

Deloitte Touche Tohmatsu Ltd consultative submission to:

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26 October 2009

Dear Sir/Madam

Deloitte Touche Tohmatsu Ltd (Deloitte) appreciates the opportunity given by the Australian Department of Treasury (Treasury) in requesting submissions on the proposed new research and development tax incentive, including feedback on the proposed changes from the current R&D tax concession program.

Deloitte supports this initiative of implementing a simplified tax credit, to be introduced from 1 July 2010, to provide a broad-based incentive to Australian businesses conducting research and development, but we have provided below our comments on the implications of the specific principles set out in the "New research and development incentive - consultation paper, September 2009" (the Paper). We have also provided feedback on the questions proposed by Treasury in the Paper for the Government's consideration when developing draft legislation to implement the new incentive.

We look forward to taking part in the continued consultation process on the new research and development tax incentive.

Please contact Serg Duchini on (03) 9671 7376 or Jason Crawford on (02) 9322 3805 if you require further information or clarification

Yours sincerely



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The new research and development tax incentive consultation paper



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Background

Deloitte Touche Tohmatsu Ltd (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 & Incentives team in Australia is part of the Global Deloitte R&D network, which has over 450 partners and staff who help clients to claim incentives for R&D activities. In Australia, we have over 40 partners and staff from a variety of backgrounds, from law and accounting to engineering, assisting Australian companies with understanding and claiming the R&D tax concession and R&D tax offset.

Our clients range from start-ups conducting cutting-edge research to some of Australia's top ASX-listed companies, covering all industries and sectors. Deloitte has polled our R&D clients on a number of the core principles and questions posed in the paper. We have included the questions and the client responses in this submission where appropriate.

Executive summary

We welcome the opportunity to make a submission on the proposals contained in the Treasury Consultation paper issued on 18 September 2009 on the "The new research and development tax incentive"(the paper).

Our recommendations on the proposals are summarised below.

Principle 1

Eligibility for the new R&D tax incentive should be extended to unit trusts and discretionary trusts to reflect the broad-based nature of the incentive and a broader cross section of legal and operational structures employed by small to medium-sized enterprises.

Question 1

R&D activities undertaken overseas by eligible entities should not be subject to advance registration. Where any resultant intellectual property is effectively owned in Australia by the claimant company and exploited for the benefit of the Australian economy, the proportion of eligible overseas R&D activities eligible for the R&D tax credit should be greater than 10%.

Principle 2

We agree with the replacement of the current concessional deduction with a new tax credit. The R&D tax credit should be "creditable" against the same Federal taxes as the refundable R&D tax credit. The R&D tax credit should not be a debit to the franking account.

Principle 3

We support the proposal to introduce a refundable R&D tax credit. We also agree with the removal of the eligible expenditure thresholds for the refundable tax credit and recommend aligning the payment of the R&D tax credit with the Business Activity Statement lodgement cycle. The refundable R&D tax credit should not be a debit to the franking account.

Question 2

Expenditure currently deductible at 100% should be eligible for the R&D tax credit. This should extend to the refundable R&D tax credit. This will reduce complexity and administration costs.

We propose the current core technology provisions dealing with non-deductible core technology expenditure be amended to allow for any non-deducted core technology expenditure to be eligible under the uniform capital allowance provisions.

Question 3

No comment.

Principle 4

The new R&D tax incentive should remain under a self assessment regime. Furthermore, all aspects of the claim process, including overseas R&D expenditure assessment, should in the first instance be carried out by the claimant. We also recommend that the joint administrative model be continued. We recommend that to provide clarification and so reduce the complexity of R&D claims, it would be highly beneficial for Innovation Australia to prepare and publish industry-specific guides similar to those used in Canada for the Canadian tax concession. Additional guidance about the nature of the activities that are considered eligible for the tax credit will facilitate improved compliance and administration of the incentive.

We submit all entities within a tax consolidated group should be able to register eligible R&D activity on a single Application form.

Principle 5

The guiding principles of “additionality” and “spill over”, while good public policy principles should not be included as a legislative requirement for the tax credit, nor should they be included in an objects clause.

It serves no purpose to include such concepts in the tax credit legislation, and to do so will lead to unnecessary confusion and the perception that these concepts may need to be satisfied at the activity or claimant level.

Principle 6

The definition of “core R&D” should not be amended to require evidence of both innovation “and” high levels of technical risk. To mandate the requirement that both innovation and high levels of technical risk exist at the activity level will be counterproductive to the intention of the incentive to encourage R&D, particularly at the SME level.

