Taxation Laws Amendment (Research and Development) Bill 2010

Submission on second exposure draft bill released for comment on 31 March 2010

Background

Deloitte is the largest network of global professional services member firms, with over 169,000 staff working in over 140 countries, and provides comprehensive business services across audit, consulting, financial advisory and taxation.

The Deloitte R&D Tax and Incentives team in Australia is part of the Global Deloitte R&D network, which has over 450 partners and staff who assist clients with claiming incentives for R&D activities. In Australia, we have over 45 partners and staff from a variety of backgrounds, from law and accounting to engineering and computer science, assisting Australian companies with understanding and claiming the R&D tax concession and R&D tax offset. The partners in the Australian R&D practice have more than 70 years' combined experience working in R&D policy and practice.

Our clients range from start-up companies conducting cutting-edge research to some of Australia's top ASX-listed companies, covering all industries and sectors.

Executive summary

Deloitte welcomes the opportunity to make this submission on the second exposure draft of the *Taxation Laws Amendment (Research and Development) Bill 2010* (the Bill) and updated Explanatory Memorandum. We note that a number of the concerns raised by stakeholders about the first exposure draft issued on 31 December 2009 have been addressed in whole or in part in the Bill, but a number of major issues of concern still remain.

The threshold questions that remain are whether these changes are sufficient to deal with the many flaws in the first exposure draft and, in particular, when viewed as a package does this second exposure draft offer improved outcomes, administrative simplicity and transparency for claimants compared with the existing R&D tax concession? Does it reflect the policy objectives contained in ***Powering Ideas*** and deal with the strategic direction laid out in ***venturousaustralia*** and in so doing deliver tax-based innovation policy that targets and provides appropriate support to Australian companies investing in R&D in 2010 and beyond?

Although the Bill contains several improvements, on balance we don't think that it will provide claimants with greater administrative simplicity and transparency. Nor does it simply and adequately provide support for commercially-oriented R&D undertaken in Australia. Service-based innovation and associated R&D will also receive very little support under this Bill as the underlying concepts of eligibility are rigidly based on scientific method requirements. This approach does not translate neatly into this increasingly important wealth-creating sector of the Australian economy.

We provide specific comment and recommendations on the following aspects of the Bill:

1. The new definition of 'core R&D activities'
2. The new definition of 'supporting R&D activities'
3. The new definition of 'excluded R&D activities'
4. Integrity measures
5. Clawback
6. Feedstock
7. Overseas R&D
8. Administration.

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1. New core R&D activities definition – Section 355-25

Section 355-25 sets out the proposed definition of 'core R&D activities'.

This definition is completely new in how it is constructed and as such is a dramatic departure from the current definition in section 73B (1) of the *Income Tax Assessment Act 1936* (ITAA 1936), and from the definition proposed in the first exposure draft.

The new definition omits the terms 'considerable novelty' and 'high levels of technical risk' but essentially retains the meaning behind those two terms and carries their meaning with the 'and' test into the new R&D tax offset. Consequently this definition, although new in construction, does not in substance significantly differ from the definition proposed in the first exposure draft. The concerns raised then remain relevant now. It is more restrictive that the existing definition of research and development activities contained in section 73B (1) of the ITAA 1936.

The focus of the new definition of 'core R&D activities' is on experimental activities:

> *(a) Whose outcome cannot be known or determined in advance on the basis of current knowledge, information or experience, but can only be determined by applying a systematic progression of work that:*
>
> > *(i) Is based on principles of established science; and*
> >
> > *(ii) Proceeds from hypothesis to experiment, observation and evaluation, and leads to logical conclusions; and*
>
> *(b) That are conducted for the purpose of generating new knowledge (including knowledge about the creation of new or improved materials, products, devices, processes or services).*

Although they are not explicitly mentioned in the new definition, the dual requirement of "considerable novelty" and "high levels of technical risk" in substance still need to be satisfied when one works through the requirements of section 355-25, as all of the requirements are connected by the word "and".

