefore interested in your opinion about the fact that there would be no requirement for the intellectual property rights of any new development to be held in Australia. What do you have to say about that?

Dr Shaw—A general comment is that, with a global economy, globalised industries and countries competing for investment, it seems to make more sense to provide an incentive to where the R&D is being conducted and to the countries in which the R&D is being performed, rather than to whoever owns intellectual property. It really should not matter if the intellectual property is owned overseas but, if the activity is being done in Australia and generating research benefits, spillover benefits and jobs for Australians in R&D, it should receive the same, consistent treatment. My understanding is that, for years, Canada has had an R&D tax incentive that has been based on where the activity is located and not on the intellectual property, and it just seems to make more sense in a global economy when you provide an incentive to where the activity is occurring anywhere in the world. Doing that would bring Australia's R&D incentive more in line with that trend.

Senator EGGLESTON—So you are arguing that that might enhance the prospects of getting R&D in Australia—and I think that is a good point. But surely there is economic benefit from owning the intellectual property. It will end up being in New York, London, Basel or somewhere and people will be paying for the use of that intellectual property, and that money will be going into the British, United States or Swiss economies.

Dr Shaw—Absolutely. That may well be the case. What I am referring to are the projects that would have come here to Australia were it not for the fact that intellectual property is owned overseas. It is that subset of projects that would have been here but for the intellectual property ownership. You raise the point of the competitiveness, if you like, of the clinical research environment. I mentioned in my opening statement that, even in the last decade, the environment has changed since the beginning of the noughties. I was at an international biopharmaceutical conference in 2006, and I distinctly remember the senior minister from the Indian government being there and making quite a strong pitch for clinical trials work to be conducted in India. The argument he was putting forward was that, compared with even five years earlier, the standards of intellectual property laws and the clinical capabilities in India had accelerated to such an extent, and the costs were still relatively low, that he was now pitching at an international conference in the US for clinical trials work to be done in India. For me, it gave a good example of how the landscape has changed even in the last five to 10 years in terms of clinical competitiveness. We are making the general point that the new R&D tax credit will help in Australia maintaining its position.

Ms Monk—With respect to the ownership of intellectual property, this is my understanding of the way that the R&D tax credit has been structured: you have the 45 per cent refundable tax credit for small to medium enterprises with a turnover of under $20 million and then the 40 per cent for larger companies such as our members so that targeting of a greater benefit for small enterprises of that sort of turnover is naturally going to be targeted towards growing start-up type R&D companies in Australia where that IP will be held in Australia. I think that the two-tier approach is targeted more towards companies where the intellectual property is more likely to be owned in Australia, but also we work in a global industry and, as Dr Shaw has said, it does not matter where our intellectual property is held as long as that R&D is being done in Australia.

At the moment, because of the nature of our organisations, our member companies can only qualify for the international, premium R&D tax concession, and they only get the full benefit of that if they are growing their R&D investment in Australia by approximately 20 per cent per year. That is a very high hurdle for our companies to qualify for the tax concession; whereas the 40 per cent non-refundable tax credit means that they can get a real benefit for all of their R&D investment in Australia. That, we believe, will make R&D in Australia 10 per cent cheaper than it is now, and that is a really big drawcard for our global head offices to say, 'Let's send more of our R&D to Australia.'

Senator EGGLESTON—The pharmaceutical industry has a lot of connections with Switzerland. Some very big companies operate out of Switzerland. I understand that in Switzerland there are very generous tax conditions for research and development. Would you like to elaborate on that briefly by comparison? Are you able to do that?

Ms Monk—I am not familiar with the situation in Switzerland, but we can reflect upon where we see, through discussions with our members, where they are redirecting their research and development expenditure to—and it is very much to India, China, Brazil and eastern Europe. That is where there has been this shift in recent times of where global R&D is going, because those countries have the ability to start their clinical research very fast, they have large populations to do the trials in, they have the ability to complete the trials quickly and their costs are lower than Australia's. So we are competing on all those different metrics to bring those R&D dollars to Australia. If we can address one of those elements through this R&D tax credit to make the cost of doing research in Australia more attractive, then we are starting to redress that competitiveness to bring the investment.

Dr Shaw—My general impression is that Switzerland is one of the key research parts of Europe. I think several of the companies have research centres and head offices established in Switzerland. You would expect that would be at least partly due to the incentives that are in place there. We can provide more information to the committee on that.

Senator EGGLESTON—Somebody told me recently that the incentive is 150 per cent tax deductibility of the cost of the research, but I would be very interested in international comparisons.

Dr Shaw—We will be happy to provide that. We will take that on notice.

CHAIR—I think Senator Bushby has some questions now.

Senator BUSHBY—Thank you, Chair. And thank you to the witnesses for coming along to assist us today. Overall you seem quite happy with the changes, as they seem to suit what your members do generally and provide some benefits that are directly relevant to the way your members operate. But you also indicated that there are some things you would like to see changed. In an ideal situation what would you like done differently from the way it is put in this proposal?

Ms Monk—I guess it would be the remaining complexity of having to identify your core activities and your supporting activities, and then, if any activity came under the excluded list, having to identify that it is for the dominant purpose. There is also the fact that you have to do that and register that activity before you can qualify for the tax credit in that year. I guess, like most industries, we would like to be able to plan ahead that well but we are not always going to be able to. Projects might come up during a period of time and therefore you would have to reregister or add that to your registered activities. So there is that complexity. Then there is this concept that you have to show that the activity is either directly related to a core activity or for the dominant purpose. So, again, those two tests add to the complexity, and that will be of higher compliance burden for companies to qualify for the tax credit.

Senator BUSHBY—One of the stated aims of the legislation is actually to make it all a bit more simple. So, in that particular aspect at least, you are saying that that is counter to the stated aim or objective of the legislation?

Ms Monk—To some degree, yes, it will remain quite a complex regime that our member companies—

Senator BUSHBY—In that respect—and correct me if I am wrong—but you said it would actually make it more complex?

Ms Monk—Potentially more complex, yes, but—but for that—we still think that the legislation is sufficiently beneficial and that it should get passed.

Senator BUSHBY—I understand that overall you want it to proceed.

Ms Monk—Yes, that is right.

Senator BUSHBY—I am just trying to identify what the problems are that you see specifically or ways that it could be improved, essentially. The benefits, from the evidence you have given this morning, seem to be particularly that you would like to get rid of the requirement that multinationals have to increase their research and development spending by 20 per cent. Is it true to say that the removal of that requirement and replacing it with the 40 to 45 per cent changes are the main benefit that you see for your members?

Ms Monk—Yes, we would—the fact that it is a straightforward, simple system. The current system has a number of different things. There is the 125 per cent, then there is 175 per cent for Australian owned R&D, and then there is the 175 per cent international premium tax concession. It is a really complex system. This is quite simple. You are either an SME and qualify for the 45 per cent refundable or a larger corporation with 40 per cent non-refundable.

Senator BUSHBY—It makes that aspect of it a lot simpler.

Ms Monk—Yes.

Senator BUSHBY—Could the benefits of changing that particular aspect to make that more simple be delivered without the requirement for some of the other changes that have led to the criticisms by other groups? Could you have delivered that main benefit without a lot of the other changes that have been made, basically?

Ms Monk—I guess the difficulty we understand the government have been struggling with is that they would like to see the R&D tax benefits more targeted to more narrowly defined R&D.

Senator BUSHBY—That is a policy decision of the government to some extent. I guess what I am asking you is: could the main benefit that you see out of this have been delivered independently of the policy decision by government to try and shift more of the R&D money into small businesses?

Dr Shaw—Do you want to take that on notice?

Ms Monk—Yes. I would have to give that some thought, if I may, and come back to you, if that is possible.

Senator BUSHBY—That is not a problem. Also, Dr Shaw mentioned that there had been some criticism of the proposed legislation that I think you said was not founded. What I want to ask here is whether it is not founded in respect of your members or whether you are making the assertion that it is not founded from the perspective of other industries that are involved in R&D that are currently enjoying the benefit of the tax incentives.

Dr Shaw—I think the point I made was in terms of better defining R&D from a commercial basis. From our members' perspective, the definition is better and it better defines for our members what the nature of commercial R&D is.

Senator BUSHBY—I did not write down a direct quote, but you made a comment that there had been other criticism which is 'generally unfounded' or words along a similar line to that. My question is: it may well be unfounded for your members, but are you also saying that it is unfounded in a more general sense and asserting that, where criticism has been raised by other industries—for example, industries that may well do most of their research and development on existing production lines which may now no longer qualify—it is unfounded? Or is that just in respect of your industry?

Dr Shaw—I guess primarily from the perspective of our industry. I guess it is fair to say that. When we look at the new tightened definition, I think we are saying that from our members' perspective that definition better defines what our members do.

Senator BUSHBY—Thank you. The last question I have is about the $20 million turnover threshold which gives the variable benefit to smaller businesses. Would many of your members qualify for that, or would that generally not be the case?

Dr Shaw—My understanding—and I will take some advice in a moment—is that there are several of our member companies that would qualify for that.

Senator BUSHBY—In terms of the overall percentage of the investment that your member companies would be making in Australia, what would that represent?

Dr Shaw—I would have to take that on notice, but, as I say, my understanding is that there are at least several of our member companies that we would suspect would fall below the threshold and therefore be eligible for the expanded 45 per cent incentive. In fact, if my memory serves me correctly, some of those companies are actually involved in clinical trial activity at the moment or are seeking to expand their clinical trial activity, so they may well directly benefit by this.

Ms Monk—We think about three or four of our member companies would come under that $20 million turnover threshold. They are usually going to be companies that have been relatively newly established in Australia but are part of global corporations, but they are investing in R&D in new medicines, new vaccines, in Australia. One company I can think of has been established here for a number of years, but the nature of its business is that it is more targeted toward smaller types of products.

Senator BUSHBY—I understand that there are, but if you could take on notice the percentage of overall investment in R&D that that represents I would appreciate it. Thank you.

Senator CAMERON—One of the arguments I hear from the pharmaceutical industry continually in a general way is that the industry invests lots in research and development and that that investment—because of the high cost of research and development—justifies the high cost to consumers of the products. I have heard that continually. How can we be sure that if we invest in your industry—and the consumer is investing through government in your industry—we are getting a fair return and that is not again reflected in the high cost of pharmaceuticals? Tell me the benefit for the consumer.

Dr Shaw—The benefits are many and varied. When R&D is conducted by our industry here in Australia there are quite strong linkages to the hospital sector. When you do phase 3 clinical trial work, a lot of that is done in partnership with hospitals—we have some data to show that—and similarly the university sector. The argument, if you like, of linkages with other parts of the research sector is quite strong for our industry.

The cost of developing medicines is a global phenomenon. The cost of developing a new medicine is increasing all the time. That is for a variety of reasons. There are scientific reasons—new technologies are emerging and there is a scientific risk involved. Some of them are regulatory—the safety requirements, if you like, the hurdles for getting regulatory approval, are increasing—and the time to development is increasing as well. It is not a unique problem in Australia; it is a global issue that the costs of developing new drugs are increasing.

Companies have to make commercial decisions about what products they want to bring to market. There are drugs that are in development that do not get brought to market from time to time because the commercial return is not there. I think one area where that happens is antibiotics. There is a reason that there are not many new antibiotics being developed by the global pharmaceutical industry at the moment. It is because the return is not there. Similarly, I think oral contraceptives are one area where the cost of the older medicines compared to the cost of new medicines is such that it is not worth the industry developing a lot of new medicines.

Senator CAMERON—But the point I am making is that the government is assisting you in your research and development activities, and you argue that that is one of the most expensive areas of your operation. I am just saying to you: how can we measure the benefit in terms of return to the consumer from the government investment in and support for your research and development? That is the point.

Dr Shaw—Part of the question is the benefit to the Australian community of doing the work here vis-a-vis doing it in places like India and China. I talked before about the emerging markets. The industry is looking to do more R&D. There is investment in R&D flowing around the world, and I guess it is a question of whether Australia wants a piece of that or not.

Senator CAMERON—Coming back to the final cost, you are saying that the government's investment in research and development support is not necessarily reflected in the final cost to the consumer?

Dr Shaw—Do you mean the medicine when they buy it?

Senator CAMERON—Yes.

Dr Shaw—In Australia we have the Pharmaceutical Benefits Scheme, so there is the expert committee that do the evaluation of whether the medicine is value for money to have on the PBS. They evaluate a whole range

of things, and one of the things they look at is whether the medicine that has been put forward is value for money for the taxpayer to subsidise and whether it is value for money to have it on the PBS. So any medicine that gets on the PBS has already been evaluated by the expert committee, and they have made an assessment based on whether the drug adds to the health outcome or not.

Senator CAMERON—That is not the question I am asking you. I am asking: if the government R&D supports 10 per cent of the cost of research and development of that product, is there any measurement as to whether that 10 per cent again is reflected in the lower cost that you put to the PBS?

Dr Shaw—No, I cannot quantify it, but it is probably fair to say that fewer and fewer of those factors are taken into account when medicines are priced on the PBS. In times gone by we had major pharmaceutical investment programs which made reference to the PBS and provided incentives to companies. I think it is fair to say that over time those programs have—in fact, there is no pharmaceutical industry program any more. The factor in pricing medicines on the PBS which takes into account industry activity in Australia has not been considered for quite some time.

Senator CAMERON—Maybe I can come back to the detail of the bill now. I want to explore the issue of 'directly related' and 'dominant purpose'. You are saying it is complex. Why should the public be confident that, if their funds are going into the pharmaceutical industry for research and development, it is directly related to research and development, that the dominant purpose is research and development and that it is a core activity of research and development? I cannot understand the arguments that those principles and values, which we are trying to reflect on the legislation, just because it is complex, should be ditched. Why should they?

Dr Shaw—I think we are saying that we do support those principles. We are reasonably confident that the activity our industry does would meet the principles you are talking about—that it is core R&D, that the definitions we would use to define R&D are the same as those in the bill. I think we are saying that we agree with what is in the bill.

Senator CAMERON—I thought you said your linking them was creating a complexity.

Ms Monk—It is complex but we accept that the government needs to target taxpayers' money towards supporting real R&D investment in Australia. The way it is structured is quite complex and that is something we will have to deal with. What we are really saying is: do you need the directly related test as well as the dominant purpose test? Could you not just have one of those? Could you say you have your core activities; supporting activities are directly related to core activities; then there is this third complexity of dominant purpose. So there are two concepts of directly related and dominant purpose. Could you not have just one of those two concepts to define what is the sort of R&D that should be supported through the tax credit?

Dr Shaw—On balance, we are quite comfortable with what is in the bill now. That is why we are supporting the legislation. Our industry is not afraid of the tighter definition of R&D which is in the bill at the moment.

Ms Monk—To add to Dr Shaw's comments in response to your a question about what benefit there is to the Australian community of R&D investment from our industry, first of all there are the jobs. We are a big employer of people in R&D in Australia, not only within our own companies' employment. Through us doing pharmaceutical R&D in Australia it helps Australia retain clinical investigators with an interest in doing work here in Australia rather than needing to look overseas to do that sort of clinical research. We are assisting to keep those brightest and best minds here in Australia. As we have said in our opening statement, it provides early access to the Australian community to new medicines through being in a clinical trial. If we were not doing those clinical trials here with new medicines, the community would have to wait until that medicine is registered and marketed in Australia. Also, through running clinical trials for thousands of patients around Australia every day the pharmaceutical company is paying for their health costs by being in a clinical trial, which then means our health system does not have to support to some degree the health care of that individual person through providing drugs, doing different tests while their in clinical trials, et cetera. There are a number of different benefits for Australians coming from our investing here in Australia.

Senator COLBECK—I want to go back to the discussion we had in relation to the 'directly related' and 'dominant purpose' tests and your concerns about the complexity around those issues, particularly the requirement to identify all of the activities upfront in the process. Is it reasonable to suggest that there may be activities or circumstances that arise during the course of conducting a particular piece of R&D that could not

be foreseen in the development of the proposal as part of the initial submission? If that is the case, what is the requirement that occurs at that time and what is the opportunity cost?

Ms Monk—I am not confident about the process of registering an R&D activity after you have registered the program you have already registered. If another aspect of the R&D activity has to be completed, I have to say I am not familiar with how you would then add that to your registration of your R&D activities. I would have to take on notice the question of how that would impact on our members. With any sort of R&D, you are working in a relatively unknown field.

Senator COLBECK—That is one of the functions of R&D, is it not?

Ms Monk—Exactly.

Senator COLBECK—You are looking for an unknown outcome.

Ms Monk—Yes, so you would have an R&D program progressing from phase 1 to phase 2 to phase 3 trials, but just as a trial might not be successful and therefore the product might not continue in its development, some aspect might be discovered through that process which you would then want to explore further. That might not be known when you are registering your activity upfront. So it is a changeable environment to some degree which you cannot know upfront.

Senator COLBECK—So under the current circumstances, either you need clarification as to how you deal with that or it potentially needs a completely new R&D application?

Ms Monk—Yes.

Senator COLBECK—Can you give us some information as to, with this proposed legislation, to what extent you might see R&D activity increase. You have said that it makes it easier and that we are in a global market competing for R&D dollars. Can you give us a sense of what potential increase there might be there?

Ms Monk—It would be very hard to quantify that. Since our regulatory scheme changed to have the clinical trial notification scheme in Australia in the early 1990s, we have seen not quite an exponential growth but a very rapid growth in clinical trial investment in Australia. In the last two years, we have seen that growth plateau and now start to decline. We are really trying to work, in Medicines Australia and our member companies, to turn that around, to see whether we can get that growth happening again. We know that R&D globally is growing but we no longer are taking as much share of the global R&D as we were formerly. That investment, as we have said, is going to India, China and other countries. We are trying to work out how we can say to our head offices, 'Reinvest in Australia.' The metrics are timeliness of starting the trial, timeliness of finishing the trial and costs of doing the research. The R&D tax credit will be directed to making the cost of doing the research in Australia more attractive.

Senator COLBECK—Say you cannot give us any estimation of what additional R&D might come here. Reading through the documentation, one of the focuses is to direct more of the R&D dollars towards smaller operators. How does that fit with the majority of your members in the largest section of the process?

Ms Monk—Our member companies would be investing on a dollar-for-dollar basis more than small to medium enterprises. As we said in our opening statement, it is approximately $900 million per annum that we are investing in Australia. But the benefit of also encouraging the small to medium start-up enterprises is that often our member companies will look for partnerships with those organisations. They might not have the capacity to invest the billions of dollars that are required to bring that product that they might have discovered and researched to market. If they partner with a global pharmaceutical company, that partnership can then invest the money that is required to finally bring the product to market. Those start-up companies—small to medium enterprises—in Australia are also important to our member companies on a global basis.

Dr Shaw—We are happy to see if we can find some data on the R&D coverage. I do not know what we have, but we can certainly have a look. As I just flagged before, we think some of our smaller companies would qualify for the 45 per cent incentive being below the threshold.

Senator COLBECK—From our perspective—just following on from Senator Cameron's questions—the amount of investment is going to have an impact on the tax credits or payments that are available. We will be talking to Treasury later in the day but we would like to get some sense of where that might be heading and compare it with some of the other evidence we have had and some of the criticisms you have discussed in your submission this morning. Some are saying that it is going to impair their access to R&D credits. You are obviously in a different situation in your specific area.

Dr Shaw—The statistic I can give you off the top of my head is that the pharmaceutical industry accounts for about 4½ or five per cent of the R&D performed by manufacturing businesses in Australia. I think it is second behind the car industry. In terms of the scale of the R&D that is done by our industry compared to other industries, I think we are second behind the car industry in the manufacturing sector. I will find the data for you.

Senator COLBECK—I would be interested to get some information on that growth and the plateauing of the R&D funding in recent years and a sense of the drivers for that as well. The only other thing I wanted to touch on was IP. It has been canvassed a little bit broadly, but governments are often criticised for allowing IP to escape. I am just trying to get a sense of what the pay-off is for actually saying, 'We will allow the IP to go offshore.' We are often criticised for allowing something to develop or not to develop, and then the IP gets sold offshore, the product is developed and effectively all we are left with is the R&D. I am just interested in your response to that.

Dr Shaw—I guess a general comment is that, as part of a global economy where there are investment funds and projects and movement of capital all around the world, having an incentive that recognises that global interconnectedness is a good thing. What we were talking about earlier was particularly those projects where the intellectual property is already owned overseas and potentially could come to Australia but for that intellectual property restriction that exists at the moment. We feel that the R&D tax credit in the way it has been proposed now has the potential to attract those projects that may not have come to Australia because of those intellectual property provisions.

Senator COLBECK—So what you are saying is that if someone owns the IP offshore and they brought it to Australia, it would effectively be trapped here.

Dr Shaw—They would have the opportunity to perform it here with an incentive—

Senator COLBECK—Under the current circumstances, if they were to bring the R&D here, the IP would be trapped here and therefore that could be a disincentive for that particular piece of R&D to occur here.

Dr Shaw—I think what I am trying to say is that there might be projects overseas that would have come here but currently do not qualify for the incentive but under the new scheme would.

Senator COLBECK—I really am trying to get a sense of what the pay-off is.

Dr Shaw—Yes. That is fine.

CHAIR—Thank you, Medicines Australia, for coming in this morning and giving evidence. I appreciate that it was fairly short notice, so thank you.

[10.04 am]

PARSONS, Mr Robin, Partner, Indirect Tax, Ernst & Young

Evidence was taken via teleconference—

CHAIR—Mr Parsons, do you have an opening statement to make?

Mr Parsons—I have worked in the R&D tax concession group in Ernst & Young since 1992. EY is a big four accounting firm and we service both the large and small companies of Australia. We thank the Senate committee for affording us this opportunity. I wish to cover three key areas and Ernst & Young will make a fuller written submission by 28 May. These areas are, first, general comments about the policy intents—

CHAIR—Sorry to interrupt you, Mr Parsons, but you are a little indistinct.

