



BDO Kendalls

BDO Kendalls (Australia) Ltd  
Level 18, 300 Queen St  
Brisbane QLD 4000  
GPO Box 457 Brisbane QLD 4001  
Phone 61 7 3237 5999  
Fax 61 7 3221 9227  
[info.brisbane@bdo.com.au](mailto:info.brisbane@bdo.com.au)  
[www.bdo.com.au](http://www.bdo.com.au)

ABN 77 050 110 275

26 October 2009

General Manager  
Business Tax Division  
The Treasury  
Langton Crescent  
PARKES ACT 2600

By email: [rdtaxcredit@treasury.gov.au](mailto:rdtaxcredit@treasury.gov.au)

Dear Sir/Madam

### **Submission - the new research and development tax incentive**

Please find below our submission in relation to the Treasury Consultation Paper "*The new research and development tax incentive*" ("the Consultation Paper").

#### **About BDO**

BDO is Australia's fifth largest professional services firm with offices in every major capital city in Australia.

Employing over 1,200 people nationally, our Partners, Directors and staff include specialists from our major business and financial disciplines including Audit & Assurance, Corporate & International Tax, Corporate Finance, Forensic Services, Risk Advisory and Business Recovery & Insolvency as well as a wide range of contemporary consulting services and specialisations.

BDO has one of the most experienced Research & Development incentives practices in Australia. BDO's Research & Development division has significant experience in providing advice for private and public entities, ranging from small start-up companies to established businesses in the manufacturing, food processing and technology sectors, and through to large listed and multinational enterprises in a diverse range of industries, including mining, pharmaceuticals and manufacturing companies with significant investments in R&D activities.

BDO's Research and Development team provides advice to hundreds of Australian companies each year, by assisting those companies in accessing a range of government incentives including the R&D Tax Concession, R&D tax offsets (cash rebate), R&D grants, the Export Market Development Grant, the Enhanced Product By-law Scheme, the Tariff Concession Scheme and other State and Commonwealth innovation and industry assistance schemes.

Our multi-disciplined R&D team includes accountants, lawyers, scientists and ex-ATO and AusIndustry employees. Accordingly, BDO is well placed to understand, at a practical level, the needs of Australian businesses in relation to the Research & Development tax concession and we have used our wide ranging, practical knowledge in order to formulate our response to the Consultation Paper.

#### **Summary of submission points**

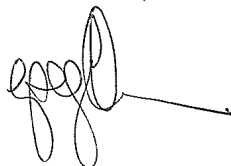
- The concept of "additionality" is likely to have an adverse impact on the ability of small to medium enterprises (SMEs) to access the new incentive - the very businesses that Treasury seeks to redirect the benefit towards. This is due to the fact that most SMEs are often focused on the development of a *singular* start-up product or technology and do not have surplus resources or capacity to proceed with "additional" R&D.

BDO Kendalls is a national association of separate partnerships and entities. Liability limited by a scheme approved under Professional Standards Legislation.

- Adoption of many of the design principles (especially those requiring claimants to demonstrate innovation **and** a high level of technical risk, or requiring claimants to distinguish between costs incurred on core and on supporting R&D activities) will not achieve the simplification to the new incentive designed by Government. Instead, implementation of these principles will increase the complexity and compliance costs to Australian businesses and will result in a material reduction in the level of R&D activities undertaken by Australian business, especially SMEs.
- The “conducted in Australia” requirement should be more flexible, and administered on a case by case basis. There will always be instances where R&D activities need to be conducted offshore, to assist in the successful realisation of an R&D project. Such projects often have significant technical risk and can be for the benefit of the broader Australian economy. As such, a more flexible approach should be adopted in allowing Australian businesses to access the new incentive where activities are conducted off shore.
- Treasury should individually review each category of R&D expenditure currently classified as non-enhanced. In our view there are strong arguments to classify certain categories of expenditures as being eligible for either the full 45% tax credit, or at least a 30% refundable tax credit.
- Expenditure incurred with respect to associate entities should not be subject to an additional eligibility requirement that they be paid in cash in order to be eligible for the R&D tax incentive.
- It is our view that there is no need to add to the list of activities excluded from being core R&D activities, as this would not resolve any of the Government’s concerns surrounding the cost of the R&D tax concession.
- The new R&D tax incentive should do away with the multiple sale requirement for R&D activities involving the development of software. In our view, software expenditure should no longer be subject to a separate test for eligibility.

The points raised in this Executive Summary are the subject of further detailed comment, as attached. We set out further details of these points in the detailed discussion attached. If you would like to discuss any aspect of this submission, please contact me on (03) 8320 2102 or Tracey Murray on (07) 3237 5832.

Yours sincerely  
**BDO Kendalls (Australia) Limited**



**GREG THOMPSON**  
National Tax Technical Director

## Initial comments on design principles

Before proceeding with our responses to the specific questions raised in the Consultation Paper, we take this opportunity to comment on the proposed design principles of the R&D tax incentive as expressed in Principles 1 to 7 of the Consultation Paper.

### *The concept of “additionality”*

Paragraph 12 of the Consultation Paper confirms the Government’s philosophy behind the changes to the R&D Tax Credit program. It is the view of Treasury that:

*“More fundamentally, an effective R&D Tax Incentive needs to result in firms conducting R&D that they would otherwise not perform...”*

This philosophy is further supported by Principle 5 which states:

*“The new R&D tax incentive should target R&D that:*

- (a) Is in addition to what otherwise would have occurred; and*
- (b) Provides spillovers...”*

This concept of “additionality” is a concern and indeed if pursued, is likely to adversely impact the ability of small to medium enterprises (SMEs) to access the incentive - the very businesses that Treasury seeks to redirect the benefit towards.<sup>1</sup>

The concept of “additionality” is one that really only applies to larger businesses with excess resources. This is due to the fact that most SMEs are often focused on the development of a *singular* start-up product or technology and do not have surplus resources to proceed with “additional” R&D. For SMEs with limited resources, an eligibility requirement that focuses on supporting R&D “in addition to what would otherwise occur” would preclude all but a few from claiming any benefit from the Government’s incentive program.

By way of a simplistic example, XYZ Company is a biomedical research company, established in 2007 to follow a line of research related to the development of a cure for a specific type of cancer. Almost all employees are dedicated to this project and the team has successfully developed a line of research which they have patented. Although the company has no income and has significant carried forward tax losses, the original line of research continues into the 2011 year. This is due to the fact significant resources are required in order to develop a commercial outcome.

In the above example, there is little doubt that the company’s R&D activities are central to the original reason the company was established. It actually only undertakes one type of activity to develop a cure for a specific type of cancer. If the principle of additionality was to become a threshold for access to the R&D tax concession, XYZ Company’s activities would potentially be ineligible due to the fact that the R&D conducted by XYZ Company is not in addition to what would otherwise have occurred. If XYZ does want to undertake R&D in addition to what would otherwise occur, it would apply for a Government Grant, where at least 50% of the required funds are provided by the Government and there is a requirement to demonstrate that the project would be unlikely to proceed without the grant funding.

If Treasury’s intention is to target R&D activities that are in addition to what otherwise would have occurred, the majority of recipients of the R&D tax incentive would not be SMEs.

### *Business R&D and the concept of additionality*

The concept of additionality does not appear to take into account the reason businesses conduct R&D activities. For example, paragraph 8 of the Consultation Paper indicates that the new R&D tax

---

<sup>1</sup> See paragraph 10 of the Consultation Paper.

incentive will be more effective in delivering support for business R&D. Whilst there is no further examination as to what constitutes “business R&D”, it appears that this term is used to distinguish the R&D activities undertaken in the normal course of business with a defined tangible commercial outcome from R&D activities that do not necessarily have any practical commercial outcome, such as R&D undertaken in universities.