This is also supported by statements in the Explanatory Memorandum examples. Paragraphs 2.13 and 2.14 refer to "significant risk" or uncertainty of outcome. The rationale for the scientific method in the first instance is that the uncertainty of outcome warrants its use. Paragraphs 2.16, 2.17, 2.18 highlight that the new knowledge test is, in substance, akin to "considerable novelty".

This new definition of 'core R&D activities' has as its central requirement the necessary conduct of experimental activity or activities undertaken for the purpose (noted as sole or dominant in the Explanatory Memorandum) of generating new knowledge, which is extended to include knowledge about the creation of new or improved materials, products, devices, processes or services.

The requirement of experimental activities undertaken in accordance with the scientific method (hypothesis to experiment, observation, evaluation and the making of logical conclusions) underpins the new definition's requirement that the knowledge gap or information gap that needs to be bridged by the R&D activity (experiment) must be significant. As described in the Explanatory Memorandum, "the knowledge of whether something is scientifically or technologically possible, or how to achieve it in practice, will not be deductible by a competent professional in the field on the basis of current knowledge, information or experience". There must be a significant risk that the outcome of the experiment is not the desired one.

This, in essence, is the existing requirement that the activities contain high levels of technical risk in the uncertainty of outcome. The existing test is reshaped into a new definition, but the requirement remains the same.

The Explanatory Memorandum states that the requirement to employ the scientific method reflects the threshold degree of novelty in the new ideas being tested. This requires going beyond the validation and implementation of existing knowledge in a different context or location. It must go beyond the confirmation of what is already known – even if this knowledge does not exist in the company carrying on the activities. The knowledge gap needs to be of sufficient significance to require the adoption of the scientific method.

This is a high threshold indeed, as it extends knowledge and information beyond the confines of the company carrying on the activities and, as such, sets the bar higher than the current innovation requirement. We recommend that the test for new knowledge be based on knowledge that resides within the claimant or claimant group or that is readily accessible on normal commercial terms to the claimant or claimant group.

This new definition will require both high levels of technical risk “and” considerable novelty to be present for a core R&D activity to exist. Consequently it is, in substance, the same as the definition contained in the first exposure draft. The widespread concerns raised in response to Treasury’s initial consultation paper issued on 18 September 2009 and the first exposure draft about the requirement of satisfying both tests is equally valid for the new definition in section 355-25.

Subsection 355-25(b) retains terminology used in the first exposure draft, i.e. “conducted for the purpose of generating new knowledge (including knowledge **about the creation** of...” (our emphasis). The phrase “about the creation”, compared with the existing definition in section 73B(1)(a)(ii) of the ITAA 1936, which refers to “creating new or improved…”, shifts the focus away from applied R&D or ‘development’ towards ‘research’. This issue was pointed out during the consultation process, but remains in the Bill.

This terminology also appears to be in conflict with the ‘object’ clauses. Subsection 355-5(2) provides that the object of the proposed provisions “is to be achieved by providing a tax incentive for industry to conduct, in a scientific way, experimental activities for the purpose of generating new knowledge or information in either a general or **applied form**” (our emphasis). We recommend that the definition of ‘core R&D activities’ should be amended to reflect support for **application** R&D explicitly.

The examples contained in the Explanatory Memorandum also highlight how difficult it is in practice for the scientific method to translate to commercial or industrial R&D. This is particularly so for service-based industries.

The existing definition of eligible R&D activities in section 73B(1) also has difficulties when it comes to supporting service-based R&D and it was noted in the Cutler review that consideration should be given when refining the definition of eligible R&D activities to improving its application to service-based R&D. This has not translated into the revised definition, which still has this issue. The practical implications for potential claimants trying to apply this new definition to their activities will be considerable.

2. Supporting R&D activities: Section 355-35

The Bill has redefined ‘supporting R&D activities’ as those that are “directly related” to core R&D activities. This definition runs parallel with the current meaning associated with the existing R&D tax concession. The proposed definition significantly diverges from this, however, when it comes to those activities that are:

- Excluded activities (as defined in proposed section 355-30)
- The production of goods or services
- Directly related to the production of goods or services.

In such cases, the supporting activity will only be eligible where it is undertaken for the ‘dominant purpose’ of supporting R&D activities. This additional restrictive dominant purpose requirement will operate to exclude those activities where the prevailing or most influential purpose is not to support the core R&D activity.