There is no international precedent for mandating both innovation and high levels of technical risk to satisfy the definition of eligible “core” R&D activities. The introduction of this dual requirement will result in the Australian definition of “core” R&D activities being one of the most stringent technical and effective definitions globally, adversely affecting companies conducting R&D locally, hindering the Government’s goal of ensuring Australia remains economically competitive in level of business R&D being conducted.

Principle 7

We welcome the continuing recognition of supporting R&D activities and expenditures under the new R&D tax incentive. Research and development activities that are undertaken in a commercial or industrial context are necessarily underpinned by a range of supporting activities that enable the core R&D activity to occur. The key is to ensure sufficient and commensurate connection with the core R&D activity, so that the subsidy under the R&D tax incentive scheme is warranted and appropriate. We have significant concerns, however, with the current proposals to provide a framework of identifying and then limiting the eligibility of supporting activities in the consultation document.

Each proposal in the paper assumes that claimants can readily identify and appropriately attribute expenditure to “core” and “supporting activity”. Our experience indicates that this is not the case. When such an exercise is required under audit activity, the limitations of financial systems, the necessary blending of activity and cost between supporting and “core” that this process demands is often very time-consuming, costly and subjective.

Question 4

We have provided an analysis of each option for consideration, including a discussion of the likely industry and administrative effects of each proposal.

Question 5

We do not support the proposal to amend or extend the current list of activities considered core R&D activities.

Question 6

We support repealing the multiple sale criteria for software R&D. We believe software R&D should be considered under the same legislative criteria as all other R&D activities, and recommend using the Frascati Manual definition for software R&D as a broad-based definition for eligible software R&D activity as a source of guidance for activities likely to be considered R&D.

Access to the incentive

Principle 1 – The new R&D tax incentive will be available to companies incorporated in Australia for R&D conducted in Australia. Location of IP ownership of the resulting IP will not be relevant.

The current R&D tax concession allows companies incorporated in Australia and public trading trusts to register for and access the concession. The current proposals continue to preclude certain business structures from eligibility.

We recommend that eligibility for the R&D tax credit extend to unit trusts and discretionary trusts that undertake eligible R&D activities. The refundable R&D tax credit is directed at entities with group turnover of less than \$20 million a year. Many businesses in this market segmentation operate via a trust structure. The current restriction to Australian incorporated companies will impose a practical restriction on the number of Australian businesses that can access the benefit. It will also introduce the requirement for incorporation, bringing with it additional compliance costs and administration together with a range of other tax consequences.

The inclusion of trusts as an eligible business structure for accessing the new R&D tax incentive also recognises that many large/established businesses, particularly in the property and construction sectors, operate using unit trust structures and would also be eligible for the new tax credit.

We support the proposal to remove the location of legal and effective ownership of resulting IP as an eligibility criterion for the R&D tax credit. The requirement that R&D be conducted in Australia by eligible registered entities brings us into line with 24 countries globally that have selected location as a core requirement of eligibility. The current requirement of both effective ownership of IP and location of activity was unduly restrictive.

We submit that consideration should be given to expanding the eligibility and breadth of activities and expenditures necessarily undertaken overseas, to reflect the reality that in certain industries it is not possible to conduct certain activities in Australia. The current processes for advance registration of overseas activities could provide the objective criteria for determining when overseas activities will be eligible for inclusion. The current process of advance registration should, however, be replaced with self assessment criteria. This is discussed further under Question 1 below.

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

We believe that the general rule should be relaxed in two ways.

Firstly, we believe that the new R&D tax credit should adapt the current R&D tax concession program, under s39EC of the *IR&D Act 1986*, in allowing companies to claim project eligible expenditure on overseas R&D activities related to a larger R&D project conducted in Australia. In many industries, the means to conduct a full program of R&D activities that will eventually meet a technical project objective is severely constrained by the level of resources available in Australia. For example, many clinical trials, required to validate the development of new drug/compound, require a suitable sample size of patients afflicted with the target condition to produce statistically significant data. The Australian population may be too small to provide enough patients for a trial, which means this work must be done overseas. Likewise, in the case of electronics manufacturers, semiconductor manufacturing facilities, particularly those suited to the prototyping of new semiconductors, are largely unavailable for general development work, whereas mature semiconductor production facilities are readily available offshore.