Business R&D is the focus of the R&D tax incentive; however this appears to be at odds with the principle of additionality. R&D is undertaken by businesses for a wide variety of reasons, however they all have a commercial focus. Whether it is to develop the next new product, to develop an innovative technique to enable them to reduce costs, to design a novel piece of equipment in order to automate a manual process, or to develop a novel process to increase a machine’s throughput, all business R&D is undertaken with a commercial outcome in mind. As such, business R&D is not **additional** to the usual R&D activities of a business. Instead, business R&D has its basis in the strategic objectives of the business and, if successful, will enable the enterprise to sell more products, reduce costs, employ more people or stay in business, all of which have a significant spillover benefits for the broader Australian community. If the principle of additionally is maintained, it will be contrary to the concept of supporting business R&D.

#### ***Support for successful R&D?***

The current R&D tax concession supports the conduct of R&D activities regardless of the ultimate success or failure of the project. There are however provisions in place that limit eligible expenditure incurred with respect to all types of R&D activities, such as the feedstock provisions.

Attachment A of the Consultation Paper provides examples of R&D projects that Treasury believes should not attract support from the R&D tax incentive. All three examples have a number of similarities in that they appear to emanate from larger businesses (due to the size of the claims), and have resulted in successful outcomes which the companies have been able to commercially exploit. In analysing these examples, Treasury does not question whether the activities are R&D activities. Treasury’s prime concern appears to be related to the fact that each of the examples did not leave the company out of pocket and that public funding was provided to a company that was successful in its R&D activities and had been able to exploit that success.

If the three examples used by Treasury had resulted in failure (and a cost to the business of between \$15 million and \$200 million), would Treasury have cited them as examples of activities that did not warrant public support? Indeed, what would Treasury’s position be in the following scenario?

*“ABC Company is involved in the development of unique software which, if successful, will be capable of predicting the potential for patients to contract certain diseases. Over a 5 year period, ABC Company works on two specific software tools, at a cost of \$10 million each. The result of the first project is successful and ABC Company licences the technology to medical facilities around the world. The second project fails in testing and cannot be commercialised.”*

In the above example, would the new R&D tax incentive be available for either of the above R&D activities? Both had high levels of technical risk and innovation, both projects are part of ABC Company’s core business (ie: they are not additional to its core activities) and both had the potential to provide significant spillover benefits to Australia. One is successful, one is not. The company makes enough money through the exploitation of the first project to cover research and development costs, but the second project has left the company \$10 million out of pocket.

If the new R&D tax incentive only operates to support or subsidise *failed* R&D activities, or R&D activities where the commercial exploitation of the result does not cover the development costs, one is inclined to question whether the R&D tax incentive is an effective way of motivating Australian businesses to invest their scarce resources in R&D activities. From a practical point of view, if a company has to wait until the end of the R&D project to determine eligibility to the R&D tax incentive (dependent on whether the project has succeeded or failed and if the company has

been capable of commercialising the R&D to offset the cost of development), how does that make for a streamlined, predictable result or certainty of investment? How would a SME be encouraged to conduct R&D in addition to the R&D they are already conducting, when they can guarantee they will only gain access to the new R&D tax incentive if the project fails to produce a commercial outcome? If the project fails, the company will receive a 45% tax credit, however, it will still be considerably out of pocket, and have nothing to commercially exploit. This is not the manner in which real business decisions are made and, as it is currently proposed, an additional 7,000 businesses are unlikely to be motivated to conduct additional R&D activities simply to access the proposed R&D tax incentive.

### ***Size does matter***

One of the overarching themes that pervade the Consultation Paper and the associated public forums is the fact that Treasury believes reform is required due to a recent and significant escalation in the size of R&D claims. Indeed, without reform, the Government cannot afford to proceed with the incentive in its current form and would expose the Budget to lower value-add claims.

In seeking to address this issue, Treasury proposes that the only option available is to “tighten up” the definition of what constitutes R&D activities. However, the questions throughout the Consultation Paper appear to have little to do with the “tightening up” of the definition of R&D activities, and more to do with how to limit expenditure associated with R&D activities (see for example Question 4 of the Consultation Paper).

In seeking to explore all options for reform and how best to direct support for R&D activities to the intended target (ie: SMEs) has the Government explored all options? For example, instead of making changes to the legislation that are likely to increase complexity and lead to a reduction in applicants from the intended recipients, has the Government considered the following options:

- Placing a turnover threshold on eligibility for the R&D tax incentive. If the Government intends to redistribute support to favour the SME sector, a turnover threshold could be used to achieve this aim.
- Clarifying the operation of the feedstock provisions, such that the provisions limit the level of R&D expenditure eligible for the R&D credit. An example could be found in the manner in which New Zealand deals with the issue (net cost of items processed or transformed by the R&D).
- Placing an overall limit on the size of claims for the R&D tax incentive, in much the same way that other incentives do (eg: the Export Market Development Grant). A limit on the size of claims would better enable the Government to subsidise the cost of conducting R&D activities, regardless of success or failure and without increasing complexity. It would also enable companies to conduct core and supporting R&D activities and commercially exploit the results of the R&D activities, but with the knowledge that there is a subsidy for their R&D activities and certainty as to the level of that subsidy.

The above examples are suggestions as to how to achieve the Government’s intended result, without the complexity and unintended results that will eventuate if the proposed R&D tax incentive program is implemented. While sectoral rules and claim caps were discussed and disregarded at some pre-consultation meetings, it is our view that that a capping option should now be seriously considered.

In our view, adoption of many of the design principles would materially reduce the level of R&D activities undertaken by Australian business, especially SMEs. Reduced support, coupled with an increase in complexity will fail to achieve the objectives of the Government, other than to significantly reduce the level of Government support for innovation in Australia.

Simplification will not be achieved by requiring claimants to demonstrate innovation *and* a high level of technical risk or by requiring claimants to distinguish between costs incurred on core and on supporting R&D activities. Nor will simplification be achieved through increased compliance activity by AusIndustry and the Australian Taxation Office (ATO). Accordingly, we recommend that Treasury adopt a **capped** option which places an overall upper limit on the level of R&D expenditure incurred by a company that is eligible to receive an R&D credit. This may be an arbitrary approach, but certainly no more arbitrary than the \$20 million turnover threshold for access to the refundable R&D tax credit. In any event, similar types of thresholds appear to operate effectively for other grants and Government incentives.

#### ***Impact on Australia's OECD innovation rating***

According to the Australian Bureau of Statistics,<sup>2</sup> in the 2007/2008 year Australia's Business Expenditure on R&D (BERD) as a percentage of GDP was 1.27%. This places Australia 14<sup>th</sup> in the OECD community and well below the average BERD/GDP ratio of 1.59%. Australia's BERD/GDP growth has made steady progress towards the Ecad's average over the past few years, in part due to the Government's support for innovation via the R&D tax concession.

However, we have significant concerns that this statistic will regress under the new R&D tax incentive regime, for a variety of reasons including:

- Complexity associated with establishing a company's eligibility for the new program and the potential repercussions of getting it wrong will result in a number of eligible companies not claiming the R&D tax incentive.
- The proposed tightening of the definition of what constitutes R&D activities will likely lead to a reduction in the type of activities eligible for the R&D tax incentive.
- Whilst Treasury is endeavouring to keep the program revenue neutral (compared to the current program), a significant increase in administrative cost for the ATO and Innovation Australia will effectively result in less funding being made available for innovators.

Furthermore, it is difficult to see how an additional 7,000 small to medium enterprises will start conducting additional R&D activities as a result of the new program, as the Consultation Paper seems to suggest.