The Explanatory Memorandum notes that “[i]mplicit in the dominant purpose test is the acknowledgement that activities can serve, or be conducted, for more than one purpose”. It further states that “[a] critical consideration will be the extent to which the activities in question will also achieve outcomes (particularly production or other commercial goals) over and above assisting the conduct of the core activities, and the importance of those outcomes in the context”.

Again we submit that the dominant purpose test is an inappropriate legislative measure to determine the eligibility of supporting R&D activities. A dominant purpose test will not only introduce a very high bar for eligibility that is out of step with foreign R&D regimes, but will also be very difficult for all claimants to determine and apply in practice.

We recommend that the current requirement contained in section 73B (1) be maintained and strengthened with appropriate guidelines:

(b) other activities that are carried on for a purpose directly related to the carrying on of activities……..

Alternatively, we recommend that consideration be given to introducing the concept of the "extent to which" or "extent that" a supporting activity is directly related to a core R&D activity in determining if it is an eligible activity. This concept is well known and understood by corporate claimants.

The current drafting of section 355-25 presents several issues for consideration:

(a) What is the 'production of goods and services'?

The Explanatory Memorandum states that production activities "are those that produce goods and services, along with their directly related activities". This explanation does little to provide clarity and leaves the phrase open to interpretation. Rather than providing a more certain outcome, it results in the potential for contention.

The ordinary meaning of 'production' is the manufacture, creation, fabrication, assembly, construction or invention of a tangible or intangible item. The term 'goods' is also one of wide meaning, and can include merchandise, property, produce, wares, commodities, supplies or possessions. The term 'services' might include an intangible item, such as software, the supply of a process or facility.

The breadth of these terms gives scope to restricting the definition of supporting activities severely in those cases where the activity is, or is directly related to, the production of a good or service.

By redefining supporting activities as proposed, the support for R&D will move from an industrial R&D program to one that is laboratory-based and does not necessarily provide commercial outcomes.

(b) How does this affect industries that need to undertake R&D in a commercial environment?

The Government needs to give closer consideration to the implications of this provision in not providing support to industrial-based R&D. The provision does not offer sufficient recognition of the context of commercially-based R&D and the benefits it generates.

In industries like manufacturing, it is often the case that pilot plant facilities will not be available. This is generally for commercial reasons and reflects the tight margins with which such industries operate. As a result, it becomes necessary to conduct R&D activities in a commercial sphere, using commercial production facilities. Due to the lack of dedicated trial facilities, and the need to continue the operation of a business, the activities are likely to be undertaken for the dual purpose of supporting R&D and production.

The examples in the Explanatory Memorandum seem to suggest that the determinative factor lays in the reason why the production line needs to be operated and the related consequences. In those cases where the production run differs significantly from a normal commercial run, it is possible that the dominant purpose test will be satisfied. This will cause concern to claimants who undertake R&D activities for the purpose of generating new knowledge about the creation of a new or improved product or process.

In many cases the new knowledge will necessarily extend to the manner in which a product formulation or conceptual design can be achieved on a commercial scale. The basis of the R&D project will not be complete unless this outcome is achieved. Whether the production runs in such R&D activities differ sufficiently from normal production is bound to involve an element of subjectivity. What are the resulting compliance costs that will be incurred to support such a claim? What burden of proof will be required to support the purpose of the production runs?

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(c) How does this meet the objective of the proposed legislation?

The stated objective is to encourage industry to conduct R&D activities that might not otherwise be conducted because of the cost of the activities or an uncertain return from the activities, in cases where the knowledge gained is likely to benefit the wider Australian community.

The cost of undertaking commercially-based R&D activities is generally an additional cost, including the cost of lower efficiencies and yields associated with developing new knowledge about the development of a new product on a commercial scale, or there being a greater amount of downtime as a consequence of getting improvements to a production process fully operational. Government support is required to help progress such activities, which lead to the generation of new knowledge to the benefit of the Australian economy.

The R&D activities might not otherwise have been conducted without the support of the proposed R&D incentive. The return from the activities may be uncertain and it is necessary to trial this on a commercial scale. The knowledge gained will be of benefit to the wider Australian economy through the generation of new intellectual property, employment, new product variants, increased competition and price variants.

