COMMONWEALTH OF AUSTRALIA

Official Committee Hansard

SENATE

ECONOMICS LEGISLATION COMMITTEE

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

FRIDAY, 21 MAY 2010

SYDNEY

BY AUTHORITY OF THE SENATE

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SENATE ECONOMICS

LEGISLATION COMMITTEE

Friday, 21 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 Bushby, Cameron, Colbeck, Eggleston and Hurley,

Terms of reference for the inquiry:

To inquire into and report on: Tax Laws Amendment (Research and Development) Bill 2010

WITNESSES

Committee met at 8.58 am

CHAIR (Senator Hurley)—I declare open this second hearing of the Senate Economics Legislation Committee's inquiry into the Tax Laws Amendment (Research and Development) Bill 2010 and 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 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. Such a request may, of course, be made at any other time.

[8.59 am]

BURN, Dr Peter, Director, Public Policy, Australian Industry Group

WILLOX, Mr Innes Alexander, Director, Government and International Relations, Australian Industry Group

CHAIR—I welcome Dr Burn and Mr Willox from the Australian Industry Group. Would you like to make an opening statement?

Mr Willox—Thank you very much for the opportunity to appear today to discuss what the Ai Group sees as a critically important issue if we are to move in the right direction in raising the research and development effort and the broader innovation effort of Australian companies. We have a short opening statement that we will make in two parts, if we may. I would like to make some comments about why we regard the subject matter of this inquiry as so critical, and then I will hand over to Dr Burn, who will indicate our major concerns with the legislation that this committee has been asked to examine.

In essence, the Australian Industry Group believes the proposed legislation overall to be deeply flawed and, if implemented, it would significantly reduce the innovation efforts of Australian industry. The feedback from our members as we have researched this legislation indicates very little support for the proposals in core economic growth industries, such as mining, manufacturing and construction.

Despite around 20 years of moving in the right direction, Australia continues to lag behind the OECD average on business expenditure on research and development. Our view is that the government's proposed R&D scheme will undermine this trend and more likely put the country's business R&D effort into reverse. One may ask why this is so important. We would argue it is important because research and development undertaken by business drives primary improvements in its productivity and equips it for greater global competitiveness. This is particularly important in the context of the demographic and, indeed, the environmental challenges we will face over the coming years as these challenges give us even more reason to improve domestic productivity and competitiveness. When business R&D gives rise to new and improved products, services and processes in a primary business, it demonstrates to other businesses avenues that they can follow by adopting similar improvements in their own businesses. This process of demonstration, leading and following delivers benefits called spillovers that are not captured by the primary business that undertakes the R&D. The presence of these spillovers provides the rationale for public sector incentives in support of the primary R&D process. Without support from incentives, the R&D decisions of the primary businesses will fail to factor in the broader economic and ultimately social benefits that derive from business R&D, and therefore in total there will be less than the socially optimum level of business R&D expenditure.

By providing an incentive, the government stimulates a level of expenditure beyond that which the primary businesses would otherwise undertake and elevates the quantity of business R&D spending towards a socially optimum level. The importance of R&D in raising productivity and improving competitiveness is, of course, relevant across the entire economy. However, it is doubly valuable for businesses on the slower side of Australia's two-speed economy. The pressures on key sectors, such as manufacturing, agriculture and tourism, to adjust to the greater call on internal resources, the higher domestic currency and the upward pressure on interest rates that are associated with the ongoing strength of demand for Australia's mineral commodities put a premium on improvements to productivity and competitiveness improvements. Moreover, for the manufacturing sector in particular, the same forces driving demand for our mineral commodities—that is, the rapid industrialisation of China and other emerging economies—are also driving unprecedented levels of global competition for manufactured products, pulling down prices and challenging Australian producers both in export markets and in our domestic economy.

For these overall reasons the Ai Group has long been a supporter of business R&D and of the tax incentive for business R&D. We regard it as a critical element in the relative success of Australia over the past couple of decades. We regard the role it has to play over coming decades as being of even greater importance. I will now hand over to Dr Burn, who will elucidate more formally our concerns about the legislation as it now stands.

Dr Burn—As my colleague has said, Ai Group is a strong supporter of business R&D and of the tax incentive for business R&D. In this context there are a number of elements to the proposed changes to the R&D tax concession that Ai Group fully supports. These include the change to the form of the incentive from an augmented deduction to a tax credit. This, together with the higher effective rate of incentive and the more

substantial increase in the rate of the refundable credit for a broader range of small to medium businesses, was warmly received by our Ai Group over a year ago, and we retain this support.

We also support the proposal to extend eligibility for the tax incentive in cases where the intellectual property is owned offshore, and the proposal to partially remove the anomalous treatment of software under the tax incentive. We supported these changes despite the government's proposal to remove the premium 175 per cent concession for certain incremental R&D expenditure. Our reasoning was that, given the government's unwillingness to expand its support for business R&D, funds needed to come from somewhere. It was not our preferred position but it was one we supported in the light of restrictions imposed by the government.

We support these changes and think they should take effect from 1 July 2010. These are positive changes that will improve the tax incentives for business R&D. They are measures that are aimed at improving productivity and competitiveness. However, we very firmly oppose the fundamentally new approach to defining business R&D expenditure that is embodied in the legislation before the committee. It is embodied in the objects clause, the changed definitions of eligible expenditure and the restrictions related to the treatment of core and supporting expenditure.

Our opposition has three elements: the timetable that the government has imposed, the restrictive nature of the definition of eligible business R&D expenditure and the heavy compliance requirements that we anticipate would arise from the structure of the new approach. Firstly, the government has given itself an absurdly short timetable for community consultation and examination by the parliament of what is a fundamentally new approach to the definition of eligible expenditure. The new approach would apply to all business R&D expenditure undertaken from 1 July 2010. Under the timetable now before us, business will have about two weeks to examine the act before R&D expenditure will come under the new regime. Furthermore, as this is a new approach, legal experts and practitioners undoubtedly will discover anomalies and unintended consequences over the coming months. These will require amendment and will require convincing the government that amendments should be made. Assuming the government is receptive, the new approach to business R&D will be adjusted on the run.

Putting aside the particular features of the proposed changes, this timetable itself will increase the range of grey areas surrounding the tax incentive and the resulting uncertainty will see businesses scale back their expenditure. This outcome sits in stark contrast to the purpose of the R&D incentive, which is to encourage additional R&D expenditure by businesses.

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

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

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

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

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

The narrow coverage of the objects clause suggests to us that the government intends to pare back the role of the R&D tax incentive to fund, almost exclusively, research. It does not intend to include much of what business R&D is about—namely the development of existing knowledge to 'devise new applications'. Instead the government intends that the R&D tax incentive will apply to activities conducted for the purpose of producing new knowledge. It would be more straightforward to refer to it as the 'research tax credit'.

The definition of core R&D activities in the bill confirms the research focus of the new approach to business R&D. The approach outlined in the bill leaves little room for the majority of what business R&D is actually about—what, in the Frascati model, is called 'experimental development'. Experimental development is defined as:

… systematic work, drawing on existing knowledge gained from research and/or practical experience, which is directed to producing new materials, products or devices, to installing new processes, systems and services, or to improving substantially those already produced or installed.

In its 2007 report *Public support for science and innovation*, the Productivity Commission broke down the proportion of business expenditure on R&D into four categories: pure basic research, strategic basic research, applied research and experimental development. Based on 2004-05 data it estimated that the total business expenditure on R&D was allocated as follows: pure basic research, 1.8 per cent; strategic pure research, 5 per cent; applied research, 31.6 per cent; and experimental development, 61.6 per cent. Critically, the Productivity Commission used exactly the same definition of experimental development as quoted above. The central point about that definition is that it covers systematic work, drawing on existing knowledge gained from research and/or practical experience.

It may be contended that while experimental development is excluded from the definition of core R&D, it is adequately covered in the definition of supporting R&D. We think that it is not and that the neglect of experimental development is further reinforced by the definition of supporting R&D activities. In the bill, supporting R&D activities are defined as activities directly related to core R&D activities except if they are activities that are explicitly excluded or if they are an activity that 'produces goods or services', or 'is directly related to producing goods or services'. One of our advisers put it this way:

… it is difficult to think of many supporting activities that don't fall into one of the three dominant purpose categories given that any activity directly related to production is captured.

I can summarise the second element of our strong opposition to the changes to eligibility for business R&D in this way: they exclude a large proportion of business spending on R&D.

The third element of our opposition to the proposed approach is that it will increase compliance costs. Under the proposed approach, business will need to split its R&D activities into core R&D activities, directly related supporting R&D activities and supporting R&D activities subject to the new dominant purpose test. This would be a permanent feature of the new approach and will add substantially to the business compliance costs of the program. As is generally the case, the extra compliance costs will fall disproportionately on smaller businesses.

Our claim about compliance costs is very different to the claim made by the government in the explanatory memorandum. We think the government's claim is wrong. It appears to rest on a view of the relative complexity of the 175 per cent premium concession that will be removed. It is true that the premium concession is complex and has a high compliance cost. However, only 26 per cent of the 7,754 companies who were registered for the tax incentive in the 2007-08 year used the premium concession. The other 74 per cent used the 125 per cent concession. Certainly for these 74 per cent of businesses the compliance costs under the new arrangements would be higher. Our assessment is that, for the remaining 26 per cent of businesses, the jury is out on whether the complexity of the premium concession would match the complexity of the proposed approach.

I have a final point on the compliance cost argument. We think that most businesses that would claim the R&D tax incentive under the new approach would experience an increase in their compliance costs. However, we would concede that, once mature, the new approach would involve a reduction in the total compliance costs associated with claiming the tax incentive across the business community, but this is because we anticipate a very sharp reduction in the number of businesses that are eligible to claim the new, highly restrictive tax incentive and assess it to be worthwhile to apply for a tax incentive that applies to such a narrow range of their total R&D expenditure.

CHAIR—Dr Burn, you probably would not have had the advantage of seeing the evidence yet, but yesterday we questioned Treasury, the Department of Industry, Innovation, Science and Research and AusIndustry about the question to which you have alluded related to production processes not being included in R&D expenditure. They were adamant that that is not the case and that the examples in the explanatory memorandum illustrate that. Have you had discussions during the whole consultation period about this bill with Treasury officials? Have you raised your concerns with them?

Dr Burn—We have raised our concerns with them about their approach. I should say that since Easter there have not been a lot of opportunities to raise our concerns with the brand new approach that was unveiled just prior to Easter. But we certainly have raised our concerns with them and we do not get any comfort from the examples they provide.

CHAIR—Why is that so? Can you provide examples where it would not be covered? I am struggling with this because we get people saying it will not be covered and we get people who will be responsible for the administration of this bill saying it will be covered.

Dr Burn—Fundamentally, our concern that production related activities will not be covered is because they are excluded or, rather, subject to a dominant purpose test.

CHAIR—Yes.

Dr Burn—That is fundamentally why we say that. Our advice and our reasoning is that activities such as trials and testing, prototype development and troubleshooting in process improvements, which are all things that would be undertaken in a production environment, would not be eligible as supporting expenditure. No matter what the government people might say, we can only go on what is in the words of the bill and what we and our advisers and our members interpret those words to mean.

We have a self-assessment regime here. We do not want to be left to the whim of officials and their interpretations and assurances—'Oh, yeah, sure; that'll be included'—when, on any reading of the bill, people looking to self-assess will say, 'I'm excluded.'

CHAIR—But the provisions allow for people to go to AusIndustry, discuss it with them and get a binding ruling.

Dr Burn—Which runs counter to or in conflict with the nature of our self-assessment regime, which is how the tax system works. It will then be up to the interpretations of whichever official you may happen to get to indicate what they think should happen or may happen, and then there is the uncertainty of an audit.

CHAIR—But is that not normally so with the tax system as it is? You are relying on the interpretation of a tax official.

Dr Burn—We take much greater comfort when the law—what is written in the bill—is more conducive to what the officials are saying, but when the bill contains words that appear to exclude the activity we cannot then rely on the assurances.

CHAIR—You said yourself it was excluded unless it was the dominant purpose.

Dr Burn—Yes.

CHAIR—Don't you think that that is reasonable—that a production process that is included should be part of the R&D if it is to qualify for R&D expenditure?

Dr Burn—We think that the activities should be included if they are producing novel results. Whether or not they are connected to the production process seems to me to be irrelevant to that. The fact is that things are done in reality. In the business world, innovations are made as things are being done. The fact that that happens and that that is the nature of business innovation is why we object to this. Those activities are directly related to production. On the reading of the bill, those activities are excluded.

CHAIR—If they are not related to the core R&D?

Dr Burn—No. It is 'or'. I think that the clause is—

CHAIR—We had very explicit evidence from Treasury that that is not the case.

Dr Burn—I have a great deal of respect for the Commonwealth Treasury, but they are not always right. Very often, in framing legislation or an approach to legislation, they run into errors.

CHAIR—How would you phrase it?

Dr Burn—Normally there is adequate time to examine these things, to consult with them and to provide scope and opportunities for things to be adjusted before they are taken to the parliament, but not in this case. I am sorry—what was your question?

CHAIR—How would you phrase it? How would you like to see it phrased, given that the government has been very clear that it does not want to include production processes that are not related to R&D?

Dr Burn—We like the idea that supporting activity should be directly related to the core R&D, and that is the definition that applies.

Mr Willox—I think we have difficulty with the concept.

CHAIR—What concept?

Mr Willox—The concept that the government is trying to apply here from the dominant purpose test.

CHAIR—Even if it is tangentially related, you would like to see it included in the R&D. I do not understand. What is wrong with dominant purpose? Is it unreasonable that it has to be dominantly related to R&D? How else would you phrase it?

Dr Burn—The current act's phrase is that it is directly related.

CHAIR—Even 5 per cent?

Dr Burn—Sorry—even 5 per cent?

CHAIR—If a tiny part of your production processes are taken up with R&D—5 per cent—you think that that expenditure should be allowed.

Dr Burn—We think that it would be a very sensible outcome to include it, because it is R&D.

CHAIR—A small percentage of it is R&D or is related to R&D.

Dr Burn—I am sorry, no. The directly related elements should be counted. I am not saying that the whole expenditure on production should be included, but the parts that are directly related should be. But, under the proposal, things are excluded if they are connected to production.

CHAIR—Again, all I can say is that Treasury are adamant that that is not the case.

Senator EGGLESTON—I would like to pick up on your comment that novel innovations development that is related to a production process but where that nevertheless is not the dominant purpose of the development should be included in this. Would you like to give us some examples for the record of what you would regard as novel developments which are produced by research?

Dr Burn—Examples of novel developments produced by research?

Senator EGGLESTON—You were talking about novel invention.

Dr Burn—Okay—research and development.

Senator EGGLESTON—Research and development that is not included under this definition.

Dr Burn—Our understanding is that if something is directly related to production and is a supporting activity then it is not included. Things like prototype development and troubleshooting in process improvements, which are clearly related to novelty, would not be included.

Senator EGGLESTON—So these would be unique developments which your process of research would have discovered or developed and they would enhance the production process of whatever it is that you are producing. Is that not what you are saying? You can have small developments which add some unique approach to a program.

Dr Burn—They can be small or they can be large. We are not too worried about the research elements of things. We think research hopefully will be captured in the element of core R&D. What we are concerned about is the experimental development—that is, the application of existing knowledge in new ways. Clearly it does not fall into the definition of core R&D and, because one way or another it is excluded under the supporting R&D tests, it will not be eligible to be claimed as supporting R&D either. That is our concern and that is not really research related; that is more experimental development—this process of developing things on the run, if you like, in the production process, which is, as the Productivity Commission notes, where 61.6 per cent of 2004-05 R&D expenditure undertaken by business actually occurred. I emphasise: that is 61.6 per cent.

Senator EGGLESTON—That is a very significant amount, so that is very important to have on the record. You also mentioned in the beginning of your comments that you were concerned about the lack of consultation and the timing of the release of this legislation inconveniencing business. Would you care to expand upon that for the record?

Dr Burn—My concern is that just before Easter a fundamentally new approach to the business R&D tax incentive was unveiled. I have forgotten the time lines, but it was about two weeks.

Mr Willox—It was two weeks.

Dr Burn—It was about two weeks that we had to digest and provide feedback on it. It was a short time before the legislation was produced. We will detail in our submission things about this new legislation that we were uncovering yesterday and will no doubt uncover today and tomorrow as well. We are only just uncovering that now. No doubt after 26 May, when submissions close, new things will emerge. This time

frame is not an appropriate time frame for introducing a fundamentally new approach to the central program this government has for supporting business research and development.

The inconvenience to business is something that will come out later on because, from 1 July 2010, the new regime, if it is passed, will be the regime that governs R&D, and business will just be there saying: 'Well, who knows? We've got AusIndustry saying that. We've got the weight of legal opinion saying this. Who knows?' The whole concept of supporting and inducing additional R&D will be undermined by that uncertainty. Even if overall it worked out to be a fantastic new approach once the dust had settled, this problem would exist.

Mr Willox—The time frame is very short. That is what is causing enormous agitation among our membership in particular. This is a whole new concept suddenly being laid out in front of them with very little time for them to absorb it, respond to it and then attempt to adapt to it. As Peter said, this is causing a lot of problems among our membership who are heavily involved in R&D, because they are now suddenly having to turn around and examine their R&D pathways through the future and how it applies under this new legislation without much time at all—hardly any—to adapt.

Senator EGGLESTON—Have you discussed the time frame with the government?

Mr Willox—Yes, we have. We put it forward in our original proposals that the legislation should be delayed to allow for further discussion with business.

Senator EGGLESTON—How long would you like to see it delayed for?

Dr Burn—We have asked for it to be delayed, but we have suggested that the delay should apply to the restrictions on eligible R&D but that the changes that are relatively straightforward—that is, changes related to the change of the form of the tax concession, the changes to the rate of the new tax credit, the expansions relating to software and proposed changes relating to offshore-owned IP—should all proceed. But the restrictions should be examined much more closely. The reason for that is that no doubt—not today—you have been made aware of concerns that exist around the misuse of the tax concession. We share those concerns.

When the Cutler report came out, we were very receptive to what was in it. Basically it said that there are some areas where there was a case of misuse and that the definition of R&D should be refined to address those areas of misuse. We think that is a sensible thing to do as ongoing maintenance of the tax act. But they did not recommend a wholesale rewrite of the definition of expenditure eligible for R&D, nor was there an indication in the government's media release and announcements in the budget last year, when it indicated that it was proceeding with some changes, that it was going to redefine eligible R&D. I should say also that there was a consultation paper produced in September 2009 and draft legislation produced just before Christmas last year which pointed to and then contained a very different approach to changing the R&D tax incentive to that which was produced in April.

Senator EGGLESTON—So there is a lot of confusion there.

Dr Burn—There is ongoing confusion. We anticipate that it will only get worse.

Senator EGGLESTON—Unfortunately, it has been the pattern of the Rudd government to introduce legislation with short time frames and leave industry to try to cope with the changes without adequate time.

Senator CAMERON—What? Are you making political speeches? We can all do that.

Senator EGGLESTON—Thank you, Senator. I am making a comment.

Senator CAMERON—And I am going to give you political speeches if you want.

CHAIR—Order!

Senator EGGLESTON—I do think that this is an example of the typical pattern of the Rudd government—introducing legislation in short time frames.

CHAIR—Senator Eggleston, we have a short time frame.

Senator EGGLESTON—I would like to ask the witnesses whether or not they would like to see the introduction of this legislation deferred for at least a year so that all the problems can be sorted out.

Dr Burn—Our first, best approach would be to see those changes which I mentioned earlier go through and the restrictions on eligible R&D expenditure put aside and then re-examined with clarity around what the objectives are. If the objectives are as set out in the Cutler review—to refine the tax concession to address areas of misuse—that should be put forward as an objective, and consultation on how to achieve that should be undertaken. We would be an active and willing participant in that. We would support a number of the changes,

as I have indicated, but would recommend that the restrictions on eligibility not be proceeded with and that they be delayed and reshaped so that they address the objectives set out in the Cutler review.

Senator EGGLESTON—Thank you.

Senator CAMERON—Dr Burn, it was not just the Treasury who gave evidence yesterday. The department gave evidence on what would and would not be eligible. I asked them specifically about one example I knew from practical experience in terms of applying research and development to a production process—and you are probably familiar with this. This is a food-processing plant that processes peas. New technology is produced—pneumatic technology, electronic technology and computer technology. It identifies a black pea coming through on the production line. The pneumatic jet pushes the black pea out. It is highly sophisticated break-through technology. You produce that technology on pure research. You then build the technology, you put it on your production line and you test it. I thought that was a perfect example of what you are saying is a problem if you do not get some access to research and development funding for testing it online. Both Treasury and the department were quite unequivocal in saying that, yes, the process of installing that on the production line—and you could even have the production line running for a day, a week or three months to test it and make it work—would be eligible. Isn't that a typical example of that what you are looking at?

Dr Burn—I suppose there is a degree of comfort in that, but the bill says that supporting R&D activities are activities directly related to core R&D activities, except if they are directly related to producing goods or services. We have a problem with reconciling what our friends from the department of industry mean. I worked with these guys when I was in Treasury. They are also from Treasury. What these people say about that case is not what the bill is saying.

Senator CAMERON—I am surprised you were not monitoring the hearing. Did you, AiG, monitor the hearings yesterday?

Dr Burn—No. We have not seen the transcripts. I do not think they are up there.

Senator CAMERON—You could have monitored them, because both the department and the Treasury were there. They have made that statement in unequivocal terms. If that is the practical outcome of the legislation, does that make it a more acceptable form for you?

Dr Burn—We think that the legislation should be clear about what the practical outcomes should be. At the moment the bill suggests to us that that would not be a practical outcome.

Mr Willox—There is a difference here between the intent that they say will apply and what is actually written in the legislation. That is our concern. Fundamentally it is the legislation you go on, not the promise or an offer from an industry department bureaucrat.

Dr Burn—What would be the status of a comment made by an official in a Senate hearing when someone was being audited for their R&D expenditure?

Senator CAMERON—I think the statement would hold some weight, because you have senior department and Treasury officials indicating on a practical example that this is how it works. That *Hansard* will come out; it will be on the public record. Let me go to another issue. You talked about the *Frascati Manual*. I tried to have a look at the *Frascati Manual*, but you cannot get it; you have to buy it. That is always a problem.

Dr Burn—Could I buy him a copy?

Senator CAMERON—I do know that the *Frascati Manual* defines experimental development as:

… systematic work … which is directed to producing new materials, products or devices, to installing new processes, systems and services, or to improving substantially those already produced or installed.

The argument you advance is that the bill is inconsistent with the *Frascati Manual*. Is that correct?

Dr Burn—That is right.

Senator CAMERON—Can you show me how the new definition does not fit that *Frascati Manual* definition?

Dr Burn—Yes. The definition of 'core R&D activities' under the bill is:

… 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 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 …

I believe the Frascati model is about drawing on existing knowledge in the quote that you have just given me. Our view is that the quote that you have just given me related to Frascati does not fall into the definition of 'core R&D'. The question then is whether it survives all the little obstacles that are put in the way of something qualifying as 'supporting R&D'. We think that, given the general nature of those qualifications, there is a very grave risk that it will not qualify as 'supporting R&D' and will not qualify at all for any tax incentive under the new act, if this bill is passed.

Senator CAMERON—I ask you to have another look at that in the context I have put it to you. You might need to take it on notice. Could you also provide me with details of where experimental activity on a production line would not fit within the new definition of 'core research and development', because I am not convinced, after hearing Treasury and the department yesterday. We may actually be closer than you think in terms of where we are on this. I would like you to go back and have another look at that and answer those questions.

Senator BUSHBY—Thank you for your evidence today, which I think has been very useful. Quite clearly, from your perspective, the nub of all of this appears to be that the way the bill is written does not necessarily reflect what the government and its officials are saying will be the impact. Yesterday we heard evidence from Treasury and were told that all real issues that had been raised have been addressed, other than those where that was specifically intended to be the case for policy reasons. The only other issues that had been raised with them were those that either were not made out because there was enough information or were not strong arguments. From your consultation with the government through its officials, do you agree with that statement—that real issues that you raised have all been dealt with?

Dr Burn—No, they have not been dealt with.

Senator BUSHBY—Do you think you raised them in a way that made the case and provided enough information for the government to understand those issues?

Dr Burn—We did the best we could do in the timetable available to us.

Senator BUSHBY—But I understand that—particularly recently with the final bill—there has not been a lot of time to do that. However, there were consultation processes previously where you raised these issues and you believe you did so in a way that the government should have understood, but they have not been addressed.

Dr Burn—Yes, we did. However, we raised only issues that were put before us at the time. Issues that arose only in April clearly were not the subject of any discussion between us and the Treasury.

Senator BUSHBY—Which particular issues arose only in April?

Dr Burn—The new definition of research and development.

Senator BUSHBY—The definition in particular.

Dr Burn—There is a new objects clause.

Senator BUSHBY—I just wanted to get that on the record. I am aware that we are short of time. On the intention of drafters, in your experience, is it always the case that laws are interpreted as intended or in accordance with statements that are made by ministers in explanatory memorandums?