The above observations tend to suggest that the new R&D tax concession is likely to lead to fewer companies accessing the program and a reduced number of R&D projects eligible for support. In addition, for those R&D projects that achieve eligibility, there will be a material reduction in the level of eligible R&D expenditure available. Reduced support for R&D activities will have a significant and adverse effect on Australia's BERD/GDP ratio, and is likely to result in a reduction in Australia's OECD ranking in this regard. This ranking is an indication to the world as to how innovative Australian business is and is tied to the level of support the Government provides for investment in innovation.

---

<sup>2</sup> Australian Bureau of Statistics: 8104.0 - *Research and Experimental Development, Businesses, Australia, 2007-08*.

## Responses to questions raised in the Consultation Paper

### ***Question 1: Should there be any exceptions to the general rule that eligible R&D activity must be conducted in Australia?***

In our view, the “conducted in Australia” rule should be relaxed, when compared to the current provisions. The current R&D tax concession is prescriptive and formula driven and does not provide the necessary flexibility to drive internationally accepted R&D projects. Any R&D incentive should drive R&D activities that are of benefit to the Australian economy. To restrict the new incentive to only Australian based R&D activities will be an impediment to planned R&D expenditure undertaken by Australian businesses operating globally. Moreover, a requirement that all R&D activity be conducted in Australia seems at odds with the Consultation Paper’s assertion that the location of the ownership of the resulting intellectual property is not relevant.

Where elements of the R&D activities take place outside of Australia (whether collaborative or not), there are often significant examples whereby the results of the R&D activities have a broad benefit to the Australian economy. Pharmaceutical companies are an example, whereby a significant proportion of the R&D activities involved in drug development are required to be carried out in an overseas location. These activities often have significant financial risk and commonly fail. They are however activities that, if successful, will benefit the Australian economy and, if unsuccessful, will provide significant spill over benefits to the Australian economy in terms of jobs, know how, etc. Under the current provisions, 10% of a project can be claimed as eligible R&D expenditure, if advanced registration is approved.

Many Australian companies (such as pharmaceutical companies), would benefit from a relaxation of the 10% overseas expenditure content rule. By relaxing the rule, companies will be incentivised to expand world class R&D programs, to the benefit of the Australian economy, rather than seek support for such activities in a country with a more supportive incentive program. The key to this issue is flexibility.

### ***Question 2: How should the new R&D tax incentive treat R&D expenditure that is currently deductible at 100%?***

#### ***Background***

From the initial implementation of the R&D tax concession, and during its ongoing evolution, various categories of R&D expenditure have been classified as a non-enhanced deduction and eligible at a 100% deduction rate.

The reasoning behind classifying a non-enhanced deduction as such is dependant upon the specific expenditure in question. Classification of core technology as a non-enhanced deduction was to prevent two claims being made for what is essentially the same expenditure. “At risk” expenditure was classified as a non-enhanced deduction as, in the absence of financial risk, it was the opinion of the Government that this would be supporting a company to undertake an activity that was already commercially sensible to undertake.

There have been a significant number of legislative changes over the years to clarify the treatment and benefit associated with certain types of non-enhanced deductions. Despite these changes, under the current R&D tax concession program, a potential benefit still remains for companies eligible to claim the R&D tax offset to claim non-enhanced deductions, as the current legislation allows these companies to cash out expenditure that is deductible at the non-enhanced rate.<sup>3</sup> The

---

<sup>3</sup> It is important to note that many companies view the ability to cash out their R&D expenditure as more of a timing difference rather than a permanent difference. In cashing out R&D expenditure at a non-enhanced deduction rate a company is bringing forward an equivalent financial benefit that it would have otherwise received in later years through a reduction in its tax payable position.

ability to cash out R&D expenditure (compared to carrying it forward to offset against future tax liabilities) greatly enhances cash flow for small innovative companies when they most need it - during their initial growth phase.

#### *Consultation Paper suggestions*

At page 6 of the Consultation Paper, Treasury puts forward two suggestions with respect to the method in which the non-enhanced deductions could be treated under the new R&D tax credit program, specifically:

- i) provide companies with a non-refundable tax credit at the prevailing company tax rate regardless of the size of the company; or
- ii) completely exclude the R&D expenditure.

We have considered these options from all angles, however we have come to the conclusion that either option results in the same outcome - no additional benefit (in terms of an improved financial or tax payable position) to the company from undertaking R&D activities with respect to the non-enhanced deduction categories of R&D expenditure. In addition, the first option has the potential to create additional work for a company, as the company will be required to devote additional resources to the preparation and lodgement of the R&D tax incentive claim through the requirement to collate and classify the R&D expenditure.

Our issue with the options put forward in the Consultation Paper is that they are both based purely on a concern that an increased refund is potentially accessible under the new R&D tax incentive. There appears to be an absence of analysis as to the effect that the changes will have on the stated goals and objectives of the R&D tax incentive, or the potential significant adverse effect such changes could have on a specific group of claimants, being those companies who currently claim the R&D Tax offset incentive.

We submit that it would be an opportunity missed to implement a new R&D tax incentive and not revisit expenditure that has traditionally been categorised as a non-enhanced deduction and determine if it is still the appropriate treatment.

#### *The impact on SMEs*

As previously stated, a material concern we hold with respect to the Government's suggestion to make tax credits for non-enhanced expenditure non-refundable is the impact this will have on SMEs currently eligible to cash out these categories of expenditure. The implementation of non-refundable tax credits for non-enhanced expenditure will operate to decrease the level of support some SMEs receive compared to the current provisions, especially given that companies will inevitably compare the first year of the R&D tax credit program to the last year of the R&D tax offset program.

The purpose of the offset/refundable credit is to provide innovative small companies, particularly those in tax losses who cannot gain immediate benefit from the R&D tax incentive, with an opportunity to increase their cash flow when they most need it (during their initial growth phase while they are developing that one product that they are able to take to market). An increase in the categories of expenditure that are unable to be cashed out will only operate to decrease cash flow, thus restricting the perceived or actual support that the Government is offering to SMEs. Therefore, the implementation of a non-refundable tax credit for non-enhanced expenditure may inhibit the Government's stated objective of redistributing support to SMEs.

#### *A non-refundable non-enhanced deduction and encouraging R&D activities*

The design of the R&D tax incentive system provides Treasury with an opportunity to reassess assumptions made over the past decade with respect to the treatment of non-enhanced deductions. Analysis of the categories of non-enhanced deduction expenditure readily presents the casual

observer with certain categories of expenditure that should clearly be excluded from the definition of R&D expenditure and treated under the normal taxation provisions. For example, Government Grant funding provides companies with, as a general rule, dollar for dollar funding. In many cases, Grants can provide complete funding. It is generally accepted by business that, if the Government is already funding 50 percent of a project, then such funding replaces the additional 7.5 per cent of funding provided through the R&D tax program. In this situation, sufficient support has already been provided (via the current clawback provisions), and hence, the expenditure should be excluded from the definition of R&D expenditure. The large majority of companies that receive direct Government funding during a particular year, would view such treatment (i.e. the ability to claim such expenditure as part of the R&D tax concession) this as a solid level of support.

Unfortunately, the rationale behind the exclusion of other categories of expenditure is less apparent. Categories such as “interest” or “residual feedstock” are two examples of R&D expenditure where their exclusion may not necessarily achieve the technical objectives of the R&D tax concessions.

Consider interest incurred in R&D activities as an example: if a new company funds its R&D activities through debt funding, does it not deserve every possible chance of developing and commercialising a new product when compared with a company that funds similar activities through retained profits? If the aim of the new R&D incentive is to encourage companies to undertake R&D activities, why provide a disincentive to companies that want to fund their R&D via debt funding with borrowed money? Interest is often a legitimate cost of undertaking R&D activities, no different to wages or certain types of administrative overheads such as insurance premiums and rates/land taxes (both eligible under the current legislation).