It appears that the proposed legislation does not sufficiently recognise these outcomes.

(d) Isn't this a thinly disguised feedstock provision?

The first exposure draft included an augmented feedstock provision in which there would be a clawback in those instances where a marketable output resulted from the R&D activities.

The Explanatory Memorandum for the Bill includes an example where R&D activities are conducted through the production of a marketable product. In such case, although R&D activities were necessarily undertaken, the dominant purpose of those activities is used to exclude the activities. It is of concern that this dominant purpose test may in practice take the place of the stricter proposed feedstock provision and reduce the amount claimable.

(e) Is this simply R&D for R&D's sake?

By limiting the definition of production-based supporting activities to those that are undertaken for the dominant purpose of R&D, the credit will exclude those activities with a dual purpose and those that are undertaken within a commercial environment. Very few businesses undertake R&D outside a commercial environment. From a commercial point of view, when undertaking an R&D project it is essential to consider, among other things, the resources required (both tangible and financial), the proposed exploitation of results and how they will be commercialised, and the scheduling of R&D and its impact on the operation of the business. R&D activities need some level of commercial grounding to ensure that the results of the activities can be commercialised. Failure to do so will result in most businesses undertaking R&D for R&D's sake – an objective that the Explanatory Memorandum notes is not the intended aim of the R&D tax incentive.

(f) How has this simplified the law?

The introduction of these new definitions will present additional layers of compliance and cost for claimants. Each claimant will need to consider:

- 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?
- Is it an activity that is the production of a good or service?
- Is it directly related to the production of a good or service?
- Is it for the dominant purpose of supporting core R&D activities?

The proposed definitions are complex and cumbersome and will cause much concern and cost in their application.

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3. Exclusions list

Proposed section 355-30 outlines the activities that are specifically excluded as core R&D activities.

We welcome the fact that the exclusion list has been relaxed and will now only prevent the listed activities from being core R&D rather than extending to supporting R&D activities.

The requirement that that supporting activities be undertaken for the dominant purpose of supporting core R&D is, however, of particular concern in relation to the excluded activities list. This new requirement of dominant purpose will significantly affect the ability of claimants to treat the listed activities as supporting R&D. This is a further reason for the removal of the dominant purpose test, as discussed in section 2 of this submission.

We also welcome the fact that the list of excluded activities is largely the same as the list contained in the current legislation. The obvious exception, though, is software, where a new exclusion has been incorporated into the excluded activities list that replaces the 'multiple sale' provision in the current legislation.

Under the new exclusion, where software is developed, modified or adapted solely or primarily for internal business administration of the entity for which it is developed (or entities connected with it), the activities will not be eligible core R&D. Such activities may qualify as supporting R&D, but only if they are undertaken for the dominant purpose of supporting core R&D.

The Explanatory Memorandum notes that the change reflects the fact that ongoing developments in e-commerce and software distribution methods mean that the 'multiple sale' provision no longer adequately reflects the original policy intent. It goes on to state that the new exclusion reflects the fact that such software activities are site specific, can usually be expected to be undertaken without an incentive, and that additional public benefit from subsidising such activities is limited.

Overall, the proposed treatment of software R&D represents a positive step forward when compared with the first exposure draft, and the removal of the outdated multiple sale requirement is an improvement on the current treatment under the R&D tax concession. We feel, however, that there could be unintended negative consequences flowing from the proposed new rules.

In particular, consider a situation where a company undertakes software development R&D primarily intended for its internal business administration. Under the current legislation, if the company has a secondary intention of making that software available to others, the activity will qualify as core R&D. Under the proposed legislation, though, any secondary intentions become irrelevant. This adds complexity and subjectivity to the legislation. For example, where the company has a dual purpose in undertaking the R&D, how is the primary purpose determined?

To remove this subjectivity and complexity, we recommend that the exclusion for 'in house' software be limited to software developed solely for in-house use.

4. Integrity measures

Proposed subdivision 355-F provides the new integrity rules governing the operation of the R&D credit. There are four discrete rules, similar at a high level to the current rules, with the common themes of entitlement to deduct and the quantum of entitlement.