Mr Willox—No, unfortunately that is not the case. We feel that, if the legislation goes through as it now stands, it will be the subject of much testing going forward. It will need a lot of examination—perhaps through the courts and through the auditing processes. This will lead to uncertainty in the years ahead, we believe, if this legislation stays in place, because it is not clear. The difference between the legislation and what might perhaps have been stated as to intent is quite marked.

Senator BUSHBY—I am not sure whether either of you is a lawyer, but are you aware of whether, under the rules of statutory interpretation, statements made by the minister in the explanatory memorandums or by officials at a Senate hearing are at all binding on courts in terms of the way they interpret law?

Mr Willox—Neither of us is a lawyer.

Senator BUSHBY—I actually know the answer, but I am not giving the evidence!

Senator CAMERON—Why don't you prompt them? Then they can inform us.

Senator BUSHBY—Since you are asking the question, Doug, my understanding is that it will be persuasive when the wording is unclear, but it is not at all binding.

Mr Willox—Let me put it this way: where there are differences between intent and reality, there is often a great big black hole, which makes things very unclear for business when they are trying to go about the business of doing business. That, as well as the eligibility criteria and the compliance costs, will weigh very heavily on industry going forward in what it hopes to achieve and do in R&D programs as it moves forward. We have already seen from a lot of members indications that they would have to consider pulling back or pulling out of Australia in terms of R&D if the legislation goes through in its current form.

Senator BUSHBY—Okay. That is probably the case with your bigger clients. But I take it from the comments that were made earlier about the self-assessment process that a lot of your smaller businesses that these changes are specifically intended to benefit will look at all this, see the uncertainty and the compliance costs and come to the conclusion that it is all just too hard, and will not proceed.

Mr Willox—There is a lot of indication from smaller companies that this will all become too complex for them and will be a major disincentive for them to step forward in R&D because they do not know where it will end up and they do not know what the audit will find, and they do not know what the officials from whom they will have to seek advice will find. It makes it very difficult. When you are a small company, you do not have the resources to move forward.

Senator BUSHBY—We heard evidence yesterday that the rulings that are available are only on the facts, not on the law. Your main concern is about the law rather than the facts.

Mr Willox—Correct.

CHAIR—I think there is a question on notice.

Senator CAMERON—I indicate, Dr Burn, that I may have a number of questions on notice relating to the issue of core R&D, so I will get them to you as soon as possible in writing.

Dr Burn—Thank you very much.

CHAIR—I thank the Australian Industry Group for attending.

Mr Willox—Thank you.

[9.47 am]

CHIA, Mr Andrew, Group Tax Manager, Cochlear Ltd

OLIVER, Mr Gregory, Research and Development Analyst, Cochlear Ltd

ROBERTS, Dr Christopher, Chief Executive Officer, Cochlear Ltd

CHAIR—Welcome. Thank you for coming in this morning. Dr Roberts, do you have an opening statement?

Dr Roberts—Just a very brief one, Senator. Good morning to all of the senators.

Senator CAMERON—Good morning.

Dr Roberts—Good morning, Senator Cameron. On my left is Mr Andrew Chia, who is responsible for our global tax in Cochlear, and on his left is Mr Greg Oliver, who has been many decades in industry policy. He has grey hair like I do! He advises us on our in-house R&D. We have been a party to the Advanced Manufacturing Coalition, which is presenting after us. That group has provided a very, very important submission to you. We absolutely endorse that submission. I think it is extremely well written, pithy and succinct. It hits the key issues. I really want to emphasise the importance of that, but I feel it is relevant to attend and appear in front of you to add Cochlear's perspective on it.

Cochlear has been a quintessential example of a company that has benefited from long-term bipartisan innovation support of the government. Probably we are here today less about Cochlear and more about emphasising the importance of this legislation. It is probably the single most important piece of legislation in terms of supporting innovation, and innovation, particularly technical innovation, is probably the single most important tool that you have to create wealth in this country. Professor Robert Solow, from MIT, was awarded the Nobel Prize in economics in the eighties for demonstrating that technical progress had a far, far greater impact on driving economic prosperity and growth than, indeed, labour and capital together. Technical innovation is absolutely key.

This legislation has been in place for decades in various forms, and appropriately you are looking at taking this legislation, tweaking it, reforming it and making some improvements. That is to be applauded. It seems, when you stand back and look at it, that there are probably three things that could be addressed in this legislation. No. 1 is: was the incentive appropriate enough for SMEs, given that they did not have taxable income? No. 2 is: was there a particular problem with the way software was dealt with in the legislation? No. 3 is: what is the impact of the large, perhaps excessive, claims being made, and is there a distortion from that?

I think that largely those three issues have been dealt with, in terms of the changes being made for the tax credit system for the SMEs. I think that is to be applauded. It is absolutely excellent and fantastic. But I think the legislation has problems, if I could suggest that, in the way it is dealing with the other two problems it is fixing up. It is probably less about software. I think software has been amended, and we can probably take that off the table. But it seems that the baby is being thrown out with the bathwater in trying to fix up how you deal with these excessive claims so that, to the extent that you are going to give some more money to SMEs, the overall cost of the program is neutral.

I assume that one of the objectives of this legislation is to keep it revenue neutral, and that is fine, but the changes to the definitions of R&D are genuinely problematic in terms of various industries—for example, in manufacturing, the importance of the development side versus the research side in manufacturing. You end up with unintended consequences, such as the consequences of complexity and the like from the dominant purpose test, and I am not sure why. There are other mechanisms of keeping the legislation revenue neutral—for example, capping a claim or capping the multiple supporting R&D could be your core R&D. The piece that puzzles me is the solution for the problem that is being proposed.

I will leave my comments there. To summarise: the legislation is incredibly important, absolutely incredibly important. It does some good things for SMEs, but it is still problematic around the definitions, and it is easy to fix. There are other solutions. It can be done by 1 July, and we do not have to make it as difficult as it seems. I think there is a very common theme in some of the things that I have heard and some of the things that the AiG mentioned. I will leave it there.

CHAIR—I think you are right in stating that there is bipartisan support for research and development. I think the minister sees that as a way of improving and stimulating further research and development in industry. You were talking about other ways of achieving this, including capping, but we have had other

submissions that suggest that capping would not be the way to go and that that in itself would cause problems. Where do you see other solutions in this whole thing?

Dr Roberts—I am sorry; I have not heard the argument against capping, but you need something to keep it revenue neutral. If you do not want to cap it, perhaps you could cap the ratio of supporting R&D to core R&D. From my understanding, some of the excessive claims are where the supporting R&D is very, very large relative to the core R&D. You deal with it by a multiple like that. There are other ways of dealing with it, perhaps by pre-approval for the program.

CHAIR—That is indeed part of this. AusIndustry has been given significant additional expenditure both to go out and educate business about the changes and to allow for increased auditing and for pre-approval of programs. That is indeed part of this package.

Senator COLBECK—On your comments relating to the timing of the legislation, I think it is probably fair to say it has been a fairly turbulent six or eight months since the initial proposals in the discussion paper came out in September and the initial draft legislation just before Christmas and then the latest version arrived just before Easter. It has been moving very quickly. The government has responded to some of the initial concerns that came out prior to Christmas. There has been quite a move from that initial approach to where we are today. But it really has pushed us up very hard up against the 1 July commencement date for the legislation.

Yesterday we heard officials from AusIndustry saying that they would be giving information—information sheets and things of that nature—to industry in July. From my perspective, that would have to be quite problematic. Getting information in July about a tax that started on 1 July would create all sorts of difficulties. On the opportunity to effectively introduce this legislation with the obvious improvements that you talked about but also to try to deal with the negatives, you have mentioned placing caps on claims. Do you have any sense of the scale on which that might work? You also mentioned the ratio side of things. From a practical perspective, what are reasonable scales for that sort of thing?

Dr Roberts—I do not have the data. I have never seen the data, which is not public, on how big the big claims are et cetera. My understanding of the number of companies is that there are maybe 8,000 companies registered and perhaps 200 companies claiming more than $10 million, for example. It must be a relatively small number of companies that have very, very large claims. Someone would have access to that information. I do not know the quantum that it needs to be. Someone must have that information.

Senator COLBECK—Let us go back to Cochlear. From your perspective of the new definitions and the difficulties that they create, when you decide whether or not to make a claim under the new regulations or new definitions, you would obviously do a risk analysis of whether something does or does not comply and what it will cost you to go through the consultative process and make a decision, yes or no, about whether to make an application for this R&D and then decide whether or not to do it. Does the legislation as it is worded now tip that in favour of saying it is too risky: 'Let's not do the R&D,' or, 'Let's not make a claim'?

Dr Roberts—It certainly adds complexity and cost.

Senator COLBECK—So compliance is up?

Dr Roberts—Compliance cost. From my understanding of yesterday's evidence, there is an estimate of $30 million to $50 million from Treasury of the extra compliance cost over something like four years—tens and tens of millions of dollars of extra cost that is completely non-productive. For sure, we have to take some of that cost, like a lot of other cuts. Greg, do you have a comment on the complexity?

Mr Oliver—Yes, I can add to that. As you know, under the current R&D regime, there is a requirement for R&D plans. While that requirement will not exist under the new legislation, there will nonetheless be a significant amount of additional planning required by companies so that they can reassess the eligibility under the new definition, on the one hand, and also, importantly, to predetermine, perhaps throughout the annual life of a project, what activities will now be core and what will be support.

We see that preparatory role now as being very significant not only in terms of the additional workload that we have but also for a lot of the smaller companies that do not. While we do not want to ingratiate ourselves here, we have quite a sophisticated R&D planning mechanism, not for the tax concessions but of course because we are in a regulatory regime and we have very specific and detailed plans. For us it is an easier impost, if I can use that expression, to step in and do that. In fact, we have already started. We anticipate somewhere between now and September having in place what we need to do, what projects we will claim and on what basis we will claim them.

Attendant with that we have already commenced new time-recording systems for the up to 300 respondents in an R&D claim so that we can track and monitor their activities so that we will be in a position to register their activities in April 2011. We are not complaining about that; it is part of the regime in which we live. We do this elsewhere in the world. It is quite an onerous task for us but, more importantly, for the smaller mediums.

Senator COLBECK—It appears to me from the evidence so far that it is effectively largely manufacturing and the work that needs to go on in the development of the manufacturing processes that are most significantly hit by the revised definitions because of the dominant purpose test.

Mr Oliver—Yes. That is our reading of it.

Senator COLBECK—That is where the additional compliance cost comes in, and that is where the additional risk comes in as to whether or not these issues will comply. It brings in the risk factors of the self-assessment process and the potential consequences down the track with the additional resources that have been supplied for things like auditing and the approach from government.

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

Senator CAMERON—Thank you, Dr Roberts, Mr Oliver and Mr Chia. Can you provide us with an example of where an activity would be excluded by the dominant purpose test, which you believe should be covered by the new tax credit?

Mr Oliver—I will just set the framework here. First let me say that the dominant purpose test is not a major impost for Cochlear because we have very well prescribed test processes and procedures. We are in a regulatory environment. We have to build implants that survive in a person's head for 75 years and we cannot get it wrong, so we have very well prescribed reasons for doing trials. On some occasions we have output from those trials that is saleable but, generally speaking, because of the saleable output we cannot claim the inputs to the trial under the current feedstock rules.

There would be an impact from dominant purpose because some of the activities that support a trial would be supporting activities. Because of that saleable output, there will no doubt be some disconnection of the eligibility because of that. But you must realise that a lot of the R&D we do in the factory, plant or production area is new tool and process design as opposed to just running a new product design through similar tools. There are two arms to R&D here: one is product development and, importantly, the process development. Recently we spend approximately $90 million on developing a new nuclear—

Senator CAMERON—I am sorry, Mr Oliver; I do not have a lot of time. I would like you to come to the question. What would you be excluded from doing under the new legislation that you can do under the present legislation?

Mr Oliver—It would affect some trial costs.

Senator CAMERON—Why?

Mr Oliver—Because they would fail the dominant purpose test.

Senator CAMERON—Why would it fail the dominant purpose test?

Mr Oliver—Because in many cases, depending on where we are in production, such as a prepilot stage as opposed to a postpilot stage, there will generally be some fortuitous saleable product that will go with that. We can get into this debate and argument about whether we are doing it for the dominant purpose or we are doing it to meet the trials. What I am saying to you is that, as much as we have a very strong regulatory reason to do the trials—we cannot sell a product in the world without them—we still feel there could be some challenge to some of the claims we make in dominant purpose. My opening remark was that, while it is not a significant impost on Cochlear, our production R&D is perhaps less than 20 per cent of our total claim as opposed perhaps to the multiples we see in other areas.

Senator CAMERON—Can I ask you to have a look at the whole context of the proposed legislation? As you aware, you read legislation in its overall context; you don't just read a part. You have to look at the other areas.

Mr Oliver—Sure.

Senator CAMERON—Can you look at the objects clause and give me some comment on the objects clause, which refers to both research and development. It says:

The object of this Division is to encourage industry to conduct research and development activities …

I ask you also to have a look at the evidence that was given yesterday in my questioning of the department and Treasury on the example of the pea. What would be different between that example and issues that you say are a problem? If others who are producing food can claim for associated activities and development activities, why can Cochlear not do the same thing?

Mr Oliver—We have not been of the view that under the new objectives we cannot continue to claim the R&D that we do. We have not said that. But we do believe there will be some impact in regard to that because of the transition point between when you are doing research and when you are doing development. I am not talking production environment, so let us talk about the D&D workshop, if you like, to remove that. We see that there will be some point at which we have to make determinations as to whether or not we are still learning and as to whether or not we still get an acquisition of knowledge throughout this process. Does that answer the question, Senator?

Senator CAMERON—No, sorry.

Dr Roberts—May I add a comment? Senator Cameron, the objects clause in the draft legislation definitely narrows the definition and has a much greater emphasis on the R rather than the D, compared to the existing situation. Do you not think that?

Senator CAMERON—No. I am just saying that the evidence we have from both Treasury and the department which will be implementing the act is that there is no problem here. The examples they give are that you can conduct research and development. My practical experience in the food industry demonstrates that there is not a problem, given the response that we got yesterday. I would like you to have another look at that and maybe come back with some practical examples.

Mr Chia—In regard to the application of when the taxpayer is audited, they are audited by the ATO as well. From that perspective, it is the greyness and the certainty which Cochlear, as a taxpayer, will face under the scrutiny of a different department, from our perspective. As much as AusIndustry and Treasury say it is nice in intent in terms of the EM and the examples they provide, the legislation is a bit grey, and that uncertainty creates a bit of discomfort.

Senator CAMERON—I know that other senators are waiting to ask questions, but I have just one more issue. I think you are a member of AiG. They indicated that they wanted a self-assessment regime. There is still a self-assessment regime here. They spoke about the inconvenience to business. I suppose what we have to balance against the inconvenience to business is public good and accountability for public expenditure. That is a fundamental issue for us.

I have seen examples where large multinational mining companies with core R&D that is worth $20 million say they are using that in their production processes, and suddenly their claim becomes $500 million. In the construction sector they say they will install new air-conditioning in a building, so they claim the cost of the whole building against the R&D. In the manufacturing sector, people are upgrading a processing plant and claiming the upgrading for the whole processing plant against R&D. I am sure that is not Cochlear's view of how this should work.

The question I put to you is: how do we balance this effectively to make sure that these types of rorts are out of the system and that companies like Cochlear, which are investing in the national good, are looked after in terms of their R&D? That is the issue for us.

Dr Roberts—Senator Cameron, we are completely aligned in terms of what the problem is. Where I do not think we are aligned is about what the solution is and how we fix the problem. What we are saying is that the way it has been fixed has a whole series of unintended consequences and there are other ways to fix it that must have been looked at and presumably rejected. I guess it is far from intuitive why those other relatively simple solutions have been rejected. Those two examples that you mention could very, very easily be addressed by setting some ratio of supporting versus core R&D or a cap.

Mr Oliver—Or even a cap on the overall size of the project that then drives the need to have an internal review or advance approval.

Mr Chia—Or when trials are run over a period of time, such as when a trial is run over more six months, you get approval for that to become eligible expenditure under the new incentive.

Senator COLBECK—I have a question in relation to Senator Cameron's question and the evidence that Mr Oliver has just given. In relation to some of the production trials that are associated with the R&D and just thinking back to some of the examples in the explanatory memorandum that talked about revenue from the trials, you make that specific point. I think that is raised as one of the discussions in the examples in the explanatory memorandum.

One of the grey areas that comes out of this whole process is the revenue that might be garnered from the trial itself and the question mark that that places over the trial process as to whether or not it is still R&D. Going back to Senator Cameron's example of the black pea and the technology that is involved in that, the question mark becomes whether, if the company that is putting that production line into place gets significant revenue out of the trial from selling the product that is made with the new technology, that places a huge question mark over the eligibility of that particular part of the processes from the definitions of the new regulations.

Mr Oliver—Senator, firstly just for the sake of understanding, under the current legislation the costs of running the trial—that is, the overheads and the direct factory costs to the extent of running the trial—are eligible regardless of whether you have saleable output. The magnitude of the saleable output is what affects the feedstock inputs that get into that trial cost. Just to be clear: first of all, just because you run the trial in a production environment does not mean it is ineligible, and whether you are doing core R&D or support R&D on that process is really irrelevant to that. I have to confess that I saw the new feedstock provisions yesterday and did not understand them. I would not comment on them today because in my experience with feedstock is that no-one does understands them for some years after application. Someone in the room may qualify this, but I sensed that the new feedstock rules will now call that centre bit 'feedstock'—that production cost. Someone in the room might know better, but maybe not. I cannot qualify the exact impact of the new legislation in respect of the new rules in that regard.

Senator COLBECK—That was certainly something that I picked up when I was reading through the examples in the explanatory memorandum. You have mentioned the fortuitous sale of product from a trial and that creating a question mark.

Mr Oliver—Yes.

Senator COLBECK—So I was just looking for some clarification on that particular point because I think it is one of the areas that remains very grey—

Mr Oliver—It is very relevant.

Senator COLBECK—and creates uncertainty as part of the new regulatory wording in the new bill.

Mr Oliver—Absolutely. Yes, I totally agree.

Senator BUSHBY—I note that you are part of the Advanced Manufacturing Coalition, which has put in a submission. As an individual company, have been you been dealing with Treasury as well?

Mr Chia—Absolutely, yes. We have been in the consultation process ever since—

Senator BUSHBY—As part of that, you have raised the concerns that we have heard about today?

Mr Chia—Yes.

Dr Roberts—Yes.

Senator BUSHBY—And they have not been adequately addressed, in your view?

Mr Oliver—No, I would not—

Mr Chia—They have been very cooperative throughout the consultation process. That has been great. There was a first round of the consultation.

Senator BUSHBY—But clearly you have raised concerns that still exist as you sit here before us today, so they have not been fully addressed.

Mr Chia—Not entirely.

Dr Roberts—A lot has happened in that consultation process. I think that there have been some very positive amendments and changes, but there are still some problem areas.

Senator BUSHBY—The definition of R&D is a new change.

Dr Roberts—It is objects, definitions and dominant purpose test. It is the consequences of those three areas and what you can and cannot claim, and then it is the complexity that that introduces, for no obvious good other than fixing the examples that Senator Cameron cited, where there are other ways of fixing it.

Senator BUSHBY—Exactly. There is more than one way to skin a cat, so to speak.

Dr Roberts—You are actually quite close. You could amend this. It would be relatively straightforward.

Senator BUSHBY—While still delivering all the outcomes the government is seeking to deliver?

Dr Roberts—While still achieving what you want to achieve.

Senator BUSHBY—We heard evidence this morning that the Productivity Commission report in 2005 included a breakdown of research and development and showed that experimental development at that time was about 61.6 per cent of the proper R&D activity at the time. From Cochlear's perspective, what percentage would experimental development be of your research and development as opposed to the other three categories, which were—and I did not get the actual term—initial research at 1.8 per cent, strategic-pure research at 5 per cent, applied research at 31.6 per cent and experimental development at 61.6 per cent of the research and development?

Mr Oliver—A year from now under the new legislation, we could probably answer that. In this last year, 2008-09, for example, we would have had a very high ratio of the research side because we are in a phase of developing quite a lot of new products, so there has been a lot of emphasis there and very little on the production side, if you like, in that same time period.

Senator BUSHBY—But that will change depending on—

Mr Oliver—It changes where you are in the project.

Senator BUSHBY—the level of maturity of the research you are doing.

Mr Oliver—That is exactly right.

Senator BUSHBY—At times you might have to put a lot of effort and resources into the research side of it, and necessarily that then moves on to your experimental development side of it.

Mr Oliver—Yes, exactly.

Dr Roberts—It is the importance of the D as well as the R, and a company like Cochlear is doing more D than R. It is capital D and little r. We call it R&D. It is the recognition that it is an ongoing step-by-step-by-step building on what has gone on before. To give you an example, 30 years after the first implant of our cochlear implant, we are still spending 13 per cent of our revenues on technological innovation—30 years later, 13 per cent of R&D. We are doing that because it is a step-by-step journey, and it is development. I guess that is the difference between, say, devices and drugs. A drug either works or it does not, but with a device you hit it with a hammer or paint it green or make it blue and add a little widget or whatever, and you develop it. It is a development process. It is the successful development of that over the long term that creates substantial competitive advantage and keeps you in business, and that is why the development side is really important. Even if you come up with an emphasis on the R that might help the SME when it starts up, unless it gets in its head that ongoing development it will not be there. It is a really important point.

Senator BUSHBY—I agree that it is a really important point. Given that, and given the way the bill is currently drafted, as opposed to the evidence we have heard from Treasury officials on how it is intended to be interpreted, and given your reading of that, what impact do you think that will have on Cochlear's ability to continue to invest 13 per cent and to maintain your competitiveness against your competitors in other places, which I believe exist?

Dr Roberts—Less of our activities are claimable, so we are less able to do that, by definition. That is a consequence of it. That is the consequence for Cochlear, but this is more than Cochlear.

Senator BUSHBY—I know.

Dr Roberts—This is what we are doing for Australia.

Senator BUSHBY—You are sitting here before us and you are, in a lot of ways, an iconic company in terms of the way in which Australians view you. One of the reasons that you are an iconic company is because you have been able to invest and develop a product which does great things, and you do it in Australia.

Dr Roberts—Correct.

Senator BUSHBY—I think all Australians would love to see that type of example right across the board with other companies. If this bill has the potential to put that at risk, as I believe you are saying, that is important for the committee to hear about.

Dr Roberts—It is hard to read this stuff and not see a distinction between the R and the D, coming back to the objects test. I am surprised at some of the evidence yesterday, given the way the draft legislation is written.

Senator BUSHBY—Thank you.

Senator EGGLESTON—One of the provisions in this bill is that intellectual property need not be held in Australia. I wonder whether you have a comment on that. Where is Cochlear's intellectual property held—in Australia, or overseas?

Dr Roberts—It is in Australia.

Mr Chia—Basically, Cochlear's R&D activities and all the IP are located in Australia. We will continue to be an Australian company in terms of what we continue to develop in products. Initially in our input to the consultation process as part of the Cutler review we suggested looking at the broader picture of how to encourage keeping IP in Australia. It was one of the recommendations that came out of the review, but it was obviously not put on the agenda because of the revenue neutrality of the whole program, which the government wanted to achieve.

Senator EGGLESTON—You thought IP should be kept in Australia. Is that what you just said. I am sorry; I could not quite make that out.

Mr Chia—Yes, sorry. To clarify that point again: yes, IP should be kept in Australia.

Senator EGGLESTON—Briefly, what specific disadvantages do you see in its not being required to be kept in Australia, if any?

Mr Chia—Pardon?

Senator EGGLESTON—What specific disadvantages do you see, if any, in not requiring IP to be kept in Australia? Do you see this as a measure which might disadvantage Australian research and development and industry?

Mr Chia—In terms of international competitiveness, other regimes around the world encourage the return of royalties to be taxed more favourably. There are international incentives that encourage a greater deduction. From the perspective in which I understood the intention of the legislation, it was to keep Australia competitive in terms of the other OECD nations. We are addressing the R&D part, but I think the IP part has been shelved because of the revenue neutrality of the program.

Senator EGGLESTON—Given the time, thank you.

CHAIR—I thank Cochlear for coming in this morning.

Proceedings suspended from 10.20 am to 10.33 am

GREEN, Prof. Roy, Dean, Faculty of Business, University of Technology Sydney

Evidence was taken via teleconference—

CHAIR—I now welcome Professor Green. Professor, would you like to make an opening statement?

Prof. Green—Yes, I could make an opening statement in general terms. Good morning and thank you for inviting me to the committee. I think the main general point is the importance of innovation to public policy. R&D support is part of that, but only part, and innovation policy is crucial at this stage of our development, largely because of its impact on productivity. There are wider elements as well, as were highlighted in the Cutler review, *Venturous Australia: building strength in innovation*, on environmental issues and climate change and also on social inclusion.