A company is able to claim land tax/rates it incurs if it owns the property on which R&D activities are undertaken, whereas a company that rents its premises cannot as it does not incur this type of expense. Parallels are able to be drawn to a company being eligible to claim interest payments. Both are cost of undertaking R&D due to the commercial arrangements in which the company decides to operate in yet one type of cost (ie: land tax) is eligible while another type of cost with the same nexus to R&D activities (ie: interest) is not.

The point to be made is that the overarching objective of the R&D tax concession is to support and encourage companies undertaking R&D activities. Historically, and for various reasons, some categories of expenditure have been reduced to 100%, however, it has been recognised as important to continue to allow companies the ability to cash out this type of expenditure. If the new R&D tax incentive intends to prevent companies from cashing out this type of expenditure it will not provide the encouragement to companies to undertake R&D activities.

### *Conclusion*

A blanket statement that effectively removes or negates a company’s ability to access cash associated with eligible R&D expenditure exposes itself to failing to achieve its intended and stated goals, specifically:

- implementing an R&D tax incentive that redistributes support in favour of SMEs; and
- supporting and encouraging companies to undertake R&D activities in order to develop new and innovative products and processes.

We suggest that the best approach is to investigate each category of R&D expenditure that is currently classified as non-enhanced and re-consider whether the various categories of non-enhanced expenditure should be eligible for a refundable 100% deduction, eligible for a 125% deduction, or whether it should be completely excluded. In assessing this eligibility, the Government needs to determine if the incurring of a category of cost supports a legitimate R&D activity.

If this analysis is undertaken correctly, we are confident that costs such as interest, residual feedstock, core technology, etc are all costs integral to the successful commercial development of novel and innovative projects, processes and systems. In our view these types of expenditures should be eligible for support under the new R&D tax incentive, if not at the 45% credit rate, then certainly as a refundable amount at normal tax rates.

***Question 3: Should expenditure incurred with respect to associate entities only be eligible for the new R&D tax incentive where paid in cash?***

The R&D tax incentive legislation should not be designed such that the R&D tax incentive can only be claimed in respect of expenditure incurred to associates until it has been paid in cash. It is submitted that the current arrangements (which require expenditure to have been *incurred* in order to be eligible for the concession) is a sufficient threshold for access to the incentive.

All R&D expenditure must, in the first instance, be “incurred” for tax purposes (not merely for accounting purposes) to be eligible for a tax deduction. It is important to note that the tax law concept of “incurred” is more stringent than that which applies for accrual accounting purposes. We are therefore of the view that the statement in the Consultation Paper that “under the current arrangements, expenditure on R&D is incurred under accrual accounting principles”<sup>4</sup> is incorrect. Under the current arrangements, R&D expenditure is *not* incurred until, in a technical legal sense, the taxpayer has an inescapable obligation to pay an amount - a threshold which is considerably higher than the basis on which many accounting accruals are made.

Essentially, for a loss or outgoing to be “incurred”, the taxpayer must be “definitively committed” and “completely subjected” to the loss or outgoing in the year of question. In the process of determining this question one must refer to all relevant circumstances and facts, of which, among other things, being associated entities would impact the conclusion.

There is already sufficient scope for denying access to the R&D concessions in situations where taxpayers claim certain expenditures that are not properly “incurred”. For example, in ATO ID 2006/238 the ATO ruled that, in the context of the R&D provisions, no deduction under section 73B(14) of the ITAA 1936 was available for certain unpaid wages that were outstanding for a number of years as the wages were not “incurred”. This was the case notwithstanding that under accrual accounting principles, the unpaid wages were properly recognised in the accounts as an expense incurred by the taxpayer.

As business taxpayers typically recognise expenditures on an “incurred” basis (which will usually precede the time at which those expenditures are settled in cash), there may often be a timing difference in that a company might obtain a cash refund in relation to an outgoing before it is settled in cash. This situation is not limited to transactions between associates. In our view, amendments to prevent the normal operation of the accruals recognition of tax accounting is beyond the intention of the new R&D tax incentive provisions.

It also appears from this question that the Government assumes that all transactions between associated entities are not necessarily genuine transactions, or will have abnormally long payment terms, which is simply not the case.

Further, should this measure be introduced, a number of unnecessary burdens and adverse consequences are likely to arise. These include:

- claimants will be required to isolate R&D expenditures made between associates and to identify those that remain unpaid. This could pose significant compliance issues for tracking such payments on computerised accounting software as they would be classified as a normal supplier;

---

<sup>4</sup> Paragraph 42 of the Consultation Paper.

- claimants would effectively be forced to favour related party creditors in preference to unrelated creditors when prioritising payments;
- compliance and interpretational issues associated with determining when an amount has been paid in “cash” will arise, especially where associated parties that provide goods and services to each other offset their inter-company accounts as goods and services are traded between these entities, rather than paying their inter-company liabilities in cash.

In light of the above, we submit that the requirement for expenditure to have been incurred is sufficient to extinguish claims for costs that have not been properly incurred to associates, thereby stopping refunds for which Question 3 purports to prevent. All other things being equal, there should be no difference between the taxation treatment of transactions between associated entities compared to those applying to transactions between non-associated entities.

#### **Question 4: Supporting activities**

##### ***Should supporting activities:***

- a) Be capped as a proportion of expenditure on core R&D?***
  - i. If so, what would be the appropriate proportion (for example, 1:1)?***
- b) Only be eligible where they are for the sole purpose of supporting core R&D activity?***
- c) Exclude production activities or dual role activities?***
- d) Only be eligible on a net expenditure basis?***
- e) Attract a lower rate of assistance than core R&D?***
  - i. If so, what would be the appropriate rate?***

##### ***Background***

R&D activities, by their very nature, require trialling and testing of the developed technology, processes and products. Trialling and testing is often conducted as part of the development of a technology, process or product (ie: as part of the experimentation process, the results of which are fed back into the process and may in fact result in additional core R&D) or at the end of the development phase, to ensure the hypothesised solution produces the anticipated outcome. Trials and tests can be undertaken in the lab, in a small scale prototype environment or scaled up, to replicate the actual conditions the technology or process was developed for. This final phase testing, whereby smaller trials are “scaled up”, is the most common failure point for most R&D activities and, as such, is an integral aspect of the R&D cycle.

Supporting activities not only “support” the core R&D activities, they are directly related to the success or failure of an R&D project. Depending on the type of R&D activity, supporting activities (in the nature of trials and tests) can take much longer and cost much more than the core R&D activities. As an example, pharmaceutical company commonly requires a number of phased approaches to a project. Once a core compound or drug has been developed (generally based on past research and hypothesised outcomes), the actual effect of the drug in a range of circumstances needs to be trialled and tested. Phase 1, 2a, 2b and 3 trials are integral to the overall R&D project, however, are most aptly described as supporting activities. These supporting activities are carried out for a number of purposes (testing the efficiency of the drugs, determining the limitations in certain populations, legislative requirements in order to eventually register the drug etc) and are often many times more expensive than the core R&D activities themselves.

Manufacturers often go through a similar R&D timetable, whereby a company may seek to develop new technology, processes or products in order to create a new device to solve a technical problem (similar to the scenario outlined in the illustration on page 10 of the Consultation Paper). Once such a device or technology is developed, the manufacturer will be required to trial and test the success of the device in a trial run. If the device or technology is successful within this simplified environment, a broader scale, production style trial is still required. Only through this larger scale trial can it be proven that a successful outcome may be obtained. Alternatively, this broader scale

trial could also show that a commercial outcome is unable to be obtained or what further developments are required in order to achieve a successful outcome. Similar to the pharmaceutical company, these testing activities commonly need to be carried out in a “real life” environment and are integral to determining the success or failure of the core R&D activities. Also like pharmaceuticals, the trialling and testing activities (supporting activities) can cost many times more than the core R&D activities.