(a) Expenditure not at risk

The provisions dealing with determining whether expenditure is at risk, and therefore claimable, have been perhaps one of the most contentious aspects of the R&D tax concession in recent times. A similar rule to Section 73CA of the ITAA 1936 has been incorporated into the draft legislation in the proposed section 355-405.

Disappointingly, the application of the rule is not clear, and the Commissioner's explanation in ATOID 2009/107 does not appear to have been adopted in its entirety in disregarding the fact that the relative experience and skill of the subcontracted entity is likely to lead to a successful outcome. Under proposed section 355-405 it will be a requirement to consider whether

> *"the R&D entity or its associate had received, or could reasonably be expected to receive, consideration:*
>
> *(i) as a direct or indirect result of the expenditure being incurred; and*
>
> *(ii) regardless of the results of the activities on which the expenditure is incurred..."*

There are different implications depending on whether the consideration is less, equal to or greater than the expenditure incurred. The pertinent aspect is (ii) above, in that expenditure is not taken to be at risk where the success of the R&D is not relevant. This is a double negative. Read another way, if the successful outcome of the R&D is a precursor to consideration being received or receivable then the expenditure is at risk and eligible. There must be a nexus between the expenditure on the R&D and the receipt of consideration for that expenditure in order for the 'not at risk' rule to apply. If consideration relates to activities generally, then arguably it does not relate to R&D specifically.

Problematically, in determining whether consideration is receivable or could reasonably be expected to be received, regard will need to be had to "anything that happened or existed before or at the time the expenditure is incurred… and…anything that is likely to happen or exist after that time". In practice, an entity will need to consider something that has or could happen before or after the R&D expenditure is incurred. Form and substance are to be taken into account.

If an entity is doing R&D for one or more foreign corporations, or if the entity is a permanent establishment, this rule will not apply as it will be in direct conflict with the nature of such R&D and therefore the policy intent of encouraging foreign entities to invest in R&D in Australia.

While the concept of financial risk is directly addressed with this rule, the broader concepts of project control and effective ownership of R&D are not codified formally within the proposed legislation. The Explanatory Memorandum suggests that the concept is implied in the proposed legislation.

The general 'on own behalf' rule in the Bill is contained in subsection 355-205(2), which provides that:

> *...an R&D activity is not an activity to which this section applies if the activity is conducted, to a significant extent, for one or more other entities not covered by any paragraph of subsection 355-205(1).*

Also of concern is the phrase "to a significant extent", as this wording does not provide any real clarity about determining whether an entity is entitled to make a claim and what the threshold must be in establishing entitlement.

The question must be asked, what if one or two elements of the implied test are satisfied but the third test is not? What takes priority?

We see this as an improvement opportunity, and recommend that the existing requirements of subsection 73B (9) form part of the final legislation to provide legislative clarity to all claimants.

(b) Disposal of R&D results

Section 355-410 is intended to replace subsection 73B(27A) ITAA 1936 but the proposed wording of section 355-410 is potentially broader than the current legislation. The current legislation (contained in sub-sections 73B (27A) and (27B)) is confined to the disposal of specified assets, (e.g. plant, building, core technology) and to the granting of access to, or the grant of a right to use, any R&D results. Although the granting of a right to use R&D results has been interpreted to include an outright disposal of the R&D results (refer to the Explanatory Memorandum to the *Taxation Laws Amendment Bill 1990*), the current legislation generally only deals with the direct disposal of assets incorporating the R&D results or other assets that are identified specifically.

The proposed wording of paragraph 355-410(1)(b), particularly sub-paragraph (iii), is potentially much broader than the existing legislation. It includes "an amount from *disposing of a *CGT asset, or from granting a right to occupy or use a CGT asset, where the disposal or grant resulted in another person acquiring a right to access or use any of those results". CGT assets is a broad category of assets and, as such, section 355-410 potentially has a much wider application than the existing law. For example, subparagraph 355-410(1) (b) (iii) could apply to the sale of shares in a company where a valuable asset of the company is intellectual property developed as a result of past R&D activities. This would be the case because, as a result of that share sale, the new owner has the right to access or use the intellectual property owned by the company. As currently drafted, the **entire proceeds** from that sale would be included in the assessable income of the vendor of the shares under paragraph 355-410(2)(b). The cost base that the vendor had in the shares could not be taken into account to reduce that assessable income because a share in a company is not a 'depreciating asset' which is required in order for paragraph 355-410(2)(a) to apply.