The productivity agenda is really central to the R&D element and has been covered also to some degree in the House of Representatives Standing Committee on Economics, which reported earlier this year. But that was in large part in relation to the structural deterioration of productivity growth that has occurred in Australia over the last few years—since about 2000 and 2001—what the causes for that were and how we would address that in public policy. It made a number of recommendations. One aspect is undoubtedly the case—that is, behind the windfall gains of the resources boom mark 1 we did experience a structural deterioration in our productivity performance as a country. That potentially undermines our longer term recovery agenda, especially as we move into boom mark 2 and another terms of trade shift which will threaten the creation of the so-called two-speed economy and, in that context, with a lot of pressure on our export firms and our import competing firms, both in manufacturing and in services, but particularly in manufacturing.

Productivity through innovation will be the key to our future competitiveness. In that context, R&D support has been shown, I think, in the literature to have an impact on productivity and growth. There is a recent report to which I might refer you—in fact, it is so recent that it came out only in the last few days in the United Kingdom. It is a document that was delivered to the new Prime Minister, Cameron, that resulted from an inquiry led by James Dyson, the famous entrepreneur, called *Ingenious Britain*. It contains quite a lot of evidence in relation to R&D support and, in particular, the experience of tax credits in the UK with reference to a number of studies of the impact of that on growth and productivity. But it also refers again to the wider context.

There is a lot of other literature which puts competing claims for other aspects of innovation and public research. A new report was announced or introduced only a matter of weeks ago by Jonathan Haskel of Imperial College in London called *Public support for innovation, intangible investment and productivity growth in the UK market sector*, which highlighted the importance of public research. It needs to be taken into account in making assessments of the cost-effectiveness of various forms of innovation support. Finally, another aspect of innovation which is often overlooked is the non-R&D, non-public research element of innovation and that is organisational innovation—what needs to happen to improve the management of our organisations to achieve productivity growth. The London School of Economics and a team with which I was involved—sorry, was someone wanting to say something?

CHAIR—No, Professor Green, we were listening carefully.

Prof. Green—I heard something in the background. Just to complete that: the importance of organisational innovation should also be stressed in this context and the role of management. There was a study recently by the London School of Economics, and we participated in that from the Australian end with Australian data showing the enormous impact of improving management of our organisations and its impact on productivity. I know that this committee's inquiry is about R&D, in particular, in relation to the tax credit. I am happy to talk about that, even though I must stress that I am not a tax expert—I am coming to it as an economist. I am happy to talk about the tax credit but in the context of this broader approach to innovation which has to be underpinning the government's agenda.

CHAIR—Thank you, Professor Green. I think we have had a good deal of support from submissions regarding the tax thresholds and the changes to the tax law. I think it is fair to say that a lot of the criticism about the bill in specific instances is around this idea of the development and the processing of research and the dominant purpose clause that has been introduced. Do you have any comment about that? Are you aware of these criticisms?

Prof. Green—I am aware of the criticisms. I was concerned initially when the changes were announced that this was not an exercise to cut the resources aimed at the scheme in the guise of shifting resources from

one group to another. Having looked closely at the changes, I think that they are positive ones. Even though they will disadvantage some areas that are currently gaining from the existing scheme, they will favour others. I would like to quote briefly from this new document *Ingenious Britain* which goes right to this issue. They have had that debate in Britain recently. Let me read this out. You will find this on the web and I am happy to send you the link:

The current system is well intentioned but not well targeted. It needs to be reinforced if we are to secure the future of the UK as a high tech hub. Too much money currently goes to the wrong companies and too little to the right companies. It needs to be refocused to those companies where the barriers to a sustained R&D programme are greatest and the potential spill overs to the rest of the economy are greatest. That means high tech companies, small businesses and start-ups.

We are not the only country having this debate. I think the current amended draft exposure bill, or whatever the title currently is, alleviates concerns about the tightening up of some of those criteria. There is still some definitional way to go in relation to what is in fact R&D and the *Ingenious Britain* report—and I would agree with this as well—advocates a broad view of what is meant by R&D. In fact, Singapore is taking its R&D tax credit and turning it into an innovation and productivity tax credit. Some countries are including design training and intellectual property protection.

It is important for us not to constrain what is meant by R&D, but I do support the move to something like dominant purpose and also that ventures should be innovative and risky. I think that is essential to getting those smaller companies out on the cutting edge that wish to participate. I might add that another recommendation of this Dyson report, which I think will be very important if we are shifting the focus to smaller companies and to ones that are taking risks, is that those are precisely the companies that cannot spend a lot of time filling in forms. The kind of system that finally emerges from these inquiries and from the government's deliberations has to be one that is accessible and user friendly for those companies.

CHAIR—Part of the criticism has been that this will affect particular sectors, among them manufacturing, but also mining and construction. Do you see that as being a consequence of this bill?

Prof. Green—Not necessarily. It depends almost entirely on what the companies are doing. The point is that, if they are doing R&D that is risky and innovative, it should be covered by the terms of the new scheme. As I said, I am not a tax expert and I am not an expert on the application of the R&D measures. But provided that companies are undertaking R&D within what I hope will be a broad definition, they ought to be eligible for such return, but it may not be simply return for business as usual. Continuing return by the government scheme to companies that are simply replicating what they do from one year to the next at the expense in the end—we have to bear in mind in a limited resources environment—of companies that are trying to do something new but that do have not got access to the scheme, I think is probably against what most people would consider to be good public policy and good use of public resources.

CHAIR—I think you have been very strong in the past on development and improvement of processes, particularly in manufacturing but also in other areas. There was some criticism from Dr Chris Roberts of Cochlear that the emphasis on this bill was on the research side and not on development. Would you concur? Do you think there is any query about this bill on that?

Prof. Green—If that is what Chris Roberts is saying I would be concerned because obviously he is one of our leading entrepreneurs and a leading R&D participant in a very successful company. I think any committee would be well advised to heed his comments. I do not know whether that necessarily is the impact. I think he is probably firing a warning shot to say, 'Make sure the definition of R&D includes the D.' It has to be innovative and risky and development can be—in Cochlear's case it could well be. He is making that point hoping no doubt that those definitions will be such that his R&D efforts can be included.

But he has to make sure that, even if the definition of R&D is sufficiently broad, the nature of the activity in which he is engaged is genuinely risky and innovative activity and is not just turning over an R&D budget from one year to the next, which companies can do. It is undoubtedly useful if we had more generous resources to do so. I think that, if more resources were available, we could include everyone in this scheme who is currently receiving it plus an additional element. Unfortunately, if the scheme is limited and we want to include companies that currently are not getting access, there has to be some tightening up of the criteria for those who are currently receiving it. I hope that Cochlear is not one of those that misses out.

CHAIR—Thank you. I will go now to Senator Eggleston.

Senator EGGLESTON—Thank you very much. I was very interested in your remarks supporting this proposal. Earlier this morning we heard from the Australian Industry Group and they were quite critical of this proposal. They suggested that business will scale back expenditure rather than increase expenditure on

research. They said that the government apparently intends to restrict research and development to research and that this legislation should be renamed the 'research tax credit', and that it does not deal with experimental development, which is what the business of research and development is all about. What do you say to those remarks, in view of your own comments?

Prof. Green—I do not see that that should necessarily be the case. The development aspects and experimentation will I guess be the result of the formal definition of R&D when it emerges from the government. I have not seen that yet so I really cannot comment. I am not sure whether anyone else can comment either except to say that is what they want to see included in the definition, and that undoubtedly puts pressure on the government to do so. But in relation to the resources allocated to the scheme, looking at the budget papers an increase is budgeted for to about $1.5 billion. From my point of view I am satisfied that this is not a scheme that is attempting to cut costs in this area; it is continuing to budget for increases with some changed definitions, criteria and targets. It is premature, for me anyway, to comment on the definition of R&D and I am not sure that anyone can until they see it.

Senator EGGLESTON—Would you suggest that the British definition to which you referred might be something that this government in Australia could consider?

Prof. Green—I am sorry, I missed that, Senator.

Senator EGGLESTON—In your opening remarks you referred to the new UK government report on tax concessions entitled *Ingenious Britain*. Does that contain a definition of research and development?

Prof. Green—It contains a proposition about what it would like to see covered in research and development, and it is extremely broad. It also refers to schemes that are moving the tax credit to something like 200 per cent, and it advocates a huge increase to that level. I cannot imagine that the UK government would entirely accept those recommendations, but there is no harm in a document like that being very ambitious. But it certainly advocates—and you would expect this from James Dyson—that R&D includes areas like design. If we are looking at the link that we are trying to make in public policy now increasingly between manufacturing and design, does this count as R&D? I would hope that it does. That is the nature of the broad definition, including experimentation and prototyping.

Senator EGGLESTON—I have one last question. This bill changes the requirement that intellectual property should remain in Australia. Do you have any comment on that?

Prof. Green—I think essentially this is recognising that we are part of international markets and international supply chains and that IP is something that is now much more fluid. I think, with care, that proposition could be accepted with the government reviewing it maybe after two or three years of activity to see exactly to what extent it has resulted in benefits domestically. It is a bit of a risk for us in public policy but I think, given the globalisation of R&D, it is something we should try out to see what the impact might be.

Senator EGGLESTON—But you said it is a bit of a risk and it should be reviewed after a period of time.

Prof. Green—I think it should be reviewed to see exactly to what extent it has stimulated the R&D effort in Australia and has not necessarily resulted in R&D being eroded or being located abroad.

Senator EGGLESTON—Thank you.

CHAIR—Senator Cameron?

Senator CAMERON—Professor Green, I have just been having a quick look at the *Ingenious Britain* report. I must say that I am not an expert; I am just scanning it after you advised me about it. One of the arguments that is put by the report is that 25 per cent of government research and development should go to early-stage high-tech small to medium enterprises. One of the problems that has been identified is that there is an industry hanging off the research and development funding in Australia. That industry of consultants actually skews the amount of public funding heavily towards the big end of town. Big companies and big businesses are accessing the bulk of the R&D. This legislation is attempting to change that. I would like your comment on whether you think the legislation goes far enough in changing it back to what the Dyson report is saying.

Prof. Green—I agree with those comments. In introducing any change, those who are receiving resources are bound to make the most noise, and those who are about to receive benefits do not know it yet and therefore are not necessarily part of the constituency for change. That is the problem of all change and transition in any scheme, and this is no exception. Whether we go far enough with this scheme I cannot really say, but it think it

is a move in the right direction. I take your point that there is an industry of consultants who have an interest in the current arrangements and who will make their point of view very well known.

But I think the problem in introducing the scheme is that all of those struggling and vibrant entrepreneurial businesses that will gain from it are not aware of it yet. In order to make them aware of it there will have to be—and this is the point in Dyson's report as well—a lot of public awareness raising for those companies that these are the companies that we want to focus on for the future of the country to develop those companies and to ensure that they succeed. As I said at the beginning, an R&D tax credit is only part of that story; there has to be a whole ecosystem of support for companies that want to get to the next stage.

In my position at a business school I see so many great ideas out there—we are an ingenious country too—but we do not follow through the implications of that and we do not support early stage companies to the extent that other countries do. We see so many bright ideas and, in particular, so many young individual entrepreneurs failing after a year or two of activity, not necessarily through their own failure. Sometimes it is, of course, and sometimes it is simply a lack of skills, which is another aspect of all this, but there is also a lack of nurturing of companies at early stages. The R&D tax credit ought to be part of this broader ecosystem.

Senator CAMERON—I think the other report to which you referred was the Haskel report from Imperial College. Is that correct?

Prof. Green—That is correct, yes.

Senator CAMERON—I had a quick look at that and one of the key recommendations there is that, even though some of the R&D in the UK is well-intentioned, it is not well targeted, and that the spillovers are greatest in high-tech, small start-up companies. That seems to link with the Dyson report which states that 25 per cent of government R&D should go to early stage, high-tech SMEs. Examples that have been discussed with the committee are, for instance, in the resource sector, core R&D worth $20 million has been turned into a $500 million claim when it is linked to mining operations. Do you think the legislation does enough to make sure that we focus on where the spillover to the community and industry are the strongest? Do we do enough in this legislation and are we doing enough to stop some of the rorting that has been reported?

Prof. Green—I am not sure whether we are doing enough. I think that is why I refer to the broader ecosystem which encourages both the early stage ventures and the spillover impact of R&D tax credits in the broader knowledge community. I certainly take the point that is made in the Haskel report that in the way the R&D tax concessions were structured in Britain, and this is a retrospective look at the experience in Britain over 20 years, the money going into public research through the research councils was having far greater impact—more bang for its buck, as Haskel pointed out when the research was being launched—than the R&D tax arrangements as they were previously structured. So Britain has spent some time trying to target its R&D tax arrangements and there is still some way to go for them as well.

All I can say is that ours suffer from the same defects and they are moving in the right direction now with this legislation. I think there were some anomalies in the original draft, and I think the government has tried to address those, and there may still be more that we could do. At a minimum—it is hard to get everything through the House of Representatives and the Senate, as we know, in one bite—if we just focus on tightening the criteria, reorganising the access to resources, encouraging awareness, and placing this tax credit in the broader innovation public policy environment so that it is linked to other measures that encourage new ventures, start-ups and SMEs without detracting from legitimate claims from larger organisations, I think this policy will have made an important contribution.

CHAIR—Senator Bushby?

Senator BUSHBY—Professor Green, I am a little confused by your opening statements and some of the comments that you made about not seeing a definition of R&D. Have you seen the final bill as introduced to the House of Representatives?

Prof. Green—I have not seen the definition of R&D in that, if that is what you are referring to.

Senator BUSHBY—From what I understand from the evidence that we have received, the definition, including the dominant purpose test et cetera, was finally put forward sometime in late April as part of that bill. From my assessment, that is where it appears that most of the current concerns arise in respect of this legislation. This morning we heard from Cochlear and the Australian Industry Group, and yesterday we heard from a number of tax specialists and specialist advisers in R&D tax who have raised this point as a concern. Coming back to the comment you made earlier, you said that it appears on paper to preclude a lot of the D—the ability to attract tax credits out of R&D. Given those concerns are based largely around the definition and

the terms in which it is finally being presented, which came out only a few weeks ago, there has been little opportunity for consultation. That is where most of the concerns have arisen.

Prof. Green—I see. I was under the impression that the government had yet to define more clearly what the scope of R&D was, but perhaps I have missed something.

Senator BUSHBY—Maybe I am missing something, but I am just giving you an opportunity to comment. That definition of R&D seems to be where most of the concerns raised by those involved in R&D activities are arising. I acknowledge that the way in which it is defined in the legislation is quite different from the intent as outlined to us by Treasury officials. But the words that are written down in the legislation raise serious concerns in relation to what impact that may have on the ability of companies to claim for their experimental development as they take their research from an academic level and try to put it into production.

Prof. Green—Yes. I can only really comment in principle as I do not have the words in front of me. I would certainly advocate, as I have just done in the context of the Dyson report, that in experimentation prototyping the D element of R&D is an important aspect of the definition. I would be surprised and concerned if that were not to be part of a final scheme.

Senator BUSHBY—Yesterday Treasury officials basically said that to pay for the higher rates of the tax credits we needed to narrow the base. Quite clearly, there is a policy intention to narrow the base and the activities for which you can claim these credits in order to pay for the higher rates and the greater focus on small and medium enterprises. We have also heard evidence that there are a number of ways this could have been done to keep the overall range of measures revenue neutral, including potentially capping the amount that is payable or, alternatively, introducing a ratio between direct R&D and supporting R&D to ensure that you do not have the big blowouts in supporting R&D, and other potential options that could have done that. But they appear to have gone down the path of narrowing the definition or taking a more narrow approach to R&D rather than the broad approach to R&D that, as you mentioned, *Ingenious Britain* thinks you should take. If that is the case, is that a concern?

Prof. Green—I think an inevitable part of the transition is that there will be some narrowing and tightening of criteria in relation to aspects of R&D criteria, not necessarily in the definition of R&D itself but in relation to what is risky, what is innovative and what is the purpose of the exercise. That tightening, if there are to be resources for companies that have not accessed it before, is an inevitable part of what we are doing. In an ideal world, of course, and without Treasury looking over our shoulders, I guess one would say, 'Let us take what we have at present and add to it.' In a resource constrained environment that is not possible, so governing is about choice. If a choice is to be made I would certainly be one of those who would advocate that some of those larger companies that have accessed resources on a habitual basis in the past may have to lose some of that in order that newer companies with newer ideas can access it. I think that is just a point of principle. We can argue about the means by which that comes about, and you mentioned several options. I guess tightening the criteria is one of them. As long as that is done cleverly and accurately, it will achieve a purpose.

Senator BUSHBY—I guess that is the question: will it be done cleverly and accurately? None of the evidence we have received suggests that there is any opposition to addressing abuse of the system. That is an appropriate thing to be doing and it is a good time to have a look and freshen up the way we approach these things to make sure that does not happen. Most of the objection comes from the fact that the way it appears to be written in the bill will narrow the definition of R&D and remove the ability for companies that are undertaking legitimate R&D activities, in particular, the development side of the R&D, to access the tax credits, and that the choice has been made to do that rather than some of the alternative ways that we might have limited the expenditure to pay for the shift to the smaller companies.

Prof. Green—As I said, I cannot comment on the detail, as I am not part of the tax expert group that you have been calling in to give other evidence. I am looking at it from the broader issue of public policy and the application of principles. But I certainly take your point that, if it does narrow R&D in an illegitimate way—and that excludes legitimate R&D, including the D part of experimentation and other forms of development—I would be concerned. I cannot say it would be the case precisely without seeing what the final definition of the bill will look like. But I can certainly see that companies might have some concern if they saw that that area of their activity was going to be eliminated from consideration for these tax credits.

CHAIR—Thank you, Professor Green, for participating this morning. Thank you for your evidence.

Prof. Green—Thank you for having me.

[11.07 am]

APPLE, Mr Willian Nixon, Industry and Economics Adviser, Australian Manufacturing Workers Union

OLIVER, Mr David, National Secretary, Australian Manufacturing Workers Union

BALL, Mr Alan, Vice-President, Finance, Thales Australia

HIND, Dr Andrew Robert, Research and Development Manager, Varian Australia

McLAUGHLIN, Mr Steve, Financial Controller, Marand Precision Engineering Pty Ltd

REEN, Ms Melanie, Adviser, Advanced Manufacturing Coalition

CHAIR—Do you have an opening statement that you would like to make, Mr Oliver?

Mr David Oliver—I do. I have a brief opening statement. The presentation that we are giving today is from a group of concerned company and union leaders who have formed together as the Advanced Manufacturing Coalition. For the purposes of the submission, the group covers the AMWU, Marand Precision, Cochlear, Hoffman Engineering, who is an apology for today, Thales and Varian Australia. Each of these organisations has concerns about how the changes to the research and development tax concession will impact on each of their organisations. But we also have a shared concern about how it will impact on all manufacturing businesses across the country.

As emphasised in the introduction to our submission, which I believe you should all have, we began discussing this issue at a roundtable meeting on the future of manufacturing which was held in Canberra late last year. At that time concerns were raised by a number of manufacturing company leaders. As we point out in our submission, it was acknowledged that the government had determined as a policy objective to make the new R&D incentive more advantageous to small and medium enterprises which is defined as firms with turnover of less than $20 million. However, there was considerable concern that larger firms with turnover of more than $20 million, who account for more than 70 per cent of Australia's R&D, could be disadvantaged by the approach that Treasury was developing. In the case of manufacturing case, around 75 per cent of the $4.5 billion that the industry invests in R&D is undertaken by firms employing 200 or more people.

As many leaders at the roundtable discussion were on the government's Future Manufacturing Industry Innovation Council, we determined that we would make a joint submission through that council about our concerns directly to Minister Kim Carr. Today, under the banner of the Advanced Manufacturing Coalition, we will make a submission to you about our shared concerns on the new R&D legislation, and how the changes will impact on manufacturing. As emphasised in our submission, it is our assessment that the objects clause of the legislation is too narrow; the new definitions of R&D are overly restrictive in what will qualify as eligible expenditure; the distinctions between core and supporting R&D will create unnecessary compliance and reporting issues for both large and small enterprises; the dominant purpose test will severely restrict genuine manufacturing R&D carried out in a production environment; the new feedstock provisions will not assist manufacturing firms; and the draft legislation that you have before you is draft three.

Yet there are to be more changes and there are too many unknowns, and unknown unknowns, to proceed with haste in implementing it. That includes the explanatory memorandum that will provide a context for the courts and the audit assessment process in the years ahead. We have tried to be constructive in this submission and highlight to the committee areas where we think the legislation can be amended, and also where we think the status quo should be retained. I agree with the view of Chris Roberts from Cochlear when he indicated that he did not believe that we were that far apart on our points of differences and it would not take a great deal to try to resolve them.

But we have also been realistic in drawing to the attention of the committee the fact that the legislation will have some negative consequences for manufacturing. In our assessment, many manufacturing firms, particularly large global firms, will take the view that the legislation increases the time cost and risk of undertaking R&D in Australia, that it is legislation that is more supportive of basic research rather than experimental development, and that 70 per cent of manufacturing R&D in this country is in fact experimental development. We are also concerned that it represents a serious compliance and red-tape problem for business in general and SMEs in particular.

I have said before that, over the second decade of the 21st century, if manufacturing investment in R&D grows by 10 per cent per annum the industry will invest more than $80 billion in research and development. If, on the other hand, manufacturers' R&D investment grows by only two per cent per annum, only $50 billion

will be invested. So the difference between a growth of 10 per cent or two per cent over a decade is $30 billion. We know that Australian manufacturers need that to remain globally competitive, to prosper and to focus higher up the value chain on doing things and making things where we will have sustainable, competitive advantages. This will also be the decade when, more than ever, manufacturers will have to invest to reduce their carbon footprint and increase their energy efficiency. This is core business and not a luxury and it is central to what is required to be internationally competitive. From our union's perspective a big area for potential growth, particularly in R&D, will be in the area of renewable energy and a means of trying to reduce our overall emissions. R&D helps us do those things, and we say that this draft legislation, as written, hinders rather than helps us to achieve our long-term goals.

At the end of the day, this is also very much about this and the next generation of manufacturing workers in this country who need prosperous, innovative firms to help sustain job and income security. We say that this legislation hinders rather than helps that as well. As you can see, we have a number of representatives with us today and, along with our advisers, we are happy to answer any questions and to try to provide practical examples of the problems we are concerned about. That concludes my opening statement and we are ready for questions.

CHAIR—Thank you, Mr Oliver. I appreciate your submission. Are you in fact saying that manufacturing processes need to be improved, including under energy constraints and, therefore, the government should support it under this R&D bill, or are you saying generally that manufacturing needs more support? It seems to me that if processes need improving it might be supported under different arrangements rather than research and development, because in doing that you are restricting research and development start-up grants to new and innovative companies.

Mr David Oliver—Not necessarily. A whole range of programs are available to the manufacturing sector and specific sectors within the industry. I reference as one example the challenges of climate change that are before us. We know that the government is looking at areas in respect of that and at separate programs, but they are not mutually exclusive. There should be general support for the industry overall. We have argued that. For many years our union has argued that the industry needs support, in particular, in R&D. History has shown that where you take the hand off the wheel in regard to stimulating investment in R&D you will see a decline in manufacturing. That is why our union believes it is very important for the government to do whatever it takes to encourage investment in that area. It is critical. If we are not researching and developing it here, ultimately we will not be making it here.

CHAIR—I take your point about the research and development. What I am asking is whether you see any distinction between innovative processes and general processing improvement. It seems to me that what you are saying is that that distinction should not be made.

Mr David Oliver—That is correct. I am sure that the other representatives sitting at the table will give you practical examples of where innovation needs to be encouraged, which is part of the overall R&D.

CHAIR—It might be better to produce another program, or to bring together other programs, that improve production processes rather than include them in an R&D program.

Ms Reen—Process improvements are R&D, even in the definition in the R&D tax credit.

CHAIR—Then what are we arguing about?

Mr Apple—I think the basis of the argument is that in manufacturing most of the R&D process innovations for energy efficiency will be taking place in a production environment. Yesterday, Senator Cameron had a discussion with AusIndustry. The AusIndustry example, in replying to the black pea, talked about—and I watched it on webcasts from beginning to end—a number of areas of greyness. In fact, that greyness is that there might be 30 experimental steps in that, as there might be in doing R&D process improvements for energy efficiency. There will be some arbitrary guidelines about what is classified as core R&D in that energy and efficiency R&D program, and what is classified as supporting R&D. Once it runs into supporting R&D within a production environment it will be hit by the dominant purpose test, which has the potential to close down some of that energy efficiency incentive R&D.

CHAIR—You take no comfort from the fact that AusIndustry also said that they would provide education and rulings beforehand on that kind of process?

Mr Apple—We think you could save the $30 million to $50 million that Treasury, AusIndustry and the Department of Industry, Science and Resources talked about yesterday. You managed to get out of them in one day, in one hour, what we have not been able to get out of them in eight months, that is, 'How much saving do

you expect to get by tightening R&D eligibility on the dominant purpose test?' The transcript will show they said that 15 per cent to 20 per cent of eligible expenditure will be knocked out. So the question is, if you have to knock out 15 per cent to 20 per cent of eligible expenditure to make this program revenue neutral, you have two choices.