Whether a company is in the area of pharmaceuticals or manufacturing, supporting activities need to be conducted within an environment able to replicate “real life” test conditions in order to produce a successful outcome. As such, during the conduct of supporting activities, a company will generally produce something of value and/or something that is saleable. This can include products, technology, processes, know how, waste, etc. However, this production of something of value should not be used as a road sign that the supporting activities are somehow less valuable than the core activities.

Our concern with the options proposed by Treasury is that they do not appear to recognise or acknowledge the importance that supporting activities play in the overall R&D process. That being said, we recognise the need for a reduction in the quantum of R&D expenditure currently being claimed under the current program.

Any changes the R&D tax concessions should continue to appropriately recognise supporting R&D activities without adding additional layers of complexity to the R&D claim process and creating excessive disincentives to companies in claiming the tax credit.

The options as currently proposed do not go far enough in recognising the importance of supporting activities and consequently we are of the opinion that the advantages of a capped system should be further investigated. Alternatively, Treasury should investigate the ability to reduce claims via the correct, consistent and transparent application of already existing provisions, including the feedstock, guaranteed return and on own behalf provisions. While this will achieve Treasury’s desired reduction in the level R&D expenditure eligible for the R&D credit, it still acknowledges the importance of supporting R&D activities and minimises the complexities and disincentives associated with the other options currently being proposed.

#### *Comments on Consultation Paper suggestions*

Throughout the Consultation Paper, Treasury expresses concern as to the increasing size of R&D claims under the current regime and that in Treasury’s view some activities are of questionable merit, in that the subsidy provided outweighs the net benefit to the Australian community. Treasury provides three examples at Attachment A that, in Treasury’s view, represent claims of questionable merit.

Principle 7 of the Consultation Paper outlines why Treasury believes claims under the current R&D tax concession are escalating and are not delivering the intended results to the Australian community. Principle 7 outlines the Government’s intention to continue to recognise “supporting activities” under the new R&D tax incentive, however, claims will be the subject of new limitations.

The commentary under Principle 7 outlines a number of proposals as to how to limit claims associated with the cost of conducting supporting activities and range from a “capping” methodology to an exclusion methodology.

In response to Treasury’s suggestions with respect to the treatment of supporting activities, it is our view that to limit, cap or reduce the ability to claim supporting activities is likely to have an adverse impact on the integrity of the new R&D tax incentive and will add unnecessary complexity to the issue. With that said, we acknowledge Treasury’s desire to reduce the size of claims arising under the current R&D tax concession system.

#### *Responses to Question 4*

- a) *Should supporting activities be capped as a proportion of expenditure on core R&D? If so, what would be an appropriate proportion (for example 1:1)?*

The option of capping supporting activities is an option that would add unnecessary complexity to the new R&D incentive. Many large companies, their advisors and even the ATO and AusIndustry struggle to distinguish between core and supporting activities. Indeed, one of the examples cited in the Consultation Paper (Example 1 of Attachment A) makes reference to blended core and supporting activities.

Therefore, adopting a supporting activities capping option, regardless of the proportion the supporting activity expenditure is capped at, will result in claims that are open to a significant level of interpretation and therefore a significant level of risk for claimants, particularly SMEs. This option will require enterprises to firstly assess whether each activity contains innovation and a high level of technical risk, requiring judgements to be made on concepts that are highly subjective and open to interpretation.

In addition, there is no legislative definition or guidance as to what constitutes an activity and the breadth of the activity as described can materially affect the eligibility of R&D expenditure. For example, one company may register “development of a prototype” as an activity, and if it is able to demonstrate innovation and a high level of technical risk in one part of that activity, the expenditure on the entire prototype may be viewed as eligible. This needs to be compared with a company that, while developing the same prototype, registers the four main components of the prototype construction instead of the entire prototype. If only one component has the requisite level of innovation or high level of technical risk, then the expenditure associated with the other three components would be considered ineligible or receive a lower level of support.

Once an activity has been identified, companies must ascertain if the activity has innovation and a high level of technical risk, again subjective concepts. Eligible core activities then need to be costed, to ensure only expenditure associated with the core activity is identified. This figure would then be used as a base figure, a proportion of which is used to limit supporting activity expenditure.

The complexity of identifying an activity that contains both innovation and high levels of technical risk could lead many businesses to either inadvertently misclassify activities or expend significant resources trying to justify why a specific activity is a core activity.

Due to the subjectivity of the underlying concepts, this is likely to be an area of increased ATO and AusIndustry attention and again, due to the subjective nature of the concepts, is likely to result in protracted engagement between Government agencies and Australian businesses, simply to ensure the terms “activity” “innovation” and “high levels of technical risk” have been correctly interpreted.

In our view, the time required to assess, support, advocate and audit the correct interpretation of these subjective concepts is likely to be counter productive for little benefit, with the potential for significant consequences to SMEs (the target recipients of the incentive) in the event that the initial assessment is incorrect. In addition, if the original assessment of what is a core activity (and associated costs) is incorrect, any claim for supporting activities will also be incorrect if the level of claim for supporting activity is tied to the level of claim for core activity. The potential for incorrect claims would materially increase if this approach were adopted.

We are of the view that claims for supporting activities should not be capped or tied to a proportion of expenditure on core R&D activities. We submit that this approach would add

unnecessary complexity to the process and that other options to limit overall expenditure should be explored.

- b) *Supporting activities should only be eligible where they are for the sole purpose of supporting core R&D activity?*

As previously noted supporting activities are often conducted in order to trial or test the success of the core R&D activities. In addition, the conduct of supporting activities generally reduces the risk of failure associated with the core R&D activities. For example, the reason most companies conduct a small scale trial (such as a “lab trial” or a “bench top trial”) is due to the fact that the R&D is so technically risky, the company is unsure it will be successful. A small scale trial minimises the impact of failure (in terms of cost) if the trial is unsuccessful, compared to a trial conducted in a “real life” environment. Depending on the results of “lab trials”, a company may undertake additional R&D to rectify or overcome identified technical issues, or scale up the trial to replicate the manner in which the novel technology/process is anticipated to be used. In many instances, this will require a trial at a commercial facility, either in house or at an external facility.

In our view, limiting the eligibility of supporting activities to those that are conducted for the sole purpose of supporting core activities will introduce additional complexity to the administration of the new R&D tax incentive and may adversely impact the manner in which R&D activities are undertaken.

In terms of additional complexity and building on past comments, if the new R&D incentive only supports activities undertaken for the **sole** purpose of supporting core R&D activities, claimants (which the Consultation Paper prefers to be SMEs) will need to determine what is an activity, whether it has innovation and high levels of technical risk and, if not a core activity, whether the activity is undertaken **for any other purpose** than supporting the core R&D activity. Sole purpose is a very specific and all encompassing concept. It is a positive test and will require the claimant (resource constrained SMEs) to generate and hold documentation that confirms the activity had no other purpose. This requirement could lead to a number of unintended consequences. For example, if a small business builds a prototype (the core R&D activity) and then tests that prototype (the supporting R&D activity), the trials (supporting activity) may have (in the company’s view) been conducted for the sole purpose of supporting the core R&D activity. However, what if the company also undertook the trial in the presence of a potential investor to secure funding for further development? If a “sole purpose” approach were adopted, it is assumed that a trial, in the circumstances outlined, would not be considered an eligible supporting activity, due to the fact that the activity was not conducted solely in support of the core R&D activity.

What if a trial was used to train staff, or to try out a new raw material, or to also test new equipment? Presumably the existence of another purpose for the supporting activity would preclude such activities being classified as eligible supporting activities. Another example of the impact a “sole purpose” test would have on the ability to claim supporting activities can be seen with a pharmaceutical example. Phase I, II and III clinical trials, whilst essential to the trialling and testing of the success of the developed drug, also produce information necessary to the drug’s principal registration package (for regulatory approval) and to assist in gathering data that can be used in securing partnering arrangements with distributors. A sole purpose test would result in such activities, essential to the conduct of a successful R&D project, being deemed ineligible.