Furthermore, as section 355-410 is an exclusive code for taxing such CGT events (refer to the proposed new terms of section 118-35 ITAA 1997) the income is ordinary income and not a capital gain. This means that capital losses cannot be used to offset against any assessable amount.

We submit that the current drafting of section 355-410 has the potential to give rise to double taxation as the cost base of a CGT asset cannot be applied to reduce the results amount that is included in assessable income in circumstances where the CGT asset is not a 'depreciating asset'. The cost base of a CGT asset represents what the vendor has paid (directly or indirectly) to acquire that asset and may also represent an amount on which another taxpayer has paid tax on. This issue is of particular concern given the expanded scope of the proposed section 355-410 (as currently drafted).

In this context, it is difficult to understand why a distinction should be made between 'depreciating assets' and non-depreciating assets in paragraph 355-410(2) (a). This can, for example, be a critical issue for intellectual property developed as a result of R&D activities, as not all intellectual property will qualify as a depreciable asset. Given that the full range of CGT assets that can be connected with R&D activities is covered by paragraph 355-410(1)(b), it is, in our view, appropriate to include all CGT assets in paragraph 355-410(2)(a) such that only the excess of the results amount over the asset's cost base is treated as assessable income. It should be noted that the Explanatory Memorandum to this section draws no distinction between 'depreciating assets' and non-depreciating assets. Paragraph 3.126 of the Explanatory Memorandum to the Bill states:

> *The amount assessable is generally the amount received or receivable. However, where the amount is from disposing of a* ***CGT asset****, or from granting a right to occupy or use a* ***CGT asset****, the assessable income amount is the amount received or receivable less the cost of the asset (just before the disposal or grant)." (our emphasis)*

We submit that the position expressed in the Explanatory Memorandum is the position that should be adopted in the new legislation. Our recommended wording for paragraph 355-410(2)(a) is:

> *if the results amount is derived from the disposal of a *CGT asset, or from granting a right to occupy or use a CGT asset – an amount equal to the extent (if any) that the results amount exceeds the asset's *cost base just before the disposal or grant;"*

In our view, the application of paragraph 355-410(2)(a) should not be restricted to a results amount covered by subparagraph (1)(b)(iii). It is possible that a CGT asset could be disposed of, for example, in connection with a results amount covered by subparagraph (1)(b)(ii) based on the current interpretation of similar wording in paragraph 73B(27B)(a) ITAA 1936. For example, an R&D entity disposes of intellectual property that was the product of R&D activities. The Explanatory Memorandum to the *Taxation Laws Amendment Bill 1990* states:

> *New subsection 73B (27B) explains the reference in subsection 73B (27A) to a company receiving or being entitled to receive an amount in respect of the results of any R & D activities. This reference is to include three situations. In the first situation, described in paragraph (27B)(a), a company grants access to or grants a right to use any of the results in return for which it receives or becomes entitled to receive an amount; here the company might* ***sell the results outright*** *or licence another to produce the results….* (our emphasis)

Based on this interpretation of the words "grant of access to, or the grant of a right to use, any of those results" in paragraph 73B(27B)(a) ITAA 1936 as potentially covering the sale, it would seem that a disposal of intellectual property could fall within the similarly-worded subparagraph 355-410(1)(b)(ii). Furthermore, as intellectual property is a CGT asset, the disposal could potentially fall within subparagraph 355-410(1) (b) (iii). The wording of subparagraph 355-410(1)(b)(i) is also quite broad, such that an amount received for the disposal of intellectual property could be considered "an amount for the results of any of the R&D activities". Accordingly, an amount received from the disposal of intellectual property could potentially fall within three of the categories of 'results amounts'. Paragraph 355-410(2) (a), however, only allows an asset's cost to be taken into account for the purposes of subparagraph 355-410(1) (b) (iii). Therefore, it is submitted that paragraph 355-410(2) (a) will be nugatory unless its scope is expanded.