Mr Parsons—How is that?

CHAIR—Better, thank you.

Mr Parsons—The second area is specific comments around dominant purpose and alternatives for this, and there is a list of several unintended consequences of the current bill as we see it.

In terms of philosophical comment on policy intention, I suppose I would make three points. One of the overarching policy objectives was revenue neutrality, including the abolition of the incremental 175 provisions. It does in itself save hundreds of millions of dollars. Conversely, the rate and threshold increases will cost the same sort of quantum. Then there are various definitional tightening measures, some providing uncertainty to revenue outcome due to undefined terms and clauses such as in the core definition. Some clearly limit revenue, such as changes to support activities and dominant purpose, which are the target of excessive claims. The lack of modelling on the effect of these major changes does lead one to question two things: has this been achieved and does anyone really know?

Another policy intent is the objective to address excessive claim behaviour, and we support the principle. It has been tackled in part by limiting production trials and with feedstock changes. We think the government is on the right path with these. But I will explain shortly how there are unintended casualties with this broad principle-based approach of dominant purpose in particular. I highlight that some specific concerns can be better targeted with specific provisions. Lastly, it is a policy intent to redirect assistance from large corporates to SMEs. An illustration of this is the differential rates for SMEs. However, this bill does leave a minority of SMEs considerably worse off, and I address this in my final point.

Turning to dominant purpose, it is a high black-and-white hurdle. We understand and support the government's concern on support activities, particularly production trials, making up a disproportionate percentage of an R&D claim in some cases. But production trials do provide the valuable scaled-up development feedback important to product and process development. Manufacturers in particular use production trialling to verify and improve their R&D. Manufacturers can also be characterised as a high turnover, low margin business and sector, turnover often in excess of the $20 million turnover threshold in this bill but still with wafer thin profits. By necessity they are ultra efficient. Their production trials are undertaken in a dual setting of production and R&D because they are experts at undertaking multiple tasks with the same scarce resources. Production managers and R&D teams work in tandem with dual purpose. Dual purpose does not get through the dominant purpose test. Manufacturers suffer under this principle-based approach and we believe they are unintended casualties of the bill.

There are alternatives to the principle-based dominant test to tackle specific areas of concern the government has highlighted. We have already in written submission provided some of these, and they include apportionment, less black-and-white language and specific provisions to tackle specific concerns. The dominant test also extends beyond production trialling, due to the definitional aspects of what a production trial is and the extent to exclusion list in the supporting activity.

The final point we wish to make is that there are unintended consequences in this bill. We have previously stated in written submissions on these points that they include problems with SME grouping, depreciable assets installed ready for R&D use, corporate limited partnerships and disposal of part R&D assets. I will highlight one of these. The bill, at proposed division 355-100 (1), groups parties at the 40 per cent level and not at the current greater than 50 per cent control or connect. SMEs commonly enter fifty-fifty structures, or JP arrangements, with larger groups—groups with a greater than $20 million threshold—to further find and

progress R&D. This is a common practice; it is not an unusual example. Those SMEs in this current arrangement would not enjoy the refundable credit that they enjoy under the current provisions.

We commend the government and understand their policy intent. We support areas of their concern and we think they are on the right track. However, we question the execution in some parts and think the bill does have material shortcomings, some of which I have highlighted. We ask that the unintended casualties and consequences be amended and reconsidered.

CHAIR—Thank you, Mr Parsons. You were talking about dominant purpose and production trials. The government are saying that trial and error and production trials may inform part of an eligible activity, but I think the interpretation is that they do not want to indefinitely consider production trials to refine production measures; they want companies to concentrate on new knowledge. Can you give us a concrete example of where that might unduly disadvantage a company doing R&D?

Mr Parsons—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.

CHAIR—Yes, but in my understanding of the bill the proposal is that that would be included: you could make a case for that sort of production trial and it is not an iteration of that with unlimited R&D subsidy.

Mr Parsons—My interpretation is that production trials, in the main, would be seen as a support activity, so they would be under the dominant test. As I mentioned—

CHAIR—Why would that be unreasonable? Why should that be excluded?

Mr Parsons—That is not unreasonable to be considered as a support activity. However, when that production activity is undertaken in the dual setting of producing an output and in an R&D program, I do not think dual pass is dominant. So my position, I suppose, is that 'dominant' is not sympathetic to the practical realities of how manufacturers go about their production trials.

CHAIR—Yes, Mr Parsons, but the government does not have unlimited money in any program and needs to target assistance properly. So where a production trial does have a dual function, maybe the dominant purpose is not for R&D but for other purposes, then I do not see that that is properly targeting scarce R&D dollars.

Mr Parsons—I understand the argument. I suppose my comment is: is it an intended or unintended consequence that manufacturers, the way they practically execute this production trial is in a dual setting, do not allocate percentages of weight to the two areas. It is done, as I have tried to explain, with an R&D team and product managers working together to solve these problems. Their production trials with the dominant setting would never get through the hurdles that are in the bill.

CHAIR—Yes, I do understand that it has not been required to provide the weighting in the past and would be an additional compliance step, but I guess that is where we might differ on whether that is reasonable or not. But to move on to the issue of the policy, could you run through again the revenue neutrality aspects that you alluded to?

Mr Parsons—I think I am correct in saying that revenue neutrality was one of the guiding principles with the policy change. There are large amounts of money in terms of the abolition of incremental 175 provisions that save hundreds of millions of dollars. Conversely, there is rate and threshold increases, particularly at the SME level that costs money. There have been tightening measures that have occurred, dominant purpose, feedstock and other areas, but no modelling has been done that I am aware of that shows this policy intent, which I understand and respect, has actually been achieved. And on some scenarios we have seen, it is quite a dramatic fall in R&D support. So although I am not blessed with the full knowledge of the Australian economy, I do fear that without any modelling, we are blindly heading towards the policy objective.

CHAIR—My understanding is that modelling was done, and we will explore that with Treasury later in the afternoon.

Senator EGGLESTON—In the Prime Minister's speech of 18 January 2010, addressing the *Intergenerational report*, he spoke of the importance of increasing Australia's productivity to two per cent. I note that you made a submission to Treasury in which you commented that the existing R&D schemes object is better suited to match the policy and intent of the government to support innovation in Australia. Do you think this policy as it is will contribute to increasing Australia's productivity to two per cent? Or is it going to limit research and development in effect?

Mr Parsons—I really could not answer that. I do not feel comfortable to say that this would achieve that two per cent. Clearly an innovative Western economy is essential to compete going forward against tiger economies such as Asia. It will not be with cheap labour that we will effectively compete with these economies. I suspect that everything the government can do in promoting and being a market influence with respect to innovation can only put Australia in better stead than without that. I suppose a supplementary question to that is: has this bill changed the mix compared to the current provisions? I just find that really hard to comment on.

Senator EGGLESTON—You find it hard to answer. One of the changes under this provision in the proposed bill is that intellectual property will not have to be held in Australia. Do you have a comment on that?

Mr Parsons—Yes, it is a fact that globalisation has created a dynamic where intellectual property is very transportable and is protected in jurisdictions outside of Australia. It is an unfortunate reality that we need to work with that reality and recognise that where R&D activity is within Australia, that delivers many good outcomes for the Australian economy and that we need probably to be sympathetic with our legislation to understand that IP can be held anywhere in the world.

Senator BACK—Mr Parsons, I was wondering if you could respond to a concern I have with particular regard to SMEs. The concern has been expressed to me that the original R&D tax concession was aimed to encourage domestic companies to engage in R&D, and that was successful. Under the new legislation, it appears that there is an expectation that that level will continue and that the new provisions really are directed to additional R&D being undertaken, especially in the applied area. The concern is that unless there is that continued underpinning of the original provision, that in fact R&D activity at the SME level will taper off and possibly even cause these companies to look overseas where other countries offer more attractive concessions. Would you care to comment on that concern?

Mr Parsons—I think there is an element of concern around that on two levels. Firstly, dominant purpose is not friendly to SMEs. SMEs, like manufacturers, are efficient entities. They do not have the luxury of higher profits, so they will do things in the most efficient manner and if regimes overseas are more attractive, then that will be seriously considered. Secondly, it will also change behaviour with respect to the specific and what I believe are unintended consequences in some of the provisions, particularly SME grouping. I do re-emphasise that that provision does not work. An SME commonly entering a fifty-fifty structure will not get the refundable credit where the other party is a large corporate, and that will clearly drive them to a different outcome and that could possibly be an overseas outcome.

Senator BACK—In that same vein, could I ask you to comment particularly on the changes predicted for the registration procedures and provisions, again especially for SMEs. I am thinking of it more in terms of increased compliances. Obviously larger companies that have R&D departments can sequester these, and they are clearly identifiable. I just wonder what your view would be on any difficulties with compliance for CEOs and CFOs in identifying in advance as part of the registration provisions to the extent that they would not then fall foul of compliance requirements.

Mr Parsons—I am not fully up to speed with where the guidelines are at, but a lot of the answers to that question do lie in undisclosed guidelines and regulations. Subject to that, there are some unusual and fairly onerous aspects to this bill as I currently see it, in the sense that far more paperwork will be needed to verify that fairly nebulous terms have been satisfied. I am specifically referring to the 'experiment' and 'experimental' terms in the new bill, and the 'dominant purpose' test and the need to apportion, most probably. But I do limit my answer in the sense that some of the detail is not out, and so there could be more or less administration, depending on that detail.

Senator BACK—My final question goes to augmented feedstock provisions, which were the subject of a lot of spirited discussion after the first draft. I understand that they have not been included in the second draft and are still being worked on. Do you have any comment or any recommendation from your perspective as to how you would like to see these provisions dealt with in the new legislation?

Mr Parsons—There are some feedstock provisions in this bill. They are different from the old bill and they would appear to be more of a tightening position than the old bill. I must say I fundamentally support the concept that, once companies are profitable or are earning revenue out of their R&D endeavours, there should be some limitations on the amount of assistance government is providing. Companies need government intervention most in the formative stages of any product or process development. Having said that, these current feedstock provisions are a tightening and, if that is the government's intent, all well and good, but I would not characterise them in any other way.

Senator CAMERON—Mr Parsons, you are the Partner, Indirect Tax, for Ernst & Young?

Mr Parsons—That is correct.

Senator CAMERON—So, within this indirect tax area, does Ernst & Young advise companies on accessing research and development funding?

Mr Parsons—That is correct.

Senator CAMERON—How many clients do you have?

Mr Parsons—It would be over 1,000 clients across all of Australia.

Senator CAMERON—So, out of 8,000 companies who access research and development, Ernst & Young have got 1,000 of them as clients?

Mr Parsons—I find that a little misleading because a lot of the entities we deal with are groups.

Senator CAMERON—What do you find misleading? I am not sure what you mean.

Mr Parsons—'Eight thousand applicants' would often refer to groups of clients. So, within a client—particularly complex clients—there would be up to 50 or 100 entities. So it is slightly misleading to say we are 1,000 of the 8,000 because some of those corporates would be complex groups which I would be including in the 1,000, but you will only have one applicant.

Senator CAMERON—But you are not an insignificant player in terms of advice to companies on accessing research and development grants, are you?

Mr Parsons—No.

Senator CAMERON—So you obviously make profits from the government's research and development activities?

Mr Parsons—That is correct. We charge fees for our services.

Senator CAMERON—So you are a profitable company; you are making profits out of the existing research and development activities. How many of your 1,000 clients would not come under the new definition of 'small to medium enterprise'?

Mr Parsons—Probably around half.

Senator CAMERON—So 50 per cent of your clients are big players?

Mr Parsons—That is correct.

Senator CAMERON—Out of the grants that you achieve for the companies that you advise, do you have a dollar figure for the half of the big companies? Can you tell me what that dollar figure is against the dollar figure for the other half, the small companies, that you advise?

Mr Parsons—No, I would not have that. But I take it from the tenor of your question that we would receive more from the greater than 20 million than from the less than 20 million.

Senator CAMERON—I am sure you have figures within the company as to how much the big companies achieve out of the research and development grants, and for the small companies. Can you take that on notice for me.

Mr Parsons—Sorry, what is the precise question?

Senator CAMERON—The precise question is: you say 50 per cent of the companies you advise are small to medium enterprises; is that correct?

Mr Parsons—Correct.

Senator CAMERON—I am asking you whether you can give me a dollar figure for the grants that you help the small to medium enterprise companies achieve, compared to the grant figure you achieve for the large companies that you advise. I do not think it is that complex, is it?

Mr Parsons—It is, actually. We would not disclose the benefits that we would gain for clients.

Senator CAMERON—I not asking you to disclose the benefits. I am asking you for a global figure, which does not disclose any names. I am simply asking you, in the context of our deliberations—given that you have a vested interested in the legislation—how much you achieve for your large companies against the small companies.

Mr Parsons—We do not identify the benefits we obtain for our clients. Therefore, on an individual basis or on a group basis we could not add that up.

Senator CAMERON—Why not? This is public money. You are achieving, for 1,000 companies, benefits through the system. I am simply asking how much goes to small companies and how much goes to large. Are you telling me that Ernst & Young cannot tell me that?

Mr Parsons—Ernst & Young cannot quantify the benefits to clients, if I understand that to be your question. The reason is that we do not necessarily have full insight to all of the R&D calculations. We provide some specialty services in some cases. We definitely are not privy to loss positions or larger corporate issues. So, no, we cannot.

Senator CAMERON—I find it quite amazing that if you advise companies you do not know what they achieve. Anyway, if that is how Ernst & Young operates, that is how you operate. In relation to the various companies you advise, do you advise companies in the resource sector?

Mr Parsons—Yes we do.

Senator CAMERON—Are you aware of companies in the resource sector claiming $500 million for research and development when the core R&D cost is $20 million?

Mr Parsons—No, I am not. I am aware of Senator Carr's comments of last week.

Senator CAMERON—Given that you are aware of those comments, has Ernst & Young taken any steps to clarify the comments with the minister? Have you taken any steps to identify whether what the minister is saying is actually happening?

Mr Parsons—I have participated in five consultative processes with relevant people within Treasury and the department and AusIndustry. So I have been a participant in the discussions. I must admit I only received Senator Carr's comments early this week and I have made no attempt to get further clarity on that particular comment. I have been an active participant with relevant departments.

Senator CAMERON—Are you aware of any areas—not this specific one—where the cost of the core R&D for a mining company is a set figure, but the claim is multiples of that figure because the claim then becomes linked to the normal operation of the mine?

Mr Parsons—Not specifically. However, as I said in my brief presentation at the start, I do understand the government's concern about supporting activities being a large percentage of the total claim. As I said, I think the government is on the right path there. I do not disagree with your comments but I do not have the specifics I think you are after.

Senator CAMERON—Do you advise companies in the construction sector?

Mr Parsons—Yes we do, but not to the same extent as other sectors.

Senator CAMERON—I assume you are an expert in this area. You would know some of the issues and controversy that have gone on. Are you aware that some construction industry companies have been claiming research and development for improved air conditioning and yet arguing that the whole cost of constructing a building should be offset against R&D because it contains innovative air conditioning?

Mr Parsons—No, I am not. I did read those comments from Senator Carr as well.

Senator CAMERON—Is that something you would say, consistent with your comments on mining, should stop?

Mr Parsons—It is a very specific case. I would like to understand the fuller detail. I will reiterate my prior comments that I think the government are on the right path with certain elements of what they are doing.

Senator CAMERON—Would that also apply for the ship-building sector, where boat builders are building boats for millionaires and claiming it as research and development?

Mr Parsons—I am not specifically aware of that either. There is a ship-building example in the EM to the new bill that is not unsympathetic to those ship builders. Again, I am not aware of the specifics you are talking about.

Senator CAMERON—You may want to take this on notice. Has Ernst & Young done any analysis—given that you have been talking about doing modelling—or any modelling of the cost to the public purse of such rorts as I have just described?

Mr Parsons—No, we have done no modelling in this area.

Senator CAMERON—Why not?

Mr Parsons—But we have proposed alternatives. We are not in any way arguing against the basic policy objective around excessive claims.

Senator CAMERON—That is just like the footballer who broke the other footballer's jaw and says, 'Change the rules; I won't do it again.' I am just asking: how much has this cost the public purse? Have you any idea at all?

Mr Parsons—I have not got the global view you are looking for. Obviously the cost of the R&D tax concession is detailed in various government reports. I do not have the detail you are asking for.

Senator CAMERON—Would you be in a position to do an analysis of your clients and provide us with details as to whether these types of uses of public funds have taken place and how much that has cost the public purse?

Mr Parsons—It is difficult because I do not understand the specifics of the support activity that the government wishes to curtail.

Senator CAMERON—Has Ernst & Young participated in providing advice to clients that replicate or are similar to some of the examples that I have just used?

Mr Parsons—No.

Senator CAMERON—You have not? So all of the thousand clients you have got have basically dealt with core activities, they have had funding for the dominant purpose of research and development and their activities have been directly related to research and development. Is that what you are telling me?

Mr Parsons—The dominant purpose test is not in the current law. What I am saying is that we execute our advice in line with the concepts and theories of directly related supporting activity.

Senator CAMERON—What is the dominant purpose again? What were you saying about the dominant purpose?

Mr Parsons—There is no dominant purpose test as it is espoused in the new bill in the current act. It is hard to superimpose the current bill before the House in terms of what the old provisions currently state.

Senator CAMERON—Are you aware of the Institute of Chartered Accountants?

Mr Parsons—Yes, I am.

Senator CAMERON—Are you aware of Yasser El-Ansary, the tax counsel for the chartered accountants?

Mr Parsons—Yes, I am.

Senator CAMERON—Are you aware of the comments he has made in relation to the bill?

Mr Parsons—I am not.

Senator CAMERON—I will just take you to that and get your comments, because it seems to me that the Institute of Chartered Accountants has a different view from Ernst & Young on this, which is quite interesting. Mr El-Ansary has been working closely with the government on the changes and believes the definition of 'core R&D' is more improved. He said:

It's much broader than it was before and not only that, it's much easier to understand. That's one of the objectives here—to make R&D tax credits more user friendly ...

He goes on to say:

The package is a significant leap from where we were in December 2009. It's clear the Government is focused on rebalancing and retargeting the R&D tax credit for the SME market, rather than the big end of the market.

Is that a fair comment from Mr El-Ansary, given you are an expert in this area and you have looked at the legislation?

Mr Parsons—Absolute, and I think it is consistent with my opening address. Save for those small unintended consequences for the SMEs, I think that is a fair statement and I agree with it. I have been part of that consultation with government and I do agree with Yasser that, from 18 December to April, there has been massive improvement.

Senator XENOPHON—Following on from Senator Cameron's line of questioning, you do agree that under the current system it is open to abuse and rorting, in some instances?

Mr Parsons—Yes, excessive claims are a possibility using the support activity provision in the sense that they become disproportionate. I would express it as 'excessive claims providing a disproportionate outcome which allows for poor outcomes in terms of policy'.

Senator XENOPHON—Sure. Others might call that rorting, though.

Mr Parsons—Sure, yes—and others have.

Senator XENOPHON—I am just looking at your submission to Treasury. You said that replacing the old scheme with a new scheme will not be revenue neutral. Can you explain the basis of that calculation.

Mr Parsons—We say it in the sense that we are uncertain it is revenue neutral. The abolition of the incremental 175 per cent provision is a significant revenue saving measure. I think it is a little understated. Conversely the rate and threshold increases will cost the revenue, and this is to be applauded, particularly for the SMEs. But there are definitional tightening measures and I go back to my manufacturing example with dominant purpose. Manufacturers will, I think, be unintended casualties, which will result in less assistance going to them. I think I am on record as saying that we do not have that modelling, we do not have that insight. But we also have not seen that modelling. I understand the need to tighten; therefore I suggest alternatives that do not have unintended casualties.

Senator XENOPHON—Which countries do you think get it right? Is there a template? Is there a model of the best way forward in terms of other countries, in terms of a legislative framework for R&D? Are there some countries we should borrow from more than others in terms of getting it right?

Mr Parsons—There are a cocktail of jurisdictions and it is hard to answer that question, but I would highlight one aspect. Educating and making the Australian workforce intellectually competitive is surely a very good thing for the 21st century, and elements of legislation that promote that—a differential reward for labour investment and the like—are attractive mechanisms in other jurisdictions.

Senator XENOPHON—Which ones?

Mr Parsons—I would have to take that on notice.

Senator XENOPHON—If you could, that would be useful.

Senator BUSHBY—On the excessive claimants issue that has been discussed, in your opening statement you said that you agreed that some of the changes are heading in the right direction but that you think it could be better targeted. For the committee's benefit, would you explain how it could be better targeted?

Mr Parsons—Yes. I would highlight two areas. The first is the dominant purpose. It is a black-and-white hurdle and it is a high hurdle. It could be modified or made more friendly to manufacturers in particular—and I have spelt out why I think this—who will be over the $20 million turnover very quickly because they have high turnover but wafer-thin profits. So, around dominant purpose, I would highlight apportionment, caps to limit the big end, less black-and-white language, and specific provisions. The second one is SME grouping. SME grouping—where you go into a fifty-fifty arrangement. This is a small biotech or a small IT company and it goes into a fifty-fifty arrangement with a large corporate. They will not get the refundable credit. This is an unintended consequence, I am absolutely sure. But that would be another area I would look at.

Senator BUSHBY—How important to your clients, both small and medium, is the current R&D concession? Do you consider the change to the new R&D incentive as proposed will threaten some of their activities—their R&D activities in particular—completely? Might they conduct them in Australia and look elsewhere?