Choice No. 1 is that you can bring in a new system with 7,754 applicants and registrants to the scheme with new definitions of R&D, new notions of a dominant purpose test and also a feedstock provision, or you could say, 'There are 213 companies in Australia that do more than $10 million worth of R&D.' You could have a stream whereby for those companies who do more than $10 million of R&D—the three per cent—and the ratio of their core to supporting R&D was greater than, say, three to four to one, they would have to get an advance ruling about whether or not their R&D would qualify. That is not therefore a problem about an expenditure cap; it becomes an issue about an advance ruling. In Senator Cameron's example of the $20 million core mining R&D, 480 supporting, that would be going down the second track. There would be a set of rules about how you justify 480 hanging off $20 million.

So the question becomes: if, as was told to the Senate yesterday, that this is the fifth best system in the world and you want to take this to being the first best system in the world, would it not be better to use the existing definitions of R&D, meet a test of innovation, meet a test of high technical risk, and send three per cent of the claims down this path, of which you will find three per cent of the three per cent are claims that you would want to close down to save the 15 per cent to 20 per cent that you need to make it revenue neutral? That is what we would do.

CHAIR—I must say that it is good to have an alternative, but I suspect that if we were to hold a hearing on the alternative we would have a number of submissions that also said that was unduly complicated and difficult. I appreciate you coming through with an alternative for us to consider. You mentioned the feedstock provisions. Treasury officials claim that the feedstock provisions are the same scope as the existing law in that they simply consolidate all feedstock rules in one subdivision, change the form of the new feedstock adjustment to that of an increase in assessable income rather than a reduction in offset, and that simply overcomes technical flaws in the existing rule and avoids the need to put a value on outputs at the end of each year that are not yet in a marketable state.

Ms Reen—It does mean that you do not have to come up with a value at the end of each year, but the legislation is not absolutely clear on what needs to be included in your feedstock input calculations. While the explanatory memorandum is, the legislation is not. We only saw these feedstock provisions not so long ago, so we have not had a lot of time to look at them. But the work that we have done indicates that, particularly for manufacturing companies that have more than one process line, an extremely complex set of calculations has to be done.

CHAIR—You do not accept that it is simply putting together all the existing rules into one subdivision?

Ms Reen—No. There were questions about the old feedstock provisions and it really does not answer those in the legislation.

CHAIR—What were the questions about the old rules?

Ms Reen—What constitutes feedstock?

CHAIR—So you want improvements to the old law?

Ms Reen—In the submission we have described the couple of minor amendments that would resolve those issues.

CHAIR—But what you describe are changes to the current—

Ms Reen—To the legislation.

CHAIR—To existing current laws?

Ms Reen—No, to what is in the tax credit legislation. There are two clarifications to remove ambiguity from the legislation. While the explanatory memorandum is a bit clearer, it would be better if the legislation were equally clear.

CHAIR—I go back to Senator Bushby's questions. It is interesting to me that people are not prepared to accept the explanations and examples in the explanatory memorandum. My impression was that the explanatory memorandum is accepted as a clarification of the legislation. I am a bit puzzled as to why people are discounting—

Ms Reen—If you are talking about the explanatory memorandum in its totality, there are inconsistencies between examples and there are also factual errors—we have counted up to 14 errors—in references to the legislation.

CHAIR—Would you be able to detail those for us?

Ms Reen—I cannot now, but when we have that information.

CHAIR—Thank you.

Senator COLBECK—I was going to go to the same point that we have just heard about. Yesterday the Australian Taxation Office said to us quite explicitly—and if you were monitoring you would have heard it—that the feedstock provisions have not changed. Effectively, what it said was that they have not changed. As we have just heard they have been aggregated. You do not accept the fact that—

Ms Reen—They were not great provisions in the first place. I think that is our point.

Senator COLBECK—So there needs to be work on the feedstock provisions and you have made some suggestions in your submission about that. It appears to me that the major concerns that come through this whole process relate specifically to the impact on manufacturing—obviously there are some impacts on mining which I think were specifically targeted—and on infrastructure and construction. Several witnesses have said that we are not too far apart as part of this process. Earlier we discussed with some of them the time frame within which we have had to deal with this announcement in the 2009 budget and then the iterations of change. Do you think it is possible to make the changes that need to be made, if they were accepted by the government, and have this legislation ready for implementation satisfactorily on 1 July so that industry can go ahead with it, given that AusIndustry said yesterday it was preparing to provide information on it in July?

Mr Apple—I think that the legislative drafting team and the two responsible ministers had two choices. Choice No. 1 was to say, 'By 1 July all we have to do is change three things. We have to change deduction to tax credit, to fix up software, and close down whole of mine, whole of building, whole of construction site and whole of factory.' If you made those three changes you would take really excellent legislation with excellent definitions of R&D that have stood the test of time, and meet the innovation test or the high technical risk test. You would have those three savings, one which was targeted at large in-house businesses' usual software development and the other which would close down Senator Cameron's issues of whole of mine, whole of construction site, whole of building and air-conditioning.

If you wanted to make those three changes, you could have that done next week. However, a group within the legislative team and an opinion said, 'No, this is fundamental reform to your tax credit system. We want to start right from the beginning and change the entire objects clause through the entire legislation.' Now it becomes very difficult to unscramble the egg by 1 July. We think you can unscramble the egg by 1 July but it would mean going back to what was the world's fifth best system, according to Treasury and to the KPMG survey, and making it the world's best system with three amendments on deductions rather than tax credits, software and this provision for the 213, which is an example to close that down.

If you did that you could have that up and running by 1 July without any problem and you would save $30 million to $50 million. Why would you have to go out and educate all the industry about a system that it has been using for 25 years? Yesterday I heard Treasury say that there have been no significant court hearings and court decisions on this legislation. That suggests it is working pretty well since the Unisys decision came down. Therefore, why would you take something that was not broken, other than five terrible claims over here and some software over there and say, 'Yes, we can fix that up by 1 July'.

Senator COLBECK—At the estimates in February, when we were looking at a previous iteration of where we were at—I give the government credit for the fact that it has moved from where we were in November—about 23 claims were being disputed out of the 700 or more a year that were being picked up. That was 23 claims over 10 years, so a fairly low proportion was in dispute. Senator Cameron referred specifically to the buildings and to the whole of mine stuff. How many of those claims would be in the disputed category? Do you have information of or knowledge about that?

Mr Apple—No. You get in very lurky territory when you try to get some factual details about these things. I just hear stories about them.

Senator COLBECK—Senator Cameron might have more detail than I do, but we are hearing about them too. We will see whether we can find out through the appropriate channels. I just thought you might have had some further information on it. I discussed with the previous witness this issue of the grey area around

production runs and the way that the new definitions apply to whether or not you will be able to sell the product. I have been reading some further examples of that and how they might work. Ms Reen, you referred to discrepancies in the explanatory memorandum verses the legislation. Do those things relate to those areas of eligibility of production runs as part of the R&D process and how they might apply or not?

Ms Reen—They do. The inconsistencies are around what types of activities are considered core and what are considered supporting.

Senator COLBECK—I go to Senator Cameron's black pea example. I have seen the technology operate in plants for other commodities that are close to where I come from, for example, potato chips. Senator Cameron, I am not trying to verbal you at all—

Senator CAMERON—I am sure you would never do that.

Senator COLBECK—Sometimes I would.

Senator CAMERON—Is that Tony Abbott?

Senator COLBECK—Never say never, Doug. I think we both agree that that sort of R&D is an important part of the process and should be considered as an R&D activity, so I think we are on the same wavelength there. It is around those sorts of things and whether or not that three-week or three-month production run of peas went into commercial sales. Does that create a real grey area around those issues—

Ms Reen—These are the guys to talk to.

Mr Apple—There are three great companies here that can tell you what sort of uncertainty that creates.

Mr Ball—Maybe I will start. A typical example in our company is that we would take on some experimental development work for a new vehicle, for instance. That would have significant risks. Those risks would continue right through pre-production to the prototype phases. At that point we feel there is a grey area as to whether that becomes supporting or core. At that point the risk is still enormous as to whether they will have any successes with that product because at that point it is not a product. To us that is, if you like, core R&D, but under the proposals it is not so clear—it is a grey area. It is a typical real-life example that our company is living with today.

Dr Hind—I support that point of view. At Varian we do basic research, applied research, and we develop a product. One of the key things that has to happen to commercialise that product is to transfer it to a production environment. That involves considerable risk, it involves prototyping and it involves a pilot. As has been said, under the current legislation that is a big grey area for us. We are not sure what, if any, of that activity will be eligible under the tax concession. As a company we have been using the tax incentive for the last 20-odd years. We believe that we have used it in the spirit in which it has been intended to be used. We understand it and we understand the current definitions. As has already been alluded to, we think that we are close—and we agree on the basic drivers for some of the changes that are being made—but it is the uncertainty and lack of clarity over dominant purpose, feedstock and the definition of R&D that are of concern to us and that make it difficult for us to plan and to justify with our parent company in the United States that it should continue to invest to continue to invest in R&D onshore in Australia, which we have done for the last 40 years.

Senator COLBECK—I ask both of you: what would be the impact of those things being knocked out of the process? If you fall within that range of people we are trying to save—that 15 per cent to 20 per cent of people—what would be the impact on what you do now of losing that capacity?

Mr Ball—The impact to us is that we are a large multinational company that has centres of excellence throughout the world, and it has opportunities as to where it wants to invest its funds. There is a risk that we could lose from our company some of that innovation and skills, and it could be done elsewhere in the region. That is the biggest risk to us.

Dr Hind—It is the exact same risk for us. Over the years we have built a capacity and a capability in Australia to do this R&D work and we have some very intelligent people doing that work, but there are equally intelligent people elsewhere in the world. Part of the justification for continuing to do that here is to tax slash cost-effectiveness of doing R&D in this country combined with the capability of doing so. So the risk is that it would go offshore.

Senator COLBECK—In the context that we heard yesterday where we are effectively in a global market—I think you are reflecting that in your comments yourselves as you are multinational companies that have R&D nodes around the globe—they will go to the most cost-effective because that is the natural flow for investment funds?

Mr Ball—Ultimately the shareholders will make a decision on what is best for them. There is a risk. Clearly there is a risk.

Senator COLBECK—Is it possible to quantify that?

Mr Ball—I cannot quantify that today because we still do not have certainty as to what the dominant purpose rules are.

Senator COLBECK—That risk could vary, based on what the final form of the legislation is or is not?

Mr Ball—Yes.

Dr Hind—As Nixon was saying before, if we could make those three changes and do that by 1 July I think the majority of people here would be fairly happy with that. We have an existing system we understand, we have definitions we understand and we have processes for preparing applications, registration et cetera. It targets the areas of concern that we all have, I think—the whole of mine type claims that we talk about and the software side of it et cetera. That takes that uncertainty out of it which, for me, makes it difficult to plan for my R&D budgeting next year and for ensuing years and to sell it to my corporate colleagues in the United States.

Senator COLBECK—I thought you would have been fairly well on the way. You would have liked to have made your investment decisions on the R&D for next year and out years. Depending on where things end up, is there also a potential investment pause in that space?

Dr Hind—Yes. We have made those investments based on the legislation as it previously was. Changes to that will affect what we do moving forward.

Mr Ball—Similar to ourselves we have a ruling three-year plan that is reviewed every six months in detail. There would be a consistent review of all those, and any changes in legislation for anything, not just R&D.

Senator COLBECK—The last 12 months or so since the announcement, and particularly since the November exposure draft, would have been fairly exciting for you guys in trying to work out exactly where you were going to be and what you were going to invest?

Mr Ball—Absolutely. We have done some analysis but we need to see where the legislation takes us over the next month or so.

Senator COLBECK—Thank you, Madam Chair.

CHAIR—I will ask one question before I go to Senator Cameron. Will the changes to the tax treatment advantage your company?

Mr Ball—I do not believe so.

Dr Hind—I do not believe so.

Senator CAMERON—Mr Hind, you said on a couple of occasions that you understand the current system. When you make an application for R&D is that done by the company or do you have external assistance to do that?

Dr Hind—It is done with external assistance, yes.

Senator CAMERON—Why would you need that external assistance if you understand what you are doing?

Dr Hind—I do not think we would call ourselves experts in the area of R&D tax incentive law et cetera. As we do with a number of aspects of our business, we look for external help, be it logistics, procurement and R&D for that matter. We engage with universities and with CSIRO et cetera. It is just a more cost-effective way for us to get that sort of expertise to help us prepare our applications, our project planning and the administrative paperwork side of the process.

Senator CAMERON—If I asked you what the multiple overlapping tests were for the current legislation would you be able to tell me now?

Dr Hind—I would not be able to tell you with as much detail as other people at the table, but other members of my company would certainly be able to.

Senator CAMERON—But they still require external consultants to make an application because they are not expert, is that correct?

Dr Hind—Correct.

Senator CAMERON—The existing regime is quite complex, is it not?

Dr Hind—Yes, I accept that.

Senator CAMERON—The argument that has been put is that there are 25 years of history in industry and people understand it. You use the law, but you require external expert assistance. I put it to you that that is a generality; that is a general position in the industry. Consultants are used extensively because of the complexity of the law. Would that be your understanding?

Dr Hind—I would not dispute that, but I would argue that the changes that are being proposed will not reduce the complexity. That is my concern.

Senator CAMERON—Other people have a different view. Treasury and the department have put it clearly to us—

Dr Hind—I am sure that they have a different view, which is why we are here.

Senator CAMERON—I know that you guys want to devastate the Public Service, but give us a break.

Dr Hind—No-one was having a go at you.

Senator CAMERON—What is the difference between the old test and the new test?

Dr Hind—There is not one difference. One area that concerns me is that the definition of R&D seems to have changed. It is now more 'R' than it is 'D'.

Senator CAMERON—Tell me why?

Dr Hind—It is focused on the innovation technical risk side. From our perspective, as is said before, we take a lot of risks. We may do proof of concept and fundamental research, and we may develop what is a prototype product. The risk for us is in taking that product and bringing it to market.

Senator CAMERON—Can you take me to the part of the legislation that makes it tougher? Can you take me to that point?

Dr Hind—I do not think there is one single part.

Mr McLaughlin—From our organisation's point of view the one major difference that affects us is the dominant purpose test. That is the difference. There is no equivalent in the old legislation.

Senator CAMERON—Tell me how the dominant purpose test differs?

Mr McLaughlin—There is a test now, whereas there was no test before. Someone who supported the core activity was eligible. Now there is a dominant purpose test that the legislation says can be twofold. It can be both commercial and supporting the R&D, but if it is commercial potentially it is ineligible.

Senator CAMERON—I am not sure whether that is a correct reading of the legislation. On page 5 of your submission, which I have here, the debate relates to the process to identify core and supporting activities. The proposition is that this will be more costly, more risky and more time consuming. I thought that the process you outlined was pretty simple. Is the activity a core R&D activity? If not, is it a supporting activity directly related to a core R&D activity? Is it an excluded activity and, if so, is it undertaken for the dominant purpose of supporting a core R&D activity? It is all pretty simple so far. Is it an activity that is the production of a good or service? Is it directly related to a good or service? Is it for the dominant purpose of supporting core R&D activities? From my point of view, I reckon that if we are to hand you public money, sometimes in the tens of millions of dollars, to carry out research and development, these are not huge hurdles to get over. Is this the appropriate spend for public money? Why would that not be a problem?

Mr McLaughlin—Because it is a test that was not there in the past. The production excluded activities, even though it is recognised that they might be in support of core R&D. Is there a potential market out there, because we do not do R&D just for the sake of it. If we are doing R&D it is with a purpose in mind. If we have to build a piece of equipment in order to trial and test that R&D, again we will not build a piece of equipment just for the sake of it. We will do it because, potentially, there is a commercial market. The test states that if there is a commercial market it is ineligible. If we did it just for the sake of it it would be eligible. My understanding might be wrong but there are plenty of experts—

Senator CAMERON—What company are you with?

Mr McLaughlin—Marand Precision Engineering.

Senator CAMERON—You build precision engineering components. If you build a prototype precision engineering component and a customer says, 'I want to install that on my production line' and that precision engineering component requires the production line to be stopped, you need installation on the production line,

there are costs to install it, and you then trial the production process. According to both Treasury and the department, that is covered.

Mr McLaughlin—It is sort of covered. We make special purpose equipment. For example, we could be making an engine tray—

Senator CAMERON—Just let me ask you the question in generalities and not in your detail. If it is the case that that is then covered for R&D tax purposes why is there a problem?

Mr Apple—There is a big difference, Senator Cameron. It comes down to the webcast yesterday of your discussion about the black pea with AusIndustry. Of course, the interesting thing on the transcript is where the AusIndustry person started talking about the area of greyness. What they would do with your black pea is they would identify 30 experimental activities based around what was going on. If you want an example of that go to pages 38 and 39 of the explanatory memorandum and to case No. 3, the Russian wood koala dolls, and you will find a whole series of experiments. The first test will be which of those experiments is core R&D, and which of those experiments is supporting R&D? Once you arm wrestle over that you will have to test to what extent you can apportion some of that core R&D as eligible expenditure and, within the supporting R&D, how much of that would qualify, if any? How many of the 30 experimental steps would be classified as supporting R&D, and how many would be classified as core R&D? Look in the explanatory memorandum at case No. 2, EcoStartup, which is a simple one for all senators to read. After reading the example, ask yourself what is the core R&D and what is the supporting R&D? It is supposed to be an experiment. 'Experiment' could be interpreted as a hypothesis, a series of observations or a series of tests.

Senator CAMERON—But core and supporting are still covered.

Mr Apple—Core is over here as something to which a dominant purpose test does not apply. Supporting is where they get their 15 per cent to 20 per cent, which means for some companies it is nothing and for other companies it is 30 per cent to 40 per cent, and it may even get up to the BDO example of 65 per cent or more.

Senator CAMERON—How does that differ from the current one?

Mr Apple—In the current one you have systematic, investigative, experimental activities that qualify as core R&D and you then have to meet a simple test. Is it innovative, does it have considerable or appreciable novelty on the one hand; and/or, does it have high technical risk on the other hand? In the first two drafts of the legislation we were confronted with what Treasury and the Productivity Commission have asked for, for 10 years. They wanted people to pass both tests—both an innovation test and the high technical risk test. That is what we were debating. All of a sudden that debate changed and we were given a new set of definitions altogether, which as I think your next presenter, Deloitte, will tell you, amounts to the same thing but in a much more confusing way. The only major difference I have with you yesterday—

Senator CAMERON—With me?

Mr Apple—Yes, with you. If you put this legislation in—

Senator CAMERON—Why me?

Mr Apple—If you put this legislation in you will not bankrupt the consultancy industry. It will quadruple the number of people that they have as clients. Even the pet shop galah will need to get a ruling about whether pecking the seed is core dominant or supported. It is very complex.

Senator CAMERON—I did not get that impression from the consultancy industry yesterday.

Ms Reen—It is a lot more complex.

Senator CAMERON—It is more complex?

Ms Reen—Yes.

Senator BUSHBY—Mr Apple, you indicated in your comments then and in comments that you made earlier that you are aware of the evidence that was given yesterday. I guess that you probably watched it via telecast. What do you make of Treasury's evidence that all properly argued and justified concerns have been addressed, and that all remaining concerns are based on misunderstandings of what is proposed?

Mr Apple—I think we would all agree to disagree with our colleagues. We would say that in the evidence you have in writing and in presentation from the consulting profession one of the major problems they have is that this is a very short piece of legislation—at least the guts of it—and then you have this huge explanatory memorandum. The inconsistencies in the explanatory memorandum, which will be so much of the definition for assessment purposes—are still there. That is one problem that is still there. Because we only just got the

definitions of feedstock provisions, a number of issues are still about now that it will be in addition to assessable income and, therefore, the tax rate is brought back into the system. It is different from what we thought it was going to be before. From my point of view, the debate I had with them since November and December was, 'Why do you not just do three things? Change it from deductions to tax credits, fix businesses' usual software and close down the whole of mine, whole of factory, whole of construction site and whole of building. Deal with the three per cent. You will find that three per cent of the three per cent are doing bad things, so fix it.

Mr David Oliver—Senator, can I just add to that? That was picked up earlier by Chris Roberts. Chris said that if the statements that were made by the department and Treasury were clarified in legislation that would get us a long way. I know that others have said we can rely on comments that are said here, and others have said we can rely on the explanatory memorandum. But from our experience with other bits of legislation, such as the workplace law that has been introduced, we know how long a reliance on explanatory memorandum lasts—not very briefly in hearings such as this. Everyone is saying that they want some clarity on it. The best way to get clarity is not by putting something in a transcript here or even by tightening up the explanatory memorandum. It would be what we would see as tweaking the legislation to give it more certainty.

Senator BUSHBY—From my perspective I think that makes a lot of sense. As I understand it—and I am interested in Ms Reen's view as a tax adviser—the EM, along with a suite of other factors will be relevant to any statutory interpretation when it arises. But it is only a relevant persuasive factor. Ultimately, if the words in the law are clear and are contrary to what the EM might state, the words in the law will prevail. I see Ms Reen nodding so I take it that she agrees with that?

Ms Reen—Yes.

Senator BUSHBY—As such, I think that what you are saying makes a lot of sense. If that is the intention—and it is the government's intention, and the bureaucrats are saying that it is—why not reflect that in the law?

Mr David Oliver—Yes.

Senator BUSHBY—Mr Apple made the comment that those three changes could be made. It seems to me—and I am interested in any of your views—that those three are consistent with the stated objectives of the government in making the changes to the law in the first place.

Mr Apple—I think they would be consistent with the government but, in fairness, if I was suddenly transformed into a Treasury official I think the point I would make is that this is new legislation, therefore, I want to rewrite it from the objects clause to the end of the legislation. The evidence that Mr Apple has given of this simple change to get at the whole of mine examples that Senator Cameron has given, were actually considered at one point. We know that the pharmaceuticals industry, under the P3 program, has had to work within a regime where there has to be a ratio between core and supporting, and over and above that will not be eligible. But in some industries there are huge amounts of supporting R&D and in the others there is only some. We decided that we wanted to treat all industries equally and, therefore, we had to find tests that applied to 7,754. While Mr Apple's proposal might be very interesting because it gets us down to three per cent and finding three per cent of the three per cent, that is not the perfect first-class best approach to legislation.

Senator BUSHBY—Essentially, you are saying that the government, through its officials, is seeking to reinvent the wheel rather than to fix something that is working generally, but that is able to be tweaked to deliver the government's objectives?

Mr Apple—I think that the Treasury officials would probably say that if you go back to the Productivity Commission reports over the years about what is basic applied and experimental research and development, what deserves to be supported and what should not be supported, it is better to start with an entirely new system, with a new tax credit and a new objects clause to better reflect the government's intention of when it intervenes to do things. This is the perfect time to totally rewrite the legislation and to make a total and big reform of the system. Our reply to that is that, as they said, it is the fifth best system in the world. You can make it the first best system in the world with three simple changes. The problem they would have with that is that after eight months of drafting an entire big piece of legislative reform, how do you go back to the fifth best system in the world, tweak it to become the best and say, 'Oh, that was a good idea?'

Senator BUSHBY—There are some political implications there.

CHAIR—Thank you to the Advanced Manufacturing Coalition for coming in this morning. Thank you for your assistance.

[11.55 am]

DUCHINI, Mr Sergio, Partner and Research and Development and Tax Incentives Practice Leader, Deloitte

CHAIR—Welcome today, Mr Duchini.

Mr Duchini—Thank you for the opportunity to present our views today. I will commence with a brief opening statement which I will read, if I may, and then I will gladly answer any questions. I also state for the record that Deloitte will be making a more detailed submission by the due date. But, given the timeliness, it is just me today. For the record, I am a partner at Deloitte and the practice leader of the Deloitte R&D taxing incentive service line. I have been engaged in consulting on the R&D tax concession since shortly after its introduction in 1986. The national Deloitte R&D practice works with a broad range of Australian and multinational corporates in providing assistance with the effective management and compliance with the requirements of the Australian R&D tax concession, as well as on a range of other global concessions.

Our clients include Australia's largest listed companies—mid caps—and extends down to private and listed companies which would fall under this new concept of SME with turnovers of less of $20 million per annum. We also work across a diverse range of industries. As a firm we have always taken a positive and active role in the ongoing development of Australian innovation policy, have made submissions to all major reviews and have appeared before previous House of Representatives and Senate inquiries in the past. We are always objective and considered, and we are measured in our approach to this debate.

As relevant to the development of this bill, we have been very active since Senator Carr announced, on 22 January 2008, the review of the national innovation system, and included in its terms of reference the consideration of the appropriateness, effectiveness and efficiency of the R&D tax concession scheme in promoting innovation. We have made submissions to the Cutler review, engaged in public and private consultations following the release of the consultation paper in September 2009, made detailed submissions on the first and second exposure drafts and subsequently engaged in private consultation with Treasury and others. We have also made a subsequent submission on the second exposure draft.