Our other comments and recommendations about proposed section 355-410 are:

- We assume that section 355-410 is not intended to change the current position under subsection 73B(27B) ITAA 1936 whereby subsection 73B(27A) ITAA 1936 does not apply to an amount an entity is entitled to receive because of its own use of the results of R&D activities. To make this position clear, we recommend that section 355-410 includes a new subsection (4), along the lines of the following, in order to replicate the position under section 73B(27B) ITAA 1936:

  For the purposes of paragraph (1) (b), an R&D entity does not receive or become entitled to receive a results amount if the R&D entity receives or becomes entitled to receive the amount in consequence of the use by the R&D entity of any of those results.

The application of the transitional provisions to section 355-410 requires further clarification in the *Income Tax (Transitional Provisions) Act 1997*. Presumably, it is intended that disposals of R&D results occurring after commencement of the new legislation would be dealt with under the new legislation even if the actual R&D claims were made under the current section 73B ITAA 1936. We submit that section 355-410 should apply to all disposals occurring on or after 1 July 2010, (i.e. irrespective of the R&D entity's year of income) and notwithstanding that R&D deductions were claimed under 73B ITAA 1936.

5. 'Clawback' in cases of R&D related grants

The Bill contains clawback provisions that attempt to ensure that a claimant cannot obtain both the benefit of the R&D tax credit and a grant for the R&D activities. The provisions in proposed subdivision 355 work by imposing a further income tax liability at the rate of 20% of the grant received, acquitted or receivable (the 'grant amount').

The aim of this clawback is to recover the concessional 10%, (i.e. the excess of the 40% credit over the 30% tax rate) component of the R&D tax credit on the part of total project spend subject to grant funding. As it is typical for grants to be provided on the basis of 50% of project spend, the 20% rate is applied to the grant amount.

Where a claimant is entitled to a 45% R&D tax credit instead of the 40% rate, the clawback provisions are not effective to claw back the full value of the tax credit. In such cases, the clawback amount is still based on 20% of the grant amount, which is generally effective only to claw back the benefit obtained by 40% rate claimants. According to the Explanatory Memorandum, this result is an intentional measure, to ensure simplicity of application.

There may, however, be an unintentional consequence in that grant recipients will be disadvantaged when the grant amount is provided on more than a 50% of the project spend basis.

A comparison of the application of clawback under the current and proposed rules is shown in the table below. This shows that the net value of grant is reduced by the additional tax imposed on the grant receipt.

R&D regime	**Current concession**	**40% R&D tax credit**	**45% R&D tax credit**	**40% R&D tax credit**	**45% R&D tax credit**
Project Spend	$2,000,000	$2,000,000	$2,000,000	$2,000,000	$2,000,000
Grant received, acquitted or receivable	$1,000,000	$1,000,000	$1,000,000	$2,000,000	$2,000,000
Clawback (grant x 2)	$2,000,000				
Concessional value of R&D concession[1]	Nil	$200,000	$300,000	$200,000	$300,000
R&D clawback (20% of grant amount)	Nil	$200,000	$200,000	$400,000	$400,000
Net value of concession	Nil	Nil	$100,000	-$200,000	-$100,000

6. Feedstock

The Bill does not yet include the redrafted feedstock provisions.

We understand the feedstock rules will be drafted to have the same effect as the current definition in section 73B (1) ITAA 1936.

7. Overseas R&D – Section 28BA of the *Industry Research and Development Act 1986*

There is a notable change in the Bill relating to claiming overseas R&D. Specifically this is in the introduction of section 28BA (5), which provides:

> *The fourth condition is that the total actual and reasonably anticipated expenditure of any entity in all income years on:*
>
> *(a) the overseas activity; and*
>
> *(b) each other activity (if any) conducted wholly or partly outside of Australia and the external Territories that has a significant scientific link to the Australian core activities;*
>
> *is less than the total actual and reasonably anticipated expenditure of any entity in all income years on:*
>
> *(c) the Australian core activities; and*

[1] Concessional value of the R&D concession is calculated as:
- 10% (40% credit rate less 30% tax rate) for claimant entitled to a 40% credit
- 15% (45% credit rate less 30% tax rate) for claimant entitled to a 45% credit.