Mr Parsons—The R&D assistance, however it manifests itself, does change client behaviour and it does promote the behaviour I think the government is looking for. R&D grants, similarly, did this. The extent to which a party would restructure their affairs, be it overseas or away from the behaviour the government is

looking for, really is case by case. I think it is very difficult to give a broad statement on that level. The issue around whether these provisions will encourage more meritorious behaviour in the R&D space will again be a case-by-case situation. Clearly there are some winners with this. SMEs—save for the unintended consequences I mentioned—will be more inclined to partake in R&D activity.

Senator BUSHBY—So, on the SMEs, you are saying that, despite the fact that there is a more generous concession that will be offered if they meet the requirements under the new incentive, the fact is that the other changes probably make it less likely that they will be able to meet the requirement, because of the nature of—

Mr Parsons—Yes. I do feel for the manufacturer above the $20 million threshold. They are not an SME in this definition, yet their profits would be small compared to some SMEs. So I do not think they are winners in this. There is a philosophical argument about whether their production trialling should be supported. I hear the comments and I understand the arguments about that. But there are manufacturers that I think are SME manufacturers but are greater than $20 million.

Senator BUSHBY—You mentioned manufacturers a number of times. It appears from the evidence we are getting that manufacturers will be the hardest hit by these changes. Is that a correct conclusion to draw?

Mr Parsons—Financially, others may be harder hit, but the sector that cannot take it all I think is manufacturing, with Australian dollar concerns and the rest. I think it is a fair statement: manufacturers over the $20 million threshold are hard hit.

Senator BUSHBY—Thank you.

Senator COLBECK—Can I just go back to the grouping of SMEs and your discussion about the percentage thresholds of the shares of the relationship. How would you modify that? What would you do to actually bring that to a reasonable threshold? What modifications would you suggest in the legislation to fix that?

Mr Parsons—For those interested, it is item 1 and item 2. Item 2 has the fix; item 1 does not. Item 1 needs to replicate item 2 and replicate what currently exists, which is greater than 50 per cent. There is a very real reason. If you have something less than 50 per cent—that is, 40 per cent, which is what the current law says—you have the ability, in theory, to group everyone in the world, because you can be 50 per cent with everyone, if you know what I mean. That obviously does not occur but it is a very real problem around multiple 50-50s. You end up grouping people that are not connected. So it is an easy fix and it is a necessary fix, in my opinion.

Senator COLBECK—You talk about less black-and-white language in respect of the 'dominant purpose' and you have made a number of representations with respect to production trials. What needs to change there? Less black-and-white language would perhaps scare a lot of people, because most people would like to see more black-and-white language. What do you suggest that we look at moving, in respect to that?

Mr Parsons—I did put forward our apportionment caps. I would imagine caps would be attractive to the government because that would hurt the large end, not the SMEs. With respect to less black-and-white language I was referring to the word 'dominant'. 'Dominant' is used in the Tax Act in part 4A and other places. It has a very high hurdle to it. I do not have the language at the forefront of my mind but there would be words other than 'dominant' that could satisfy what the government needs and still, perhaps, be a bit more sympathetic to manufacturers. With respect to specific provisions, the prior senator highlighted many concerning areas around 'specific excesses'. 'Specific excesses', in my personal opinion deserves specific provision. But the government is wedded, it would appear, to principle based legislation. I understand the theory around that. Apportionment is a methodology used throughout the Tax Act. Caps are not without their problems but they do provide very real, black-and-white limits to revenue.

Senator COLBECK—Perhaps you could provide to us on notice some suggestions of where that might be pointed to.

Mr Parsons—Sorry, I did not understand the question.

Senator COLBECK—You said you did not have, off the top of your head, what terminology you might suggest. Could you provide us something, on notice, that might provide a solution to the criticism that you have.

Mr Parsons—Sure. I have highlighted four options. The third one is less black-and-white language. Yes, I will provide that on notice.

CHAIR—Thank you, Mr Parsons for participating in the hearing today.

Proceedings suspended from 10.52 am to 12.05 pm

ALLAN, Mr Steve, Director, Moore Stephens

HICK, Dr Alastair, Director, Commercialisation, Monash University

McWATERS, Mr David, Divisional Director, Corporate Finance, Monash University

Evidence was taken via teleconference—

CHAIR—Welcome. Do you have any comments to make on the capacity in which you appear?

Mr McWaters—Thanks for the submission that was done was by the Group of Eight, and Monash is obviously a member of the Group of Eight. Mr Steve Allan is from Moore Stephens, who are the tax consultants for Monash University. Steve will now talk to you, if that is okay, and give you a brief overview of the submission and some highlights.

CHAIR—Thank you. Mr Allan, please go ahead.

Mr Allan—We made a submission in response to the changes proposed in the September 2009 research and development tax consultation paper. The key element of that submission was to provide for an additional tax incentive to industry to undertake their research and development at a university rather than do it in house or overseas. The submission of the Go8 was not accepted but we appreciate this short period today just to work through some of the key aspects of the submission.

Importantly, the submission that we put in would have an impact not only on the universities but also on the not-for-profit research institutions, including the CSIRO. At the outset, we understand that the industry driver for undertaking or not undertaking research is not solely receiving a taxation benefit. Rather, after industry makes the decision to undertake research, the university sector is trying to influence the location where the research is conducted. The benefits that the universities provide are obviously access to research expertise, access to existing background intellectual property that the university may have developed and access to research infrastructure and equipment at a marginal cost. This, combined with receiving an additional financial incentive via the tax system, would certainly provide the university with a compelling reason to get industry to favourably consider the university proposition of conducting its research at a university.

We will work through for a couple of minutes the four key points that we have in our submission. The first is that the university sector, in the last five years, has invested very heavily in building commercialisation and industry engagement divisions. These have been created to encourage industry to better utilise the intellectual property and research infrastructure of the university sector.

The second point is that the federal government and state governments have also in the last five years continued to make significant financial contributions to building research infrastructure across the university sector. Certainly much of the Education Investment Fund grants have been directed to providing research infrastructure. There is a missing element, and that is that currently there is no material additional financial incentive for the private sector to undertake research at a university, even though both the university and the government have made significant investments in recent years. So the proposal that we made via the Go8 was to provide an additional tax credit to the industry sector to encourage them to utilise the university infrastructure in research. We have proposed that that additional tax credit would have no cap on it. The credit that we submitted was the equivalent of the existing 175 per cent tax credit. We felt it was important to have a tax credit system different from the existing 40 or 45 per cent tax credits that are proposed in the bill.

We believe that the government and the universities have jointly developed a research landscape which provides for a streamlined interaction between the universities and industry. The introduction of the financial incentive to fully capitalise on existing R&D infrastructure, which is currently underutilised by industry, would ensure that the government received the maximum research outcome and also the maximum benefit for society. Given the current levels of research funding received by universities, we believe that the short-term financial impact of this concession on the budget would not be a material one. Certainly the ATO would be better placed to indicate with certainty the amount of research and development that is conducted at universities, because that is disclosed on R&D tax returns that are lodged with the ATO.

In summary, the creation of a research and development incentive would provide a trigger or a compelling financial reason for industry to investigate the alternative of conducting research at a university rather than doing it in house or overseas. That was the essence of our submission. It was a fairly simple outcome that we were after: creating an additional financial incentive for industry to conduct their research at the university.

CHAIR—Thank you, Mr Allan. Dr Hick, did you have any additional comment?

Dr Hick—There is no additional comment to make at this stage.

Senator EGGLESTON—I am interested in the issue of intellectual property rights. You mentioned intellectual property rights in the course of what was just said. At the present time, I think they have to be retained in Australia. Under this proposal, that is not the case. I know that intellectual property rights are very important to universities as an issue, considering the amount of research that has been undertaken by them, and I am aware of the Gray case in Western Australia. Do you have any comments about the intellectual property proposals in this legislation and how they will affect universities?

Dr Hick—Intellectual property, as you said, is a big issue when we are dealing with research with industry and external commercial partners. We usually manage that through licensing intellectual property to the commercial partner. We are used to dealing with research partners from all over the world. We have relationships with companies in all parts of the world. So this is something we deal with on a day-to-day basis. There is no current disincentive for us to deal with one jurisdiction over another. Usually, achieving the greatest benefit to society is our primary objective in choosing a commercial partner.

Senator EGGLESTON—That is commendable. As I understand it, when the university has had research done under its aegis, in most cases it likes to retain ownership of the intellectual property rights.

Dr Hick—That is correct. We retain ownership of the intellectual property rights on most occasions, although on some occasions they would be assigned to the partner in a legal agreement, depending on the commercial terms. We would license the right to use those intellectual property rights to the commercial partner. They are then able to commercialise that particular piece of intellectual property according to the terms of that licence, and usually that will be on a worldwide basis.

Senator EGGLESTON—So you do not see any issues about the fact that, under this legislation, intellectual property rights for the outcome of any research will be held by foreign nationals in the United States, the UK, Germany and Switzerland? That will not affect you in any way?

Dr Hick—It would not directly affect us. We are used to that situation happening at the moment. The ownership is one issue. There is also a beneficial rights issue. In those situations, we would usually retain a beneficial interest so that what we would be getting at return back to Australia. We would also usually include a diligence provision, which means that, if the intellectual property is not developed, it is returned to the university so that we can further develop it and find another partner.

Senator EGGLESTON—Are you familiar with the Gray case in Western Australia?

Dr Hick—Yes, I am.

Senator EGGLESTON—Does that have any implications for the universities in relation to intellectual property rights under this legislation?

Dr Hick—No, not under this legislation. The universities—and Monash is one of them—have been undertaking a review of our intellectual property policies and statutes and regulations as a result of the Gray case. We have been addressing the issues that were brought up in the Gray case.

Senator BUSHBY—As I understand it, the Group of Eight universities have been in discussion with the government about your proposed changes. You made submissions to the earlier consultation processes?

Mr Allan—Yes. We made a submission and we did some minor lobbying of the GO8 for them to favourably consider our submission.

Senator BUSHBY—Obviously they have not considered it favourably at this point. That is the conclusion we can draw from the legislation that has been presented?

Mr Allan—Yes, that is correct. And we shot off a follow-up letter saying we were disappointed that it was not considered favourably.

Senator BUSHBY—Have you had any feedback as to why your suggestions have not been included?

Mr Allan—No, we have not had any feedback as to why our submission was not received favourably. We thought it might have been received favourably on the basis that we do not think there would be a significant financial impact in the short term.

Senator BUSHBY—That was going to be my next question. Has any estimate been put together of the direct first-round costs to government of making the changes that you proposed?

Mr Allan—At the time we did the submission there were a lot of statistics around that we could, in the next day or so, deliver to you. I think they are ATO statistics on the amounts spent by corporates of registered research agencies. Essentially the financial cost to government would be the figure multiplied by the difference between the current rates they are getting. Currently they could be getting 175 per cent or 125 per cent as the deduction. With the 125 per cent the large companies would be benefited under the proposal because they would get an additional deduction.

Senator BUSHBY—Overall your assessment of the impact of what you propose is not a huge impost on the budget?

Mr Allan—I am not sure what the definition of a 'huge impost' is. Considering the size of the education endowment fund—billions—we think it would be in the $10 million to $20 million range in the short term. At this stage there is not a huge incentive for corporates to spend their funds at the university. We would hope it would ramp itself up over a period as corporates start to use the university sector.

Senator BUSHBY—As I understand it, you are suggesting that some of the corporates that might be spending money now not in accordance with your proposal may just shift that spending, which under current legislation attracts the R&D concession, and do it through and in partnership with the universities. It would not necessary add to the overall cost, if your suggestion was taken up. Or are you saying that they should have additional incentives which would cost the government more and also potentially attract a higher level of investment than is currently occurring.

Mr Allan—Currently a lot of the smaller corporates who are eligible for the 175 per cent incentive are utilising the university sector already. So there would be no financial cost in that case. The larger corporates who have got large R&D programs would not be able to switch instantaneously their R&D programs into a university to get an additional financial incentive. They may be able to but it would be a more compelling event to try to make a long-term shift away from industries replicating a lot of the work that universities have done and the governments are funding in the university sector to better utilise the existing funding that is funnelling into the university sector, which the commercial sector is currently underutilising.

Senator BUSHBY—You mentioned underutilised infrastructure. It would be an advantage if we could make the most use of infrastructure that is there and not being used. What other benefits are there? Do you see benefits for employment in a direct or indirect sense? What impact would it have on the quality of the research undertaken by universities? Given that we are talking about universities, would it have any beneficial impact with students.

Dr Hick—A big benefit to the university is engaging more closely with industry. If we look at Monash, in the top 10 strategic priorities for the university it is currently at No. 2. It is something that we believe very strongly in. If we can engage more closely with industry it often leads to more relevant research. That is a very big incentive for us to work more closely with industry and it is why we have been investing in these activities at the universities.

Senator BUSHBY—Are there benefits for students from the quality of the research?

Dr Hick—In terms of the quality of the research, again it is about doing relevant research. Often industry and universities have complementary capabilities and access to different facilities and capabilities. The partnership often leads to increased quality of research. In terms of knock-on effects, we often see our students emerging through the system. If they are undertaking research that is of more direct relevance to industry then they become, as they leave the university system, more employable by industry because they have got direct industry experience.

Senator BUSHBY—Thank you.

ACTING CHAIR—Senator Pratt, are you on line?

Senator PRATT—Yes, I am on line.

ACTING CHAIR—Do you have any questions?

Senator PRATT—I do not have any questions at this stage. Thank you.

Senator CAMERON—Mr Allan, what is the break-up between the research and development funding that the university receives directly from government and the funding received indirectly through industry?

Mr Allan—Is this a Go8 question? We do not have the Go8 statistics here, unfortunately, but we could probably give a rough estimate of the industry research at Monash University against that of our total research spend.

Senator CAMERON—It would be fine if you want to take that on notice. Do you receive direct research and development funding from government?

Dr Hick—Like all universities, we receive significant funding from the government through the NHMRC and the ARC and from state government as well. If we look at the question of how much of our funding comes from industry, some of that comes as direct funding from industry for specific projects and other funding comes with schemes such as the ARC Linkage Projects, which is a matched funding scheme from government. A rough estimate of our industry funding would be 15 per cent. It depends on exactly how you divide the components of industry funding.

Senator CAMERON—This morning I raised some of the rorts that seem to have developed in the scheme. If you receive funding from industry, there is a possibility that some of the rorts that are taking place are helping to fund some research and development within universities. That would not be a position that you would endorse, would it?

Mr Allan—I am not 100 per cent sure as to the rorts that—

Senator CAMERON—For instance, the mining industry have claimed funding for research and development work and then applied that research and development within the production processes and by multiples of 10 increased their eligibility for access to research and development. That is why we are trying to tighten up on the definitional aspects of this new act.

Mr Allan—To some extent, the level of research that is conducted by the corporates at the universities is currently not significant. So if those definitional rorts are occurring in the production process, I think they would be occurring in-house at the corporate level rather than by having the university act as a means to create such a rort.

Senator CAMERON—Mr Allan, I am not saying that. I am not asserting that in any way. The point I am making is that, if there is significant money coming to companies and you are trying to get more company funding back into Monash to get that link between the university and industry, which I support, that funding might be due to a manipulation of government funding. You may not even know about it.

Mr Allan—We would accept that because the R&D claim is made at the corporate level; the university sector only does genuine research. But it is not visible to us what they put in their R&D return, apart from the payment that they would make to us.

Senator CAMERON—You would have no argument with the principle that—

Mr Allan—Absolutely.

Senator CAMERON—government should ensure that there are no rorts.

Mr Allan—We have absolutely no time for any discouraging or rorts of the R&D system. The university and Go8 are very upset by those, because our core business is research. The Go8 is very disappointed by any activities that taint research as a whole.

Senator CAMERON—Given that we have to deal with these definitional issues and try and focus funding clearly on proper research and development activities, what should we do in terms of definitional aspects or practical issues? Do you have any views on that?

Mr Allan—Unfortunately, when you have a definition, everybody reads it differently. I am not sure that there is a good answer. If there were an increased level of auditing done as to the definition then I think that that would help. Certainly, the ATO has created an environment now where it encourages compliance with the spirit of the law as well as the law itself, and maybe some further activity in that area would put directors on notice that, if it is too good to be true, it is too good to be true, which is an approach that has been taken by the tax office. But that would be done by AusIndustry, who manage the definitional part of the R&D area, rather than the tax office.

Senator CAMERON—Yes. Just take me to your major concern again and tell me how you think the government should resolve it—if you could do that briefly.

Mr Allan—From a university perspective, universities only do hardcore, genuine research. In respect of our proposal, universities do not usually get involved in production processes that people are still trying to argue

are research and development and that sort of thing. The university sector generally only does the more complex research activities. So we believe that any research done at a university would have a lower risk profile than any done within a corporate body, on the basis that the university's core business is research, not generating other returns.

Senator CAMERON—What if you were looking at, theoretically, a carbon capture and storage proposition—a carbon capture specific bit of lab research; you then have to take that lab research out into industry, don't you, to test it?

Dr Hick—Yes, that is right. An example of carbon capture research would be that Monash is a partner of the CRC involved in sequestration. Typically, we would be looking to engage with industry at some point, because if we do not we are not going to get the technology that we have developed out there into wider society and being used. So, yes, we would be engaging with industry, we would be involved in that, but typically our capabilities and industry capabilities are different. We are good at the research end of things; they are good at taking those things and developing them into products, processes or services. There is, if not a gap between the two, a real difference between the activities we undertake and the activities they undertake. What we have to do is ensure that the partners that we get involved with are the right ones, because if they are not the right ones they are not going to take our technology forward. So, yes, we do have to ask the sorts of questions that you are asking—is this the right partner and will we be comfortable dealing with them? And we do make those assessments all the time. Then we put in place appropriate mechanisms to ensure that our technology is taken forward in an appropriate way.

Senator CAMERON—I am not arguing that every partner you may have may be rorting the system—I am not putting that as a proposition at all—but there are examples where there have been problems. I am moving away from that to the issue of what happens if the government funds some pure research and development in universities and then that becomes a carbon capture innovation for a steelworks, and you say to the steelworks: 'Partner with us on this. We've got this great innovation that'll solve your pollution problems. Bolt this on. You build it and let's have a look at it.' How do you divvy that up between the university and the steel industry in relation to R&D support?

Dr Hick—That is a very good question, and it is one that we have to ask all the time. Usually it comes back to the capabilities of the different partners. Typically in that sort of case we will have some core technology that we are looking to take out to a commercial partner, and we will be looking at where our core capabilities are and where their core capabilities are. We will usually come up with a detailed proposal on the different activities of the different partners. Typically our involvement will drop off as the technology gets further and further down the development path, although we are often engaged in a consulting role to consult on the core elements of the technology as it gets applied in the particular situation in the type of thing that you are referring to.

Senator CAMERON—If any company uses your innovative research and development processes on their existing production processes, do you believe that they should get any support for their existing production processes in terms of it being seen as research and development because you bolt something on?

Dr Hick—We would be looking for the improvement part, because nearly all the time the technologies that come out of a university need further development before they can be applied within a commercial setting. That probably applies to 90 to 95 per cent of the technologies that come out of the university sector. They require significant further research and development before they can be utilised. In your sort of case, we would not be arguing that they could cover the whole of their production process, but they would be looking to the additional research that was necessary to take our technology and apply it to their particular situation.

Senator CAMERON—Unless the government deals with the definitional issues to restrict rorting, how do we do it otherwise? Is there any other way we can do it?

Mr Allan—In the university—certainly at Monash University—we are not aware of any unique methodology that you can implement to stop that, to be honest.

Senator CAMERON—Thanks.

Senator EGGLESTON—I would like to ask you a couple of questions about the definitions of 'research and development' and whether or not the universities think the bill has too narrow or too broad a definition of 'research and development'. These definitions have been modified now.

Mr Allan—You are after the university view on the definition of 'research and development' or what the university's definition of 'research and development' is?

Senator EGGLESTON—No, the university's views on the definitions in the bill.

Mr Allan—It is the corporate sector who claim the tax deductions on research and development, so they have made extensive submissions on the definition of 'research and development' to ensure that in their view the definition captures all the things that they believe are research and development. The university sector has not really investigated to any great extent the definition of 'research and development', on the basis that it is not necessarily relevant to the university sector in the R&D context.

Senator EGGLESTON—No, I suppose not directly, but I speculate that, if some organisation or company which was associated with the university did not get funding, that might affect your activities. Would that be the case?

Dr Hick—That is potentially the case, but, coming back to the typical sort of research that we would carry out in the university sector, it is very much at the research end of things and for that very reason is less likely to fall outside the definitions that are currently proposed and have been discussed. That is the reason that we feel reasonably comfortable with where we are at at the moment.

Senator EGGLESTON—I suppose my question in essence boils down to whether or not you think the definitions might mean that you found yourself engaged in less activity driven by business in research fields. You seem to be saying that you do not think that is the case.

Mr Allan—Certainly a more expansive definition of research and development would mean that more corporate players would want to approach a university to do research and development. The fine line with that is that research and development stops somewhere, and I guess we do look to government to work out where that line is. Because we are in the early-stage part of the line—the university does not do a lot of activities as the line gets shorter or greyer—the university does not usually see too much of that debatable type of research and development, but if the definition were very restrictive for corporates, which meant that even core research was not undertaken, then that would certainly have an impact on the university sector.

Senator EGGLESTON—Thank you. I will leave it at that.

CHAIR—As there are no further questions, thank you to Monash University and associates for taking the time to appear at this hearing today.

Mr McWaters—Thank you very much.

[12.43 pm]

GALE, Mr Kris, Managing Director, Michael Johnson Associates Pty Ltd

ROSS-GOWAN, Mr Ian, Manager, Michael Johnson Associates Pty Ltd

CHAIR—Welcome here this afternoon, gentlemen. Do you have an opening statement that you would like to make?

Mr Gale—Yes, thank you. Good afternoon, and thank you for the opportunity to present to the committee. In addition to the hearing today, we will be making a written submission by the 26th.

CHAIR—Thank you.