We propose that the cap on eligible expenditure incurred on R&D activities undertaken overseas be raised to 25%, and that the resulting IP developed through this work should be required to be located in Australia, to minimise the risk of purely foreign-owned and conducted R&D being claimed under the Australian R&D tax credit.

Further, consideration should be given to removing any limits on the nature or quantum of eligible R&D activities undertaken overseas, where the claimant satisfies the key requirements of validating that the activities could not be undertaken in Australia and retaining ownership of the relevant IP and exploiting that IP to the benefit of the Australian economy. This approach reflects the reality that some R&D must be undertaken globally by Australian companies for a range of valid reasons, and that the current system discriminates against this activity. Providing support for the R&D on this basis will provide ‘spillovers’ to Australia in the form of increased intellectual capacity, as well as the exploitation of the results the R&D.

The current requirement to certify overseas R&D activities before they are undertaken should be abolished and replaced with the same self assessment regime as R&D undertaken in Australia. The 39EC/ED process often hinders the progress of the relevant R&D project by introducing unnecessary complexity to the claim process for companies and administration by the Government.

The new R&D tax credits

Principle 2 – The Standard R&D tax credit will be available at a rate of 40 % for eligible R&D expenditure and can be carried forward when a company’s income tax liability is zero.

We agree with the abolishment of the concessional deduction provided by the current program and the introduction of a 40% R&D tax credit. This decouples the benefit from the corporate tax rate, providing certainty to companies about the quantum of the incentive. We also support the ability for these credits to be carried forward when a company’s income tax liability is zero, as the credit will still provide an incentive for large companies that may be in tax losses to conduct R&D. We submit, however, that the tax credit should be “creditable” against other Federal tax debts including GST, FBT and PAYG, just as the refundable 45% tax credit is applied against similar taxes.

The 40% R&D tax credit should not be a debit to the franking account under Division 205-30 of the *Income Tax Assessment Act 1997*. This will enhance the permanent value of the R&D tax credit and provide additional incentive to invest in R&D activities in Australia.

Principle 3 – The Refundable R&D tax credit will be available to companies with a turnover of less than \$20 million at a rate of 45% for eligible R&D expenditure.

We agree with the abolishment of the concessional deduction provided by the current program, and the introduction of a 45% refundable R&D tax credit. We support the increase in the permanent benefit being provided to SMEs in doubling the effective after tax benefit from 7.5% to 15%. Moreover, increasing the R&D group turnover test to \$20 million will enhance the impact of the concession, as a more significant number of SMEs are more likely to respond to this fiscal support.

We strongly support the removal of the cap on eligible R&D expenditure that applies to the R&D tax offset, as this was counter to the overall aim of the R&D tax concession/offset program; to increase investment in R&D without companies being concerned about losing the entitlement to monetise the value of the concession as a source of funding.

We recommend aligning the payment of the R&D tax credit with the Business Activity Statement lodgement cycle to improve the timing of access to the 45% R&D tax credit. This will further enhance its effectiveness in supporting SMEs investing in R&D.

The 45% refundable R&D tax credit should not be a debit to the franking account under Division 205-30 of the *Income Tax Assessment Act 1997*. This will enhance the permanent value of the R&D tax credit and provide additional incentive to invest in R&D activities in Australia.

Question 2 – How should the new R&D tax incentive treat R&D expenditure that is currently deductible at 100 percent?

We believe that R&D expenditure now deductible at 100% should remain deductible at 100% for the 40% R&D tax credit.

In the case of the 45% refundable tax credit, no permanent benefit would be monetised on this class of expenditure; however a timing benefit would be obtained by monetising the loss as a source of funding for further R&D. In this case, expenditure deductible at 100% would be eligible for a refundable tax credit of 30%, in effect only awarding a timing benefit to this expenditure.

We also support a technical amendment to the treatment of non-deductible core technology expenditure, which would allow the non-deducted expenditure to be claimed under the uniform capital allowance provisions. At present the non deductible core technology expenditure is not deductible under any other provision of the legislation once the relevant program of R&D is completed

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

No comment.

Administration

Principle 4 – Legislation for the new R&D tax incentive will provide for support for the scheme’s efficient and effective administration.