But today I will start with something different: I will start talking about all the positive aspects of the bill. It is a shame that Senator Doug Cameron is not here to hear it. The introduction of the tax offset and the credit, which is refundable in certain circumstances, is a positive improvement and, I think, a step forward compared to the current super deduction. The increase in the base rate of support to 10 per cent for large claimants and 15 per cent for SMEs is also welcomed. The removal of the expenditure threshold for SMEs is a dramatic improvement. The removal of the 175 per cent concession, which was complex to model, and almost impossible to model in advance for large corporate groups, is also welcome; I think it is good policy.

Aligning the time review limits to four years, as with other taxes, was long overdue and is welcome. The expansion to foreign owned R&D to include permanent establishments is also a good outcome. Increasing the base level of support for foreign owned R&D in Australia and removing the incremental nature of this benefit is also good policy. The improved criteria for undertaking R&D offshore in certain circumstances, with the lifting of this expenditure threshold from 10 per cent to 50 per cent, is welcomed and very positive for some industries which are forced to conduct elements of their R&D offshore.

The lifting of the tax exempt ownership threshold from 25 per cent to 50 per cent is welcomed. The removal of the outdated multiple sales test for software R&D, which was discriminatory and no longer reflected a modern economy and business development model for exploitation of software, is welcomed. I also believe that the expansion and role of powers of Innovation Australia, if executed appropriately, should give greater certainty to claimants over time, although I do expect a rocky start, given the compressed time frames with which we are dealing associated with the implementation of this bill.

So these are all positive improvements and, I think, enhancements to the current regime. However, there are a number of concerning implications which flow from what I refer to as the core building blocks of the proposed bill, which I will work through briefly now. They are: the nature of the activities that are to be supported by the bill; the burden of proof and evidence required to sustain eligibility by all claimants; and the compliance burden that will be imposed on claimants who seek to benefit from these provisions. So the threshold questions that remain are whether the positive changes that I have outlined in the bill are sufficient to deal with the concerns that have been expressed by key stakeholders in submissions in the past and also before this Senate inquiry.

Does the bill, when we view it as a package, reflect the policy objectives contained in Powering Ideas: An Innovation Agenda for the 21st Century and implement the vision and strategic direction laid down by *Venturous Australia*? Does it provide greater administrative simplicity and transparency for all claimants with improved support, especially for commercially oriented R&D in Australia? My answer to that question is: not quite and not yet. I think it has missed the mark in some very important areas. The definition of core R&D, although improved, vis-a-vis exposure drafts 1 and 2, does not explicitly and sufficiently cover application R&D in my opinion, and this was referred to in earlier submissions.

This stems from the policy belief that greater benefits flow to the broader community from generating knowledge rather than from the application of the knowledge that is the product of the R&D. No evidence has been presented throughout this entire policy debate that the public subsidy for new knowledge creation will yield greater economic benefit than the subsidy of the application of that new knowledge to the creation of new products, processes, services and devices. I believe that this premise is fundamentally flawed. There is significant public benefit and wealth creation occurring, with the focus of the R&D as its practical application. This is where the rubber really does hit the road, where tangible commercial outcomes are achieved and value and wealth are created. It is where corporates take on a significant risk and where technical failures are also common. In addition, although this new definition omits the terms 'considerable novelty' and 'high levels of technical risk'—I acknowledge that there is a fair degree of emotion around those terms—essentially it retains that meaning behind those two terms and carries their meaning, together with the 'and' into the new R&D tax offset.

Consequently, this definition, although new in construction, does not in substance differ from the definition proposed in the first two exposure drafts. The concerns that were expressed then remain relevant now, and it is, clearly, more restrictive than the existing definition in 73B(1). All corporates with existing operations that undertake R&D as part of, or connected to, their production facilities will face a much higher threshold in including supporting expenditures. This is the mainstay of most business expenditure in R&D in Australia. In addition, the combination of the new feedstock provisions, which we have touched on this morning, will ensure that any residual benefit will be mopped up if that R&D happens to be successful in the year it is undertaken or potentially four years after the year it has been undertaken. Further, disappointingly, claimants will be required to document and cost core and supporting activities separately on registration of their activities, and this will be a heavy burden. I am happy to take any questions in respect of that opening or any other matters that you may want to address.

CHAIR—Thank you. You were saying that the new definition is more restrictive.

Mr Duchini—Yes.

CHAIR—I do not think the government would deny that. What they are saying is that, to allow revenue neutrality, they have to be more restrictive in some areas. They have tried to target that restriction such that innovative R&D will not be affected. This is one of the ways they have gone about it. As you said, they would say that the definition of core R&D is not significantly changed and that it does include new or improved materials, products, devices, processes or services. How would you achieve that restriction without the kinds of problems that you were talking about? Clearly, it is not possible to achieve restrictions without creating problems anywhere.

Mr Duchini—I accept that. I will answer your question, but the comment was made that this has to be viewed as a package of measures. A number of tests need to be satisfied by all claimants and they are cumulative in nature. Let us start, firstly, with my opening comments around the definition of core R&D. The comment was made earlier that it is more about the 'R' and less about the 'D'. I think there is a conflict between this definition and the objects clause. I think the objects clause more eloquently and more directly says that the object of this section is to promote and support investments in R&D. But if you look at section 355-25(1)(b), I think you will find that the wording in that subparagraph could be improved pretty simply. We have made suggestions to be more explicit about the fact that you are talking about R&D associated with the creation. At the moment that subparagraph reads:

... that are conducted for the purpose of generating new knowledge (including about the creation)

I have always advocated that we should just get rid of the word 'about'. To me it connotes that it is the development of knowledge around the process of creation rather than the hard, fast creation activity that includes eligible R&D activities. I think that should be amended and I think it is a quick fix. Overall, when I as a professional read the definition I believe that it is easier to read, and I think an engineer reading it would get

it, as it talks about 'experimental' and 'experimentation'. Where is the knowledge gap? On the surface, it is a simpler definition than the clunky one that we now have. I accept that, and it is good.

However, when you read the explanatory memorandum, which gives life to the subcomponents of the words in this definition, you can see clearly that the benchmark has increased significantly and all claimants now would need to satisfy both innovation and high levels of technical risk. I think that is a significant and unnecessary raising of the bar when you also consider the changes which flow in the treatment of supporting activities and the dominant purpose test, which I will come to, and then you overlay the expanded feedstock provisions, which are different—and I will tell you why they are different compared to the current rules—what you end up having is a regime that is significantly more restrictive than the one we currently have. The new feedstock provisions will apply to corporates, effectively to reduce this regime to a limited subsidy for failed R&D outcomes. If you are successful in a production environment these new rules will require you to claw back an element of that credit not only in the year of income in which the expenditure was incurred; it is now a multiple year test. That means that if you are designing industry support which is meant to reduce the cost constraints on Australian corporates undertaking R&D, they need to do that with some certainty. You cannot model that if in year one, two, three or four you might have to claw back some of that benefit. I think it does introduce a much higher standard than we currently have. If that is done by design, well and good, but that is not what Treasury are saying. At least that is what they said yesterday.

CHAIR—You are saying that Treasury consolidates all feedstock rules in one subdivision. It does say that it changes the form of the new feedstock adjustment to that of an increase in assessable income rather than a reduction in offset. Is that where you say—

Mr Duchini—No. Let us work through it. If you go to page 27, feedstock adjustment and to subdivision 355-H, you will find that this rule differs in a number of respects. Firstly, it has multiple year application and the current rule has only yearly application. In addition, the basket of costs which this provision draws in, against which you then measure a value of a marketable output, is bigger. Let me explain the difference. Subparagraph (b) states:

This subsection applies to an R&D entity for an income year if—

ignore (a)—

(b) it obtains under section 355-100 tax offset for one or more income years for deductions under this section for the expenditure—

which is very broad—

expenditure it incurs on energy input directly related to the transformation—

that is the same as what we currently have—

for the declining value for assets used in acquiring or producing.

That is new. This particular section expands the basket of goods to include all expenditures incurred in the act of transformation or processing. The current rules do not do that; the current rules point you to the materials that a consumable transformed is part of the process, plus energy inputs, which is fine. This expands it on two fronts: it explicitly includes all expenditure and then, just in case you have got that wrong, it includes depreciation on any plant that you might have used in the process, so it is broader.

I do not understand why the comment was made yesterday that it is the same—maybe because it is so new—but it is not; it is broader. It is not as bad as the augmented feedstock provisions that were in the first exposure draft. It is a step back from that, but it is certainly broader in application than we currently have now.

Senator EGGLESTON—You made the comment that most business activities concerned with research and development are connected to production. That appears to have changed very much in this legislation and it appears to put a barrier in place to the utilisation of research and development concessions to Australian industry. How would you like to see that changed?

Mr Duchini—I will answer that question, but yesterday it was really interesting to listen to some of the commentary, and the streaming technology was really useful. When Dr Edwards was asked about the pea example, I took his response to mean that that whole production process—your example—might even be a core activity. It was interesting that he said that, although he acknowledged that there were elements of greyness. What I would do to try to better tailor this for industrially oriented R&D would be to deal with this issue of dominant purpose, which has been said ad nauseam in the presentations and even in the oral submissions.

There has to be a better way than having dominant purpose. When you understand that businesses undertake activities, they try to undertake activities in the most efficient way by piggybacking them together and achieving multiple outcomes that will achieve an R&D end and maybe a commercial objective, which is what you want organisations to do. Maybe the word 'dominant' should be softened to 'substantial', which is not an insignificant or a de minimis purpose; it is still a substantial purpose connected to R&D. Why are we imposing a dominant purpose test?

A dominant purpose test also impacts on different organisations and different industries. For example, if an organisation is in its early phase of development, and potentially in the lifecycle industry or biotech, its whole purpose of being is around new knowledge creation and discovery and, therefore, it sits really in the sweet spot of these new rules, for lots of different reasons. As soon as it starts to take that knowledge and turn it into something of value and it enters a second phase, which is trying to create something of value from what it has invested in through its knowledge creation, these rules would start to limit the support at that application end, and I think unnecessarily so. I would be focusing on that dominant purpose test to try to soften the impact. You may even want to consider whether or not you have a multi-stage purpose test for those organisations that are SME. Maybe they do not have to meet it; maybe it is directly related. For those of upwards of $20 million, maybe it is a substantial purpose. I think that the word 'dominant' needs to go.

From my perspective, having been engaged in this process since it started, this all points to the haste with which we are trying to nail this so that it can apply from 1 July. The second exposure draft was completely different from the first exposure draft. I speak openly when I say that the first exposure draft we got just before Christmas was a dog's breakfast. From my perspective, only then did real consultation start. We had a wasted opportunity from the time we had the Cutler report, to the consultation paper, to the first exposure draft. That time should have been used, I think, working on what we have as the second exposure draft, which was somewhat of an improvement, and then even the bill. On the second exposure draft I think we had 11 business days to consult. The bill came out last Thursday and we are here today talking about it. It is rushed and you will have a suboptimal outcome because it is rushed. I think you need to think about it.

I would suggest that a wise and a prudent move would be to take on board the views of the stakeholders, those involved directly and those involved in consulting—and I know there is a view around that. I would suggest that the prudent thing to do would be to delay the implementation date to 1 July 2011. Let us use the next 12 months to tweak this, to get it right, and then pass it as the law. Dr Edwards would then have a law upon which he can start to pull together his industry consultation and guidelines. Engage with industry, because they are important. I was a bit shocked that in July there will be a road show around the guidelines and they have not engaged with industry on those guidelines. How effective will they be? Use the 12 months to get it right and then have something of substance that works for most taxpayers from 1 July 2011. That is my view.

Senator EGGLESTON—Thank you very much for that; I appreciate it.

Senator COLBECK—I go back to the discussion around the dominant purpose test and the evidence you have just given to Senator Eggleston about the practical processes of operating. I was looking at Matryoshkoala III, the third example, in which it was determined that because it was so closely aligned to actual production it did not qualify under the dominant purpose test. Listening to your evidence and then going back and having another look at that, it completely and utterly misses the practical realities of operating a business. If you are going to qualify for the dominant purpose test you have to close the whole show down, realign everything and have something that works effectively just to run in that circumstance for that purpose.

The example was given there quite clearly in how it could effectively be done by closing down the whole line, operating a section of it for a little while so that you can test to see whether your modifications are going to work and then reopening it. But it completely misses whether that is possible and practical to do in the overall structure and operation of your business. Effectively, what is being asked of you is to disrupt your entire business so that you can qualify one piece of R&D, to test it and to qualify it as an R&D operation. Clearly, it misses the practicalities of operating as a business in the provisions that are required under the dominant purpose test.

Mr Duchini—I think that is correct. Businesses should undertake any activity in the most efficient manner. If that means they can run one activity with multiple purposes—and I am not saying it can be a de minimis purpose; it can be multiple purposes—and one of those substantive purposes is R&D and another one might be a commercial outcome, all well and good. Why should legislation mandate that organisations organise their activities in a particular fashion in order to ensure that they qualify for the concession?

I am not suggesting you would do that and I do not suggest that businesses would reorganise their production facility for 10c in the dollar; that is also ridiculous. But it does point to the very real example that most organisations that necessarily have to undertake R&D in a commercial and production facility because they cannot afford a separate pilot plant, a separate laboratory or whatever, do so in the most efficient manner possible. I think we should welcome that.

Senator COLBECK—Effectively, by doing so they could, because of the dominant purpose test, lose qualification as an R&D activity because of the fact that they have done it in that way.

Mr Duchini—Most likely, yes, under this definition.

Senator COLBECK—I acknowledge that we have moved on from the initial wording from the November document, which reflects on the evidence that we heard previously. Under dominant purpose the new definition still goes back to what we were talking about in our initial discussions—that is, you have to pass two hurdles, not one of two hurdles. Effectively, all that has been done in the redrafting is to say the same thing but in a different way.

Mr Duchini—Yes. The new definition in 355-25 is a clever piece of drafting as it removes two of the terms that were causing a lot of the heat and emotion in the debate—that is, high levels of technical risk and innovation and this concept of 'and'. It removes them completely from the definition, so you have dealt with that. But, in reality, when you read the examples and you work through what you need to work through to get an eligible activity, you have to have both innovation and high levels of technical risk. That is okay. If that is the design feature of the provision, that is fine, but let us be straight up about it. We have not backed away from that issue that was causing a lot of angst.

Senator COLBECK—But when the discussion comes back, and we have heard reference to Forchini a number of times as being the globally accepted definitions of R&D, effectively we are doing it but we are doing it by saying it in a different way rather than using the words that fit within that definition.

Mr Duchini—Yes. It has been re-crafted, and eloquently so. It is not that hard to read; it is shorter and it saves some paper.

Senator CAMERON—Mr Duchini, correct me if I am wrong: you have indicated that some aspects of the legislation have been elegantly crafted but that the explanatory memorandum does not reflect the legislative outline, is that correct?

Mr Duchini—I will table a document. There are 15 errors in the EM, and I have referenced them by paragraph and section. It is unfortunate, but I do that only because I am trying to be constructive. It reflects the haste with which this whole thing has been pulled together. I will table that document. There is a host of errors in the EM; I think it is because it was drafted again with such haste. I will point you to each paragraph and each subsection and hope that it will fix them. I am not alone in referring to some examples that show how tight the definition is in practice to apply and to meet in many instances.

Senator CAMERON—Under the Income Tax Assessment Act 1997, there is a linkage to the dominant purpose of support and core R&D, isn't there, as explained in the act?

Mr Duchini—Under part 4A, the anti-avoidance provisions, they use the words 'dominant purpose' and it is the most prevailing influential purpose. In that section they then give about six indicia of what it is, so a taxpayer and the courts have an opportunity to measure six very different acts to form that purpose. We do not have that. The Canadian legislation talks to experimental development in commercial production, which is what we are talking about. We are talking about undertaking R&D in a commercial production environment. They deal with it differently. They deal with this concept of experimental development in commercial production and then they lay out, through guidelines, the indicia of what it is. It is not about purpose. It is about what you have done, and why you are doing it. I suppose that it also outlines the evidence that one would need to satisfy and sustain a claim.

Senator CAMERON—How many clients does your company have?

Mr Duchini—I am ready for this. Having had the ability to listen to you yesterday, I prepared—

Senator CAMERON—I am glad somebody actually listened to what we did yesterday. Congratulations.

Mr Duchini—It was good; I enjoyed it. Firstly, we are a major practice. The R&D service offering is part of a much bigger business. The information that I will present to you today is accurate for the four years ending 30June 2008. We have not updated for the 30 June 2009 program because those claims were lodged on 30 April 2010, so it is a bit short. We lodged 995 registrations in that four-year period; total expenditure

registered was $5.8 billion; total tax benefit was $386 million—that is, tax saving, and that does not include any incremental concession. We do not track that as it is a bit difficult, given that it depends on the arrangement of a corporate group. The average size of the claim was about $5.7 million; the average benefit was $427,000; and 337 registrations were for companies with a turnover of less than $20 million, although you need to take that with a grain of salt because the way the grouping rules work, some of those organisations may in fact be grouped and the head entity probably may have a turnover greater than $20 million. The bulk of our business would be at the bigger end of town rather than at the smaller end of town.

Senator CAMERON—Mr Duchini one of the criticisms I have heard is that the consultancy industry supports the bigger end of town. As you heard in evidence this morning, the best benefit is if we can get some of this R&D into the smaller high-tech start-up firms. That is one of the problems we are trying to deal with. Do you agree that an appropriate ideal for the government to have is to get into the smaller R&D high-tech area?

Mr Duchini—Senator Cameron, you missed my opening statement when I went through about 12 of the really positive things that this bill has. One of them is the benefit it is giving to the smaller end of town. The ability to monetise up to 45 per cent of their expenditure if they are in tax losses is a massive positive. The removal of the expenditure cap is a massive positive vis-a-vis the current $2 million cap, which introduces an R&D poverty trap. As soon as you get over $2 million you do not get any cash. I think that is positive, absolutely. But you made the observation that, somehow—I think I will leave it there.

Senator CAMERON—Keep going.

Mr Duchini—No, it is not relevant to today.

Senator CAMERON—Okay. The issue we are trying to deal with is this leakage—for example, when you make a claim for, say, $10 million worth of R&D and suddenly it becomes $500 million worth of production subsidies. How do we deal with that if we do not go down the path that we are going?

Mr Duchini—Again, let me make some comments. Since 1986 there have been 24 cases—12 in the AAT and 12 in the Federal Court. There have been no substantive cases since we changed the definition in 1996 to include high levels of technical risk. The examples that you have been referring to over the last couple of days are extreme. If they are real, the existing rules would deal adequately with that. If they have not been dealt with, I believe that it only points to a failure of administration, because those projects are unlikely, in the context in which you have described them, to satisfy the existing rules.

That problem exists and it should be dealt with. A firm such as Deloitte, and I, certainly would not sign off on anything like that because all we have is our brand and we would not tarnish that brand for anything. In answering your question, though, I think these measures, when viewed as a package, not only deal with that issue but also go too far in dealing with a whole lot of other circumstances that are not 'rorts', as you mentioned.

Senator CAMERON—Can you give us any practical examples of an activity that would be excluded by the dominant purpose test?

Mr Duchini—Yes. There are a number. Again, this is linked to activities that are connected with the production of goods and services. It is always a question of degree. When an organisation undertakes a product of R&D on a commercial facility it often has to undertake trialling activity. That trialling activity itself, when viewed in isolation, often is not core R&D. Often the trial itself may not be experimental, but the data that comes from the trial feeds into a program of core R&D and it is essential and it is directly related to the core R&D. By imputing and requiring a dominant purpose test, if that trial has a degree of commercial outcome or output, that whole trial is questioned. It is a degree of uncertainty, a point of uncertainty, and I think unnecessarily so, especially with the current feedstock rules which would mop up any gain anyway.

Senator CAMERON—Before we get to the feedstock rule, would you come back to the point where you said there was a grey area or an area of uncertainty on the dominant purpose test. How do you fix that?

Mr Duchini—I think you do away with dominant purpose and you realise and accept that commercially oriented companies undertaking appropriate R&D do so for more than one purpose. I would look at using words such as 'substantial purpose'—not an insignificant or de minimis purpose but a substantial purpose that acknowledges that there may be another outcome. It may not be the dominant and it may not be the most prevailing, but it is still substantially connected with and directly related to the R&D. It is just an idea but I think it does need debate.

Senator CAMERON—If we had a substantial purpose test and there was an argument about the substantial purpose test, how would you deal with that? The bill provides for the department to deal with these issues, to provide advice and to make some determinations. Is that still an appropriate way to go?

Mr Duchini—Are you talking about the administrative powers of the department?

Senator CAMERON—Yes.

Mr Duchini—I believe that a strong administration is good for any program. A strong and effective administration allows lines in the sand to be drawn where, at least from the department's perspective, you are either on that side of the line or you are not. And you have a choice: you either agree with it or you go through the courts, but at least you know what that choice is and it is clear. I think strong and effective administration is to be applauded. One of the great advantages of the Canadian regime is how Revenue Canada is said to administer the regime. There are detailed and clear industry based guidelines developed in consultation with industry and agreed, which sort of set the parameters of what is in and what is out. Canadian taxpayers have a choice: they either align their R&D regimes with those guidelines and they get a tick or, if they believe there is an argument to say that they are inappropriate, at least they know that they have a discussion on their hands. What we have faced, I would say, is a fairly ineffective administration for very many years where those lines are not clear.

Senator BUSHBY—Thank you for your evidence; it has been very good. You mentioned in your opening statement that no evidence has been presented that you are aware of that the public subsidy of new knowledge, or the development of new knowledge, presents a greater public benefit to the community than promoting the application of that knowledge. In your discussions with officials did they indicate that there was a policy preference for promoting the development of new knowledge over and above, or to a greater extent, than the application of knowledge?

Mr Duchini—I think that sort of mantra crept in even as part of the original objects clause where this concept of spill over benefit, or greater spill-over benefit, was attached to this knowledge creation or knowledge diffusion. It also picks up on some of the language from Cutler. Whilst all that is good in a policy context in framing a policy response, I do not think it is appropriate then to turn that in and to have it apply to what ultimately should be an industrially based or commercially based support program. I think that language is probably more aligned to public sector R&D where knowledge diffusion is important.

Senator BUSHBY—So it appeared that there was some concern?

Mr Duchini—Yes.

Senator BUSHBY—You mentioned that for corporates the proposal will limit the application to experiments that have failed in the particular circumstances that you were talking about.

Mr Duchini—Yes.

Senator BUSHBY—Yesterday, that was emphatically rejected by Treasury. Can you explain why what you say is correct and why Treasury is wrong in that respect?

Mr Duchini—I did listen to Paul when he said that. Being part of a smaller group that was engaged in consulting on the feedstock provisions we have to agree to disagree. We have a view, after reading the words, that clearly the basket of goods is costs. The basket of costs which can now be captured by the new feedstock provisions specifically and explicitly is greater than what we have now. Therefore, you have a greater basket of expenditure to which the original credit attaches against which to offset a marketable product that is either disposed of or even applied to own use. So the whole concept is broader. Therefore, if you fail you do not have a problem, and that is all well and good.

Senator BUSHBY—But you never sell it?

Mr Duchini—You never sell it and there is probably nothing of tangible or market value at the end, and there is nothing to net off, so the provision will not apply. But if you are successful you have to go through this process of determining the market value attributable to the feedstock output and offset against the costs attributable to the feedstock input. There is a rather complex formula there which you are required to work through to determine what that may or may not be. But at its basic premise, if you are successful, it reduces the support under the claim.

Senator BUSHBY—When you say that you have to agree to disagree, is that a disagreement on the interpretation of the legislation as presented?

Mr Duchini—Yes.

Senator BUSHBY—So you are looking at it from your practical experience since 1986, I think, as a tax adviser in this area.

Mr Duchini—Yes.

Senator BUSHBY—You are saying that, on your reading of the words that are currently in the legislation, the impact that you just outlined is what will be the consequence. Whereas Treasury, having put it together, is saying that the intention is quite different and this is what will happen. You are saying that the words, nonetheless, will deliver a consequence that is different from what Treasury thinks it will be?

Mr Duchini—Absolutely. I have put this in writing to them and they have come back to me in writing, so I suppose we agree to disagree. The reality is that the words in these new provisions are different and broader than the words in the former definition, and also the way in which the former feedstock provisions have been applied since inception. They are markedly different and they vary from the Australian Taxation Office's fact sheet, and they vary from AusIndustry's guide to benefits, which talks about the application of these rules. It is different. Treasury is saying that we have always got it wrong. Well, I do not think so. These new rules give effect to what the old rules should have done. That is where we are disagreeing.

Senator BUSHBY—If this becomes law and you go forward advising your clients, presumably the advice to your clients will be couched around your interpretation of it, and that will have consequences in relation to what your clients can do rather than taking comfort in the words of Treasury officials at a Senate inquiry.

Senator COLBECK—That is what you are obliged to do as a professional, I suppose.

Senator BUSHBY—Exactly; that is right.

Mr Duchini—With the greatest respect, we do not take anything that a Treasury official says as gospel about how the law is to be administered. Political parties come and go, politicians come and go, government officials come and go, but all we are left with is what is written here.