Mr Gale—Very briefly, my background is that I have been consulting in the area of the research and development tax concession since 1987. My activities have included appearing at previous Senate committees such as the 1996 and 2001 hearings into R&D tax reforms. I will hand over to Ian to introduce himself.

Mr Ross-Gowan—I have worked with Michael Johnson Associates for the last couple of years. Prior to that, I had worked with manufacturing in research and development since 1993.

CHAIR—Thank you.

Mr Gale—Our firm has been consulting in the area of government support for research and development and technology since 1983, which means we have been consulting continuously in the tax concession since it began in 1985. We act for a full range of clients from start-ups through to top 100 company groups. If you look at our client profile at the moment and the proposed definition of SME, about 70 of our clients would meet the definition of less than $20 million group turnover, or the SME definition, and about 20 of our clients would meet the definition of large organisations. For those 20 group members, we are probably responsible for about 100 to 120 registrations.

We did an analysis of the proportion of R&D spend relative to turnover for our client base in the last three years when we were trying to assess the impact of the proposed bill. At the moment our SME client base is essentially a technology-intensive SME client base, and about 26 per cent of their turnover will be expressed as an R&D claim under the current rules. For those large 20 claiming groups with a turnover greater than $20 million, about 1.2 per cent of turnover will be expressed currently as an R&D claim.

I think you could best characterise us as an SME consulting primarily to SMEs in this area, as well as to some large company groups. As to the reason for us appearing: apart from having been active in the area since 1985, we have been a fully-fledged member of the R&D tax concession administration consultative group since it began in 2001. We have participated in all reviews in this area over the period of the concession and very much in the national innovation system review of which this bill is the final result.

Specifically, in this year we have had five face-to-face meetings in a small advisory group, which Robin Parsons from Ernst & Young referred to earlier today, with Department of Innovation, Industry, Science and Research officials, as well as having attendants from AusIndustry and the ATO. We have had a series of teleconferences as well about the various contents of the exposure drafts.

Our overall position is this. We are very much in support of the broad thrust of the announced government policy in terms of the changes to the existing program. We see the genesis of that policy as being *Venturous Australia*, the Cutler report, that came out of the review of the national innovation system. We support the reorientation of support towards SMEs in the program, which has been achieved through the introduction of the differential rates of credit. We support the move from the concession to the credit format. We very much support the increased base rates. Our submission to Cutler had been that the existing concession was underpowered and overcomplicated, and we thought that higher base rates needed to be introduced. The cost of that was the closure of the incremental provisions.

We have not been a supporter of—even though we have had to consult on—the incremental provisions since they began in 2001. We think that they run counter to what a concession or a credit should be, which is something that you can plan for with certainty. The incremental was an after-the-fact tax calculation that never impacted on technical components of companies.

There are certainly reasons we can see for the inclusion of foreign-owned intellectual property into the program where the work is locally performed or the R&D is locally performed. And we understand the current

eligibility criteria review in the cost-constrained environment in which we operate. So we understood that that formed part of the policy.

The announcement on budget night last year was that we needed to tighten eligibility criteria to support 'genuine R&D'. It is probably that announcement that has culminated in some of the concerns we would like to raise about the bill. That is, the central concern that we have is this idea of 'genuine R&D'. I am not sure I understand what that is, and I have always been concerned with what is eligible. And I think the review of the bill should be around what is eligible research and development, rather than someone's view of what is genuine.

We are very concerned that the government has been let down, in that we believe that the construction of this bill does not reflect its announced policy in relation to tightening existing criteria of an existing concession but, rather, that the definitional changes and related features have left us with a bill that institutes a brand new program, with a brand new set of definitions and a brand new set of concepts. And, if it comes into being on 1 July this year, it is day one for everyone. It is a different animal. And we are concerned about that.

The reasons that Treasury have provided during the consultation as to why the changes have been necessary in terms of the definition of research and development, splitting into core and supporting activities, feedstock changes, increased administrative powers and the like, have been to do with this concern with genuine R&D without really articulating what is non-genuine R&D that is currently being claimed. Perhaps that is an issue that is starting to be touched on today.

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 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.

Also, on the need to keep this particular program as revenue neutral: we have supplied modelling to all the Treasury submissions in relation to the drafts, and our modelling on the publicly available figures suggested that, with the increased rates of credit and introduction of foreign-owned IP, offset by the cost savings of the incremental provisions—which we think are about 30 to 35 per cent of the current cost of the program—you have already got a revenue-positive result, and that is before you start to look at the apparently restrictive impacts of the new definition. So to us this looks very revenue-positive, and we are concerned about that. We have submitted, in our discussions with the Treasurer's office and the various administration bodies, that we think that this will not get near the $1.4 billion announced over the next four years per year.

Finally, are we really talking about something that was raised in the Cutler report? There was a need to do something about what Cutler somewhat clumsily referred to as 'whole-of-mine claims'. I will not go into what that means, but I think it refers to eligible large operating cost claims. Cutler noted that, while these large claims in areas such as mining, civil engineering and the like are currently eligible under the program and are R&D, they are a big cost impost on the system. So the suggestion was that we should look at it. In the time available, they said, we might want to refine the definition of R&D, but that might be difficult and we might want to proceed to look at other measures. As Robin Parsons mentioned this morning, that might include a group cap on claims. So, when you have large operating cost claims, a company is acknowledged as doing eligible R&D under a definition but can only benefit in the program up to a group cap. You can introduce cost control that way.

We do not understand why, in order to deal with that issue—leaving aside the issue of rorts—you would change the fundamental precepts on which the program is based and lose 25 years of institutional understanding that has been built up amongst all companies in this program, particularly SMEs, around other concepts such as innovation and technical risks to address that issue. Our concern is that what has been done in this bill is a fundamental shift, taking the concession away from its proud history of being a program predicated on an industrial definition of research and development and establishing a pretty much scientific definition with a lot of uncertainty around how one might administer that in the context of production trials and the like. You have changed the basis of the program so that it will never cost as much as the current one does—and that has an impact on everybody. If our current SMEs are getting 26 per cent of their turnover as an R&D spend at the moment, we would expect that under this program they will go towards 10 per cent. Our large companies are going to go from one per cent to maybe just under one per cent. The impact of these measures is disproportionate on SMEs.

We are very concerned that this bill, having had long delays in the review process, is suddenly moving at lightning speed. There were concerns raised this morning about feedstock provisions. They only appeared in this bull last Thursday, and they had not been available for public comment until then, yet they appear to have potentially far-reaching impacts. We have some ideas as to what we might do to get started on the benefits that are clearly contained in this provision and move in a measured way to the outcomes the government is looking for and provide a transition process rather than a hard start on 1 July. Ian, my legislation detail guru, is with me and we are very happy to take questions on the matter.

CHAIR—Thank you. You said this dramatically alters the meaning of R&D and skews it towards one particular area and away from the development side. The new objects clause, for example, says that the object of this division is to encourage industry to conduct research and development activities that might not otherwise be conducted because of uncertain return from the activity in cases where the knowledge gained is likely to benefit from the wider economy. That is certainly not the intention of this bill, yet you say some of your SMEs will drop to less than half of their eligible expenditure. What kinds of expenditure would be ineligible under this bill?

Mr Gale—I think the objects clause is a good place to start because it sets the tone of the program and it is the first provision. The objects clause talks about research and development activities that reflect two characteristics often referred to as 'conditionality' and 'spillover'. 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.

What the credit can do is help reduce the effective cost of the R&D that companies are doing—the priorities, not the marginal projects, that they should be doing. For companies such as SMEs, that is not just theoretical and conceptual development or bench-and-lab experimentation; it is attempting to achieve new products and process improvements in their production environments. This new definition asks companies to artificially split activities into two categories, one being 'core' and the other 'supporting'. 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.

CHAIR—I do not want to interrupt you, but you are saying, as though it is fact, that this bill deters experimental development. Where in the bill does it do that?

Mr Gale—I think there is a lot to be taken from the explanatory memorandum, and the various versions that have been attached to that. There is a flavour of looking at projects that would currently qualify and identifying aspects under the new definition that would not in the mining examples that are provided and the like. In terms of your question, as someone who has worked in this area for a long time I do not know the answer. I have companies that have looked at the new provisions, the new definitions—

CHAIR—So, when you say your SMEs will drop more than half of their research and development income, what do you base that on? If you say you do not know, how can you make a prediction like that?

Mr Gale—I say I am not sure how the law will play out, but I am looking at the supporting materials and the likely response of the administration to that. 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. We look at the supporting materials, such as the explanatory memorandum, and they are essentially saying, in a range of circumstances, where we do our R&D in situ we will be subject to the dominant purpose test.' As was set out earlier this morning, it is very difficult to say, when you also have a production outcome associated with that trial work, that the dominant purpose is research and development—and, therefore, those claims would be lost.

CHAIR—Okay, but you said earlier, 'We'll set aside rorts,' but I do not think the government can set aside rorts.

Mr Gale—I would like to talk about—

CHAIR—Also, it is incumbent on the government to target its grants properly. It seems to me that it is in that production phase—and they might be doing it quite legally under the current system, and that is fine—that

a company might use research and development expenditure in production processes, which is not where the government might decide it wants to focus its grants, its expenditure.

Mr Gale—There are two elements to my response there. First of all, the question of rorts intrigues me. I think we have actually approached the government and the administration on several occasions to say: 'Let's work through those examples. What are the rorts that you're talking about? Let's look at the issues. Let's establish some rules.' I personally am unaware of rorts. Part of our job is to explain to companies where they cannot claim research and development. So rorts there, to me, imply misuse of the legislation and non-applicable claims. You have got the law and the administration to make sure those claims are not made. In relation to the ability to claim production related activities, there is enormous power in the current definition of 'supporting' activities, which is anything carried out for a purpose 'directly related to core R&D activities', and our job is to work out the directness of that relationship. Very, very occasionally, you find the innovation and technical risk issues are so pervasive in an operation that for a period of time the production operation itself is a research and development project, but that is not the norm—

CHAIR—But that is allowed for.

Mr Gale—It is in extremely rare circumstances, in my experience, that it is allowed for. Typically, for example, in the case mentioned this morning about the $21 million of air-conditioning to sustain a claim for a $100 million building, without knowing any of the other facts my reaction to that is that I would struggle to see the direct relationship between the air-conditioning research and development and the cost of the building, and that that claim should not be made. The current 'directly related' definition deals with that, so I am at a bit of a loss to understand why you would fundamentally change the well-understood definition to deal with claims that are outside the current program. If you are worried about cost, you can do that through the expenditure provisions.

CHAIR—You are saying that the government has not provided an example. Give me an example of what you are talking about, where you think one of your SMEs, without naming them, would have their income in production processes knocked out by this bill.

Mr Gale—I am loath to keep taking the mike. Ian, do you want to give an example?

Mr Ross-Gowan—As an example, you have a definition of R&D activities in 355-25 which is about core technology. 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.

CHAIR—My understanding is that it will not if you can show that it is directly related to that core R&D process.

Mr Ross-Gowan—But say it is the development of a carbon reduction process, which is going to have two dominant purposes: one of them will be the development of the carbon reduction; the other will be the production of goods and materials. Even though you could argue that that can come in as a supporting activity, currently it does not need to be a supporting activity; it would be a core activity, but it has been reduced to a supporting activity by this legislation.

CHAIR—But it could still be covered, couldn't it?

Mr Ross-Gowan—Yes, but you have gone for 'the' dominant purpose rather than 'a' dominant purpose. This makes it a harder test than part 4(a)—part 4(a) is only 'a' dominant purpose—and by making it 'the' dominant purpose, if it is assessed that 'the' dominant purpose is production, it gets eliminated and will be reduced to 30 per cent.

CHAIR—But if it is assessed that the dominant purpose is to support that R&D expenditure—that first 30 per cent—then it will be covered, won't it?

Mr Ross-Gowan—In the wording of the EM it says that if one of your objectives is production, then that is the dominant purpose.

Mr Gale—The definition of supporting activities has four elements to it now. It says that activities are supporting activities if they are directly related unless they are within one of three exceptions: they are on a legislatively prescribed exclusions list, they are production or they are directly related to production. So,

ironically, you are not directly related to R&D if you are directly related to production. It is the complexity of working out which of those four slots these activities slot into that is going to bamboozle SMEs and is concerning them. There is a general tenor in the supporting material that where you are operating in a production context, most of the time you are going to be subject to dominant purpose test, and you will not be able to meet it. One of the examples—

CHAIR—Again, give me a concrete example of a production process where this might occur.

Mr Gale—For example, if I am in the FMCG sector—the fast moving consumer goods sector—and I am developing lower fat content in dairy products, I will look at the marketplace and notice, for instance, a competitor who has been able to reduce their fat content by a certain percentage and that that gives them a market edge. So I will go to my food technologist and my biotech people and say, 'What can we do in the formulation of our constituents to bring down the fat content and hopefully preserve some of the taste?' That is not my general experience with low-fat dairy products, but once we have done that we will say, 'We will need to make some batch runs to verify that.' The way in which it is described in the EM suggests that that may not actually amount to new knowledge, on the basis that the outcome is already known because someone else has already done it. So there are two issues here.

CHAIR—I think we can take that kind of example to Treasury this afternoon to check it out, but my understanding is different from yours.

Senator EGGLESTON—I do not have many questions. In your submission to Treasury on the exposure draft you referred to 'real concerns surrounding the consultation process'. Do you wish to elaborate on that? Is that still your view?

Mr Gale—We have been very appreciative of the particular role we have been asked to play in the consultation process all the way along, including the opportunity to present today. But the general feedback from the participants in the consultation process is essentially that they have not been listened to.

The Treasury consultation paper that came out on the definition in September last year proposed alternatives from which this bill has developed. There were 200 submissions made, 165 of which were made public, with the exception of three of them which were from individuals. Of those 162 submissions encompassing every company, adviser and industry group body, all of them said, 'Do not make these changes.' It was very clear that the wording that Treasury was using was appropriated from the 2007 Productivity Commission report, which said that R&D should only be supported through the tax concession in instances of high spillover and additionality and that in fact, with the exception of the very smallest companies, we should move to an incremental-only program and scrap the base concession.

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.

Senator EGGLESTON—That is very interesting. Are you putting your additional views on this to the Treasury or referring it to the processes of this committee?

Mr Gale—Yes. We are sending it to them each time. In this written submission we would say that if you want to achieve the benefits of moving to the credit and addressing the SME concern of the higher base rate and moving to the 15c, through my dealings with their lobby groups and organisations and my client base I believe there is an appetite from large industry and if you could get a transitional phase of the year with the existing definition in place, they would possibly accept something like the 37½ per cent credit to properly consult and work out what the issues are. It is, in fairness, very late in the day to start hearing that the real concern here is rorts and that that is why we are changing the definition. That has not been part of the public discussion or the consultation until now. I am delighted that it is but I think to make the transition hard to this new world on 1 July will be a huge burden on taxpayers. It is being done with an increased compliance burden and a ramping up of administrative powers that has the marketplace very concerned.

Senator CAMERON—I have raised those issues during this hearing, and I intend to continue to raise them.

Senator EGGLESTON—The Productivity Commission's study of the current scheme concluded that the extent to which basic research and development tax concessions stimulate additional research and development is low, particularly for large firms. Do you agree with that? If you do, would you accordingly suggest a different focus and orientation of this proposal?

Mr Ross-Gowan—I would disagree with that on the basis—

Senator EGGLESTON—You disagree?

Mr Ross-Gowan—Yes. I think that the feedback from research and development into the economy is a net benefit, and I think that is borne out by the Department of Innovation, Industry, Science and Research study in 2007, which found that 70 per cent of what is supported by the tax concession is brand new R&D, R&D that is done quicker because of the concession or R&D that is done more deeply because of the concession. That report also analysed the behavioural additionality and found that, in addition to these benefits, 98 per cent of businesses actually performed better as a result of the tax concession and the addition to the economy was equal to approximately the cost. So, even before you start to get the benefits from the R&D, you are getting the benefits from the behaviour changes.

Mr Gale—To add to that, across the range of organisations, the human element of this is that you can see just how this program currently plays out in corporations. They take it tremendously seriously. If they have certainty of benefit and understanding of what will and will not qualify, it gets into things like capital expenditure approvals and the like and it forms part of plans. To be able to plan for something, it needs to be certain, simple and easy to use. The current program has complexities like the incremental. We think it is superb that is going, but these changes really jeopardise those things. You need to see how seriously companies actually take this program and how much impact it has. But it is one of a range of factors. You do not just do research and development for the tax concession. That would not make sense.

Senator EGGLESTON—Of course not. How is it that the Productivity Commission has come to a view which suggests the R&D generated from these existing arrangements is low, and your view is totally different?

Mr Ross-Gowan—I do not think it is all that different.

Senator EGGLESTON—The information has to be the same.

Mr Ross-Gowan—The Productivity Commission report in 2007 did say what you say it said, but it also cited quite a number of studies all of which found that the R&D tax concession was a net benefit to the economy. I know what they concluded, but the data from the studies that they quoted disagreed with their conclusion.

Senator EGGLESTON—You do not offer a reason for that. They must have some sort of rational.

Mr Gale—It was difficult to discern. One of the things about that report was that everybody ignored it in its draft stage. When people saw the draft, everybody submitted. We were guilty of that as well. I am not even sure we were aware it was on. There was very little support in that second stage in terms of people agreeing with their conclusions. To say that innovative companies are generally SMEs is an assertion. I have not seen the evidence. As Cutler said, we are an innovation system where all companies play a part. You need a systemic approach to get large organisations to interact with SMEs or indeed research institutes in universities.

Senator EGGLESTON—In effect you are saying that the Productivity Commission's conclusions should be discounted.

Mr Gale—I disagreed with them. I disagreed with one of the commissioners publicly and he did not seem very happy when I did. But it is healthy to have a range of views.

Senator BUSHBY—You mentioned earlier that you generally like the direction of the changes but that you think it came with a number of pitfalls. What do you actually like about it?

Mr Gale—I am not a tax practitioner, but I think the move to the credit has generally been well received. The thing that appeals to me, almost as a lay person in this regard, is that the rate of support is set independent of the company tax rate. For example, if the company tax rate was dropped to 28 per cent, you would lose some support under the current tax concession. The credit sets those rates and, again, it is certainty and the ability to be planned for. I think that the SME orientation is certainly healthy. I think SMEs have very much suffered from the closure of programs such as Commercial Ready and it is a strong cultural signal that they are

of concern and interest. At Cutler we thought the 15 cents base rate across the whole system was appropriate, but we understand the split.

I do not want to over emphasise this, but we are delighted by the closure of the incremental provisions. They were complicated. We are thinking about how a scientist, a technician, an engineer, a software writer or a food technologist think about things like incremental provisions and indeed core versus supporting activities. The 175 per cent incremental did not make sense to them and, beyond the simple case, it was a complicated after-the-fact tax calculation where windfalls occurred because of corporate merger and acquisition activity. We think it was underpowered at 7½ cents under the 125 and overcomplicated because of the premium. We have got a high base rate regime and that is great. We have got rid of the premium and we think that is excellent as well.

Senator BUSHBY—Could everything you just described have been delivered without making the changes or implementing the measures that we have already discussed in the last half an hour or so that create issues?

Mr Gale—That has been our submission. In our Treasury submissions, Ian was responsible for generating the modelling that said, 'If you introduce those higher base rates and make some assumptions about participation rates, if you look at the impact of foreign owned IP that comes in where it is locally performed R&D, they add cost imposts but you save 30 to 35 per cent, largely from large claims, by closing the incremental provisions.' It was a bit more sophisticated than a back-of-the-envelope calculation but not much more, and it said that you are already saving money. So this additional range of changes clearly steers the program into revenue positive territory and quite dramatically. A number of commentators have suggested less than 50 per cent of the current support.

Senator BUSHBY—Without those additional changes that you are submitting should not be proceeded with, what do you think it would actually cost the government to make the changes that you do like?

Mr Gale—Not much.

Mr Ross-Gowan—From the modelling that I did, instead of $1.4 billion it would drop down to about $1.3 billion to $1.25 billion.

Mr Gale—So it is a mild saving.

Senator BUSHBY—You mentioned that you primarily see yourself as consulting to small to medium enterprises but with some bigger clients. So your main focus is SMEs. The minister has sold these changes on the basis that it is going to have huge potential benefits for the small to medium enterprises, but we have had evidence this morning that counters that and suggests that SMEs will actually be worse off on balance as a result of the suite of changes. The example they used of why that would be is that a lot of SMEs partner with larger firms and, as it currently looks with this legislation, if they partner with larger firms, they are not going to get any R&D concessions at all.

Mr Gale—In relation to those partnered activities, yes.

Senator BUSHBY—My question is, on balance, do you agree with the minister or do you think—

Mr Gale—That is a clear structural concern. Robin from Ernst & Young suggested that could be easily addressed. I think the combination of the new definition of research and development and the attenuating complexities, and the brand-new feedstock provisions and the extent to which they operate meant the augmented feedstock rule was not proceeded with. The provisions that we see in this new bill, we feel, fall somewhere between the existing provisions and the augmented feedstock rule and will have an impact. AusIndustry has indicated publicly that the desire will be to operate this program by a series of public guidelines as well as advanced findings that individual companies can make. That says to me that if we are trying to do something that is delivering on genuine R&D you might see themes emerge about sectors and areas where the legislation is believed to apply more broadly. So if I am an SME in a biotech area I might be feeling pretty good right now, but if I am an SME servicing the mining sector I might be very concerned, based on the examples that appear in the explanatory materials. It is due to the change in definition, the uncertain operation of feedstock, the different administrative regime and the compliance costs.