(d) *activities conducted solely within Australia and the external Territories that are supporting R&D activities in relation to the Australian core activities.*

The requirement that:

- The overseas activity must have a "significant scientific link" to core R&D activities conducted in Australia, (i.e. the Australian core activities cannot be completed without the overseas activity being conducted)
- The overseas activity must not be able to be conducted solely in Australia because conducting it requires access to a facility, expertise or equipment not available in Australia
- The total actual and reasonably anticipated expenditure on the overseas activity is less than the total actual and reasonably anticipated expenditure on the core and supporting R&D activities conducted in Australia.

We submit that there should be no expenditure-based limit on the quantum of overseas R&D that meets the requirements of subsections 28BA(1) through (4). Although an improvement on the totally inadequate existing 10% expenditure threshold, the imposition of a 50% test continues to be an arbitrary threshold.

8. Administration

The proposed administration and compliance framework contained in the Bill and Explanatory Memorandum is problematic for claimants of the R&D tax credit in two important ways:

1. The **compliance** cost associated with applying for R&D and requirement to fragment an R&D project into discrete core and supporting activities does not account for the way that R&D is undertaken nor substantiated in a commercial environment
2. As a result, there is a distinct lack of certainty about the **administration** of the application for registration because of the categorisation of activities per se and the ability of Innovation Australia to make changes to the application outside of the ten-month window for lodgement of registration.

(a) Compliance

The requirement to register activities as either "core" or "supporting" is a departure from the long-standing approach to registering "R&D activities". R&D is undertaken on the basis of a program of related activities centred on a technical objective. The program, or project, normally comprises a number of interrelated activities, some of these activities applying to more than one project and often being undertaken across a number of sites and financial years.

It is simplistic to assume that a claimant of the tax credit will be able to fragment a project on a piecemeal basis accurately in order to apply for registration of discrete "core" and "supporting" activities for each financial year. Even further, accounting systems very rarely have the capability to track expenditure on R&D in this way and therefore any requirement to apply for registration on this basis will be arbitrary and do very little to balance compliance with simplicity.

For SMEs the problem is exacerbated because of resource constraints and cost. This is likely to stop some entities making claims for R&D, an outcome contrary to the object clause of the Bill because compliance will effectively be given greater importance than entitlement.

(b) Administration

Innovation Australia will have the power to review the application, either as an advance finding or on application for registration, and to do all or some of the following:

(a) Register some or all of the activities (positive finding)

(b) Refuse to register some or all of the activities (negative finding)

(c) Change the basis of application and the categorisation of the activities.

The Explanatory Memorandum suggests that Innovation Australia can do this without requesting further information.

This potentially conflicts with the interest of providing taxpayer certainty. It also raises an interesting question about the entitlement to be registered. If an entity lodges an application and seeks to register an activity as “core” but Innovation Australia decides after the expiry of the ten month lodgement window that the activity is actually “supporting”, is the activity able to be registered? Even if the activity can be registered under Innovation Australia’s discretionary powers, all of the claimed “supporting” activities for that “core” activity will be deemed by legislation to be ineligible. Such a finding can be made up to four years after the initial application has been lodged.

While a negative decision by Innovation Australia will be reviewable (both internally and by the AAT), it is unknown whether the process will be sufficiently transparent to afford the certainty required in a self-assessing environment. Registration is only one part of the process. The accuracy of the company income tax return will be duly frustrated because of this uncertainty and lack of clarity.

It should be noted that the manner of applying for registration currently proposed was previously implemented about ten years ago. It was abandoned soon after, on the basis that it did very little to enhance compliance and did not accurately reflect the way in which R&D is undertaken. An additional problem with this approach is that overseas regimes do not make it a requirement to apply for R&D on the basis of “core” and “supporting” activities, which will put Australia at a competitive disadvantage especially in attracting foreign companies to undertake R&D here. The compliance requirement, while important, should not be so onerous that it makes it more difficult for entities to claim for R&D successfully.