If Australian businesses are unable to claim supporting activities, due to the introduction of a sole purpose test, what are their options and what impact will it have on the conduct of R&D activities?

The Consultation Paper indicates that a considerable portion of the current R&D tax concession subsidises supporting rather than core R&D activities. If the sole purpose test

were to be adopted, in our view the ability of Australian businesses to claim supporting activities will be significantly, indeed a stated intention of the Consultation Paper. However, if the majority of activities associated with the conduct of an R&D project are ineligible for the R&D tax incentive, how would this motivate SMEs to conduct R&D activities? Why would a resource constrained SME expand its resources on additional risky R&D activities (which could fail, at significant cost to the business) if the majority of these activities are likely to be viewed as ineligible by virtue of the fact that they failed the sole purpose test? If the sole purpose test is adopted, Treasury will achieve its intended objective of reducing the level of R&D claims by reducing the subsidy associated with supporting activities. It will also have the effect of dis-incentivising the intended recipients from conducting R&D activities, due to lack of benefit and return.

As a side issue, if supporting activities need to meet a sole purpose test to attract support for the new R&D incentive, what are a business' options if the Australian business knows their project will comprise of ineligible supporting activities? It is submitted that the options may include:

- don't undertake the R&D activities at all; or
- conduct the activities overseas, in a country that provides assistance that includes support for such activities; or
- conduct the core activities and transfer/sell dedicating resources to the conduct of the supporting activities (which could result in valuable knowledge being transferred offshore, at a reduced sale price due to the untested nature of the knowledge), or
- multiple other options, none of which provide spillover benefits to the Australian economy.

In summary, we submit that supporting activities should not have to fulfil a "sole purpose" test in order to attract support under the new R&D incentive. Australian companies operate within a commercial environment. Consequently, everything is undertaken, at some level, for a commercial purpose. Therefore, a literal interpretation of the "sole purpose" requirement completely eliminates the eligibility of expenditure for supporting activities.

*c) Should supporting activities exclude production or dual role activities?*

The same issues raised by this option have been addressed in question (b) above. If an activity does not have a "sole purpose", it must have a number of purposes. Production or dual role activities are simply activities that are not undertaken for a sole purpose of supporting the core R&D activities.

It is our opinion that supporting activities should not exclude production or dual role activities. This is based on the premise that the adoption of this concept would lead to a reduced incentive to conduct R&D activities and may drive business towards decisions regarding the conduct of their R&D activities that may not be to the benefit of the Australian economy. It is also our opinion that any issues associated with the production of saleable/valuable product as a result of conducting supporting activities in a production environment can be effectively managed by additional guidance for and effective application of the existing legislative provisions.

*d) Should supporting activities only be eligible on a net expenditure basis?*

The issue of whether supporting activities should only be eligible on a net expenditure basis is, in our opinion, Treasury's answer to reducing/stopping claims associated with "whole of mine" projects and "one off" infrastructure projects. We believe that this concept has

been put forward by Treasury due to the lack of guidance material on and ineffective application of the feedstock provisions, the on own behalf provisions and the guaranteed return provisions. Whilst adopting such an approach will no doubt significantly reduce (if not completely preclude) activities associated with natural product extraction and creation of new or innovative trading stock for subsequent sale, it will also have a significant adverse impact on all enterprise's ability to claim the new R&D tax incentive and will, in effect, result in the new R&D tax incentive only supporting businesses who have failed to produce a successful outcome or failed to commercialise the results of the R&D activity. Thus, rather than being viewed as an incentive aimed at general R&D activities that produce a net benefit to Australia, the R&D incentive would become a subsidy for failed or un-commercialised R&D activities.

The principle of only subsidising supporting activities on a net benefit basis has the potential to introduce a level of complexity that will be difficult for most Australian businesses to comply with, or plan for. It also has the potential to produce inequitable results, depending on the manner in which the output of the R&D process is exploited.

If this principle is adopted, Australian businesses will not only need to distinguish between core and supporting activities, they will also need to determine the costs associated with the conduct of each category of activity. In addition, Australian businesses will then need to identify the outputs of the R&D process itself (ie: is it the resulting product, the underlying technology used to develop the product, or something else) and then identify income associated with such R&D outputs. This information will then be used to identify the "net cost" of an eligible R&D activity. If such supporting activities are profitable in their own right, the Consultation Paper indicates that support for such activities would be removed.

In our opinion, the concept of "net cost" is a hugely subjective concept and we are surprised that Treasury has not released further detail on its proposed scope of operation in order to allow constructive and meaningful consideration of the application of this option.

In assessing the potential impact of the implementation of this concept, we request the following issues/points be considered:

*The recovery of the costs of a company's R&D outlay directly from the outputs of the R&D process requires Australian businesses to identify income received from the outputs of the R&D process.*

In assessing this information, the question arises as to the time frame a company takes into account. For example, if a company conducts supporting activities which, due to the nature of the trial, produces saleable coal and the coal is sold within the same income year, the "netting" process could be quite straight forward. However, if a pharmaceutical company undertakes supporting activities that produce information specific to the development of a drug, which is commercialised 10 years after the costs were incurred, how is this income (the revenue generated from the output of the R&D activities) taken into account in the netting-off calculations?

Alternatively, what if the pharmaceutical company decides not to proceed with development and sells its knowledge to another party, or sells the company (at an increased price due to the value of the partially developed knowledge) to another company? Would such income form part of a recoupment calculation and, if not, does this not produce an inequitable result when compared to manufacturing activities or mineral extraction and processing activities, simply due to the immediacy of the correlation between R&D expenditure and the income generated from the outputs of the R&D process?

What is "the output" of the R&D process itself? The Consultation Paper suggests these are likely to be tangible items, produced as a result of the R&D process and sold, resulting in a

profit. In such instances, the Consultation Paper suggests that a subsidy would not be provided. How should the formula be applied where the output of the R&D process itself is intangible, such as know-how (which would be valuable in the hands of a competitor)? If the output of the R&D process itself is not tangible, will such outputs need to be valued for net benefit calculations?

If the net benefit concept is adopted, how can an Australian businesses plan for the conduct of R&D activities, including the funding of those activities, if they cannot assess the level of support they are likely to receive from the new R&D initiative until after the R&D project has been completed (after the net benefit concept has been applied). Financial risk may have been prevalent throughout the conduct of the R&D activities, which the new R&D incentive is seeking to support. However, due simply to the fact that a saleable product has subsequently resulted from R&D activities, the company may not attract any R&D incentive due to the application of a net benefit test.

The distinction between the profitability associated with core activities and profitability associated with supporting activities is difficult to reconcile. If both types of activities are financially risky, both should attract support under the new R&D incentive.

In our view, the “net benefit” concept has been put forward to address large R&D claims which have resulted from whole of mine or infrastructure projects (as outlined in the Cutler Report). However, by seeking to introduce a concept to address a specific set of circumstances, inequities can arise, producing results that are at odds with the intention of the incentive. If the nature of the incentive is to incentivise Australian businesses to conduct additional R&D activities, the application of “net benefit” requirements will not achieve this outcome. It may encourage businesses to conduct R&D projects with extreme risk of failure or little potential for commercial outcomes, as the concept of net benefit does appear to reward such characteristics. They are however, not the type of characteristics within an R&D project that will provide ongoing benefits to the Australian economy. This type of non-commercially focused R&D is better undertaken by Universities and is currently supported as such.

This option has the potential to drastically reduce support for commercially-focused R&D activities. This fact, combined with the rudimentary state in which it has been presented for comment, has effectively precluded it from being considered as a viable option.