This process of registration is completely different and there is an ability for the administration to disallow registration and, indeed, eligibility on the face of that document. So we would be saying to clients that they need to get this document right, because of their interaction with AusIndustry. And AusIndustry, to their credit, have said, 'We would not make decisions without interacting with you,' but the power is there for them to do that. They will be able to come and say, 'We have looked at your registration and we are concerned about 30

per cent of your claim.' That is not what currently happens. You make a claim under self-assessment and then you interact and work out whether that claim is to be sustained. I see a shift from a self-assessment program which is able to be applied for with certainty to something that resembles a discretionary, maybe quasi-grants, approach, where the guidelines tell you how the law applies. AusIndustry said, 'We will defend those guidelines until we are shown to be legally incorrect,' which seems to be an unfortunate way to start a new world.

Senator BUSHBY—You also raised the issue of how some companies have allegedly rorted the system. You mentioned that, as part of the consultation process you have been through, that is not something that has been a key driver of the changes. It is only recently that you have become aware that this might be an argument that is being used to justify the changes. Is that an accurate summation of what you were saying?

Mr Gale—Yes. I do not think the issue of rorts has been part of the discussion at all, and indeed the impact of large claims has not been an overt part of the consultation. They are eligible claims, not rorts.

Senator BUSHBY—But if those rorts do occur—and there is anecdotal evidence that Senator Cameron has put forward that maybe they do—you think it would be reasonable for the government to take some measures to address those and cut them off.

Mr Gale—If that is done by improving the compliance regime and the administration of claims that are not able to be sustained under any definition, we entirely support that. Our interests are coincident with government. My clients and our firm want compliant claims. They do not want a dollar more, and they are also not really interested in a dollar less. They want what complies. As an independent service provider, we are not in business if we deliver non-compliant claims. So we are completely supportive of any initiative about misuse of the existing provisions or the new provisions, and we have always held that position.

Senator BUSHBY—Presumably, though, the government would have a range of options that it could look at to deal with those rorts, rather than a one-size-fits-all change to definitions or whatever it might be.

Mr Gale—I would agree entirely with that.

Senator BUSHBY—And maybe there are options that might be preferable.

Mr Gale—That is certainly our position. This has consistently been put in submissions—it is part of the public record—not just by us but by large industry groups and large individual companies. They say: 'We understand the issue. We understand that our participation in the program, because we occasionally do these large programs, might be seen as too heavy a drain on the revenue, so we would be prepared to negotiate an annual consolidated group cap.' What we do not want to be told is that what we are doing is not research and development. We understand that maybe we are doing more research and development than could be funded through this program, but we want the integrity of the program to reflect that. And the SMEs get caught up in this. If you make a systemic change to address that issue and what is actually offered on the table is, 'Let us deal with the cost,' you are rewriting all the rules and it does not seem to please anybody in the end. It certainly is of great concern to us.

Mr Ross-Gowan—A good example of that would be the production issue. If production is the source of the rorts, you could have a set of rules that defined exactly when production could be, instead of just the dominant purpose test. Those rules could be, for example, that you have to be able to verify: what the experiment was, what the outcome was, that it was preplanned, that there was increased monitoring, that there were decreased costs, that there were shorter production runs et cetera. If you had a set of criteria that defined when it could be production based R&D, rather than just the dominant purpose test—

Senator BUSHBY—You could make it more targeted and ensure that you were addressing the problem and not creating additional problems for people doing the right thing.

Mr Gale—There is a lot of institutional experience, as we have discussed, with the exclusions list, which has been in place since 1985. You might add detail there. People like the certainty around that. When you get into issues of purpose, basically you can say, 'Here's our board minutes saying this is our purpose,' but you run the risk of an administrative body going: 'We disagree. That was not purpose, and it does not seem like a healthy basis on which to establish a planning incentive.'

Senator BUSHBY—Thank you very much.

Senator CAMERON—How many specialist R&D tax concession firms operate in Australia?

Mr Gale—The overall answer is that there are probably less than 50. In terms of the framework of the advisory community, there are the large four chartered firms, who would be well known to you and a couple of

whom are appearing here. There are the second tier accounting firms, and by that I mean the next 15 firms, some of whom have people with specific R&D expertise. Below that, the broader accounting community will have very patchy R&D expertise. There are firms who include the R&D tax concession as part of their expertise who are not accounting firms, and they probably amount to about 30 to 35 nationally. Up until 1996, when the program was reduced from 150 to 125 per cent, that number was growing rapidly but it shrank after that.

Senator CAMERON—But it would be fair for me to assume that there is an industry in relation to R&D tax advice in Australia.

Mr Gale—There is definitely a business.

Senator CAMERON—An industry, not a business. There are 50 firms.

Mr Gale—If that is your definition of an industry, I would assume there would be 50 firms that would say they had expertise in this area, yes.

Senator CAMERON—If there was no R&D tax concession, you would not exist, would you?

Mr Gale—No, that is not correct. We are a firm that specialises in the area of government and technology, so that is what we understand. We understand how various government programs exist to support technology and research and development and have done since 1967 federally.

Senator CAMERON—How much of your business is related to R&D tax concessions?

Mr Gale—The majority of our business currently, because that is the biggest program.

Senator CAMERON—So, without that, the majority of your firm would not exist. You would exist in a small way but not in the way you do now.

Mr Gale—My institutional experience of the area is that there is always a mixture of concessions, grants and other programs. If the mix changed, that would be the mix of our business changing, but we would still be the same business. Our business does not depend on the existence of the tax concession.

Senator CAMERON—I am looking at your website, and you basically promote the R&D tax concession as your main game.

Mr Gale—It is the platform program for R&D support in the country.

Senator CAMERON—It is the main part of your business, so if it was not there you would not be in business.

Mr Gale—When I joined the business, the tax concession formed less than 10 per cent of our business.

Senator CAMERON—I am not interested in when you joined the firm; I am interested in where you are now. You were here when I was asking questions of Yasser El-Ansary, a tax counsel for the Institute of Chartered Accountants.

Mr Gale—Yes, I was. I have worked with Yasser in this area.

Senator CAMERON—He says that it is much easier to understand the new approach. You have argued that one of the problems is that 25 years of institutional understanding in small to medium enterprises will disappear. I cannot equate that to what you say on your site, where you basically say to people: 'It's very complex. You won't be able to gain all you can from this unless you talk to us, the experts.' That is basically what you are saying on your website. So how do you on one hand say that small to medium enterprises will be bamboozled and that these 25 years of institutional understanding will disappear, when on your website you give examples of both big business and small businesses not being able to understand it and not being able to maximise their returns from the R&D concessions? Tell me where I am getting it wrong there.

Mr Gale—Yasser was comparing the definition for research and development in the second exposure draft with the first one. The definition of R&D in the first exposure draft was a move away from the current definition, so his personal opinion, which he was expressing there, was that version two was clearer than version one.

Senator CAMERON—It is not what he says—

Mr Gale—He mentioned in December 2009—

Senator CAMERON—You think that is the position, do you?

Mr Gale—Yes, I thought you mentioned he said compared to the December 2009 definition, which was the first exposure draft.

Senator CAMERON—No, I just said it was clearer.

Mr Ross-Gowan—He mentioned the exposure draft in December.

Senator CAMERON—You are assuming that he is comparing one draft with the other.

Mr Gale—Exactly, and we would say that both drafts are a significant move away from the current definition concerned. To answer the second part of your question, the reality is that this program ends up being a pretty usual and sensible outsource for companies because of the mixture of technical and tax issues that are involved. The fundamental question that we help companies with is: is it eligible research and development? We do not tell them what they are doing is eligible, we worked with them to identify what is eligible—

Senator CAMERON—No, that is not it. I do not have a lot of time, so I just want you to try and focus on the questions I am asking. I am asking you why on the one hand you are giving evidence to this committee that 25 years of institutional understanding from small to medium enterprises will disappear, and yet on your website it is quite clear that neither big business nor small business have the institutional understanding that you claim will disappear?

Mr Gale—It is difficult for any business to have the comprehensive institutional understanding that we have. We want to preserve the institutional understanding that they do have on key issues such as what an eligible R&D activity is and their understanding of concepts like innovation, risk and the like. We want R&D to be supported, and we want to work with them so that they improve their understanding. It is an outsource that they choose to make.

Senator CAMERON—It is an outsource that they choose to make. Okay.

Mr Gale—It is difficult to find someone within an organisation who covers all the areas which you need to make an R&D tax claim.

Senator CAMERON—Also about your website—the language is not as measured as your language to this committee. The language there is designed to create concern amongst your clients. You talk about new uncertainties, that this is scary, that you need to deal with the harsh reality, that there are these mischiefs that the government is perpetrating on business—is it Lokai or Loki, the god of mischief?—and you quote Loki, the god of mischief. You have really got a big vested interest here, haven't you? If this changes and it becomes easier for companies they may not need to spend hundreds of thousands of dollars for your advice.

Mr Gale—I am glad you saw my Loki opinion piece. It gets people's attention when you use appropriate language to get their attention—

Senator CAMERON—It is not whether it got my attention or not—just go to the answer. I do not want these rhetorical skills, I want the answer to the question.

Mr Gale—If I can comment on the vested interest; we consult in this area and I believe that we have as part of our public record and performance that we do say when we think inappropriate aspects of the program should be closed or changed. We have consulted every day in their 175 per cent incremental premium. We generate fees help for companies every day, and we have advocated for its closure since before it began. Back in the mid-90s you could claim, retrospectively, R&D from 1995 back to 1985, and we submitted to government that it close that—

Senator CAMERON—You have obviously watched *Frost/Nixon*, because that is what I am getting here. You just go off on your own little tangent and I am trying to keep you to the point: why are you using language here—more moderate language—than the language in which you talk to your clients about this? Why are you doing that?

Mr Gale—That language is to everybody—that is written to the general public. It is designed to draw attention to and discuss real issues. This is an opportunity, having been one of the people whose attention you are interested in, to discuss those issues. I could vamp up the language if needs be, but I do not want to distract from the issues in this forum.

Senator CAMERON—Ramp it up as much as you like, I just—

Mr Gale—I saw *Frost/Nixon*, so—

Senator CAMERON—I would just like some consistency: either it is a moderate approach to this and you are sensibly thinking it through or you are running a scare campaign, as you are on your website. You have got

a vested interest, haven't you? If this goes then a lot of your business goes. If it is easier for companies to do their own thing then you have got a problem.

Senator BUSHBY—It is not going to go, it is just going to change.

Mr Gale—It will change.

Senator BUSHBY—What will you do if it draws more business in?

Senator CAMERON—I am not asking you the question.

CHAIR—We are running short of time so I do not want any more discussion across the table. Do you have one more question, Senator Cameron?

Senator CAMERON—You indicated that you had 70 small and medium enterprises and two large groups.

Mr Gale—That is right.

Senator CAMERON—How many companies are in the large groups?

Mr Gale—It is about 120 registrations. An individual group might in one instance have 30 registrants under the program.

Senator CAMERON—Nobody can tell me this. I asked the question earlier. How much grant money do you assist the small and medium enterprises with? I am sure if you go to your client you can say, 'For small and medium enterprises we have achieved this amount of money and for big companies we have achieved that amount of money.' What is that figure?

Mr Gale—The revenue figure on impact is, we would say, about 35 per cent of the associated revenue with the SME clients and 65 per cent with the top-20 groups.

Senator CAMERON—That is not what I am asking you. I am asking you how much in dollar terms have you achieved in government grants to small- and medium-enterprise companies and large companies?

Mr Gale—In the last three years we have probably achieved about $10 million per annum in revenue for small-to-medium clients and around $40 million for the large clients.

Senator CAMERON—So it is about one to four.

Mr Gale—Yes.

Senator CAMERON—You say your business has been going since—

Mr Gale—1983.

Senator CAMERON—So you cannot give us any figures over that period of time under the existing legislation?

Mr Gale—No, but we did a study of the last three years as part of our submission. We put those figures about what the split is and what the contributions are into our submission.

Senator CAMERON—So it is mainly the big companies that are getting the bulk of the government dollar from your activities as a consultant.

Mr Gale—Under the current rules the split is about one to three in terms of the financial impact. We work for 70 small and 20 large companies.

Senator CAMERON—Thank you.

Senator BUSHBY—To give a broad overview, you are broadly supportive of a lot of the provisions that have been proposed—changes to the rates, scales and those sorts of things. It really comes back to the definitions under the new proposals that provide you with the concern that you have for the scheme.

Mr Gale—Yes. The definition of the food stock provisions and administrative powers are the ones that stand out.

Senator BUSHBY—We earlier heard evidence about the impact on the manufacturing sector, and a lot of your evidence has been directed toward that, particularly with regard to whether or not trial production runs as part of the R&D process are allowed. Do you agree with other evidence that has been provided this morning and which says that these proposed definitional changes potentially have a disproportionate negative impact on the manufacturing sector?

Mr Gale—I look at it in the product process dimension and in whether it is new or improved. I think this legislation is still generally supportive of new product development, for example. But, when you are in the

business of processes, be they environmental processes, manufacturing processes and the like, that is where the concerns are. There are also concerns when we look at improvements. The core definition is explained in the explanatory materials as saying, 'First of all you must be doing an experiment.' For years we have been talking to small companies, asking: 'Do you do systematic work? What investigations do you do? Is there an experimental element?' Under this new provision we now have to go in very hard and ask a fabricator, toolmaker or someone developing industrial pumps, 'What experiments are you doing?' I am not sure that the experimental activities will ultimately be legally interpreted as needing an experiment, but that is what the explanatory materials are saying. That is a very harsh new concept, because we have spent 25 years explaining that the tax concession does not just support white coats and foaming test tubes, which is the popular view of R&D—there are always areas in our area about a lab rat running across a bench with someone in a mask—

Senator BUSHBY—That is research versus development.

Mr Gale—Exactly, and this core definition looks a lot like legislating core research and querying whether it is doing core research and development.

Senator COLBECK—So in a manufacturing context you really need to be looking at what you do and how you do it on a continuing basis to maintain competitiveness and a place in a market, it is that element that is at risk as part of the revised definitions.

Mr Gale—Yes, because they are saying that it is new knowledge. They have taken away 10 objectives. There are currently 10 other objectives: the creation of new and improved products, processes, devices, materials and services. They have been subsumed into the one objective, new knowledge, which includes knowledge about those things. Our concern is that in a government assessment at the moment if someone walks into an SME from AusIndustry or the like and says, 'We were on Google last night, and somebody else has already done this,' this seems to be another step towards that. You will need to establish that, contrary to how a sophisticated economy operates, where competitive firms work on the same technical issues at the same time, you are somehow going to have to prove that this was not known at all—

Senator COLBECK—Or was not known to you.

Mr Gale—on a reasonable basis, and that is a much stricter test.

Senator COLBECK—We heard earlier about the term 'dominant' as part of the test and about potential utilisation of a different terminology for that given that that is a term used in the tax act. Do you see that there is a reasonable way to modify that definition to provide an outcome which achieves the stated objectives of the government—which was part of your initial evidence—but also deals with the issues that you are raising.

Mr Gale—I know Ian will make a comment in closing. I believe the existing definition and the concept of a purpose directly related and, if needs be, with some claim limits, absolutely achieves that. I think the administration has never understood the power of that definition. It absolutely keeps claims within a sensible operating level. But, yes, we need to look at alternatives. I know Ian has a view about what you might do with the wording for 'the dominant purpose'.

Mr Ross-Gowan—If you changed 'the dominant' to 'a dominant' and you put in those criteria I mentioned about controlling when production is able to be included, that would achieve the ability to cap any of these rorts. It would also give more certainty to business about what is or is not an eligible activity.

Senator CAMERON—Mr Gale, on notice, could you advise the inquiry whether you have advised any clients that they can increase their R&D concession by applying for R&D for production work against the original core R&D application? What factor increase was there for that production work?

Mr Gale—No, we have only ever advised clients as to what we believe qualifies as eligible R&D activities. The current definition is of R&D activities and includes two pathways: the systematic, investigative, experimental pathway, or core; and the directly related, or supporting. We help companies qualify as eligible for those activities.

CHAIR—Thank you for coming in for the hearing.

[1.38 pm]

MURRAY, Ms Tracey, Partner, Research and Development, BDO Australia

Evidence was taken via teleconference

CHAIR—Welcome. Thank you for coming in this afternoon and giving evidence. Do you have an opening statement you would like to make?

Ms Murray—Yes, I do. I would like to thank the committee very much for the opportunity to have evidence heard. I have in excess of eight years experience in advising clients on all aspects of research and development programs. That includes advising them on their ability to access the current R&D tax concession. I am a partner at BDO and I am based in our Brisbane office, where I lead the R&D practice. For my sins I have also been an auditor within the ATO for 10 years and I have also worked as a tax manager in an FT 100 company in the UK. I make mention of that because I believe that my breadth of experience in regulatory, commercial and chartered accounting environments provides me with a unique and practical insight into the impact on business of the proposed R&D tax credit program. BDO is a leading firm of chartered accountants in Australia. We have eight offices around Australian territories. We are seen as leading practitioners within the R&D and knowledge management areas, and we are uniquely positioned. We have a very broad range of clients, starting from early start-up companies through to the biggest publicly listed companies in Australia.

BDO has provided a number of submissions to Treasury during the course of this consultative process. Each submission did provide acknowledgement of the fact that the current tax concession program did require freshening up. Each submission then went on to detail our areas of concern with respect to the draft provisions that were provided. One particular concern that BDO has had throughout this process is the fact that each of the draft documents and concepts that we have been provided with to discuss and make comment on do not appear to enable Treasury to achieve its stated objective for this incentive, which was one of the main reasons that change was initiated. The proposed legislation as drafted is no different in this regard. Indeed, in its current format, BDO is of the opinion that the draft legislation will fail to deliver Treasury's key objective of encouraging businesses to conduct additional R&D activities and indeed to push the benefit down to a broader range of SME companies. In fact, we believe that the operation of a number of provisions in tandem, primarily the feedstock provisions and the dominant purpose test, will only reward those types of companies that are in a start-up mode or failed R&D activities. I would like to prevail upon the committee and go a little bit further as to the three main areas that we have concern with. We have done quite extensive modelling on our clients. We have had very indulgent clients in this area and I would like to highlight the three main areas that we do have significant concern with.

At the heart of the legislative changes is the fact that the legislation as presented simply cannot deliver the stated objectives. BDO does acknowledge that there does need to be a freshening up of the legislation. There is no doubt that the majority of R&D concession is held in the hands of very few claimants. We are not adverse to or questioning the need to freshen it up, and I would like that on the record. But what we are concerned about is that the provisions as drafted, in trying to close down what the government has perceived to be rorting, have an effect on every industry and every company. The very changes that were introduced to, for example, reduce the level of claim able to be made in the mining and infrastructure industry have equal application to the very SMEs that the legislation is trying to promote benefit to.

The three areas that we have concern with as the legislation stands are, firstly, that BDO does not believe that the current legislation will have any impact on driving additional R&D activities beyond those currently undertaken by companies. Secondly, we believe that the program is likely to provide revenue savings for the government and not be revenue neutral. That is due to the operation of the dominant purpose and the feedstock provisions. Finally, the complexity of the legislation and the impact of the ability of the target SME markets to make an eligible well-documented and defendable claim is of such complexity that you would have to call into question whether companies would even bother making a claim, particularly given that the ATO and Innovation Australia have more wide-ranging investigative powers.

I have quite a lot of detail behind those three concerns. I am happy to go through the modelling that we have done of different industries and the effect that it has had. Obviously, I have a lot of information that has been provided by our clients. I am happy to take any questions.

CHAIR—Thank you. You say that you have done modelling on your clients. How many clients do you have in this area?

Ms Murray—In this area we have about 120 clients. We do not have 100s and 100s of clients but for the clients that we do have we do a broad range of work, not just the R&D tax concession work. We help them manage their programs, we help them put KPIs around them.

CHAIR—How many of them are SMEs and how many of them are large companies?

Ms Murray—About 60 per cent are SMEs per the definition of the under $20 million.

CHAIR—Going to the issue of complexity, you say that ATO and other administrative areas will have more power but they will also have more power to give greater certainty through issuing—talking about AusIndustry—more extensive advice and guidance in this area.

Ms Murray—As a practitioner I would challenge that statement. I would like to take you through a claim process that an SME would have to do.

CHAIR—Under the current legislation or the new legislation?

Ms Murray—The proposed legislation. If I am an SME and I am going to try to claim under the tax credit program, I would have to make judgment calls on not one subjective issue but multiple subjective issues. So I might have 15 to 20 personnel and I outsource some of my work because I do not have enough work to keep an accountant in business for the entire week so I subcontract some of that work. In terms of making an R&D claim, I have to decide whether I am undertaking core or supporting activities. That is subjective. I have to decide whether I have produced a good or a service as a result of that. That is subjective. If I have produced a good or a service, when I produced it was my dominant purpose for producing that to support my core R&D activities? I do not know; that is subjective. If I have produced a good or a service I then have to apply the feedstock provisions, and the feedstock provisions ask me to determine what the marketable value of that product is. It could be a different value in the hands of different people. That is a subjective concept. I then have to determine what goods or materials or energy has been used in the manufacture of that, and whether there has been processing or transformation involved in that. In terms of subjectivity, I would ask the committee to ask the ATO how much money and how many resources have been dedicated to try to interpret what the terms 'processing' and 'transformation' mean in terms of the current legislation. I have had an enormous amount of contact with the tax office trying to determine what those words mean.

CHAIR—I was talking about AusIndustry, which will have more powers of guidance and advice. Surely that proves my point.

Ms Murray—No. AusIndustry in my experience are very noncommittal. They generally do not have a practical background. As your previous person said, they often do their research on Google. I am perhaps reticent to say that, but in many instances AusIndustry have very minimal practical commercial experience and they have limited experience in making a decision on such subjective terms.

CHAIR—They will not be able to provide the company with advice about what it costs them or what their organisation is doing, but they will be able to provide advice, surely, as to whether that is in line with the guidelines of this legislation.