Senator CAMERON—Tax consultants stay.

Mr Duchini—We do. We find something else to talk about. Ultimately, all that you are left with and all that the courts are left with is what is written in the law.

Senator BUSHBY—And what is passed by Parliament.

Mr Duchini—That is what you have to deal with. People might have an intention and it might be all warm and fuzzy in this room, but in reality you have to advise your clients what the words say, and that is the end of the story.

CHAIR—Senator Cameron just pointed out that you have 40 people on your team at Deloitte in this area.

Mr Duchini—There are 50; we have not updated our website.

CHAIR—You probably have more than Treasury. I suspect that your advice might be—

Senator CAMERON—There is money sloshing about in R&D.

Mr Duchini—Yes.

CHAIR—One final question. It has been pointed out that only around 8,000 businesses in Australia benefit from the current R&D tax concession. Just laying aside the problem with the dominant purpose and the feedstock provisions, in your view will this help expand that number? I think that is a very small number out of the two million or more businesses that exist.

Mr Duchini—That is a really good question and I have to say that it is a very difficult one to answer. There is an expectation that this new regime will draw more companies into the regime, and that will be a good thing. There is also an understanding that smaller organisations respond more greatly to fiscal stimulus, so the cashing out of the credit will help to stimulate and support R&D in smaller organisations, and maybe that will bring more into the pot. One of the biggest issues that we have had with this whole process—and this was borne out yesterday—is that there has been no modelling with which we can engage or comment on in relation to the likely impacts of these changes at a macro level, an industry level or a sectoral level, so it is hard for us to make these assessments.

We do get across a lot of organisations. Most of the organisations that we talk to would be aware of it, as in the existing regime. I would have thought that most that are eligible would have a go at it and seek the benefits from it. I think the fact that they are moving from a credit to a deduction, which means that if you are in a tax

loss position you can get some cash rather than just adding to your tax losses, will engage more organisations to enter into the regime.

CHAIR—Thank you, Mr Duchini, for coming in today and for your very useful evidence.

Proceedings suspended from 12.38 pm to 1.59 pm

MIHNO, Mr Andrew, Deputy Executive Director, International and Capital Markets Division, Property Council of Australia

CHAIR—The committee resumes and will take evidence from Mr Andrew Mihno from the Property Council of Australia. Do you have an opening statement you would like to make?

Mr Mihno—I do indeed. I will try and keep it as short as possible. Good afternoon to everyone. Thank you very much for the opportunity to come here to talk about the research and development incentive bill. Effectively what I want to address are three principal matters. From a broad perspective, the Property Council has been a long supporter of government's reform of the R&D incentive regime, especially to ensure that it is better targeted. We support any common-sense measures that are going to deliver appropriate R&D incentives and encourage research and development onshore, the property industry of course being one of the greatest beneficiaries of R&D incentives. It has enabled us to deliver innovative building designs and construction as well as make significant inroads into energy efficiency.

The current proposal has improved some areas of the legislation, but there are some simple points of clarity that need to be resolved to avoid jeopardising the use of the incentives by the property industry as a whole. Given that submissions are going to be provided and tabled later, I will only deal with three issues in brief, and they relate to the operation of proposed incentives through the feedstock provisions, the definition of what R&D is and clarification of a technical exclusion. The comments basically relate to simple changes that clarify the position for industry, but they are nevertheless quite important.

Overall the way the current proposal sits, if strictly read, indicates that R&D for the property development and construction industry could be substantially curtailed due to some difficulties in applying it practically. Specifically, let's take the feedstock rules, for instance. Again I note the government should be congratulated for listening to industry and returning to the older feedstock rules. However, the extension of the rules to industries that do not use prototypes is impractical in relation to this incentive. By that I mean that the measures do not give the same result for all industries. They work quite well for industries such as manufacturing, where a lot of the cost, testing and R&D is done beforehand, the prototype is made, and then the feedstock rules can be used, essentially taking out a relatively small cost of the R&D.

However, for industries where there is substantial R&D sunk directly into a one-off project at the time it is done, it has the problem that it will deny substantial legitimate R&D costs. Effectively what happens is the developer ends up with a substantially lesser incentive or little incentive. The very simple remedy for this in any case is that the proposed feedstock rules should reflect the original purpose, which applied to mass manufacturers alone.

In relation to the second point, dealing with the definitions of core and supporting R&D, I again thank the government for listening to industry and amending the current core R&D to remove the twin test. However, one thing that we wanted to bring up was that the test now focuses on new knowledge, which can be construed as emphasising research but largely ignoring the development side of the equation. In practical terms, there is a question as to whether a building development that involves on-site R&D can even be considered as an R&D cost under the incentive. For instance, in order to test a green retrofit for insulation or structural reinforcing for a new and innovative type of building, it is necessary to conduct part of the R&D within the building itself to take account of all variables. However, the costs associated with that test may not strictly fit the definition of core R&D, as it is currently defined.

That would be a very unusual outcome, I would have thought. It really depends on how you interpret 'new knowledge' regarding improving materials, products, et cetera. That is fairly easily fixed, in fact, by ensuring that the R&D definition indicates that the actual creation of new and improved materials, products, devices et cetera is a part of core R&D. That is actually a very simple change because it involves removing two words from section 355-25, being 'about' and 'the' in parentheses. Secondly, something that would be extremely useful would be a number of property related examples in the EM. Currently there is one, but a number of examples that would show core R&D for the property industry would be immensely helpful for the industry.

In relation to supporting R&D, the use of a dominant purpose test means that R&D testing done on-site that is subsequently used in the final development arguably may not be able to be claimed, because you might not be able to legitimately claim that it is for the dominant purpose of R&D, even though it was a cost sunk for the purposes of R&D. The only way to have claimed that back would be a rather counterintuitive idea of tearing down the R&D test on the site and then rebuilding a final product, but that would defeat the purpose of it.

Again, this is quite simple to fix. Change the dominant purpose test to 'substantial purpose', which I think achieves what you are looking to do but also gets us around that rather interesting technical problem. In addition, including examples in the EM in relation to that, specific to property and what can be used as supporting R&D, would be very helpful.

Finally, one of the provisions in the new bill is provision 355-225, which is a building exclusion. Basically it states that building costs for construction are excluded from R&D incentive but does not clarify in what circumstances. In the previous legislation the provision was construed as applying to the construction of R&D facilities. Given the government has indicated that this is not designed to stop construction and property R&D in any sense, it would be a very odd situation if this exclusion were to carry across to all property construction because it effectively excludes it all from R&D. What this really requires is simply a clarification that the scope relates to construction of R&D facilities themselves.

As you can probably see, most of these are very simple changes, but they are changes that will immeasurably help the industry to adjust to the impact of the new R&D.

CHAIR—Thank you very much. Can you give me any indication or ballpark figure about what percentage or what number of construction companies might take advantage of the existing R&D rules?

Mr Mihno—I cannot give you an exact figure on that. I would have thought AusIndustry would be best placed to get that figure. Given that it is generally a privately held piece of information, it is generally hard to get. If you do require it, I am more than happy to go and seek it out.

CHAIR—Okay. Could you give me some feel for that? One of the basic premises of this bill is to improve the number of companies that get access to the R&D bill. I am wondering whether it is the case in your industry that there are a small number of companies taking advantage or whether it is a little bit more widespread than I would have thought.

Mr Mihno—I would consider from discussions I have had with expert consultants and the industry members I have talked to it is quite a difficult incentive to get across the line. What we tend to find is that even very large players in the property industry find it very difficult to use. It tends to be a little bit more select but I could not give you an exact definition. In any case, as I pointed out before, if these changes are made it will certainly make it a lot easier in that regard.

CHAIR—Yes, that is what I was thinking. Indeed, the current definition would seem to me to be quite difficult for the construction industry to overcome, in terms of appreciable novelty or high levels of technical risk. You just would not put up a building with a high level of technical risk, would you?

Mr Mihno—That is right. There is that obvious technical issue of the chicken and the egg in relation to buildings in themselves. You do R&D to be able to create a product at the end, so you get into this circular problem of how much of the R&D was in relation to pure R&D and how much of it was simply what you would have done anyway for the property itself.

CHAIR—I am wondering how much of the R&D is done by the construction companies, as opposed to people who go off separately, form an R&D type company and then, once they have proved or taken a product to an initial stage, take it to the construction companies to incorporate it.

Mr Mihno—I will take that on notice, because it is an interesting question. I will certainly ask a number of people in relation to that. You will find that when you are talking about construction and property R&D, you are talking about very big projects. In many cases you are talking about iconic buildings or buildings on difficult sites—for instance, buildings where you might want to have a 75-storey residential tower but simply put it on a piece of land the size of a normal residential housing estate plot. That presents significant problems. It is not something that an SME would be able to do; it is something that a very large player does. It really depends entirely upon what sort of R&D you are talking about. Within the property industry there is a very definite division in terms of what R&D gets done by which particular players. If you are talking about R&D incentives at the large end of town, it would be done for these iconic buildings or very ambitious projects.

CHAIR—Someone like Arup might do the more innovative types of construction.

Mr Mihno—Perhaps.

CHAIR—Someone with that sort of engineering expertise. In terms of the core research and the supporting activities, could you just go back to the detail of that from your point of view? I missed a little bit of that. You were talking about the supporting activities and how they relate back.

Mr Mihno—Sure. In relation to the supporting R&D activities, when you look at it, it says that the activities are done for the dominant purpose of research and development. This is an inherent problem for the property industry because when you look at a particular site and you do R&D because you do not know, for instance, how much reinforcing you need to make this ambitious tower stand up, you have to do it on-site. The reality is that once you have done that particular piece of R&D and you have proven that it will stand up, it is just efficient economics to try and use that in the building itself rather than tearing it down and doing it all over again, which would just be a waste of money. But once you do that, once you cross that line, you end up in a situation where you say, 'Well, did I do that particular structure for the dominant purpose of R&D, or did I do it to build the building?' It is a very difficult thing to resolve from our point of view, which is why we are looking for this circuit-breaker.

CHAIR—I may be wrong but I think that Treasury addressed this to some extent yesterday. They said that if the use of it in the building related it directly back to that R&D then that would be regarded as supporting the R&D—that percentage of the cost of the building.

Mr Mihno—From our point of view as an industry, especially at the higher end of town where they are inherently conservative and do not want to get on the wrong side of anyone, it would be worth while clarifying that in the documents—through the legislation itself, as we have suggested, and/or through the EM, with examples.

Senator EGGLESTON—You have suggested that the dominant purpose clause should be changed to substantial purpose, which is what a lot of other witnesses have suggested. That would obviously greatly improve the way this works for your industry. I am a little bit fascinated by the fact that the building industry does research and development of a kind that would attract benefits under these provisions. Does the building industry publish its work anywhere? Do you come up with some new way of doing things or some technique which is then published in a journal of some kind?

Mr Mihno—There are journals. Every single organisation, like any other proprietary company, would guard its particular research and development, but they would also showcase the end results through their website or their brochures, et cetera. But it is like anything else: there is very intensive research and development going on at certain levels because that will enable them to make lighter and cheaper structures and do it faster, which obviously gives them the marketing edge. Once the information is there, you can use it moving forward and it benefits everyone.

Senator EGGLESTON—Does your industry have any products, if you like, which you own intellectual property rights for, or ideas and techniques that are sold under licence around the world to other building developers?

Mr Mihno—I am afraid I do not know the answer to that question. I will take that on advisement and I can certainly come back to you with that. I would rather not answer it now, simply because it would be misleading.

Senator EGGLESTON—That is fine. It would seem, though, that most of what you do is very much related to a building purpose and the process of production. So I can see the rationale for you wanting this change. I think that in fact would be a very good recommendation for this committee to take up—to change 'dominant purpose' to 'substantial purpose'.

Mr Mihno—I am very glad to hear that. Thank you.

Senator BUSHBY—Mr Mihno, thank you for assisting us today. Have the issues that you have raised today been raised previously with Treasury officials or other officials of the government?

Mr Mihno—Yes, they have. This has obviously been an organic process, because Treasury have been coming out with drafts as they go. As a new draft comes out, it invariably gets refined and moves a little bit further along. But the substantive nature of what we are talking about has been discussed with Treasury.

Senator BUSHBY—So the problems or the concerns that you have are particularly in relation to those three issues, but I presume there are others. You mentioned you had issues that you might deal with in a separate submission.

Mr Mihno—Yes.

Senator BUSHBY—But you have raised these issues with Treasury as they have been relevant to the respective iterations of the proposal that have been put before you.

Mr Mihno—Exactly. That is right.

Senator BUSHBY—Presumably some of them at least, if not all, have appeared in earlier iterations of these proposals?

Mr Mihno—Yes. As I was pointing out, the Treasury officials have taken on board a number of the comments that we have made, and it is, of course, an iterative process as you move along.

Senator BUSHBY—Yes, but not to the extent that they have satisfied all the concerns.

Mr Mihno—That is right.

Senator BUSHBY—In respect of those concerns that are outstanding, have officials given you any explanation as to why they have not incorporated changes to address those?

Mr Mihno—Not officially. To be fair to Treasury, the reality was that we had our final consultation in relation to this. They went away and considered the issues that we brought up and we had a long discussion. Then they introduced the bill into parliament fairly shortly thereafter, so there was not actually time to consult with them in relation to that. I have called them in relation to these matters to identify which issues were taken up and which ones were not, but at the time, as you can probably appreciate, with everything that is going on we were not able to have a long and in-depth formal discussion about what is going on.

Senator BUSHBY—As I understand it, the final form of the bill was produced and lodged in the parliament very quickly in April without any further consultation subsequent to that of the earlier drafts.

Mr Mihno—We had a separate consultation with Treasury directly as the Property Council to address our issues between the public consultation and the final bill being introduced. That was us addressing some of the iterative developments in these processes, but we never got to the point of being able to determine where that got to until, obviously, the introduction came out.

Senator BUSHBY—Are you able to outline today what reasons you were given in your unofficial discussions with Treasury for their not accepting some of the suggestions that you made?

Mr Mihno—Let me talk very briefly about that.

Senator BUSHBY—The final feedstock changes were made after that, I would imagine.

Mr Mihno—Just let me have a look at the feedstock changes. I am just trying to remember what I wrote in my last submission. The issue with the feedstock rules is obviously one they took up as part of the process and they made some adjustments in relation to that. In that regard, they took up that particular consultation recommendation.

Senator BUSHBY—In whole?

Mr Mihno—Not in whole.

Senator BUSHBY—You are still raising issues with feedstock today.

Mr Mihno—That is right. As we said, our recommendation previously was to just adopt the old rules as they were.

Senator BUSHBY—As Treasury officials told us yesterday they had.

Mr Mihno—There is an extension in the EM that indicates that it will apply to particular industries outside of mass manufacturing and mining.

Senator BUSHBY—On your reading of what has been put before parliament, there have been changes to the feedstock provisions compared to what currently exists.

Mr Mihno—That is right.

Senator BUSHBY—What about the other areas—the definition of R&D and technical execution?

Mr Mihno—In defining R&D, we raised the concept that the twin test was very difficult to get across the line. In fact, in many cases it was nonsensical for the industry. That was taken on board. Obviously the end result was that they changed the rules and changed the definition. What we have effectively got now is a new definition, so we are now responding to that new definition.

Senator BUSHBY—That first became apparent when it came out in the bill. Is that correct?

Mr Mihno—Yes.

Senator BUSHBY—You had not had a chance to look at that beforehand.

Mr Mihno—No.

Senator BUSHBY—And you have raised some issues about that today.

Mr Mihno—I have.

Senator BUSHBY—Yes, and you have not had a chance to address those issues with any officials since that was introduced into parliament?

Mr Mihno—No.

Senator BUSHBY—And your third point?

Mr Mihno—The third point, the clarification of the technical exclusion, is something that existed previously. We raised that with Treasury. It appears that no developments were made in relation to that, so we are raising that issue again.

Senator BUSHBY—One of the reasons I asked those questions in the way I did was that Treasury yesterday also indicated that in their opinion all real issues—and when I say 'real issues' I do not want to paraphrase them or misquote them—had been addressed. Basically, they said that all issues that were put to them with sufficient information that they could understand and in a way that made a case had been addressed and that any remaining issues were really based on a misinterpretation of the proposal by those who considered the issues still exist. Given that, to what extent are your concerns based on a detailed analysis of the proposed legislation?

Mr Mihno—In relation to that, obviously we have had the week to go through the legislation since it was introduced into parliament, and we have experts who deal with this and who live and breathe R&D. I have been taking advice in relation to this from them.

Senator BUSHBY—These are in-house experts?

Mr Mihno—No, not my in-house experts; these are industry experts—people who deal with R&D and industry.

Senator BUSHBY—You have consulted with industry experts, you have had a very good look at this and you have identified the issues that you have raised with us today as being real, based on the words that have been used in the proposed legislation.

Mr Mihno—That is right.

Senator BUSHBY—Among your members, how reliant is the development of new and innovative approaches to building design and the other things that you do on the availability of R&D tax concessions? How important is it for those innovations?

Mr Mihno—The simple answer is very. For those who use the R&D concessions or incentives, it is the difference in many cases between taking a risk and doing something new and doing something very simple. The classic example I could give you is one where one of the very innovative property players is building an extremely tall high-rise, a 75-storey high-rise, on a very small piece of land. I have a bit of technical jargon for you here. Usually the ratios are eight to one for land to height, and this is 13 to one. So it is literally like putting a pencil on its end.

It effectively means that you can fit much more residential area into a small space, which is of course of great benefit to the community, given the concept of urban sprawl et cetera. But they have had to embark on R&D because a 75-storey building has sway factors and things like this. It has never been done in Australia. The technology or the expertise to be able to do that is not readily available anywhere, unless you are going to ask a foreign company to come to Australia and do it, but bringing in foreign expertise defeats the purpose of having a R&D incentive. These people are in a position now where they are going ahead with this tower. The R&D is absolutely crucial to them being able to make this thing stand up.

Senator BUSHBY—That is a good example. You mentioned the community benefit, and that is something I was going to ask you about. You use the example of the community benefit being in respect of the population density. What other public benefits might flow? We are talking here largely about one-off types of developments.

Mr Mihno—That is right.

Senator BUSHBY—What other public benefits might flow from government investing through such incentives in your industry?

Mr Mihno—The classic example is jobs. Every single new innovation creates an opportunity to provide a project. With each new project, there are more jobs. There is greater prosperity for the economy, especially the direct regional economy in that particular area. Leaving that aside, the innovation itself, far from sitting with that one particular tower, then gets used in every other tower. For instance, in relation to that example that I told you about, with the R&D that they are doing they are now proposing a number of other towers that also are very tall. It is directly off the back of that, so there is a multiplier effect. In addition to all of that, you have the greater efficiency. You can build faster, you can build cheaper and you can build lighter, which means that it becomes much more affordable. That translates into the hip pocket for residential purchasers.

Senator CAMERON—I am interested in these 75-storey towers. How much did that 75-storey tower depend on government financial support for R&D?

Mr Mihno—I am sorry, in what respect? What percentage of that particular project?

Senator CAMERON—Yes.

Mr Mihno—In that particular circumstance, I do not have an exact figure for how much money related to that, but I can tell you, for instance, that for a similar structure where they had to build part of the superstructure to determine the sway factor the R&D for doing that entire superstructure and testing it amounted to approximately 20 to 30 per cent of the entire cost of the building. But I must emphasise that that depends entirely upon the building itself. It is not something that you can equate to projects across the board.

Senator CAMERON—This is what I am concerned about. You argue that we should move the test from 'dominant' to 'substantial'. Evidence we have heard says that the biggest benefit to the economy would come if we focus R&D on small start-up IT companies and high-tech companies. If we have 75-storey towers being 30 to 40 per cent funded by research and development, that makes it very difficult for the rest of the economy or the rest of industry to get a fair shake out of what is available, doesn't it?

Mr Mihno—When you say 30 to 40 per cent, probably what I should clarify is that 20 to 30 per cent, which is what I think I actually said—

Senator CAMERON—Sorry.

Mr Mihno—That is quite all right. Twenty per cent to 30 per cent represents the R&D cost against the total cost of the building. If you look at that in after-tax terms, that is about a 7.5 per cent tax benefit on a building that, if it is successful, will create a profit flow which is taxed at 30 per cent. So the net benefit is actually flowing to the government and to the taxpayers at large for doing that. The other issue I would probably raise there is that, if you look at the concept of green retrofits for buildings, something which is going to be a massive project moving forward—

Senator CAMERON—Can I go to retrofitting later? I would like to stay on this other issue before we go to retrofitting.

Mr Mihno—Sure.

Senator CAMERON—The analogy I am trying to make is that the building and construction industry is a bit like the pharmaceutical industry. The pharmaceutical industry does its research and development off market because you cannot put something into the market that is going to kill a patient. It is a bit like the construction industry. A lot of your research and development has to be off market because you cannot start building a 75-storey construction unless you are pretty well sure that all the engineering design is right, the materials are right and that you have done all of that research and development, which could be quite substantial, off market before you start building. I am not sure how you would get venture capital to dig a huge hole in the ground for a 75-storey building, put the foundations in, and have the potential, once you get up 10 storeys, to can the project. Does that happen? Tell me where that has happened.

Mr Mihno—I am not aware of that. I am aware of an example of it happening in the UK, but they did not can the project. What they did—

Senator CAMERON—I am not interested in that. I am talking about here. Where in Australia has the building industry set about an innovative project design, done all the technical work behind the scenes, dug the foundations, started the project and said, 'This doesn't work'? That is an important issue for me in terms of providing 20 to 30 per cent support.

Mr Mihno—I am not aware. In fact, I have asked that very question. I will take that on advisement because it is a question that I would like to go into in a bit more depth on with a few more industry players. But my

answer to that is that I do not know of a project that has fallen over for that reason. The simple reality is that, wherever possible, you would maintain and fix the structure. That would involve further cost.

The simple reality is that there is also a hard decision to make here as to what government wants to do with its incentive. I am aware that you are alluding to that, but if you want iconic buildings, if you want buildings that are going to be more efficient moving forward, if you want buildings that are going to be cheaper and faster to build, then the hard decision has to be that you are going to continue to support the property industry by giving an R&D incentive to allow them to do this work.

Senator CAMERON—I am not arguing that you are not entitled to an R&D incentive.

Mr Mihno—No.

Senator CAMERON—I am simply saying that I equate the property industry more to the pharmaceutical industry, where the R&D is done off market, the proving is done off market and the amount of proving that has to be done before you start building would be minimal. I have been involved in superannuation funds and I am sure we have had innovative building projects coming to us but we have never been told, 'Look, you put up the money for this, you pay for the foundations and we will have to wait until we are 10, 15 or 20 storeys in the air before we can tell you if this investment is going to work.' I have never had that, ever. I am just not sure that this argument you are putting forward as to why government should support this on-site testing stacks up. It does not happen that way, to my knowledge.

Mr Mihno—Let me give you another example that might add to this. I want to get these details right, so just pause with me for one second. Currently there is a thing called fire rated structural steel for columns and beams. Again, there is an innovative company that wants to use these particular beams in a residential high-rise, which has never been done. They have a very real risk. They do not know exactly how to do this particular project and they are never going to know until they get up there. They can get to within 70 or 80 per cent sure, let's say, just to pluck a percentage probability out of the air. But I was talking to them today and they said there is a very real risk. 'We have to do this, and if we are doing this then we're going to be relying on R&D to be able to get it right.'

Senator CAMERON—But wouldn't they be required to get building approval and safety authorities to even commence? You are the expert and you can tell me, but I would not have thought that building a 75-storey high-rise is the equivalent of testing something on a production line somewhere in the manufacturing industry. It just does not work like that.

Mr Mihno—You do not build a 75-storey tower and say, 'Wow, thank God it stands up.' What you do is you build a superstructure that is a certain height that will enable you to test whether or not it will work under safe conditions.

Senator CAMERON—And it never fails, to your knowledge, in Australia.

Mr Mihno—No, I did not say that. I said I do not have any examples where it has failed, but that does not mean it does not fail.

Senator CAMERON—Can you take it on notice and provide the committee with any example where there have been failures and significant losses to a building company because the design just fails some of these basic tests?

Mr Mihno—I will definitely do that. Again, I put this out more as a point to clarify on my behalf, but you do not build a 75-storey tower incomplete with a massive uncertainty. What you do is you go to the site and you build the superstructure to a certain height. The superstructure is not building the floors complete to a certain height; it is simply the framing. In particular in relation to a very thin building, you would set up the test. You put dampeners on top of the structure and shake it as hard as you possibly can to see what happens and make sure that it actually works. You would monitor it. If it looks like it is not going to work, you go back to the drawing board and you figure out what it is you need to do to reinforce that to make it work. It still involves risk and loss because there is money involved in doing all of that; it is just that it is not such a complete and substantial loss. But, again, I will take it on advisement and I will get that information.

Senator CAMERON—I am not sure how much of that is research and development or trying to fix a faulty design.