*e) Should supporting activities attract a lower rate of assistance than core R&D activities?*

When compared to the previous options identified with respect to supporting activities (ie: capping as a proportion of core expenditure, sole purpose, net benefit, etc), the option of attracting a lower rate of assistance when compared to expenditure associated with core activities is the lesser of the previous mentioned “evils”. Whilst this option will still result in increased complexity (due to the requirement to identify core and supporting activities), at least a level of assistance will be available for supporting activities which may incentivise Australian businesses to undertake R&D activities to a greater degree than the alternative options put forward. However, in reviewing the merits of this option, it is worthwhile noting:

- The problematic issue of “blended activities” (mentioned in Attachment A of the Consultation Paper) will continue to cause subjective judgements to be made as to what activities are “core activities” and what activities are “supporting activities”. One of the merits of the current R&D tax concession is that, whilst all projects require the undertaking of core activities, there is little distinction between the two types of activities when it comes to expenditure. Therefore, costing an R&D project follows generally accepted cost accounting practices. The need to distinguish the costs between the two categories of activities will add an additional level of complexity and administrative burden on resource constrained SMEs.

- Whilst many of the concepts required to make an assessment as to the type of activity are subjective, the potential adverse consequences to Australian businesses could be significant. ATO review activity is likely to focus on the distinction between supporting and core activity costs for the purposes of reducing an R&D claim. Such reviews are likely to focus on the ATO's view on subjective issues and, akin to the ATO's continued review of the feedstock and on own behalf provisions, are unlikely to result in any firm guidance. As such, it is our view that continued reviews of subjective terms is likely to be a significant cost to the Australian community (in terms of ATO resources) with little to no benefit to the community. The issue of subjectivity and the potential consequences of interpretation of subjective terms in the event of an audit could result in many SMEs putting R&D into the "too hard" basket.
- As a final point, the level of assistance cannot be so low as to not motivate Australian business. Whilst the potential benefits available to the below \$20 million category of claimants is attractive on face value, added complexity, risk of audit of subjective issues and reduced assistance for the significant proportion of the claims (per Treasury's own analysis) could erode the attractiveness of this concession. In our view, if the complexity associated with the issue of supporting activities makes its way into the final R&D tax incentive, what had the potential to deliver Government's motivation to Australian businesses to invest in innovation will instead be crippled by red tape and administrative anomalies, such that it does not deliver the intended benefits to either Australian businesses or the Australian economy.

### ***Conclusion***

Prior to the release of the Consultation Paper, at an R&D Tax Concession Consultative Group Meeting on the 27 May 2009, Mr Ian Cooper (Leader, National Innovation Segment, ATO) indicated that approximately 75% of the R&D budget is consumed by the top 100 claimants of the R&D tax concession. Consultative Paper, paragraph 14 states that on an underlying cash basis, implementation of the new R&D tax incentive is to be revenue neutral over its first four years of operation.

We are concerned that the result of the proposed tightening options put forward in the Consultation Paper will not only be a large reduction in the claims made by the top 100 claimants, but also a material reduction in expenditure claimable by SMEs. As no financial modelling or data driven analysis has been offered up by Treasury to allay these costs concerns, there is a risk that the new program will actually be revenue positive (ie: less financial incentives will be accessible by business). This would cause a number of companies to question the benefits of claiming the concession. If this were to occur, the quality of the R&D programs currently being undertaken by Australian R&D companies would decrease. After reviewing the options put forward by Treasury to tighten the definition of supporting activities, our major concern is that the outcome will be a material reduction in the level of eligible expenditure claimable by not only the top 100 claimants, but also by SMEs.

The second area of concern with the options as they currently stand is the complexity that they generate in requiring companies to classify and collate R&D activities and R&D expenditure.

Paragraph 9 of the Consultation Paper promotes the new R&D tax incentive as simpler and less complex due the fact that "companies will no longer need to distinguish between their base and incremental expenditure on R&D in working out their claim." Yet, under every proposed option put forward by Treasury, companies will be required to distinguish between their core and supporting activities in working out their claim with the direct result of a restricted level of support for supporting activities.

Rather than adopting any of the options put forward by Treasury, we strongly recommend reconsideration, and the subsequent implementation, of some form of a capped system, be that a cap on turnover of a company or a limit on the size of an R&D claim. Reduced support, coupled with an increase in the complexity of the proposed R&D tax incentive will make the incentive unattractive and will fail to achieve the objectives of the Government. At the very least, a capped option (either on turnover or the level of the claim) will bring certainty and clarity for both business and Government. A cap may be arbitrary but no more arbitrary than the \$20 million threshold for accessing the refundable R&D tax credit. In addition, similar types of thresholds appear to operate effectively for other grants and Government incentives.

***Question 5: Should the current list of activities excluded from being considered core R&D be:***

***(a) amended in any way?***

***(b) extended to exclude certain activities from being considered supporting activities?***

We submit that adding to the list of activities excluded from being classified as core R&D activities would not resolve any of the Government's current concerns surrounding the R&D tax concession. Most of the issues of concern appear to be linked to the amount claimed as eligible expenditure, rather than what constitutes core R&D activities.

For the R&D tax incentive to remain fair and attractive (particularly for SMEs), R&D funding should be directed to innovation across all industries and sectors.

There could be a significant unintentional adverse impact to the R&D base, should further restrictions apply. This coupled with other changes proposed by the consultation paper, could render the R&D claim process unnecessarily burdensome, with the rewards in no way compensating for the hurdles that need to be overcome.

The Consultation Paper also proposes that the list of activities excluded from being core activities also be excluded from being supporting activities. We strongly disagree with this proposal. R&D projects are diverse in nature and require a range of interconnecting activities to see the completion of the project. To prescribe the type of activities that are accepted as contributing to the success of an R&D project is likely to have an adverse detrimental effect on the conduct of R&D in Australia, and will add an additional layer of complexity to a system, the design of which is intended (but not delivering) to produce simplified transparent results to the overall success of the project and will ultimately produce net benefits to the Australian community.

***Question 6: How should the new R&D tax incentive treat software R&D?***

#### ***Background***

The multiple sale requirement was inserted in 1988 as a means to ensure that the broader community was able to benefit directly from software advancements when the use of computers and software was relatively new. At the time, a number of basic programming techniques could be utilised to produce new, yet simple and rudimentary programs akin to simple spreadsheets. While potentially satisfying the innovation requirement of eligible R&D activities, the relative merit of such advancements in respect of the broader community was considered to be low, and hence outside the then goals of the R&D legislation.

While the use of computers and software in the late 1980s and early 1990s was confined to relatively small segments of the community (and therefore did not presumably have a significant application to the wider community), the computer has now become a ubiquitous part of business life. Indeed, failing to use computers to at least a small degree to provide a conduit to potential customers and to manage the affairs of the business poses the potential to lead to the rapid demise of a business. Computers and software have now become an essential part of business competitiveness, efficiency and performance.

Advancements in computer software are occurring at an exponential rate. Hand-in-hand with this advancement is the increasing complexities and risks associated with the use and development of software. Identity fraud and general software security, particularly in the online environment, are presenting ever increasing commercial threats. In order to ensure consumer confidence and reduce the ongoing costs associated with software security issues, continued R&D in the software engineering field is essential.

The question must be asked, why should R&D involving the development of software be subject to specific eligibility rules? Consider a manufacturer that develops a physical asset that will be used by the manufacturer to produce goods which are sold to consumers. The asset is not licensed or sold to consumers and will only provide direct benefits to the company. Technological advancements and IP developed during the development of the asset will, no doubt, be closely protected and guarded, limiting any direct flow on to consumers. The commercial exploitation of the asset will be limited to the production of goods.