Ms Murray—That is true, but that gets to one of the core concerns that we have. In many instances this is a two-step process. You first have to identify whether you have an eligible activity on your hands and then you have to determine whether you have got some eligible costs to claim. In our experience we have had instances where AusIndustry or Innovation Australia have been very helpful in determining that an activity is an eligible activity. That is simply of no value when the tax office comes back and says, 'Yes, it is an eligible activity but there are no costs associated with it that you are able to claim because of the application of the feedstock provisions and therefore you cannot make a claim.' AusIndustry is one cog in the network that helps people understand the R&D tax concession as it is and, I am assuming, the R&D tax credit. But individually each regulatory body is responsible for a very specific part of the legislation and neither one is able to work with the other to give the company a single answer.

CHAIR—AusIndustry will also be able to undertake audits and work on that educational program. You do not see any advantage in that?

Ms Murray—Again, I think that education is fantastic—it raises awareness of what is eligible and what is not and helps people get a bit of rigour and structure around their R&D programs—but AusIndustry can only advise a customer or a client whether they believe their activities are eligible. 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.

CHAIR—That is not my understanding of how the legislation as proposed would work. My understanding is that AusIndustry will be able to provide public rulings and private binding rulings on request, but that is something we can explore.

Ms Murray—They are able to do that now. I myself have experience in requesting rulings from AusIndustry.

CHAIR—And you had them overturned then by the ATO?

Ms Murray—I have never, ever gone for a request for an entire program that has had a requirement to assess the eligibility of the activity from an AusIndustry perspective and one from the ATO. Generally the area of doubt in the current program is eligibility from an ATO perspective, so we have had multiple private ruling requests with the ATO, and we have had a number of requests with AusIndustry, but we have never had to have a request for the same project to both regulatory bodies. If we had to have a request with both regulatory bodies, we would have a very watery—obviously a technical term there—R&D claim on our hands and we would suggest that the client perhaps not make a claim.

CHAIR—So you asked for a private ruling from AusIndustry and the ATO—

Ms Murray—No. We have never done that. We have done them separately for different clients for different issues, but we have never had to put a request into both the ATO and AusIndustry for the same project or the same sequence of activities for the same client. Most of our ruling requests would go to the ATO, because that is the area of significant subjectivity. If you are not eligible with the ATO, you get no money back, so that is an area of concern most clients have.

Senator BUSHBY—Just on that, we were informed at the briefing that we had on this by Treasury, AusIndustry and the ATO, just as a matter of interest, that rulings that are made by AusIndustry would be binding on the ATO.

Ms Murray—That is right, but it is on the eligibility of the activities. That is currently the case. If you make a ruling to the ATO on an expenditure issue and the ATO thinks there is something not right in their view—there may be an issue with the eligibility of the activities—they will then refer the case to AusIndustry to make a determination. So there is a sharing of information between the two parties—more AusIndustry to the ATO. But, if the ATO is concerned as to the eligibility of the activities, it will go to AusIndustry. Very few go from AusIndustry to the ATO.

Senator BUSHBY—A bit like the difference between a finding on fact and a finding on law.

Ms Murray—Pretty well, yes. That is a good analogy.

Senator BUSHBY—You have raised a number of concerns about this proposed legislation. Is there anything about the broad direction of it or anything in particular about it that you like?

Ms Murray—I recognise the need for change. I believe that as tax practitioners you deal with the legislation that is put in front of you. There is no doubt that R&D claims under the current provisions are being made that are perhaps not within the intended ambit of what the original provisions were meant to be. With that said, in tax you take a position on everything, and that is what I believe has been happening: positions have been taken.

I think the main issues that affect the mining and the infrastructure industries are primarily issues associated with the feedstock provision. That has been my experience in going to tax consultative committee meetings, and they have been the main area of concern within the consulting community. I think the tax office has had more than sufficient opportunity to take a position on this. I am not saying they should take a hard or a soft position, but any position would have had a material impact on the escalation of R&D claims in these areas and industries. The failure of the tax office to take a position or to release a ruling has aggravated this situation. Where a position has been taken by the tax office it is often under settlement and therefore that information is not available to the broader tax consulting community.

So, whilst I understand that some of the claims have not been made within the ambit or the intention of the provisions, I do believe that the tax office has to some extent contributed to the uncertainty in this area. That is probably one of my concerns: if there were subjective terms in the old legislation, those subjective terms have not been removed in the current legislation and in fact have been augmented by multiple subjective terms

which are very, very difficult for SMEs—and in fact sometimes tax practitioners—to get their head around what they mean.

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. My concern is that the plethora of subjective terms within the legislation are going to (1) dissuade SMEs from making a claim and (2) actually act to reduce the vast majority of R&D claimants.

Senator BUSHBY—You have answered a lot more of my questions in that answer.

Ms Murray—Sorry!

Senator BUSHBY—That is fine—it is very informative. On that last bit you mentioned, you think it will actually act as a disincentive, particularly to small businesses making R&D claims?

Ms Murray—I do have some statistics on that, if you would indulge me.

Senator BUSHBY—Certainly.

Ms Murray—We did some modelling based on two types of clients. We have the very large SME base and then we have a number of much larger clients. We were a little bit worried about where all the modelling coming from Treasury was, so we talked to clients about what drove R&D: if they made a claim under the R&D tax credit, would they be incentivised to conduct additional R&D activities? That is that concept of additionality.

What we did is get 10 of our SME companies that are currently claiming under the R&D tax concession and we looked at their cash burn rate, where their current R&D was in terms of their business cycle, how much funding would be returned to the business if we assumed that all the R&D activities they were currently doing would be eligible under the tax credit program—which was a big assumption—and whether they would consider using that 45 per cent rebatable tax credit to conduct additional R&D activities. Uniformly they said no, in the original survey and the modelling. So we went back to them and said, 'What would you do with this money if you were eligible and you received it?' They said they would use it to accelerate their current R&D program, they would use it seek new investors in their R&D or they would try to export the R&D activities. But on the whole none of them said that they would do additional R&D activities.

In addition we said to the same clients: given this list of subjective terms, given that AusIndustry and the ATO now have extended powers to review and given that, as with the tax offset situation currently, if you make a cash out claim you generally get a visit by the ATO—given all those subjective issues, the uncertainty and the fact that you are probably going to be audited or reviewed anyway and you have limited resources so you would probably engage someone like me to assist you through that process, is it worth making a claim? They all said no. So my concern is that it is so complex and so subjective, with no certainty of outcome and with the value of the benefit is so limited, it will not incentivise people to conduct additional R&D activities. I think you are not going to attract a lot of companies to the program; you are actually going to dissuade a lot of companies from making a claim. That does not mean they are not going to conducting R&D activities. They are simply not going to make a claim because it is not worth it. And that is not revenue neutral, to be fair—you are going to be making a bit of money on this.

Senator BUSHBY—Exactly, and Treasury acknowledged at the briefing that there would be savings. Their estimate was that that would be roughly offset by the additional costs from the measures that they are introducing.

Ms Murray—The audit or regulatory measures they are introducing? Is there an additional cost of review and administering this program?

Senator BUSHBY—We did not go into that detail but we will have that opportunity later today.

Ms Murray—That is to my way of thinking when there were claims of revenue neutrality. There is no doubt there are going to be savings from the big end of town that is making very large claims, but those same

provisions are going to be applied to the small end of town, with reduced resources, and they are a one-project one-product company. They are not going to be dissuaded from that course of action. If they think they can get some money but they might have to spend it all on an audit or a review, just having the time and the money and resources of small companies being tied up with such an administrative practices wears them down. It is just not worth it.

Senator COLBECK—You are almost saying that the dominant purpose test is effectively designed to knock out activity rather than to qualify activity.

Ms Murray—Absolutely. I think if you were to talk to the legislators that introduced that, you would find there is a very clear set of circumstances that that would apply to where they have tried to reduce companies' access to the current R&D tax concession by introducing that dominant purpose test.

Senator COLBECK—When you did the modelling with your clients, did you get any assessment of what change there might be in the uptake or the claims levels of your clients under the scheme?

Ms Murray—I did. We did modelling for three industries but I only have to hand two at the moment. We did modelling in the mining industry and the manufacturing industry. In the mining industry, 90 per cent of our current claimants would have their R&D claim reduced under the R&D tax credit program by at least 80 per cent, with 10 per cent of claimants not being able to access the incentive at all. I can hear Treasury saying, 'Yahoo! The intention of the provisions was to rein in the mining industry.' Whilst that might have been the intention of Treasury, the mechanisms used to reduce the claims by the mining and infrastructure industries are equally applicable to other industries with equally significant and adverse effects.

For example, when we modelled the manufacturing industry, the very industry that Australia is striving to increase productivity in, our modelling indicated a significant number of clients would have their access to the R&D program reduced by at least 65 per cent in terms of value, with a number of well-known, world-leading companies unable to access the provisions at all because of the operation of the dominant purpose and the feedstock provisions. I would implore anyone to read the explanatory memorandum examples on dominant purpose and try to think of a scenario where R&D activities are conducted in a production environment. Having been associated with R&D projects for many years, I can say that scaling up to a production environment is the most common failure point for an R&D project. It works very well in a lab. It works very well in a trial size or a small scale and it fails abjectly in a production environment. What you are asking your companies to do is not claim or not conduct the very testing that they need to do to identify whether their R&D has been successful or not and therefore is able to be commercialised.

Going back to the explanatory memorandum, when you look at the dominant purpose test, it shows what the R&D tax credit could motivate companies to do. If you think there is rorting now, let me give you a scenario. 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.

The explanatory memorandum examples say that because my dominant purpose for spending that $4,000 was because of a commercial objective—I was going to use that in the conduct of a commercial activity rather than just in the trial—it is knocked out. Even though I used the conveyor for the dominant purpose of conducting a trial, I did have my thinking cap on and I was trying to make optimum business decisions. I thought I would spend a little bit more money to get one that could get me through the next year or two, but I cannot make a claim now because of that sensible business decision as my dominant purpose, according to the explanatory memorandum, was not for the conduct of R&D activities. It was for a commercial imperative.

If that is the intention of the legislation, I cannot possibly believe it to be correct. Taking the very hard-line stance that is in the explanatory memorandum, we modelled all of our clients except for four that we could not get the data for and we believe that all of our clients would fail to meet the dominant purpose test for at least one activity. That means it gets knocked out. Seventy-five per cent of the them were likely to fail at least 50 per cent of their activities under the dominant purpose test. That is an enormous adverse consequence of the application of the dominant purpose and feedstock provisions.

Senator COLBECK—Did you do a broader perspective on what you thought the overall saving to the government might be as a result of these changes, just across your client base?

Ms Murray—No, we did not. We have had very limited time. I have had my lovely team modelling away with Excel but we have not done that wider impact, I apologise. We did deal with the issues that we thought relevant and in order of urgency.

Senator CAMERON—Did I hear you say your modelling was done in Excel?

Ms Murray—I was just joking.

Senator CAMERON—You probably should not joke about these things!

Ms Murray—I do apologise for that flippancy.

Senator CAMERON—You do accept that modelling can be a bit abstract, it can be about idealisation and simplification.

Ms Murray—I 100 per cent agree with you. The reason that we started doing modelling is that after second draft was released we were inundated with clients who were trying to do their 2010-11 business plans and budgets et cetera. So we were asked to do a little bit of scenario analysis and modelling for them in the first instance. It did require me to make judgment calls. They are the same judgment calls that Innovation Australia and the ATO will have to make. I think I have a bit of experience. Compared to some of the Innovation Australia people I think my judgment calls are as good as the ones that are going to be made, but I do take your point that there is obviously a continuum of answers that modelling generates. I properly would err on the side of caution given my ATO background.

Senator CAMERON—Given you have made so much of this modelling in your submission can you provide the committee with the methodology for your modelling?

Ms Murray—I can give you the methodology for the modelling. As I said though there are a number of subjective calls and I said that as one of the three reasons that we are very concerned with this. If I had a client who said to me, 'Can you guarantee me—

Senator CAMERON—Ms Murray, I simply asked you could you provide the methodology because I am not sure how sophisticated that methodology is—

Ms Murray—I am not claiming it to be sophisticated. We have used cash-flow forecasting and a holistic business approach and we have looked at the historic projects rather than future ones so that is going to mean that you cannot roll those results into the 2010 year. I am happy to provide that though.

Senator CAMERON—If you could provide the methodology, including whether you had expert advice in terms of establishing the methodology. I would like to have a look at that because you have been very strong in terms of the outcomes of this, I am not sure whether it is modelling or surveying that you have done.

Ms Murray—Certainly there is an element of surveying. We first did scenario analysis and modelling. When we had answers that simply did not seem to be giving effect to the intention of the legislation we went back and talked to clients about it. It is a quantitative and qualitative exercise. It is not something that is numerically driven in its sole practice.

Senator CAMERON—I would like to see it. These 120 clients that you have—

Ms Murray—We do have 120 clients.

Senator CAMERON—I want to put the same question that I have put to previous submitters to the inquiry. How many of these clients would be small business and how many large?

Ms Murray—That was something that I answered in a previous question. A significant number of our clients, at least 60 per cent, are under the 20 million threshold.

Senator CAMERON—In terms of your capacity to deliver for these clients what is the dollar figure that you have been able to achieve for your small business clients?

Ms Murray—I do apologise, I do not have that information in front of me.

Senator CAMERON—Can you take that on notice?

Ms Murray—Yes. Do you want the level of claim of the small clients?

Senator CAMERON—Not the claim but the actual grants that have been achieved by your company for your small business clients.

Ms Murray—The R&D tax concession or grants as well? We do export market development grants, commercialisation grants and all sorts of things.

Senator CAMERON—The R&D tax concession, thanks. Can you tell me what the dollar figure is of what you have achieved over the last three years, the same as what I asked the previous witness?

Ms Murray—The dollar value of the value in the hands of my clients that we have been able to generate by accessing the R&D tax concession—

Senator CAMERON—I am not sure what you mean by that. What is the tax payout?

Ms Murray—The tax benefit to the client.

Senator CAMERON—No, what is the tax payout given to your client?

Ms Murray—Yes, the tax benefit to the client.

Senator CAMERON—No, that is different from a tax benefit. I am asking: how much R&D tax concession have you had?

Ms Murray—Yes, we can do that.

Senator CAMERON—And then compare that to the bigger companies. You have raised the issue of production processes. Do you think it is reasonable for the taxpayer to subsidise the normal mining activities of a large multinational mining company?

Ms Murray—If claims have been made where it is subsidising the normal mining activities, that is because of the operation of the legislation. To make a claim for R&D, you need to stand at the start of the project and look at the risks rather than the results of the R&D activities. For example, if that mining client was undertaking—

Senator CAMERON—Everybody has watched that movie.

Ms Murray—What movie is that?

Senator CAMERON—*Frost/Nixon*.

Ms Murray—I am not sure what you mean.

Senator CAMERON—Where you drown people asking a question with information.

Ms Murray—Really! I am sorry.

Senator CAMERON—Could you just get to the point?

Ms Murray—As I said, I am open minded to the fact that there have been R&D tax concession claims made that were perhaps not in keeping with the intention of the original legislation. There is no doubt that needs to be changed. I believe that there is a requirement to push the concession out to a broader range of clients.

Senator CAMERON—Have you assisted clients to make the type of claim where they claim for core R&D, and then it has been spun out to production? Do you assist clients to do that?

Ms Murray—Everyone does. The answer is yes. The reason is that, if you are a manufacturer, how do you know if the new process that you have developed works unless it is in a production environment? It is not a production environment for five minutes. It is one for a day or perhaps a week because of the variability of your raw materials or the fact that the whole thing falls apart after a week. That is not normal production but it is a production environment.

Senator CAMERON—You are absolutely drowning me out here. Is it reasonable for a large manufacturing company to be able to claim almost the entire cost of upgrading a processing plant as research and development under the scenario you are talking about?

Ms Murray—The answer is no. I do not think there is a mechanism there to do that, because that would be capital in the hands of that company and they would not be able to make a claim.

Senator CAMERON—Is it reasonable for a property developer to claim almost the entire cost of the construction of a new building as research and development if they put in an innovative air-conditioning plant?

Ms Murray—That is something that probably needs attention.

Senator CAMERON—Needs attention?

Ms Murray—That is probably not in keeping with the spirit of the original legislation.

Senator CAMERON—But are you saying it could happen?

Ms Murray—Under the current legislation, yes, it could.

Senator CAMERON—Thank you.

Ms Murray—I am not telling you something you do not know. In his white paper, Mr Cutler said there were instances where whole-of-mine claims and one-off infrastructure projects were being claimed. That is very widely known within the R&D tax concession community. It has been one of the main areas of audit activity for the tax office.

Senator CAMERON—And your company assists—

Ms Murray—We have not made a whole-of-infrastructure claim, no.

Senator CAMERON—You have in the mining area, have you?

Ms Murray—We have not claimed an entire mining operation, no.

CHAIR—Thank you, Ms Murray, for appearing by teleconference with us this afternoon. Thank you for your assistance.

Ms Murray—Thank you very much for the opportunity.

Proceedings suspended from 2.19 pm to 3.02 pm

ANTIOCH, Mr Gerard Januarius, Manager, Business Tax Division, Department of the Treasury

BRADSHAW, Mr Michael

DOUGLAS, Mr Ian

EDWARDS, Dr Russell, General Manager, Department of Industry, Innovation, Science and Research

MALONEY, Mr Matthew, Senior Adviser, Department of the Treasury

McCULLOUGH, Mr Paul, General Manager, Business Tax Division, Department of the Treasury

PETTIFER, Mr Ken, Head of Division, Department of Industry, Innovation, Science and Research

WEBER, Mr Tony, General Manager, Innovation Analysis, Department of Industry, Innovation, Science and Research

CHAIR—Welcome. Mr McCullough and Mr Pettifer; do you have opening statements?

Mr McCullough—The departments have a joint opening statement, if that is acceptable.

CHAIR—Yes. Please go ahead.

Mr McCullough—In these opening remarks, we wish to give the committee a brief overview of the bill. The bill refocuses the tax incentive for R&D. Its overarching aims are to increase support for all R&D companies, to encourage more small and medium sized companies to do R&D and to secure productivity growth, economic activity and skilled jobs. The reforms are consistent with the recommendations of the 2008 review of the national innovation system and the government's policy response, *Powering ideas*, its 10-year innovation agenda.

Since the announcement of the R&D tax incentive in the 2009-10 budget, the government has conducted three rounds of public consultation, considered 383 written submissions and met with 550 stakeholders at public forums. The tax incentive is expected to induce more R&D for a number of reasons. It tilts support to small and medium businesses, it makes cash refunds available to more firms, it is simpler and more predictable than the current concession and it increases certainty by decoupling support from the corporate tax rate.

Contrary to some public commentary, the bill recognises that R&D is often done alongside business-as-usual production activities. It does not skew the tax incentive towards pure research or, as some commentary has suggested, reward only R&D that fails. The first policy change effected by the bill is that the rates of support are being significantly increased. The current law works by offering a deduction against taxable income of companies of 125 per cent of annual R&D expenditure or 175 per cent of incremental R&D expenditure.

There is also a refundable tax offset for R&D undertaken by smaller companies with an annual turnover of less than $5 million and R&D expenditure not greater than $2 million. The current law also requires that any intellectual property arising from publicly supported R&D be held in Australia, except in relation to multinational entities that are entitled to the 175 per cent deduction.

This bill increases those rates. A refundable tax offset at the rate of 45 per cent will be available for companies with a turnover of less than $20 million, without any restriction on the size of R&D expenditure. This is a doubling of the existing benefit and is equivalent to providing a tax deduction of 150 per cent of R&D expenditure at the current company rate of 30 per cent.

A non-refundable tax offset of 40 per cent will be available for other companies. This is equivalent to a deduction of 133 per cent of R&D expenditure at the current company tax rate, increasing current levels of support by one-third for that group. For business with a turnover of less than $20 million, the benefit will be of practical value, even if the company is in tax loss. This is very important for cash-starved small businesses or businesses in a start-up situation.

There will no longer be a requirement for the resulting intellectual property to be held in Australia. Access to the R&D tax offset has been expanded to include foreign owned companies operating in Australia that hold their intellectual property offshore. The amount firms can claim under the R&D tax offset for eligible R&D conducted overseas, if this R&D cannot be conducted in Australia, has been increased from 10 per cent to 50 per cent of the value of the R&D project undertaken in Australia.

A second change brought about by the bill is the definition of 'core R&D'. The definition in this bill focuses more clearly on underlying experimental activities and does so in plainer language. Under the current law, core R&D activities are experimental activities that are systematic and investigative, involve appreciable novelty or high levels of technical risk or are conducted for the purpose of acquiring new knowledge or information or for creating new or improved materials, products, devices, processes or services. Activities involve high levels of technical risk under the current law if the probability of obtaining a given technical or scientific outcome from the activities cannot be known or determined in advance on the basis of current knowledge, information or experience; the uncertainty of obtaining that outcome can only be removed by applying scientific method in a systematic progression of work from hypothesis to experiment, observation and evaluation followed by logical conclusions; and that work is based on principles of physical, biological, chemical, medical, engineering or computer sciences.

This definition is problematic. There are multiple overlapping tests and qualifications applied to the basic concept, and the plain meaning of words used is not always borne out or supported by the statutory definition. As but one example, the statutory definition of 'high levels of technical risk' refers simply to unknown probabilities whether high or low. Something with a known high probability of failure would fail the test on the literal words of the definition, whereas something with very little actual risk that had a technically unknown probability of success would pass.

This bill streamlines the definition of 'core R&D' to remove these and other contradictions and improve certainty. Under the bill, core R&D activities are experimental activities 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 is based on the principles of established science and proceeds from hypothesis to experiment, observation and evaluation, and leads to logical conclusions, and that are conducted for the purpose of generating new knowledge, including about the creation of new or improved materials, products, devices, processes or services.