Mr Mihno—I suppose it is semantics. If nobody knows how to do it in the first place, that is research and development. If you have to look at a question and decide whether or not it is going to work and there is a risk in it, then it is research and development.

Senator CAMERON—One of the examples that has been discussed in the committee, and I am sure you have heard about it, is the building industry claiming the cost of a whole building because there is innovative air-conditioning being fitted in the building. Have you got any comment on that?

Mr Mihno—Yes, I can comment on that. I saw that. I read Senator Carr's comments in relation to that, and they took me by surprise to the point where I asked a number of experts, both consultants who work in the area and a number of the companies themselves. I am aware that obviously there is a real project that this relates to—it is not just plucked out of the air—but we find it quite hard to understand how you could possibly have claimed 100 per cent of the building without AusIndustry turning around and rejecting it out of hand. The current rules, on a reasonable reading, do not allow you to do that.

I am aware, and I say as a qualifier, that I do not the details. I only have two lines and what you have just told me. There may be a perfectly legitimate reason as to why it would be the case, but if you are saying to me that there is $15 million worth of R&D, full stop, and there is a $100 million build and they are claiming the whole thing, then no, I cannot see how you would do that. I am surprised that it would get through AusIndustry. Equally, though, I am aware that the nature of R&D in our industry, and the fact that there are so many variables that you need to deal with and that you deal with on-site, means that some part of every building will be R&D.

Senator CAMERON—Don't you agree, then, that we have to guard against that? I am sure you do not agree that that is a reasonable proposition. If there is a claim for 10 per cent of the build then we end up with a 90 per cent addition to that. That just seems to me to be a crazy proposition. That is why some of these 'dominant' versus 'substantial' arguments come in. Could you advise the committee on notice how moving from dominant to substantial will guard against the type of claim that was made in relation to that air-conditioning example that has been discussed at various committee meetings?

Mr Mihno—Can I impose on you to give us the full example of how that came about? I cannot give you information on that without knowing the detail of what the actual claim was. It would be irresponsible of me—

Senator CAMERON—And it would be irresponsible of me to breach privacy.

Mr Mihno—I am aware of that.

Senator CAMERON—You would be the first to say that I should not do that. But what I can tell you is that the project involved the construction of a new building that has a stated design goal of meeting newly emergent accreditation standards. The core R&D centres on improving air-conditioning, yet the company has registered around $100 million for the R&D project, of which 85 per cent is the cost of constructing the building, which the company regards as a prototype to test the R&D. The actual core R&D activities probably represent less than 10 per cent of the company's claim. I am not asking you to comment on a specific, detailed analysis; I am saying that that is the claim that was made. I would like your comments on that and how moving from dominant to substantial would guard against that misuse, in my view, of public finances.

Mr Mihno—Certainly, I can do that.

CHAIR—Thank you, Mr Mihno. We have run out of time. Thank you for coming along this afternoon. Thank you for your evidence.

Mr Mihno—Thank you.

[2.41 pm]

EDWARDS, Dr Russell, Ex officio member, Tax Concession Committee, Innovation Australia

THOMAS, Mr Peter, Chair, Tax Concession Committee, Innovation Australia

CHAIR—I welcome the Innovation Australia Board and thank its representatives for attending. We will lose one of our members shortly: Senator Cameron has to leave. If he walks out, it will be not something you said but, rather, a prior commitment.

Senator CAMERON—Do you want me to stay: that is the question.

CHAIR—Mr Thomas, would you like to make an opening statement?

Mr Thomas—Yes, thank you. In my role as a board member of Innovation Australia, I chair the tax concession committee, which is one of the committees of that board. Innovation Australia is an independent statutory board, established under legislation. It assists with the administration and oversight of Australian government, industry, innovation and venture capital programs that are delivered through the Department of Innovation, Industry, Science and Research. Innovation Australia is also empowered with functions relating to promoting the development and improving the efficiency and international competitiveness of Australian industry by encouraging research and development activities, innovation activities and venture capital activities.

The board is assisted by a number of committees, one of which is the tax concession committee, which I chair. I have chaired that committee for the last three years or so. The TCC operates under delegation from Innovation Australia. It is responsible for providing advice to the board about the operations of the R&D tax concession. In particular it has responsibility for assessing the eligibility of industry R&D across all sectors and makes decisions which are binding on the tax office in relation to whether particular activities satisfy the statutory definition of research and development activities.

We also provide advice regarding the operational policy aspects of what is presently the R&D tax concession program. We had the opportunity to make submissions to the Cutler commission and appeared before the Cutler inquiry. We have also made submissions in relation to the statement that was made on the principles for the new R&D concession, and we have also made submissions on the first draft of the bill which was released just before Christmas.

Overall the board welcomes the increase in the benefits which are going to be provided for companies that are conducting R&D in Australia. We consider that in the current amended draft legislation the range of changes that have been adopted by the government make the legislation clearer. They remove what were considered to be some unintended consequences and they ensure that the legislation is indeed more closely aligned with what we understand to be its policy intent. We support the amended draft. In particular we consider that while the new definition of 'supporting R&D activities' takes a more refined approach to applying a dominant purpose test, it strengthens the link between what are core R&D activities and supporting R&D activities.

This has been important because one of the critical issues which was laid out when this whole procedure started was that any changes should aim to be revenue neutral. The board and the TCC also welcome the additional administrative powers which have been given to AusIndustry and Innovation Australia. They ensure that the tools are there to ensure that the system is appropriately monitored, particularly given the refundable tax offsets which are now introduced to a much greater extent in the new legislation. Overall we look forward to the introduction of the new R&D tax scheme and we believe that it is a move that will improve the focus of R&D in Australia and provide benefits where they are truly needed.

CHAIR—Thank you, Mr Thomas, for outlining the reasons you support the bill. We have had quite a lot of evidence suggesting that industry participants place no faith in the assurances given by Treasury, the department, AusIndustry or anyone else about the application of the new bill, particularly in terms of that dominant purpose test and the development part of the R&D equation. Do you have any comment on that?

Mr Thomas—Our role at the TCC is to interpret and administer the legislation. We will be given guidance as to the way in which the dominant purpose test should be interpreted. We would be applying our role of determining whether particular activities satisfy the core activity and the dominant purpose activity. We would be administering it in accordance with that guidance.

CHAIR—Is it your view, as some have said, that this bill shifts the emphasis very much towards the research side and not the development side of the equation? It is not exactly an equation, sorry, but the proposition.

Mr Thomas—I do not know that it does. Certainly in the submissions that the TCC made, we were conscious that those incremental developments which occur during process were supported where there was innovation and where new methods were introduced. We were very aware of that. That was something which in our submissions we supported. The research side is obviously very important but the development side also is important. I think it remains to be seen whether the changes do skew the bill. That is not something that—certainly in relation to our submissions—was seen as being desirable.

CHAIR—Would you envisage, if this bill were to pass, that there would be consultation with industry? Clearly many people in the industry are worried about the dominant purpose aspect in particular. Would there be consultation with the industry about how they see that applying, and the guidelines that are involved?

Mr Edwards—I noted that there was comment on that this morning. Certainly there are two levels of material that are being planned. We talked about that yesterday. One is the guidelines, the factsheets and general guidance material. Yesterday in giving evidence I did say in relation to issues of significance that public findings would be used.

I certainly believe that in the area of public findings, where the board goes through a very rigorous process of producing a public finding, there would be consultation, but as for the initial guidelines, factsheets and mechanics of how to use the new program that we will get out there quickly, I would not see that as necessarily needing a long consultation period. We have an important role in getting information out quickly but, as I said yesterday, on issues of significance, where we will come to the board and say, 'Can you make a public finding on this', there will be detailed legal analysis and there will be a level of consultation before that comes out.

CHAIR—I suppose it might be said—and the government has stated—that in order to make this revenue neutral, there will be some restrictions on current R&D expenditure. The government has outlined where the aim is for those restrictions to be. That might give rise to a bit of nervousness around industry that it might inadvertently be them, or they might genuinely consider that their R&D is the type that should be caught. This is the kind of change that might produce that, because we know that there will be losers in this process.

Mr Thomas—In any change, there will be losers: that is why you are changing it. Really I think what you are trying to do is better focus it better. Clearly the move from a purpose test to the dominant purpose test automatically means that there will be fewer supporting activities that qualify for the R&D incentive. That will cause nervousness. The fact that the whole of the legislation is being rewritten rather than the existing legislation being tinkered with does cause people to say, 'What really is being achieved by this new legislation?'

Whenever there is change there will be people who see themselves as being losers. It is just a fact of life, really. But the aim is clearly to focus the R&D towards activities which, first, are seen as being those that the government wants to support and, second, there is unquestionably a move towards supporting R&D which is carried on by SMEs.

CHAIR—What is your view on the opinion that we have heard—that the term 'dominant' should be changed to 'substantial' so that it would be a test of substantial?

Mr Thomas—They are words, aren't they? At the moment it is 'a purpose', which means it can be any one of a number of purposes for which an activity is carried out and which qualifies for the concession. I think there two interpretations of 'dominant', and I have a background in taxation law. One can be that it is more than 50 per cent. The other can be that it just has to be the largest, which could well be less than 50 per cent if there are three or four types of activities. How do you judge whether something is a 51 per cent test or a 49 per cent? In the end, it is all judgement. 'Dominant' really means that it has to be the first of those activities. It has to be the main activity—the main reason why you carried it out.

CHAIR—Essentially it is the equivalent of substantial, in your view?

Mr Thomas—It is not all that different, really, is it? There could be two substantial activities. I think a dominant activity means that it has the dominant or primary activity.

CHAIR—There are a couple of other areas, such as timetabling, compliance, and so on, that I hope my colleagues might ask you about, but before I turn to them I want to ask about the spreading of this test. The

statistics show that of about two million companies, currently 8,000 of them get the benefit of the existing R&D laws. I think that that is a very low figure. Would you believe that, if the change in the law is made, that figure might have a better chance of increasing?

Mr Thomas—I would expect that there would be an increase in the number of companies that were registering for the R&D tax credit or offset, if only because the quantum of the benefit they can get is greater. Simply it is increasing from seven and a half cents in the dollar to up to 15 cents in the dollar. At the moment there would be a number of companies which just do not really see the point in registering because of the need to register and do all that sort of thing. That is particularly the case with small companies. They do not see the benefit, but they may well see the benefit in doing it when the concession is enhanced. You talk about the concession being the deduction whereas it is the credit, but you know what I mean. I am referring to the incentive being enhanced.

CHAIR—Do you believe that this unduly affects any particular industry sector? We have heard that it would have a greater adverse impact on the mining, manufacturing and the construction sectors. Can you see any reason for that to be the case?

Mr Thomas—To the extent to which companies at the moment would contend that they have very large supporting activities in relation to a particular project, the change in the legislation would limit their ability to claim supporting activities because of the dominant purpose test. Our experience has been that the mining and infrastructure areas are two areas that probably have a predominance of supporting activities compared with core activities, and sometimes a multiple. Sometimes the supporting activities are indeed a multiple of the core activities. I expect they would be those that may well be affected.

CHAIR—I suppose this next question is the crucial question. There will be some who will be encouraged to apply and will benefit from it, but there will be some that might have some cutback. Do you see that resulting in any net downturn in the quantity of R&D done, or would you expect that there will be a net upturn? I am saying that some companies might not do R&D because they are not able to claim that supporting activity and therefore they consider it not worth doing the R&D at all.

Mr Thomas—I guess you are talking about the R&D that is supported by the legislation. I would expect that there would be a lot of things that are now arguably being supported by the current legislation that in future will not be supported by the bill and that would nonetheless be carried out. Whether that means that it is R&D that is carried out which is not being supported by the legislation, or whether it means that activities that are presently being carried out are being supported by the legislation and in future will not be supported by the legislation, and therefore they are not R&D, I do not know. But if you take it that it is all R&D, there will be a limiting of the activities that are supported by the legislation.

CHAIR—But are net?

Mr Thomas—I expect there are a lot of activities that presently are being carried out that are not being carried out simply because of the support they get from the legislation. If they are R&D, I think there may not be all that much which is not still carried out.

CHAIR—Thank you. Senator Eggleston?

Senator EGGLESTON—Thank you, Madam Chair. You asked a broad range of questions, which covered a lot of ground and some of the concerns, I must say. One of the general questions I would like to ask is in relation to concessions and credits for research and development, but money spent in that area is a business expense and is tax deductible in any case, are they not?

Mr Thomas—In the main, yes.

Senator EGGLESTON—In the main they would be, so companies that do not get the benefit of this type of credit nevertheless could still write off research and development against their taxation, I suppose.

Mr Thomas—There is the issue between whether it is of a capital or revenue nature, but assuming it is a revenue nature, there is a 30 per cent tax deduction which is written into the corporate tax rate. At present, if you satisfy the definition of R&D activities you get 37.5¢ in the dollar. That is the standard rate. There is also the 175 per cent rate, which obviously enhances that. For the standard rate, you get a write-off at 37.5¢ in the dollar compared to 30.

Senator EGGLESTON—Yes. The comment has been made that this legislation will not encourage a lot of research and development from industry across the board. What is your view of that comment?

Mr Thomas—My view of the changes?

Senator EGGLESTON—Yes, this new regime.

Mr Thomas—The aim certainly is to do that. It is a question of whether the 15 per cent rate is something that causes people to undertake R&D activities that they would not otherwise have done. The other thing is that for small and medium enterprises, the 15 per cent rate only really applies to them. However, that is a refundable credit so you get the money back if you have spent that, regardless of whether you are in a tax-paying situation.

Senator EGGLESTON—Good. Some comment also was made by Deloitte that the Canadian regime has industry-based guidelines. Are you aware of the Canadian legislation?

Mr Thomas—I am generally aware of the Canadian legislation.

Senator EGGLESTON—Do you see any things in the Canadian legislation that we might usefully adopt? The comment was made that the Canadian regime has industry-based guidelines and is therefore more focused on industry. I wonder whether you could make some comment on that?

Mr Edwards—Senator Eggleston, we represent the delivery function rather the policy function. I think that skates very centrally into the policy area. However I can say that it is our intention to produce sectoral guidelines as educational material for different industry sectors, but neither of us, unfortunately, could comment on the policy deliberations.

Senator EGGLESTON—Very well. What about the question of the removal of the so-called twin test? Do you regard that as a good step in this legislation?

Mr Thomas—By the 'twin test' you mean you satisfy the definition of R&D activities, or research and development, if there is innovation or high-level technical risk?

Senator EGGLESTON—Yes, indeed.

Mr Thomas—The way in which the legislation has been written reveals an aim to be very much more simple legislation. It removes words from it which were not really backed up by a coherent definition. I think it makes it very simple as to what actually qualifies. What you are looking for arguably is a gap in knowledge and the steps we need to take to fill that gap in knowledge. Those activities, if they are being undertaken to fill that gap in knowledge, will qualify and satisfy the definition of R&D activities. It is really as simple as that.

Senator EGGLESTON—Yes, thank you. Who does the Innovation Australia Board represent? Could you explain that?

Mr Thomas—We are a statutory board that is established under legislation. We report to the Minister for Innovation, Industry, Science and Research, Senator Carr.

Senator EGGLESTON—I was just trying to determine whether or not you are an industry-based body, but you are a government agency.

Mr Thomas—No, it is a government body.

Senator EGGLESTON—Indeed. Does industry come to you and discuss these issues with you?

Mr Edwards—The members of Innovation Australia and its committees are drawn very broadly across industry sectors and that is the strength of utilising their expertise, especially in decision making on what is R&D or decision making in other facets of the programs that the board looks after. It is a broad church, drawn from the private sector. They all have their contacts within the industries they come from and they are all eminent and well known in their fields. I hope that goes some way towards answering your question, Senator.

Senator EGGLESTON—The reason I asked the question about what your support group was or where you draw your advice or information from is that one of the consistent themes in this inquiry has now been that there has been a lot of haste in this legislation. Several witnesses have said they thought the consultation with industry left a lot to be desired and was rather inadequate. It was pointed out that consultation began only after the first draft was put out at the end of last year. The second draft was put out with only 11 business days in which to consult, and now we have legislation before us. Have you had complaints or views of that nature put to you from the businesspeople who are represented on your board in relation to consultation about this legislation?

Mr Thomas—Innovation Australia is one of the many groups that put submissions first to the Cutler inquiry and to the legislation, or firstly at least the statement of principles that came through and, secondly, the first draft and then the second draft. We have made submissions. We are very aware of the fact that there was

not a lot of time in which to formulate those submissions, certainly in relation to the first and second drafts of the legislation.

I had quite a role in relation to putting together the board's submission, but I think that is really just par for the course. It just happens. You would always like more time for consultation and more time in which to get things done, but there was always, as I understand it, the desire and commitment to get this legislation to operate for the 2011 tax year. That means it really had to be in place, unless you were going to be legislating by press release, by 1 July 2010.

Sure, I think things took longer than they possibly desirably should have taken, but I do not think that is the first time that has happened. You simply adjust yourself to do that. There was a lot of consultation opportunity during the Cutler inquiry. Indeed I think there was significant ability to have your submissions in relation to the principles which were put through, but after that, yes, I would say it has been a fairly rushed process.

Mr Edwards—Senator, I think our colleagues from Treasury gave a fairly fulsome answer to that when they were asked a similar question yesterday. It included the number of consultation sessions, the time and the number of submissions. I would point you to that answer as well.

Senator EGGLESTON—Yes, I heard that answer. Nevertheless, we have heard a lot from industry expressing great concern about the haste with which preparation of this legislation has been brought forward. Surely in relation to legislation that is as important as this, I would have thought that a board such as yours might be concerned that the haste might mean that the legislation is not as well designed as it could be. It is quite obvious from the evidence we heard today and yesterday that many groups are concerned that this legislation is still being remodelled, if you like, as we race towards 1 July. I would have thought that the suggestion that this be deferred until 1 July 2011 might have met with some approval from your board, since you have an overview role with industry concerning research and development.

Mr Edwards—Senator, I understand your point but Mr Thomas's opening statement said that the board was comfortable with the legislation as it has been drafted.

Senator EGGLESTON—I heard that and I must express my surprise at it. Thank you.

Senator BUSHBY—Over the last two days a lot of issues have been raised regarding this proposed legislation, mainly by those who are affected, but also by groups representing companies from a broad spectrum of businesses. Some of these concerns have been aired, but I want to run through some of those that have been raised. One is that the legislation appears to slant support more towards research than development. You were asked about that earlier and indicated that you did not think that was necessarily the case.

One of the witnesses we had this morning indicated that, in discussions with Treasury about that aspect of the legislation, he put it that it appeared to be a mantra that was coming from Treasury—and that was his word—that there was a preferred approach and that it was a deliberate policy intention to slant the assistance more towards the research side of it in relation to the creation of new knowledge, rather than using knowledge to create new applications. Given your earlier comments, what would you say about that? Do you think that that particular witness is misreading Treasury? Are you aware of any preferred policy direction of the government in that respect?

Mr Thomas—No, I am not. I look at the new definition that has to be satisfied and I do not see in that definition that there is a slant towards research.

Senator BUSHBY—Apparently the new definition omits a phrase that was in the old definition and it included the use of knowledge to devise new applications. That is in the current definition but is not in the new one, according to evidence we heard this morning. At least in part that is driving the concerns that industry is raising.

Mr Edwards—Senator, I point to the evidence that was given yesterday. The new definition talks about products, processes and services. The concept of new knowledge is in both the old and the new definition.

Senator BUSHBY—New knowledge, but apparently, according to the evidence, although I have not checked it, it is the phrase 'use of knowledge to devise new applications', so it is not new knowledge, but rather the use of existing knowledge, presumably, to devise new applications. That is a phrase that is in the current definition, according to the evidence, but not in the new definition.

Mr Edwards—Senator Bushby, I think that would be the sort of question you should put on notice to Treasury. It is a fairly technical question. I think it is more appropriately directed there.

Senator BUSHBY—I am happy to do that. The evidence is, if that is the case, that it leaves little room to claim for experimental development. We heard evidence today that a Productivity Commission report indicates that more than 60 per cent of research and development is in experimental development. If that evidence is correct, it appears that it will bear the brunt of the changes and moving the emphasis back to research. The vast majority of R&D appears to fit into an area that these tax concessions are moving away from, according to that evidence.

Mr Edwards—Yes.

Senator BUSHBY—Yesterday, when you were in the room, Mr Edwards, we heard evidence that the feedstock provisions have not changed. We have had a lot of evidence today highlighting that they have—for example, that it broadens the impact of those provisions, taking them outside of manufacture, which is currently how it works. It now means that those feedstock provisions will apply in a much broader sense to activities and sectors where it would not currently apply, and that would have an impact on those industries, particularly those that do not create prototypes first. Often the research and development may have been a one-off project, for example. That will have an impact on non-manufacturing types of industries in terms of how those feedstock provisions apply to them.

Mr Edwards—Senator, as you know, the administration of the program is split between AusIndustry and the tax office. We look after the definition of R&D. The tax office looks after the expenditure side. I take at face value what Treasury said yesterday. I cannot add to that. It is a question best put to the Treasury tax side of the equation. As you know, their answer yesterday was that it has not changed.

Senator BUSHBY—I know they said that yesterday. Today we have heard evidence pointing to words in the bill that indicate that it has. Obviously there is a conflict. Hopefully we can resolve that through the secretariat.

Mr Thomas—The one thing I would say in relation to that is that the first bill which came through had much more extensive feedstock provisions in it.

Senator BUSHBY—I acknowledge that and a lot of concerns about that have been addressed.

Mr Thomas—Senator, certainly the board was supportive in its submission of limiting the effect of the feedstock provisions.

Senator BUSHBY—Thank you.

Mr Thomas—The intent was, like in our submission, that it should really go back to the pre-existing situation.

Senator BUSHBY—Yesterday Treasury said they needed to tighten the base to fund the increase in the tax credits. Evidence we heard this morning also noted that the impact of the tightening of the base will be overly borne by industries that underpin our economic growth, particularly mining and manufacturing. I will not go into all the technical details, but this morning we were told, because of all the reasons we are talking about, that the legislation will impact more greatly in areas such mining and manufacturing than it will in some of the other areas, and that to some extent the stated intention of the bill is to move it to SMEs rather than the bigger companies. If that is the case it will mean that there is less support for those parts of our economy that are driving our economic growth, that helped us to get through the GFC and so on. Do you have any comments on that, given your opening statement about the value of R&D in general?

Mr Thomas—I think I responded to that earlier by saying that certainly in the mining and infrastructure areas we see large claims coming to the tax concession committee large claims which are very significantly for what are now called supporting activities. If you introduce the dominant purpose test, undoubtedly those less supporting activities will be available. It clearly has that impact. That is a policy issue.

Senator BUSHBY—I can tell you that we have not had any evidence from anybody suggesting that claims that could be characterised as rorts of the system or instances of people trying to take advantage of the system should not be addressed. Nobody has suggested that and I do not think that anybody sitting around this table would argue that we need to make sure that only the claims that are legitimately for legitimate R&D purposes that will have a public benefit should be supported.

But we have had a lot of evidence saying that a general or across-the-board revision of the laws that impact on everybody to address the small percentage of cases where that does happen is not necessarily the best approach and that there are alternatives—for example, capping the credits that might be obtained or, alternatively, putting a ratio on the amount of supporting R&D to core R&D. Examples like that have been put

forward. There are other ways that might be more targeted and address the problem more head-on without having unintended consequences elsewhere.

Mr Thomas—Particularly when we put forward our submission to Cutler, I think we canvassed a number of those possibilities. We were supportive of the dominant purpose test from the start because that did not become something certain sectors were favoured in relation to others. If you introduced a cap, there would be certain sectors that benefited more or that had less detriment than others. In our submission we considered those and we came down to the view that that the most appropriate way forward was to go with the dominant purpose test, and that was our recommendation.

Senator BUSHBY—According to evidence we have had, the dominant purpose test impacts more on manufacturing. You are developing R&D for purposes that ultimately will have marketable reasons. Some of what you invest in for efficiency reasons ultimately you would like to be able to use that for the end production.

Mr Thomas—Whichever one you choose and whichever way you go, there will be winners and losers, yes.

Senator BUSHBY—Focusing on that, today we had a number of witnesses suggest that, rather than 'dominant', the word 'substantial' would be better. Do you have any issues with 'substantial'?

Mr Thomas—I think I responded to that with Senator Hurley. I think if 'substantial' had been chosen, that would not be something that you would rail against. It is better than 'a purpose'. What is a substantial purpose? What is a dominant purpose? 'Dominant' is probably slightly—

Senator BUSHBY—It is far stronger.

Mr Thomas—It is a tougher test than 'substantial'. 'Dominant' means the main test, I think, but whether that is more than a 50 per cent purpose test or whether it is just the largest of a number of tests, I do not know. I suppose in certain circumstances a substantial test would be harder than a dominant purpose where there is a large number of purposes.

Senator BUSHBY—Okay.

Mr Thomas—I cannot really add anything to what I have already said.