Compare this with technological advancements made by a bank in developing a secure and fast online banking system. The software development in this case will not be “licensed” to customers of the bank for use of the software. However the software is the backbone to the bank’s service offering to its customers and potentially provides an online banking experience with enhanced security. This enables the bank to “sell” banking services to customers. The software is the key to bank’s ability to deliver banking products to existing and potential customers. This situation should not be distinguished from the company that uses a physical asset for internal purposes to manufacture goods.

To ensure productive advancements in software engineering and development continues, access to the R&D tax concession for software development should be on a level playing field with all other eligible R&D activities and not subject to archaic and now arbitrary restrictions such as the multiple sale criteria.

#### *Comments on comparison with UK model*

At paragraph 76 of the Consultation Paper, Treasury suggests that the UK model be considered as a starting point for change. However, we are of the view that the validity and usefulness of the UK model is somewhat questionable. We believe that the eligibility of the activities listed at paragraphs 76 and 77 of the Consultation Paper are able to be assessed using the principles contained in the existing R&D legislation, namely, whether the activities involve innovation or high levels of technical risk.

In addition, the examples of ineligible activities under the UK scheme at paragraph 76 are also able to be disqualified pursuant to the current R&D legislation, on the basis that the activities do not involve innovation or high levels of technical risk:

Description of activity that is ineligible under UK legislation	Comment
The handling of interactions with users (for example the development of user interfaces and development of data entry procedures)	On their face, these activities do not appear to contain innovation or a high level of technical risk. These activities appear to be cosmetic in nature and do not evidence innovation or high levels of technical risk. However, it should be noted that this view does not accord with principles contained in the Frascati Manual (as listed at paragraph 4.1.2 of the Guide to the R&D Tax Concession), which is touted as being (or should be) the cornerstone of the Australian R&D tax concession system.
Using standard methods of encryption, security verification and data integrity testing	Using standard methods would not satisfy the requirements of either innovation or technical risk. Furthermore, these activities have been suggested by Innovation Australia in its Guide to the R&D Tax Concession to not be eligible R&D activities (paragraph 4.1.6) under the current R&D concession
The creation of websites or software using tools designed for that purpose	For a project to qualify, activities undertaken must involve innovation or high levels of technical risk. Using standard techniques and tools would (not under the current legislative requirements), contain the requisite level of innovation or high levels of technical risk. Such a view in respect of this example ineligible activity is expressed in the Guide to the R&D Tax Concession at paragraph 4.1.6

Description of activity that is ineligible under UK legislation	Comment
Creating software that replicates an established paper procedure. The fact that a previously manual task has been automated does not in itself make it R&D	Automation itself should not be ruled out as being an eligible R&D activity. Automation is a key driver for international competitiveness. Many “hardware” projects (i.e. non software related projects) are focused on automating manual processes. Consider the car industry in which the majority of a car is now assembled using automated robots. Should this activity be excluded on the basis that it is merely automation of existing manual processes? Clearly it should not. The question needs to be asked whether there were innovation or high levels of technical risk in the activities undertaken to develop the automated processes.

Paragraph 77 of the Consultation Paper lists a number of activities that would be considered to be eligible under the UK system. The focus of the R&D tax credit should not be whether a software R&D activity is a listed activity but whether the activity involved innovation or high levels of technical risk.

Activities that would be considered to be eligible under the UK system	Comment
Developing new operating systems or language	Clearly there would be innovation or high levels of technical risk contained in the activities to develop a new operating system or language. Paragraph 4.1.2 of the Guide to the R&D Tax Concession also suggests that this type of activity is eligible pursuant to concepts contained in the Frascati Manual and also pursuant to the current definitions of eligible R&D activities contained in the R&D legislation.
Create new search engines using materially new search methods	The development of a materially new search method would contain innovation or high levels of technical risk. Paragraph 4.1.2 of the Guide to the R&D Tax Concession also suggests that this type of activity is eligible pursuant to concepts contained in the Frascati Manual and also pursuant to the current definitions of eligible R&D activities contained in the legislation.
Resolving conflicts within hardware or software, where the existence of a problem area and the absence of a known solution have been documented	This example, demonstrates the existence of technical risk through the lack of a known solution and innovation that may be required to overcome the current technical inadequacies to address the known problem
Creating new or more efficient algorithms whose improvements depends of previously untried techniques	The development of algorithms have for some time been a cornerstone example of innovation and high levels of technical risk as espoused by Innovation Australia and its prior incarnations. The view that these activities are eligible under the current scheme is also expressed in paragraph 4.1.2 of the Guide to the R&D Tax Concession.
Creating new encryption or security techniques that do not follow established methodologies	Development of improved technologies would satisfy the requirement of innovation and also contain, arguably, high levels of technical risk. Such technologies are vital to ensure data integrity and identity protection. Financial institutions invest significant resources in development of improved security techniques. However, such expenditure would be ineligible on the basis that the software developed would fail most the multiple sale criteria as such advancements are backend and rarely seen by the end user. It appears, however, that there is an opinion such activities should not be excluded

In our view there does not need to be an additional layer of criteria to limit or clarify the eligibility of software R&D. The current principles of innovation and high levels of technical risk are more than sufficient to categorise software development activities as either eligible or ineligible R&D activities.

#### *Comments on Example 3 in the Consultation Paper*

Example 3 of Attachment A in the Consultation Paper uses an example which focuses on the cost of the development of a software project (ie \$15 million over 4 years), rather than the eligibility of the activities undertaken. In assessing the merit or eligibility of a project, we do not believe this is the correct approach. If the project is largely customisation and/or integration of existing systems, the comments made should focus on the fact that the customisation and integration activities would fail the innovation and technical risk tests, rather than the \$15 million cost of such activities. In addition, as described, the activities would also most likely fail the directly related activity test. This is due to the fact that, in accordance with current provisions, customisation or integration of software is an activity that would likely fail to be a directly related activity as the customisation

and, potentially, integration would not impact the technical success or otherwise of the core R&D activities. As such, whilst this example appears to be used by Treasury for dramatic effect, the eligible R&D cost associated with this project would be less than the \$15 million project cost. As such, the inclusion of Example 3 in the Consultative paper fails to demonstrate any particular issue in respect of software R&D development projects.

In terms of the level of subsidisation in respect of the project outlined in Example 3, it is difficult to draw any distinct conclusions from the facts provided in Example 3. For example, what Treasury don't take into account (or fail to note) is that the project may lead to reduced fraud or improved security. A company is not likely to invest in excess of \$15 million in a project that is not designed to produce defined returns to the company, either through reduced exposure to fraud or improved customer confidence in the services offered by the company. Furthermore, the technological advancements developed by the company's software engineers will filter through to the wider software development community through natural attrition as employees seek new opportunities or through open discussion by software developers on applicable forums or blogs. Dissemination of technical expertise in this manner is a tangible benefit derived from subsidising this project. If a balanced approach to the information provided in examples had been taken by Treasury, these benefits would have been taken into consideration when attempting to ascribe a relationship between level of subsidisation versus net benefit.

*Conclusion - software should not be subject to a separate test for eligibility*

The level of support provided to software R&D should be based on the same principles that apply to all R&D activities. That is, do the activities have innovation and/or high levels of technical risk? Are the activities directly related activities? If so, the cost of such activities should be determined using standard costing methodologies. In terms of equating the "benefit" derived from undertaking software R&D versus the cost of such activities, regard should also be taken of the economic and commercial advantages provided to the wider community/economy. For example, if a technological advancement in ecommerce security is able to reduce fraud or identify theft by a small percentage, the net benefit from such an R&D activity must also take into account the reduced cost of fraud that will arise as a result.

In summary, the eligibility of software activities should be ascertained by reference to the legislation as it applied to all categories of activity. Also, in light of the advancements made in respect of the use of R&D in everyday business operations and growing importance of e-commerce, the restriction of software to activities that satisfy multiple sale or similar requirements is no longer relevant and should be removed.