Some stakeholders have claimed that this reworked definition would skew public financial support towards theoretical research and away from the development of new products and services. This is not the case. Although the rewording highlights the purpose of new knowledge, it is clear that the knowledge can be in the practical form of developing new or improved products, processes or services. It has also been put that, if an Australian company could not access knowledge about a product owned by another company and it sought to bridge that knowledge gap through its own R&D, it may be denied the tax incentive since it might be argued that its own R&D is not generating new knowledge. Consequently, the argument goes that the Australian company would not be able to claim R&D support for that new product. Such an interpretation is not warranted. It ignores the fact that knowledge that is not accessible cannot logically form the benchmark from which the generation of new knowledge can be measured. Almost certainly, if the new knowledge is not available to the Australian company it will not be generally available. This is clearly stated and explained at paragraph 2.16 of the explanatory memorandum to the bill.

R&D to generate knowledge that is not generally available would clearly be sufficiently new. This is illustrated in example 2.9, labelled 'Grand-heap mining', of the explanatory memorandum in which a firm satisfies the test when it undertakes reasonable inquiries about how ground vibration sensors used for vulcanology might be applied to a mining context. In any case, under the current law, the concept of new knowledge already exists and, moreover, the particular activities may need to involve appreciable novelty, a concept that overlays a further element of degree and subjectivity. The effect of the knowledge test is to avoid subsidising activities that merely amount to reinventing the wheel or that merely address routine uncertainty.

An important policy change in this bill is that supporting R&D is connected more tightly to core R&D. The current law defines supporting R&D as 'other activities that are carried on for a purpose directly related to the carrying on of core R&D activities'. This bill defines supporting R&D activities as activities that are directly related to core R&D activities. However, if the supporting activity is one that is on the exclusions list, produces goods or services or is directly related to producing goods or services, that supporting activity will qualify for the R&D tax incentive only if it is undertaken for the dominant purpose of supporting core R&D activities.

The key task of the dominant purpose test for any supporting and excluded activities is to prevent activities that would be conducted regardless of core activities being leveraged off them so as to qualify for the tax incentive—that is, the R&D tax incentive should not cross-subsidise production activities that the experiment is merely piggybacking on. Another change in this bill is that the number of activities expressly excluded from

core R&D has been reduced by about half. Fourteen activities are currently listed as excluded from core R&D activities. This bill reduces this list to seven of those activities, and adds a software exclusion, thus about halving the number of activities automatically disqualified from core R&D.

The bill also makes a change to the restrictions on the ability of software to qualify as core R&D. Under the current law, the development of computer software by an R&D entity is not core R&D unless the computer software is developed for the purpose of or for purposes that include the purpose of sale, rent, licences, hire or lease to two or more non-associates of the company. The bill instead excludes from being core R&D those activities developing, modifying or customising computer software for the dominant purpose of use by the developer or an affiliate for their internal administration.

An issue raised in some submissions is the wording of the objects clause. The objects clause in the current law provides a general statement of the intent of the law to provide a tax incentive in the form of a deduction to encourage R&D activities in Australia that increase commercial competitiveness. The bill's objects clause describes the essence of R&D, namely to encourage industry to conduct research and development that might otherwise not be conducted because of an uncertain return from the activities in cases where the knowledge gain is likely to benefit the wider Australian economy. This object is stated 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. In this way, the object and the operating provisions are aligned and entirely consistent.

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.

Finally, enhanced administration will promote certainty without adding to compliance cost. The government has allocated $31 million to AusIndustry and $7 million to the ATO to improve administration of the tax incentive, and particularly to help taxpayers understand and comply with the bill. This will reduce compliance costs and increase certainty for taxpayers. In particular, AusIndustry will provide greater industry to taxpayers through more extensive advice and guidance in the form of public findings or rulings, more specific sector guidance and private binding rulings available on request. AusIndustry will also conduct more timely and informed audits. Better information through registration will allow more targeted audit activity based on risk, as will closer cooperation between AusIndustry and the ATO.

Transitional costs for taxpayers due to the change will decline over time. The new law is clearer and much shorter than the current law. When consolidated, the income-tax provisions will occupy only about one-third of the current number of pages of the income tax law. The new industry research and development provisions are just under 70 per cent of the corresponding existing law. Significantly, unlike the unlimited period for amending income tax assessments under the existing law, the bill limits amendment periods to four years. The bill includes applications, savings and transitional rules that set up the basis on which the new law will apply, and ensure a smooth transition from the existing law to the new law. The general result of these rules is that the bill will apply to expenditure from 1 July 2010 and the old bill will apply to prior expenditure. The bill also includes some special transitional rules needed to deal effectively with some specific situations that straddle both the existing law and the new law. This provides a clear and logical basis to move to the new law consistent with that commonly used for measures that are based primarily on expenditure.

That completes our overview of the bill. We would submit to the committee that the bill represents a significant step forward in delivering the tax incentive for R&D within the government's budget goal of being revenue neutral. For the benefit of the committee, we have prepared commentary in respect of several contentions that have been raised by stakeholders during the three rounds of public consultation that have led to the bill, and I will table those with a copy of my opening remarks for the benefit of the committee.

CHAIR—Thank you, Mr McCullough. I move that the committee accept the documents tabled my Mr McCullough, including his opening remarks.

Question agreed to.

They are quite comprehensive and I am sure they would be quite useful to us.

Mr McCullough—Madam Chair, that completes the opening remarks from the two departments, but AusIndustry may have something to add on the administration side.

Dr Edwards—Senators, AusIndustry, on behalf of Innovation Australia and in partnership with the Australian tax office, is responsible for a lot of the delivery functions within the R&D tax incentive. They probably fall into three major categories. The first is getting the message out. We have a strong role in promoting the program and encouraging businesses to take the benefits of the program. We are currently working on a joint marketing program, a strategic push that we are going to have, in conjunction with the ATO. One of the features of that will be a significant information surge in July and August, once the bill is passed. We are also planning information sessions in all capital cities to start in July and August, and that will be followed by a significant push by our state and regional office network to get the message out to business about the new program, its requirements and how they can access the program with some certainty. We will also be using the tools that we currently use. The R&D tax concession information bulletin is something that we regularly send out to all companies that access the current R&D tax concession. We will be having a special edition to promote the changes and point customers to where our information material lies should the bill pass. We will also be using our hotline facilities to contact a significant proportion of the customer base, again to talk to them about the things that they may need information on and to point them to the information that is already available.

The second part of our role is to reduce uncertainty. We have already drafted a number of fact sheets that we will be putting into the marketplace in July. That will continue through July and August. We need to get those out quickly to dispel some of the concerns that have been raised about the application of the new program and that we believe is very important for businesses that are planning their R&D now for the new financial year. So driving a lot of awareness and a lot of education very early is very important to create the certainty for business.

Under the new bill, from 1 July we also have the ability to undertake both public and private findings. Private findings are not a power we have at the moment. Should business approach us, we will be able to look in detail at their R&D and give them a finding about our opinion of whether the R&D meets the requirements of the act. That opinion will be binding on the Commissioner of Taxation. We do have some powers currently to do what is called advanced registration but it does not give the level of certainty because it is not binding on the Commissioner of Taxation. That new power is quite important.

We also have the ability to produce public rulings. The rulings will be on issues of significant concern to the business community, and where Innovation Australia and we believe that we need to go out and say, 'This is how we believe this area of the law should be interpreted and this is how we will behave'. That act gives businesses a much greater level of certainty. Yes, as was said earlier today, we will hold to those positions until somebody points out to us that we have actually got the interpretation of the law incorrect. Those public hearings will have a lot of legal rigour behind them before we go out. It is about creating certainty.

The third area that is important for Innovation Australia and AusIndustry is about ensuring compliance with the law. We predominantly run risk rating views for companies. They are not full audits. As I have said in another place, we have been scaling up our risk reviews of companies. Prior to this year we were doing about 350 a year. We have scaled up to 750 this year and next year we will do about 1,000 risk ratings of firms' R&D.

We have some data that goes back a little way now but it does confirm that businesses that have had these risk reviews feel more comfortable with the program. This is because it means that we have come in and said to them, 'On the basis of what we see at the moment we actually think you are a low risk and we are not interested in any audit activity here'. It can progress to where we say, 'We think you should change; we don't think you are applying the law correctly'.

If the company holds their position and we say, 'No, we are really concerned about this' then we may go to a full audit where we can produce a certificate that is binding on the Commissioner of Taxation that says that the R&D is either in or out. We do very few of those—our current level is about 20 to 25 a year. Our role is really to get the message out, reduce uncertainty and then ensure compliance with the law.

CHAIR—The first question in my mind is: what happens if this bill does not pass? Does the existing regime continue?

Mr McCullough—The current law is not subject to any sunset clause so it would continue.

CHAIR—Regarding the modelling that was done on this, did Treasury do any modelling and did that modelling find that the proposed bill was in fact revenue neutral?

Mr Antioch—The Treasury did do a costing which you might regard as modelling. It looked at the overall expenditure; not an industry by industry breakdown. Yes, this whole bill has been designed, in the changes at least, to be revenue neutral—that is, through the savings that come from a better targeting of the program. You have heard some of that this morning about the dominant purpose test and things of that nature. The software exclusion picks up the issue that software developed purely for internal administration purposes is excluded from the core definition.

Those sorts of things yield some savings and they are broadly offset by the increase in the rates. On the one hand, as Mr McCullough mentioned earlier, these rates now translate to a 133 per cent super deduction or a 150 per cent super reduction, and on the other hand, an increase in the threshold for small business from the $5 million turnover threshold to a $20 million turnover threshold, without any limitation on the R&D expenditure that they can claim. In the changes, they are broadly neutral.

CHAIR—I think the criticism here was mostly from the consultants, and both Michael Johnson Associates and BDO said that for their clients there would be a substantial drop in the amount that they could claim. It was Michael Johnson Associates who said by something like half or more than half. You do not accept that view.

Mr Antioch—It is hard to evaluate those sorts of numbers because they are based on, say, a particular company's client base. The numbers that the government has modelled—and it is included in this bill—is looking at expenditure overall. So that is the first point to make. The other point is it is not clear at all what sort of assumptions they are building in to how the dominant purpose would work. You heard this morning, Madam Chair, there are different interpretations of how it would work, and so it is a little hard. Let me go back and remind myself at least of a newspaper article that appeared maybe two months ago. It claimed that something between 30 and 60 per cent of the claims would be knocked out. I personally contacted the person who was quoted in that newspaper article—a member of a prominent accounting firm; one of the big four—and had a very good conversation with that person. It turns out that the 60 per cent number relates to fast-moving consumer goods—one of the things that, again, Michael Johnson identified this morning.

It is not clear to me at least what proportion of the total of the 60 per cent crunch, even if you accept there is a 60 per cent in that market segment, it makes up. Presumably it is a very small proportion compared to the total. We do not accept those numbers. That was a very long-winded way of saying we do not accept them.

CHAIR—Let me take an example—

Senator COLBECK—How do you make that assumption of it is a small percentage?

Mr Antioch—We do not know. It could be a small percentage.

Senator COLBECK—That is what I mean. You have just said it is very small, but how do you make the assumption? How do we know who are the winners and who are the losers?

Mr Antioch—For fast-moving consumer goods as a proportion of the total R&D—we do not have the data to actually say that. I am only saying that the 60 per cent number that was quoted as an overall reduction looks excessive.

Senator COLBECK—It is a category reduction, not necessarily a—

Mr Antioch—It is a category reduction rather than an overall reduction.

CHAIR—Let us take an example that Michael Johnson Associates gave, which was a low-fat milk production process. They were saying where they might do R&D to get a lower fat percentage in the milk. The explanatory memorandum suggests that the research might be eligible, but if they test it in the production process because another firm is doing that already, that would not be counted as eligible expenditure. I know it is quite detailed—and I would not expect this to be a binding ruling—but if you could just run us through that kind of scenario, please.

Mr McCullough—There a couple of observations. I listened to that evidence and I was struggling to pin it down to a particular cause. When I go to the explanatory memorandum and look, the general assertion that is being made is that the dominant purpose test rules out activities conducted in a production environment. I refer the committee to example 2.10—if I am pronouncing it correctly: Matryosh koala—where if you look through that series of examples on the explanatory memorandum from pages 35 to 39, there are three examples. The first two examples end up concluding—and I will not bore the committee by reading them

out—that, although the R&D is conducted in the production environment and goods are being produced, supporting activities would qualify.

We have spoken to Mr Gale on several occasions during the consultations that have taken place. I am sure he is genuinely convinced that somehow the dominant purpose test will attack specific things, but it has been very hard for us to identify what things beyond this general comment that anything in the production environment will be affected. We do not think that that is the case. We have tried to make it clear in the explanatory memorandum that it is not the case.

The other question, about new knowledge, I think I addressed in my opening remarks. Those words are there now in the existing definition. We have not changed those words. During the course of the consultation some of the consultants—I do not know whether it was Mr Gale particularly—put to us that a particular repetition of a word we had used in the definition created that impression for them, so we removed the word. I am just looking at paragraph 2.16 of the explanatory memorandum, and '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 worldwide basis'. I think somebody said, 'You might just find it on Google later.' If you find it on Google, yes, it is accessible, and there is no point, I submit, in the government funding it. But if it was not reasonable for you to find it on Google beforehand you would probably pass the test.

Senator COLBECK—Sorry to keep jumping in, but, while it is relevant to the conversation, I have a question. Does the new definition in any way limit, compared with the old definition, what might be claimable in the example you have just cited—Matryosh koala production. Does the new definition limit what might have been claimable previously versus what might be claimable under the new regime?

Mr McCullough—I am sorry if I am not getting your question, but are we talking about apart from the dominant purpose being applied to supporting activities in production, or are we talking about something else?

Senator COLBECK—Yes, that is effectively what I am looking at. It is the dominant purpose test that is being claimed as having an impact in relation to the supporting R&D. So does the new definition and the way it is being applied limit the capacity to claim for these production processes compared with the previous test?

Mr McCullough—Yes, because of an application of a dominant purpose test. But, before we get there, the starting point for all this is what experiment is being conducted. It is quite possible in your production environment—and we were just trying to describe this in plain language in the car coming over—

Senator COLBECK—We were not there, sorry.

Mr McCullough—No. I am going to try to repeat it for you. You might be producing 10,000 of a particular product, 1,000 of which is essential for you to test in your experiment—for example, is this thick enough? In those circumstances, before you even look at supporting activities, you have a core experiment. Admittedly it is only one-tenth of your entire production run, but you do have the experimental activity to begin with. So, firstly, you can start with the proposition that there can be an experiment, there can be core R&D activities conducted in the production environment. Once you have a core experimental activity the question then becomes: what about these things that support this? Where goods are produced, the test has been made to be not 'a purpose' related but for 'the dominant purpose' of R&D, so you do have to make some form of judgment that the things you are doing actually support that experiment.

Senator COLBECK—So there is effectively a tougher test, which is obviously one of the objectives you are trying to achieve. That goes to a question that Senator Back asked earlier about spending $2,000 for a trial conveyor versus $4,000 for a conveyor that would do the entire job over a period of time through the production. What I am trying to do is to balance what you are telling us in respect of the application of the dominant purpose test versus the evidence we are getting from those who are, at a practical level, applying it with their clients so that we as a committee can make an assessment ourselves as to where the balance lies.

Mr McCullough—It is very difficult to deal with these things in the abstract, so I will think my way through the conveyor belt example on my feet. If the proposition is that I have an experiment that requires a conveyor belt worth $2,000 and I choose instead to buy a conveyor belt that is of a different type not required for this, first of all, it is not a direct expense that is going to be attributable to the R&D. It is going to be a proportion of the expense that is attributable. But, if there were an experiment being conducted in the manufacturing and production, then it would be possible to say that that is the experiment. That proportion of the amortised cost of the plant that is being used in that—because I have defined my experiment and it is applying to that experiment—would be not only directly related but clearly for the dominant purpose of the

experiment. The rest of it would not. So, if you end up needing a certain piece of equipment and you go out and buy other pieces of equipment, under this arrangement you are not going to be able to leverage your claim. You are only going to be able to claim for the experiment and the cost of the plant that is related to that.

Senator COLBECK—Which is the limiting effect that you are seeking to have under the rewritten arrangements.

Mr McCullough—Certainly we have made no bones about the fact that to support the increased rates there has to be a narrowing of the base. There are only three elements that really narrow here. One is the administration, which Dr Edwards talked about. One is the dominant purpose test and the other one is the removal of the incremental claims.

CHAIR—I have no problem dealing with the dominant purpose, because that is clearly the major issue here. There was some suggestion that, if you changed it from 'the dominant purpose' to 'a dominant purpose', that might cause a resolution. Would that be so, or would that take us back to the existing system?

Mr McCullough—It is really tricky. I am struggling for what 'a dominant purpose' would mean in the circumstances where we are talking about the production environment. I am producing something and often I am really only talking about producing goods to sell or I am conducting an experiment. 'A dominant purpose'—I will have to think about that.

CHAIR—Perhaps you could take that one on notice.

Mr McCullough—We will take it on notice.

CHAIR—That will be fine.

Senator CAMERON—Still on the dominant purpose, you made a comment about an experiment versus production. But from time to time you actually need to engage your experimental research and development component into the production process to assess how it operates. How do you make that distinction?

Mr McCullough—I just have to think this through. You are asking when a business would decide that it has passed the experiment stage and moved into the production stage. I think I might need some assistance—

Senator CAMERON—No, I am actually not asking that. I am asking you if, to prove your research and development, you have to bolt maybe some component onto your production process?

Mr McCullough—I might pass to Dr Edwards on this one.

Senator CAMERON—And that might be at a cost of reducing production to do this, to test. You might get increased production because you have done it. How does all that work out?

Dr Edwards—Senator, there are some good examples in the explanatory memorandum, and you are absolutely right: experimentation happens in production lines, it happens at the full production scale, like the dolls example. With the hockey sticks, example 2.13, they say yes, and for that period of time when you have some unknowns, where you have a knowledge gap on things—'I have to tweak it here, I have to do this'—you are conducting an experiment, and that is a core activity and that is allowable under the current definition. It is about those things that support that activity, and in a lot of ways we are talking about time. 'Is it reasonable to run my full production line flat out producing goods for sale while I'm doing an experiment, a valid, core experiment?' Is it reasonable to run it for a year?' We would probably say no. 'Is it reasonable to run it for a day?' 'Well, let's talk about the gap in knowledge you have and how long it takes to fill the gap in knowledge. We accept that you've got the gap in knowledge, we accept that it has to be filled in the production environment, but it comes to an end.' Once we have ended that gathering of information to fill the knowledge gap, the experiment is over and the rest of the running of the production line has a dominant purpose to produce goods for sale.

Senator CAMERON—The example I am thinking of is a practical one that I saw a few years ago. That was in a food processing plant where they were introducing electronics that could detect a black pea in a production line. It was highly sophisticated, very complex technology—lots of work to do this—but they could actually expel a black pea from the production line. Now, you could not test that unless you were running at full production and you cannot install it unless you stop production. This is the type of feedback I am getting from people. They are asking, 'How does the new legislation affect that?' I think that is a reasonable question. That might take a week; it might take two weeks. I have worked on these things and you have to adjust. You have to take it out. There is lots of work in this and it could take up to a month.

Dr Edwards—There is, and that is part of the negotiation and the greyness of this, to some extent. 'You have a gap in knowledge, you've proven that. This technology didn't exist before. We have to put it on the line. How long is it going to take before you're confident that it works? How long before you fill the knowledge gap?' We as administrators of the program will sometimes struggle with that issue and we may need to get an expert in who says, 'I'm from the industry, I understand the technology; in reality they have to run this for two months—but not two years.' You test by going to the extremes. That would be extreme, unless the expert tells us it is not extreme. But two months at full production may very well be absolutely appropriate to test that.

CHAIR—Dr Edwards, I was wondering if you wanted to respond to some criticisms by, I think, BDO that AusIndustry were not able to properly make these assessments, that they were not people who were close to industry or understood the processes very well.

Dr Edwards—Our role is to apply the law to the projects that we see. The decisions we take are supported by private sector experts. That is why Innovation Australia, the statutory body, are the group that have control of the program in an administrative sense; they are private sector experts. Where we are unsure, we do two things. We use industry experts to help us. We commission them to look at the projects and give us a report and then we utilise that information in making our decisions. We also use the experts on our tax committee and on Innovation Australia to vet our decisions, because at the end of the day they make the decisions under the current program.

CHAIR—My apologies if I misquote in my last question, because I was not there for the full time. The universities, as I understand it, are asking for special consideration because of their position in trying to attract industry research.

Senator EGGLESTON—They are seeking additional tax concession to enable research to be undertaken at universities. That came from Monash University, representing the Group of Eight.

CHAIR—Perhaps you could also take that one on notice; that would be useful.

Mr McCullough—We will take that on notice.

Mr Pettifer—I can say a little bit about it. It was the Group of Eight at the table. We have seen that submission. It seems to me that they are proposing a policy change, and having yet another differential rate of support for research which is undertaken by universities. I think that was the proposition. There was a bit of discussion during that evidence that it would make sense because it would mean that university infrastructure was used. There is nothing to stop university infrastructure being used by companies who access the proposed tax offset. They might well choose a university to do the research work for them. I guess I just saw it as a significant new element of policy which I do not think needs to be addressed as part of the consideration of the particular proposals that are on the table. My colleague may have some more to say.

Mr Weber—It is probably worth noting that this notion was raised as part of the ventures Australia review. This notion was put to the tax committee then and I think it was not accepted in the final proposal from the Australia Venture Capital Industry Review.

Senator EGGLESTON—I was quite interested in that university issue, because universities do say that, unlike in the United States where there are great tax concessions for people endowing universities and sponsoring research, relatively speaking Australian universities are not so well off for funding. I thought this suggestion by Monash was a way of increasing university funding for research. As you say, it is a change of policy, but perhaps it is one that might be considered.