Senator BUSHBY—We have touched on timetable issues in respect of consultation. Evidence also has been put forward in respect of the timetable that the last-minute rush, particularly with the final draft of the bill that has been introduced to parliament, has meant that there were changes that had not been consulted on, and the overall uncertainty surrounding the application of some of the issues may well have unintended consequences that will need to be worked through. If it becomes law, the practical application of the law will throw up things that were not expected, and this may lead to uncertainty and the inability particularly for small business to participate, because they will not know whether or not they qualify. By the nature of small businesses, they do not have a lot of time to research these things or even to phone you guys and talk to you about it. They are focusing on trying to make a dollar. But it may have a counter effect in terms of the likelihood of small business going off and doing R&D, knowing that they can get government support—because they just do not know whether they can and they do not have the time to go and find out. Do you think that that evidence has any potential to be right?

Mr Edwards—Senator, I would probably make one observation, which is that something like 62 per cent of companies that apply for the tax concession are represented by a consultant. Once the law is passed, I think the message will go out very quickly to that 62 per cent. Yesterday we spoke at some length about the sorts of things that we will do to get information out into the marketplace. They are mitigating factors and change at any time will have to deal with that issue.

Senator BUSHBY—Good for jobs in the consulting industry.

CHAIR—Senator Bushby, we are well out time.

Senator BUSHBY—The advanced manufacturing council appeared, representing businesses and unions including the AMWU. Nixon Apple from the AMWU says that most of the objectives of the government in delivering the R&D changes could be achieved by focusing on three things: putting through legislation that changed it to the tax credit system; fixing the software issues; and addressing the rorts head-on—without the need to start from scratch and change so much of all the other things that had been changed and that that could be done easily and quickly, without attracting the criticism and the concerns that have been raised, by 30 June, even if the government decided today to do that. Why have we not taken the simple approach? Why has it

been complicated by making changes that have led to a lot of criticism being directed at the government when the basic core issues that could have been fixed were able to be remedied quite simply?

Mr Edwards—I think Treasury responded to that during their evidence yesterday by saying that it is a 1986 act, it is old legislation and it is old language and it needed to be rewritten, no matter what. But, Senator, that is—

Mr Thomas—The current legislation is some of the most mishmashed legislation I have seen. It has really been something that started off reasonably simply and it has just built up. It has so many anomalies and so many difficulties with it that it is absolutely prime for a complete rewrite.

Senator BUSHBY—But, according to Treasury, it is still the fifth-best system in the world.

Mr Thomas—The system might be, but I cannot believe that they would say that about the legislation.

CHAIR—That was KPMG that said that.

Senator BUSHBY—But Treasury quoted it.

CHAIR—Yes, Treasury quoted it.

Senator BUSHBY—KPMG also has been highly critical of some of the aspects of the bill as it has been drafted.

CHAIR—I thank the Innovation Australia Board for attending this afternoon. I ask Caltex representatives to come to the table.

[3.27 pm]

CHENOUDA, Mr George, Manager, Taxation, Caltex

TOPHAM, Mr Frank, Manager, Government Affairs and Media, Caltex

WILSON, Ms Felicity, Adviser, Government Affairs and Media, Caltex

BOLTON, Ms Kathrine, Tax Analyst, Caltex

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

Mr Topham—Yes, I would like to make a statement on behalf of Caltex. My position with Caltex gives me a fairly broad range of responsibilities for the development of policy and submissions. The expertise I bring to this committee is broad in relation to industry competitiveness. Responses to any questions the senators might have on that issue and how the industry works will be dealt with by my colleagues. Felicity Wilson has prepared and co-ordinated the submission. Our real experts who look after tax matters within Caltex are George Chenouda, who is the manager of the department, and Kathrine Bolton, who is an adviser within the tax area. I suspect that most of your questions will be directed to them, but I am very happy to take general questions.

Caltex has made a submission to this inquiry and provided a confidential addendum to its main submission which we are very happy to talk about. That addendum contains details of R&D claims we have made and that are current. Some of the line items are confidential, so if you wish to discuss them we might have to be a little circumspect about a little bit of the wording but we could discuss the substance of the case studies.

In terms of the matter at hand, Caltex is probably familiar to the senators as the major refiner and marketer of petroleum in Australia. We have a long history of investment in R&D, averaging approximately $15 million per annum. Our concern is that the current drafting of the legislation could leave a substantial amount of our R&D expenditure ineligible for tax credits. We have provided submissions throughout the various stages of consultation held by Treasury. While we welcome that, we believe the consultation has been inadequate to properly assess and debate the implications of such a major and complex change to the legislation. We believe the eligibility rules are flawed and that the implementation timetable is unreasonable and impractical. We acknowledge the importance of R&D in facilitating growth in the economy and supporting a skilled workforce, but we do not accept that the changes intended to support SMEs must come at the expense of larger enterprises, such as Caltex, that play a major role in Australian manufacturing. Manufacturers like Caltex face strong overseas competition. To remain viable, ongoing R&D into product and process improvements is essential.

We are concerned that the new rules will unduly restrict legitimate R&D expenditure and erode the competitiveness of Australian manufacturing, including our own. We accept that support should apply to genuine R&D, not routine business activities, but we are most concerned that the definitions will adversely affect genuine R&D that is related to improving existing business activities. We propose amendment of the core and supporting R&D activities definitions by adopting the OECD definition for R&D and removing the dominant purpose test for supporting activities so that all activities meeting the OECD definition would qualify. Even if Caltex's amendments were to be accepted, we believe that implementation of the new rules should be delayed for at least 12 months to allow businesses to develop an understanding of the definitions and develop plans and procedures to enable compliant legitimate claims to be made. We therefore believe that implementation by 1 July 2010 is impractical. Thank you for the opportunity to make this opening statement.

CHAIR—Thank you, Mr Topham. Let us go to that OECD definition. In your submission you quote it:

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

Then you also say 'remove the dominant purpose for supporting activities so that all activities meeting to above definition would qualify'. That is a major widening of the current definition. In fact, the core R&D exclusions, although they were reduced from 14 to seven, still include research in social sciences, arts or humanities. If you are going to include culture and society in the definition, that is a huge expansion, would you not agree?

Mr Topham—This is one response to which I will immediately defer to our tax experts, who are pretty familiar with this.

Mr Chenouda—In relation to the OECD definition, in light of what was provided in the bill, obviously the government felt that the current definition was not adequate. Consequently we looked at what was acceptable worldwide and we tend to be part of the OECD. That has already been adopted across a number of the OECD countries, such the US, Canada, the UK and so forth. We felt it was better to go with a scheme or system that we and others have worked with and which constitutes some precedent, rather than a situation whereby we are creating new law and did not understand anything. We had no precedent to act upon or to work from.

CHAIR—The OECD covers the definition for R&D for things like 150 per cent and 170 per cent tax credits.

Mr Chenouda—I have not done enough research on that. I can take that on notice.

CHAIR—All right. Let us go to more specific examples. Thank you for providing examples. If we go to case studies, you say that while the impacts of processing may be generally known from public research, the exact impact on Caltex refineries is not known, as all refineries are unique in design and operation, and that therefore R&D must be undertaken to determine the impact on your specific equipment and the process changes that must be made, as well as at what cost, to calculate whether the purchase of a particular crude oil is justified. I do not know whether that would be covered under the new test or the old test; we have not asked. However, it seems to me, as a layperson, that that is getting your plant to work properly.

Mr Chenouda—Our plant already currently is working properly. However, we have to source different types of crude oil. Our refineries were built back in the fifties and sixties around the time when crude was readily available from Bass Strait. The crude types were light base crude and low sulfur crude, which did not require a lot of processing to produce the quality petrols and diesel that the nation required. However, as our own crudes become less and less available, we have to go offshore to a lot of different areas to source different types of crude of different qualities.

Our refineries were not geared and designed for that purpose and they operate at very high temperatures and pressures. As you would know, if there are any hiccups in our refineries, they entirely shut down. It is a seven days a week, 24-hour operation. Before we can bring in any crude, even if we know what its qualities are and what its likely outcome will be, we do not know exactly how that crude will react with the system.

CHAIR—I understand that. You need to test it.

Mr Chenouda—We need to test it to ensure that it will not create hiccups.

CHAIR—Is that not a normal factory process? Would you not normally do that?

Mr Chenouda—It is like this: what if it causes major hiccups in the system and the whole refinery comes down? If the whole refinery comes down, potentially it could be out for months and the whole state could come to a halt.

CHAIR—Is the testing you do in the process plant, or is it in the laboratory?

Mr Chenouda—There is some initial work that is done, but most of the testing is done on the run.

CHAIR—Okay. Let me talk about a process that I know about. I was involved in a company that made a piece of equipment that went into a mine's slurry and determined the percentage of ore that was in there. There was R&D money that went into that equipment. Then the mining company adjusted what went into the slurry to adjust its processes and get the maximum return on that ore. As far as I know, there was no R&D provided for that process because I think mining companies regarded that as part of their normal adjustment process for their ore extraction. Is that not similar to petrol refining?

Mr Chenouda—I cannot speak for the mining area. In my career I have not been involved with the mining industry. I can speak only about the oil industry. However, if we are trying to improve and adapt our refineries to suit different situations, I think there is a big difference between a slurry where, if things go wrong, it is not going to cause problems.

CHAIR—I am sorry, I might have misled you. What I meant to say was that if you developed a piece of equipment or changed a particular part of the refinery process such that your process was more adjustable—for example, some new thing that you needed to do or piece of equipment that you needed to put in—then I think we could all see that that involves new knowledge, R&D. But to simply adjust your plant processes is different.

Mr Chenouda—The issue is that the whole refinery is an integrated system. It is not just one plant that does one thing and then we get that out and put it into a tank and maybe sell it. There are a number of

processes that the crude and the semi-finished products and so forth go through. Each one of those processes operates independently and yet they depend on each other, if you know what I mean. They are all linked by a computer program. There are a lot of pressures and temperature controls. There is different material within the units themselves and the type of steel that is used to accommodate the types of heat exchanges that the process has to be run at. There are a number of systems.

CHAIR—Exactly. If you were developing a new heat exchanger, I would understand.

Mr Chenouda—A heat exchanger is one thing, but I am talking about the actual process itself. If I am going to change an aspect of my process in here, it could have a drastic impact on the process a little bit further down the line. If I do not know what is happening there, that could cause major problems to me. Therefore that would break down the whole system.

CHAIR—Perhaps I am missing something, but I do not understand how that differs from any production process in essence. Perhaps we will go to some of your particular problems with the legislation. I am not saying that I do not accept that, in your list of R&D, there is not a lot that is not genuine R&D. Have you taken this to Treasury and asked for any advice? Have you had any detailed discussions with them about this?

Mr Chenouda—We made a number of submissions in relation to each of the exposure drafts.

CHAIR—But you have not had individual discussions with Treasury.

Mr Chenouda—Not directly.

CHAIR—Are you aware of evidence given yesterday by Treasury and the Department of Industry, Innovation, Science and Research?

Mr Chenouda—I have read only two. That is all.

CHAIR—Okay. Yesterday Treasury said that they regarded product and process expenditure, provided that it met the dominant purpose test, could be included in expenditure that was eligible for the tax concessions.

Mr Chenouda—Currently the proposal is for two tests: first you have to satisfy the core requirements of R&D and once that is done you have to satisfy the dominant purpose test. In a production environment, trying to identify what is the dominant purpose is quite difficult. Being a tax person who is reasonably experienced in interpreting tax laws, defining what is the dominant purpose is quite a difficult task to achieve and to prove to the authorities what your dominant purpose is.

In a production environment where other things are being used for a number of purposes, for our engineers to be able to determine what is the dominant purpose at any particular time is a very difficult exercise for us. It would be very difficult to count and track every single minute that every engineer and every technician spends on every single task and then determine what is the dominant purpose for that particular project. If there are a number of projects—some qualify and some do not qualify and so forth—how does one prove what is the dominant purpose? We are not talking about a dominant purpose, we are talking about the dominant purpose, according to the test.

CHAIR—My interpretation of what Treasury said was that if a process was run that was linked to the R&D that proportion or that expenditure could be related directly to the R&D and that would be included. Indeed you would have to, as you mentioned, measure that quite carefully and include those measurements, but it would still be included.

Mr Chenouda—According to our interpretation of how that is going to work, I do not believe that that will be the case.

CHAIR—Okay.

Mr Topham—Senator, could I add that the point you raise and where your interpretation may be at odds with ours is pretty well the point we are making. In the very short time available for the matter to be considered, it has left a great deal of debate about the impact of the new rules. So, as we put in our submission, we believe an extended period is necessary to do pretty well exactly what you are discussing, which is to be able to test out with the designers of the legislation whether the impact they believe will occur is in fact what will occur.

CHAIR—Mr Topham, I have to say that we have had during this hearing Treasury saying one thing and some submitters flatly refusing to believe them. I do not see that any extra time would resolve that.

Mr Topham—What we are saying is that, when you go to practical examples within industry, we might find that the parties are a long way apart or in fact very close together. But the lack of time in which to

consider it has led to that gap. Time to properly consider the realities of industry may lead to a better consensus, but our concern is that once this gets down to administrative and indeed judicial decisions on interpretation we might find that what the government has intended is not in fact the consequence.

CHAIR—It might well be argued that, once AusIndustry can begin to issue guidelines, only when the legislation is in place and we can begin accumulating that information and get those guidelines will we be really able to reach any resolution.

Mr Topham—We would see that, though, as probably leaping into the void because the legislation would be passed and the impact would be upon us rather than considering those things ex-ante so that they can be fixed before they are legislated. But the other aspect I want to raise is that there is a very clear difference between eligibility under the old rules and under the new rules. The splitting of the core and supporting purposes tests in the new laws is quite different from the all-in-one definition of the old.

CHAIR—It is, yes.

Mr Topham—And we are concerned that the issue of technical risk underlies what we believe to be genuine R&D under the old rules will not be eligible under the new. I might leave an elaboration of that to future questions.

Senator EGGLESTON—We might go to that very issue because you say that while you accept that support should apply to genuine R&D and not routine business activities, you are most concerned that the definitions will adversely affect genuine R&D that is related to improving existing business activities. You also state that Caltex proposes an amendment of the core and supporting R&D definitions by adopting the OECD definition, which was mentioned earlier. I must say Deloitte took a similar point of view in evidence they gave us before lunch. They said the definition of R&D does not differ in substance but is more restrictive when connected to production, which is in fact the mainstream of research and development in Australia. Do you want to expand upon your views for the record?

Mr Chenouda—For our situation, we undertake R&D in the production environment. It is in that environment that we actually see our technical problems and the risk that we face in continuing with manufacturing to improving our manufacturing processes and being able to improve our units on a continuing basis. We are faced with situation in which there are much bigger and much more modern refineries around us that we have to compete against. Given old refineries, we cannot spend the billions of dollars to upgrade them and buy new technologies, so we constantly have to upgrade our technologies.

We have some very smart engineers who, with very old equipment, are constantly looking for ways and means to try to meet what is happening around the world. It is not the same old equipment that we have had since inception because it has been continuously modernised and improved and so forth so that the original piece of equipment is no longer the same piece of equipment that we started with. It is all the incremental improvements that we are continuously making that are critical for us in making sure that we continue to participate in being productive in an environment in which we face a lot of strong competition from overseas.

Senator EGGLESTON—I presume you communicated that view to the government in the process of consultation.

Mr Chenouda—We put that in our previous submissions.

Mr Topham—My colleague Kathrine Bolton certainly has examined the matters of definition in great detail.

Ms Bolton—Under the definition of core R&D activities whose outcome cannot be known or determined in advance on the basis of current knowledge, we go into a lot of our R&D based on what is in front of us and not really understanding what is happening in other refineries. We interpret that as being that if we were to set up an R&D activity, do we need to now consult with our competitors and ensure that the R&D activity is not being completed in their space. The definition has broadened our scope in what we can determine as being an eligible R&D project.

Senator EGGLESTON—Yes, it has broadened it to that degree, but it still limits you in other ways. I wonder what you would consider to be the real purpose of the government's legislation. What do you think the real objective is? Is it to promote pure scientific research, or is it to reduce expenditure on research and development credits?

Ms Bolton—The way we read the legislation is that it is limiting because it is focused on the research. This was mentioned earlier with innovation of industries. We see research and development by our entity, Caltex,

basically being a lot more at the development end. We are forced to drive new processes under a historically existing system, so the concept of research does not really gel with us because we would have to build separate laboratories and separate refinery units to our existing systems to set up new products to meet the requirements of this change.

Mr Topham—What the government has sought to achieve in boosting R&D in SMEs is admirable and we would support that objective. However, given the budget stringency that it faces, we believe it has sought to reduce the amount of money that is flowing to Australian manufacturing industry. In a sense you are hitting existing manufacturing industry for additional taxation to support SMEs.

If R&D is of benefit at all, it will boost economic growth. We would have seen that it is in Australia's long-term interest to boost R&D overall rather than have a type of zero-sum approach to R&D expenditure. Damaging Australia's traditional manufacturing in the hope and perhaps the expectation that SMEs will pick up the slack is probably a somewhat dangerous policy approach.

Senator BUSHBY—You are lucky that Senator Cameron is not here.

Senator EGGLESTON—Thank you.

Mr Topham—I was looking forward to Senator Cameron's interventions.

Senator BUSHBY—Yesterday he made the point that it is all the government's money and why should the government be spending on you rather that it being the other way round. Anyway, I am sure he would have objected to that.

Senator EGGLESTON—I am sure he would have, but nevertheless thank you for putting that point of view forward, which does, I think, have some credibility. You also state that the implementation of the legislation should be delayed until 1 July 2011 or later, which I must say I agree with because it would provide time for the various problems that have been raised during this inquiry to be ironed out before the legislation was implemented.

Senator BUSHBY—I have just a few questions. Earlier in response to a question from Senator Hurley you were discussing the processes involved in developing new processes and things. Just for the record, processes themselves can be patentable ideas, can they not? You can actually patent them. You do your research and development into developing something that you can never touch or is never going to do something itself; it is a new way of doing things that might involve pieces of machinery or new and innovative ways of putting them together and injecting things into them and whatever it might be. But the process itself and the idea can be patentable. You can put a lot of research and development into developing an idea which then can be such that you can actually patent that.

Mr Chenouda—It may not always be possible to patent that.

Senator BUSHBY—Not always, but ideas themselves can be patentable.

Mr Chenouda—Ideas obviously can be patentable.

Senator BUSHBY—And processes.

Mr Chenouda—Sometimes our engineers might wish to write papers on that, if they have the time to do things like that, and discuss those things at engineering forums that they attend. Those sorts of engineers will grab other people's ideas and build upon them and they will say that somebody has tried something in this instances and it may or may not have worked. Then we may take that and put it to a completely different application, find different applications for that idea and develop it further into something that has not even been thought about.

Senator BUSHBY—You would classify all of that as research and development.

Mr Chenouda—That is right.

Senator BUSHBY—On the definition of R&D, you touch on it in your submission, which I have had a quick look at. I have read one of your older ones but before today I did not have a copy of your current one. We have heard a number of other witnesses say that the effect of the proposed legislation will be to shift the focus of R&D assistance to more R and less D. Your submission discusses shifting the focus to the laboratory and away from the commercial application, but I take it that that is roughly the same thing in terms of concept. Why do you think it does this, given that Treasury says that it does not, as did Innovation Australia earlier? What is it about the legislation that shifts that focus?

Ms Bolton—It is the definition coming under supporting R&D activities, the dominant purpose of supporting core R&D activities, where producing goods and services is supporting R&D activity for that dominant purpose. How that is defined has not tested and we do not understand how Treasury will view that. Throughout the year they have given us examples of how they view that, but when it comes to us defining our core R&D activities and calculating the supporting activities will that view still be solid? Can we rely on that view? Under the legislation we need to support that it is a dominant purpose to be able to make that claim.

Senator BUSHBY—Over the last two days we have had a lot of evidence from tax advisers and industry organisations that have taken advice from their tax consultant. They were all of the opinion that the way in which the words are written in the legislation draws them to conclude nothing other than what you are saying, which is that the legislation is shifting away from the development side and more towards the research and the more theoretical area of R&D. Yet Treasury has said that it is not intended to do that, that is not the way it is supposed to work, and they do not think it will work that way in practice. Ultimately you as a body that needs to comply with the laws will take your advice and you will have to comply with the words as written in the legislation rather than what Treasury officials might say at a committee hearing into the legislation, or even what might be said in the explanatory memorandum. It is the law that is passed by parliament that will bind you, is it not?

Ms Bolton—Essentially we would have to apply for a private ruling if we want to get some comfort in interpreting the dominant purpose test and how we have applied it. To apply for a private ruling takes time and a lot of effort.

Senator BUSHBY—On the basis of your analysis of the law, how do you think a private ruling would be likely to go? Does it look like it is a grey area to you, or does it look like it is clear?

Ms Bolton—Very grey, yes. Very grey.

Senator BUSHBY—Treasury also gave evidence yesterday that they believe that all real concerns have been addressed. When they said 'real' they expanded on that. I hope I do not misquote them, but I will paraphrase them by basically saying that 'real' concerns are the ones that have been justified, were clear and provided enough detail to justify those concerns as being ones that needed to be addressed. They say that all real concerns that have been raised with them have been addressed other than those that were deliberately caught by the changes—in other words, people were complaining about things that are part of the policy changes that were intended to be made—or alternatively that the rest were based on misconceptions or misunderstandings of the proposal.

Presumably Caltex have gone into detailed consideration and applied your practical experience to what you are looking at, yet you are still before us today and saying that you have concerns. How confident are you that the concerns you hold are justified and are not based on misunderstandings or misconceptions of what the legislation is?

Mr Chenouda—Being tax practitioners who have to deal with the law all the time we constantly have to go back to what the law is actually saying. It is what the words in the law are saying. It is how the judges will interpret these words. Yes, explanatory material and other policy may be considered by the courts, but ultimately when one is dealing with the administrator or with the ATO, it always goes back to what the words mean. This is what we always have to go back to.

Our interpretation, based on our experience in interpreting other tax legislation and other tax laws, always comes back to what the words mean, how they can be interpreted and how we interpret them in the light of our experience in interpreting GST law, income tax law, excise laws and so forth. That is what we will always have to go back to. This is where our advisers always go as well. Yes, they refer to external material but ultimately that is only if the law is not clear.

If the law is quite clear about the dominant purpose test then you have to produce evidence to support the dominant purpose test. Statements in any other extra material that may be in the explanatory memorandum or otherwise are immaterial. It is quite clear that, if you start establishing the dominant purpose test, the judges will go to the income tax legislation, to part 4A and to other areas to get guidance on how to interpret that. That is what we are doing in interpreting this legislation. We cannot say that it has to be interpreted in a certain way. In some cases it may initially be interpreted that way, but who says down the track that some other administrator will not say, 'No, you're wrong'? We have had that experience many times with other tax rules that we have had to administer and comply with.

Senator BUSHBY—Thank you for that answer. Thank you for your confidential information on the research and development that you do, which demonstrates that there is quite a substantial degree of research and development that you undertake and that quite clearly you make use of the current tax concessions. What would the impact be on your ability to continue doing research and development, and therefore your ability to maintain your competitiveness in accordance with what you state in your submission, if your concerns about the impact of this legislation are justified? What impact would that have on your ability to go about your business and remain competitive?

Mr Chenouda—Overall, we are a high-cost, low-margin industry. Every single bit actually counts towards our profitability for our shareholders and the sustainability of our industry. It may not mean much initially, but with every single tax addition, every single cost addition, we become more and more uncompetitive. Therefore it will make a difference in the long run—maybe not immediately. In the long run it will start hurting us more and more. As I said, we are doing a lot more to try to remain competitive, and this will push us back just that much further.

Senator BUSHBY—I note you say that a lot of the R&D you do is to try to basically keep ahead of the game, or at least keep up with the game. Would Caltex make the decision not to proceed? How important a factor is the R&D concession to the decisions that you make to invest and stay ahead of the game?

Mr Chenouda—If you noticed, not all the projects we put in have been successful. With some of them, we spent a lot of money and they have not been successful, or have not achieved what we desired to do. I would say that these things should be looked at more closely to gauge the likely success rate. That means we have to start picking winners in what might deliver a real benefit to us against the other ones. These are situations in which we have to start facing more and more cost constraints. It may make a difference to which projects we decide to go ahead with.

Mr Topham—While we are very uncertain under the new rules about what we might be able to claim, a very rough calculation that we have done based on our interpretation of the rules is that only 20 per cent of current claims would be allowable. I emphasise: only 20 per cent. In dollar terms, that would be over $4 million a year. When you add that $4 million a year to the many other cost imposts we find being imposed on us here and there and when you consider that oil refining is a very low-margin business, it really starts to significantly eat into our competitiveness.

Worse than that, when an engineer puts up an internal proposal for an R&D project for a process improvement, he might find that the capital is not available because the R&D expenditure would be disallowed under the new rules. That in turn has a multiplier effect because, if his project does not go ahead, the potential value of that project would not be gained. The impact upon the company could be several times the loss of the R&D impact. Perhaps that is something that the committee could take into consideration.

CHAIR—Thank you for that. I thank Caltex for attending this afternoon. The committee is now adjourned.

Committee adjourned at 4.04 pm