As I understand it, there have been suggestions by industry that the new exposure bill will reduce the number of eligible claimants by about half. I just wondered what Treasury expected would be the number of currently eligible claimants that would not be eligible under the new exposure bill.

Mr Antioch—We have not looked at the numbers as such. We have tried to model things on the expenditure. Just by way of observation, it seems as if some of the claims that half or 60 per cent—thereabouts—will miss out on the proposed bill, tends to work from the premise that most, if not all, of the R&D activities that are intertwined in some way with production will be removed. Through examples we have tried to demonstrate that we do not believe that that is the case. We certainly do not accept numbers of that kind.

Senator EGGLESTON—You do not accept that there will be a 50 per cent reduction in claimants.

Mr Antioch—Not in expenditure. We can see that the issue about the size of claimants and the number of claimants does vary. We do not have a way of checking who is putting what sort of claim, groupings and those kinds of things.

Senator EGGLESTON—You are talking about the amount of money that is involved. Yes, I see.

Mr Antioch—Yes; that is right.

Senator EGGLESTON—Are you doing any modelling to assess the number of claimants eligible under the current arrangements that would be excluded? Have you done any modelling whatsoever on this?

Mr Antioch—I do not believe so but I might call on my colleagues from the quantitative area.

Mr Maloney—We have not undertaken specific modelling on the number of claims. As Mr Antioch said, we base our costing on the value of claims. We do not specifically go down and look at the number of claims that would be affected; nor do we look at individual claimants or have a way of estimating the impact of that.

Senator EGGLESTON—Given that this affects the R&D industry in Australia, I am a little surprised that you have not considered how it might affect the players in the field individually.

Mr Maloney—It is very difficult for us to be able to estimate that, so we have tried to keep it at an aggregate high level at a macro sort of level and tried to estimate the change in terms of value and expenditure on R&D.

Senator EGGLESTON—Could Treasury inform the committee as to the impact this bill will have on R&D investment in Australia, firstly by the effect on the overall amount of money spent on R&D investment and secondly by industry—mining, automotive, pharmaceutical, agriculture and so on? Are you able to provide any details of that kind of breakdown on notice?

Mr Antioch—By virtue of the fact that the changes are revenue neutral, we would not be expecting any significant changes in the investment profile of R&D. As to the second part of your question, I think it goes back to this issue about industry-level, category-level analysis. I will stand corrected on this, but I think that typically our revenue estimates, when we make tax law changes, do not necessarily go down to that level of detail. I suppose we are assuming that a dollar of investment in mining and a dollar investment in manufacturing each has the same social value—you can take it down to that level. So it is the overall dollars that are spent and the overall dollars that are claimed as a tax incentive that matter in the end.

Senator EGGLESTON—I suppose you could argue that, but I would have thought that there was also a public policy interest in encouraging research in areas which might be of importance to the Australian economy, such as mining, agricultural research, medical and pharmaceutical research and so on. Have you given consideration to targeting and encouraging industry research in specific industry areas that might be important to the Australian economy as a matter of public policy?

Mr Antioch—I suppose to the extent that the bill does encourage the SME sector a fair bit, you could say that by type of organisation these companies would be encouraged to do more R&D.

Mr McCullough—I think that again we are into the area of a different policy. This bill does not seek to distinguish between industries, so we have not costed another policy that would push industries in a particular direction.

Senator EGGLESTON—It is an unfocused bill, in other words.

Mr McCullough—Sorry, Senator, that is not what I meant.

Senator EGGLESTON—You are not seeking to encourage industries in specific areas; you are just providing an across-the-board encouragement to research and development, and I wonder if that is good public policy.

Mr Antioch—I would characterise it as a fairly neutral impact, because you are not necessarily favouring one sector or another and you let the commercial imperatives out there take the research where it might go.

Senator COLBECK—But one of the imperatives was, to use one of Senator Cameron's examples, to limit the whole of mining: to limit those sorts of claims and bring them back into a more focused R&D claim.

Surely, part of the intent was to focus some of these things. When you say that you are anticipating that the R&D spend is effectively going to remain the same is that an assumption of your calculations or is it an output of your calculations? While the assumption is going in do you assume that your R&D spend is going to stay the same, despite the changes in laws, or is that an outcome that you get once you run the model? I think

Senator Eggleston's question is a legitimate one with respect to the potential impacts in different sectors. One of the things that we have heard today is that manufacturing is one sector that is potentially negatively impacted on. It does not appear from what you are saying to us that the modelling actually looks at any of those sectors, so the government does not necessarily have any idea based on the advice that you are giving them as to where the impacts might lie. That is one thing that we are concerned about. If you are just looking at a macro level how does anyone have a chance of actually having an understanding of that?

Senator EGGLESTON—I agree with those comments.

Senator COLBECK—It is a question. I would like to get a response from it.

Mr McCullough—It is difficult because you are starting by saying that you have heard the evidence that says these things will be impacted in this way and then you are asking us whether we have modelled that. Our answer is that there is no basis for us to find a distinction as between industries and therefore no cause to even attempt to model as between industries.

Senator COLBECK—There are objectives that the government has had and we have heard them put to us. Senator Cameron has given us some examples in the construction industry, in the shipbuilding industry and in the mining industry of what he has termed as 'rorts'. The government is seeking to minimise those. I am not sure whether those alleged rorts are actually claims that are outside the terms of the current legislation or not and perhaps we can get an answer to that shortly. If you are actually looking to limit things and refocus the application to smaller businesses versus large industry, surely there must be some sense of who is going to win and who is going to lose. I think it is reasonable that we ask those questions. If the basis of the modelling is that there is X billion dollars spent on R&D, our assumption is that that expenditure will continue and so this is the impact on tax revenue or tax exchanges within the system then we are trying to get at the basis of that. Also I think it is reasonable to have an understanding of who is going to win and who is going to lose because legislation is in fact targeted to do some of those things.

Mr Antioch—The issue becomes one of how much the budget estimates included in terms of the tightening, what is magnitude of the tightening. It is between 15 and 20 per cent in aggregate terms.

Senator COLBECK—And that may impact to a greater level on certain industry sectors.

Mr Antioch—To the extent that particular types of claims are predominant in particular types of industries. If the dominant purpose test on its application finds, let's say, business as usual production is being claimed right now but is no longer eligible in the future and if that happens to be skewed to particular industries, yes you are right. But if it is not, the test applies across the board.

Senator COLBECK—I understand that and the evidence has been consistent with that. What we are trying to get a sense of is what industry. Is it going to impact more on mining or manufacturing, which the government has an obvious interest in, and I know the minister has a particular interest in? What are the impacts going to be? How do we as a committee make a judgment on that? We are trying to assess whether or not we pass the legislation and find out where the impacts are going to be. Your modelling does not show us any of that.

Mr McCullough—With respect, the answer is not in the modelling. If the examples of inappropriate outcome exist, and they may exist across a number of industries, then what we have tried to do with the bill is to have a look at those examples and, rather than do some costing of them, look at the reason why they might be excessive. One that comes to mind—and it is a mining example, but I pick it because it is one that somebody mentioned to me relatively recently—is the notion of pumping out water above an ore deposit. Despite it being found on the facts to be for the predominant purpose of production, nevertheless under the old definition of supporting activities, the costs of pumping the water out were accepted as supporting R&D. If that decision was correct—and I do not know whether it got appealed all the way—that is not the sort of policy outcome that we are trying to reflect in the bill.

Senator COLBECK—I am not arguing about your intent. I accept and understand your intent.

Mr McCullough—I do not know of anybody who could tell me how many of those examples are in mining, manufacturing, software development or somewhere else. We have looked at the examples and the policy problem, and that is what the law reflects. The costings, therefore, do not distinguish between industries, and the law does not distinguish between industries either.

Senator COLBECK—I accept that, and I accept that they are broadened. But that is one of the issues that have been raised with us. In your consultations—and you said you have had three rounds of consultations with

people who work within the sector—what has been the feedback? The evidence that we have heard this morning indicates that manufacturing is potentially going to be a loser. I want to get clarification on that. You are the guys that are supposed to be doing the modelling and telling us this basic information. If you cannot tell us, who can?

Mr McCullough—I will put it bluntly as this. I heard evidence again this morning that no R&D will be allowed in the production environment. I went to some detail earlier on in my evidence explaining how that is not correct. If that is the assumption on which somebody is saying, 'Therefore 50 per cent or 80 per cent of my clients won't get anything,' they are proceeding from the wrong assumption.

Senator COLBECK—But surely you would discuss this in your negotiations on the bill.

Mr McCullough—Yes, we did.

Senator COLBECK—You would have interaction on it and get some sense of these sorts of things. One witness today said there would be about a 50 per cent reduction in the spend, based on their client base. Another witness is going to come back to us with some evidence as to what the sort of spend will be. They say there will be a reduction in spend as well. Overwhelmingly the evidence has been there will be a reduction in spend.

Mr McCullough—After the first draft bill, I wrote to every person who put in a submission—there were over 100; there might have been 190—and said, 'If you have examples of where you think this bill will give the wrong outcome, please provide them to us.' We went through those examples rather forensically, and that is why we changed parts of the first draft of the bill to where the second draft of the bill is. When we went out with the second draft, again I wrote to all the people who had submitted and said: 'Here are all the changes we have made. Here are the reasons. If you still have a problem that you think is the wrong outcome, come back to us.' Again, a number of people did. We used that feedback either to clarify that the outcome that they were concerned about was not going to arise—again, either by changing the bill or by changing the explanatory memorandum—or to say to them, 'We think that's precisely the circumstance where it's so loosely connected to R&D that you probably wouldn't pass the dominant purpose test.'

Senator COLBECK—So there is no data available that you can provide to us on a sectoral basis as to where the winners and losers in this process are, except to say, 'We think small to medium enterprises will get more and larger enterprises over $20 million will get less.' That is effectively all you can tell us.

Mr McCullough—There is no industry data.

CHAIR—Mr Antioch, did you want to say something?

Mr Antioch—There is a question still hanging, I think, and it came from Senator Eggleston, as to the particular types of industries that might be encouraged. We have an R&D grants program that has a better targeting mechanism. The tax way of delivering support, if you like, has always been fairly neutral in its impact because it relies on industry to buy into it, to claim the deduction. That is why we have that system.

Senator EGGLESTON—My view is simply that there is some public policy interest in encouraging research and development in specific industries. I suppose, to some degree, the information you just provided does answer that question, but I do think that this is, as I said before, a very unfocused piece of legislation, although that seemed to make Mr McCullough raise his eyebrows a little.

Senator CAMERON—Some of the evidence says it is too focused!

Mr McCullough—I would say 'equitable', Senator, but that is just me!

Senator EGGLESTON—It does not really seem to me to be promoting research and development in key areas of the Australian economy, which is perhaps something I would—

CHAIR—I think the Liberal Party called it 'picking winners'!

Senator EGGLESTON—No, no. There are public interest groups. We have a public interest in promoting various sectors of our economy. I wondered if any comparative studies had been done of Australia and other countries, such as the US, the UK, China, Singapore or Japan, on how their legislation in this area compares to your proposals.

Mr McCullough—We have certainly collected some data on the operations of overseas mechanisms. I think Mr Antioch came across something rather recently that compares Australia with other regimes.

Senator EGGLESTON—Perhaps you could provide that information to the committee.

Mr Antioch—Yes, certainly. Just before handing it over, it is from KPMG and it was issued this month, a few weeks ago. It looks like—from their analysis, at any rate; I am not endorsing this analysis, just passing it on for the committee—Australia in 2008 ranked fifth in the world for R&D competitiveness, if you like. With the changes that KPMG believes are being presented here, Australia jumps to the No. 1 position. The commentary is interesting in itself. It says, if I may very quickly read a small portion of it: 'The dramatic change in the survey is for Australia, moving up from fifth place in 2008 to first in 2010. The change is a result of Australia adopting a new R&D tax credit system as of 1 July 2010 that is refundable for corporations that meet defined revenue limits.'

Senator EGGLESTON—That is talking about the structural mechanics rather than the specific industries, but if you could table that we would be very grateful.

CHAIR—We have gone over time, and I do not know about other senators but I have changed my flight time now so I am suggesting we go till about 4.20 pm. Senator Bushby?

Senator BUSHBY—Just on revenue, you have discussed the impacts in a general sense, but most submissions we have had from expert advisers in this space suggest that your predictions of revenue neutrality will prove to be wrong and that it will work out to be a net saving for government for various reasons. That is primarily because, as I think Mr McCullough noted, there has been a narrowing of the base to support the concessions. On the flip side, the experts do not seem to think that there will be as big a take-up of the increased rates, particularly by small businesses, because of the complexity and the challenges of doing so—that in the end, even if they are spending on R&D, they will not actually bother to make the application because it would just be too hard to keep track of all the records that they need to be able to make the case.

Mr McCullough—This was the evidence of BDO, I think, Senator?

Senator BUSHBY—Yes, but it was backed up in general by others. To what degree has Treasury modelled this? Do you have firm numbers that you have modelled to look at what the impact will be from the cost of the increased rates and the dollars involved in narrowing the base?

Mr McCullough—I will make a couple of logical points before we move to the modelling. I heard that evidence and I was a bit stunned at the idea that either the ATO or AusIndustry could possibly do a 100 per cent audit of all small businesses and thus cause them to incur so much compliance cost that it was not worth making the claim. I was also aghast at the idea that the real problem was in the feedstock provisions with this bill, because the feedstock provisions are not changing. I could go on to make a few other points—

Senator BUSHBY—Those are very good points, and I invite you to make summaries in response to the evidence that was given, but I have a short amount of time and I want to ask some specific questions. I want to know whether you have done specific modelling on the impact of increasing the rates, what your predictions are and what the specific modelling on the impact of narrowing the base is.

Mr Antioch—As I said earlier, those impacts are broadly offsetting.

Senator BUSHBY—I know that you said that already. I have not asked you yet what the actual dollars are; I am asking you whether you have done the modelling and have specific dollar figures that you have estimated.

Mr Antioch—To build up a costing you would have to look at those sorts of things.

Senator BUSHBY—So you have gone through the exercise? You have reached the point where you have those figures and on that basis you then concluded that they are broadly offsetting?

Mr Antioch—Absolutely. I think I said earlier in my evidence that it is 15 to 20 per cent.

Senator BUSHBY—That is the impact of the narrowing of the base?

Mr McCullough—And there would be a corresponding 15 to 20 per cent increase in the rates. That is how you get it revenue neutral.

Senator BUSHBY—So 15 to 20 per cent works out to roughly what in dollars?

Mr McCullough—About 300.

Senator BUSHBY—This is a derogatory term and I do not mean it, but that is effectively a money churn of about $300 million from one side to the other?

Mr Antioch—That is right. If I may, the program is not capped, so it is not a target. Some commenters have said, 'Are you hitting a particular target or not'. It is not that. If R&D increases, the concessions automatically increase.

Senator BUSHBY—I note that in your answer to question 18 posed by Senator Eggleston at additional estimates you made the comment that the modelling undertaken to cost the proposal took account of the impact that the increased concessionality would have on the use of R&D concessions and the tightening in the concession that would be required to offset the impact. Given Mr McCullough's comments that to support the increase in rates there had to be a narrowing of the base, was the narrowing of the base specifically calculated to roughly offset the increase in the rates? Did you sit down and say: 'We'd like to offer these increases to the rates. What changes do we need to make to the base to roughly offset that?' Was that a deliberate decision?

Mr Antioch—That is the kind of fine calculation that is beyond anyone's ability to do, but I think that in rough terms—

Senator BUSHBY—Really my question was about the motivation for narrowing the base to offset the cost of increasing the tax rate.

Mr Antioch—Because it was revenue neutral: it had no net impact on revenue, I suppose.

Senator BUSHBY—So essentially you said, 'This is what we'd like to deliver,' and you went off and looked at how you might narrow the base to pay for it.

Mr Antioch—In broad terms. It is not exactly that. It has worked out like it is ultimately revenue neutral. That is what we did.

Senator BUSHBY—If the advisers are correct and it turns out that it is revenue positive for the government, is it likely that you will go back to adjust it to try to get it back to a revenue-neutral position?

Mr Antioch—Obviously I cannot speak for the government, but there is built into the bill a review in three years.

Senator BUSHBY—Do the terms of references of that review include the amount that is raised?

Mr Antioch—The review would be of how well this program is delivering the incentive. Is it working? We will get some evidence out of that, and that may well be a point when the government of the day chooses to do something.

Senator BUSHBY—I will change tack: the vast majority of the evidence that is being presented before the committee today and also the submissions that have been put forward to you as part of the consultation process from the expert advisers in the area seem to raise the sorts of issues which we have heard about today. Mr McCullough and others today have sort of said, 'They're wrong there.' 'They're misinterpreting this' or 'They're misinterpreting that.' Given that these people are experts in the area and work in it very day, how are they getting it so wrong? Why are they missing what you say is quite obvious that—

Senator Cameron interjecting—

Senator BUSHBY—Of course I still want to make it, but it seems to me by making the arguments that they are making—

Senator COLBECK—I think that is actually making an assumption.

Senator BUSHBY—they are actually arguing in the interests of their clients, not in their own interests. They are arguing against what they see as increased complexities which ultimately, I would have thought, would be a dollar mine for them down the track. It will require their clients to come and see them more often because it is going to be harder, if what they say is true. You have had this consultation process. They have gone through it and they still do not get it.

Mr McCullough—It is very hard for me to comment on why somebody else does a particular thing. Suffice it to say, we have tried to explain. We have tried to change. In fact, I point to the fact that this is the third version of the bill. It is not like somebody in Treasury or someone else has said, 'I know best and we'll put it out.' We put out a draft. When we got some feedback, we changed it in all of the respects that were raised—not in all of the respects that were raised; all of the respects that were raised that were backed up by an argument that we could understand. I suppose we have got to the point where we cannot understand any other arguments for change that are being put. I hear people saying the dominant purpose test will knock out everything in production and I point to pieces in the bill and the explanatory memorandum that say that is not so. So I do not know why some of that is maintained.

Senator BUSHBY—Yet this morning we had advisers also on that very point pointing to the examples in the EM and saying this is what concerns them.

Mr McCullough—Again, I did not hear all of that evidence, so I cannot really comment on a particular case. It could have been anything. It may be that they are concerned, and we have not understood. It may be that they are concerned that this thing is no longer eligible. It may be that by some of these changes—this has certainly become clear in some of the consultation we have done—certain things that were claimed under the old law that are not being changed were not and were never allowable. For example, I have heard somebody complain about the fact that we start with an experiment and suggest that this is a whole new regime and that is the key to the newness of it. But the old law requires experimental activities. AusIndustry guidelines virtually say: First start with the experiment. So why some of this evidence is given, I do not know.

Senator CAMERON—Mr McCullough, Michael Johnson Associates in arguing against the bill say that one of the problems was that there was 25 years of institutional understanding from small and medium enterprises in relation to research and development. I found that a bit disconcerting when their website was saying: 'Your company will explain all this to you. We're the experts.' Have you got a view on this institutional understanding that is going to be destroyed; is there an issue there?

Mr McCullough—I do not claim to be an expert, and so I do not follow the history; however, I will make two factual points. One: the argument was made to us at some stage during the consultation that all of the legal precedents would be thrown out. That worried me, so I went back and said, 'What are these legal precedents?' Apparently, there aren't any that relate to anything post 1996—I will confirm that on notice, if I may. There just are no recent judicial pronouncements that are going to be so valuable as to be tossed out. I fear, and I am not trying to overplay this point, that the institutional understanding is in some ways institutional misunderstanding. That is all I can say on that. Perhaps AusIndustry may be able to assist.

Dr Edwards—No, but my understanding also is that there have been very few legal decisions post 1996. We have tested some of the more obscure areas in that period of time but not on the fundamental definition of R&D. The law has been fairly settled in that space for quite some time.

Senator CAMERON—Ms Murray from BDO made some very strong statements about the effect that the legislation would have on the uptake of research and development and she claimed that this was done on the basis of modelling. Ms Murray has taken on notice that she would provide the methodology of the modelling. Given that she is making such strong claims on that, would Treasury be in a position to give us its view on that modelling as soon as practicable?

Mr McCullough—We would be happy to provide the committee with any analysis of any models that are presented to us. I do not want to say anymore on that.

Senator COLBECK—Dr Edwards, you made some comments before about the information that you were putting out in July—fact sheets and things of that nature—so that people can make their investment decisions for the next financial year. Surely they would have made their investment decisions for the next financial year by now. There has been some discussion about how quick the legislative process is going to be, given the consultative process and accepting that this piece of legislation has changed, as Mr McCullough said, three times so far.

Surely people would have already started to make their investment decisions, and providing that sort of information this late in the piece would have to be an issue for them. It is a bit difficult for me to accept that it is effectively timely to give them information sheets in July about decisions that they would have already made or have been making, particularly in the context of a transition between the two pieces of legislation.

Dr Edwards—You are correct in your assumptions. For us, providing information prior to the law passing is very difficult and obviously not practical. There are certain areas of the new legislation that change; there are areas that do not change. Those areas that do not change are still covered by our current guide to the tax concession—things like record keeping and the like. Certainly on these important issues, it is not possible for us to go to the market prior to the legislation passing.

Senator COLBECK—I understand fully that you are applying what you are being given to apply and there is a process. It is our role to make assessments of what is feasibly practical to impose on people from a legislative perspective. I just want to clarify the points that you made about getting that data out. As I said, people would have already made their investment decisions by now and now they are in a grey space.

Dr Edwards—You are correct. Some will be waiting to the see the passage of the legislation, I suspect.

CHAIR—Thank you everyone. I take it that the departments will take any other questions on notice if they are provided. Thank you for coming and giving such a comprehensive response today.

Committee adjourned at 4.23 pm