We support the proposal for a continuing self-assessment regime, under which claimants will continue to self assess their eligibility to register for the R&D tax credit and calculate their entitlements. As a benefit provision, the new research and development incentive should be able to be claimed without significantly encumbering claimants with administrative requirements. We also agree with the continuance of the joint administration model, with Innovation Australia registering self-assessed claims and making a formal assessment about the eligibility of R&D activity as required, with the Australian Taxation Office administering the provision of the tax benefit through corporate tax returns, and also ensuring the correct calculation of eligible expenditure.

We believe that administration of the concession will be greatly enhanced if Innovation Australia issues improved guidance on an industry basis to assist with an understanding of the breadth and operation of the new R&D tax incentive. It is recommended that reference be made to the Canadian model, which provides detailed guidance on industry-specific issues associated with their R&D tax credit program.

To reduce the administrative burden on claimants that conduct R&D within a tax consolidated group, we recommend that a single Application for registration of R&D Activities, or its new form, be sufficient for registering the R&D activities of an entire tax consolidated group.

Eligible R&D activity

Principle 5 – 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 – benefits that are shared by other firms and the community – that are large relative to the associated subsidy.*

The guiding principles of “additionality” and “spill over”, which may resonate as good public policy design, should not be included as a legislative requirement for the R&D tax credit, nor should they be included in an objects clause.

It serves no purpose to include such concepts in the R&D tax credit legislation, and to do so will lead to unnecessary confusion and the perception that these concepts may need to be satisfied at the activity or claimant level.

The chorus of concern raised during the consultation process on the likely uncertainty in administration that these principles will create if they are enshrined in the R&D tax credit legislation must be considered.

Core R&D

Principle 6 – Eligible R&D activity will be defined as systematic, investigative and experimental activity that:

- (a) involves both innovation and high levels of technical risk; and*
- (b) is for the purpose of producing new knowledge or improvements.*

We strongly oppose the rewording of the definition of “core R&D” activity to include the “and” test.

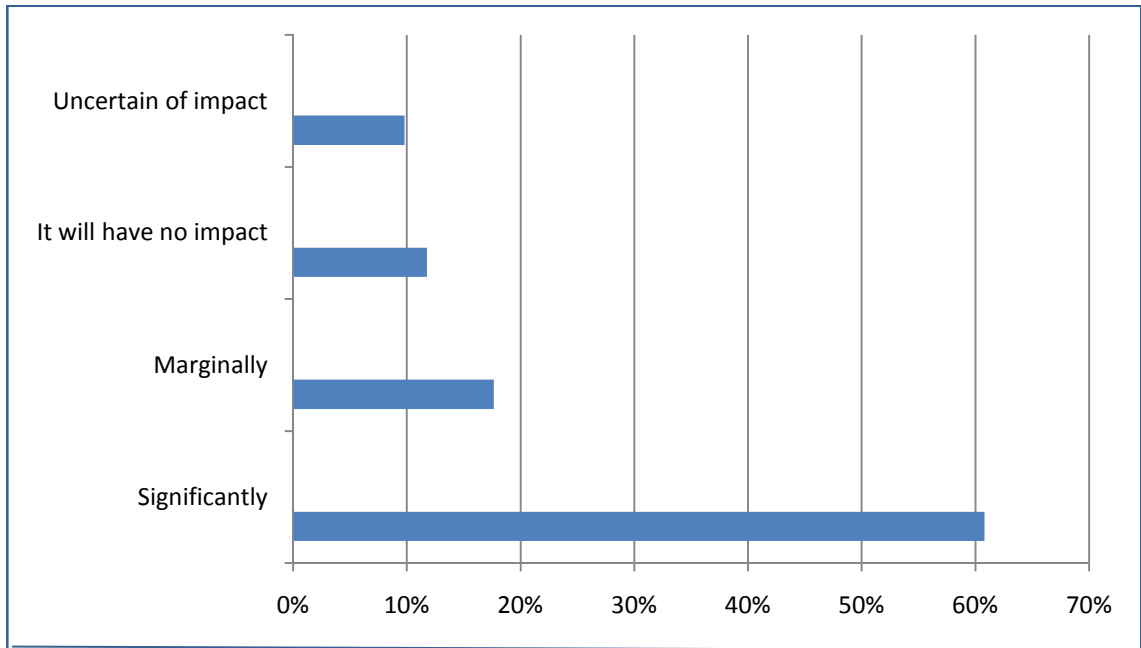
The definition of “core R&D” should not be amended to require evidence of both innovation “and” high levels of technical risk. To mandate the requirement that both innovation and high levels of technical risk exist at the activity level will significantly reduce the number of claimant entities and projects claimed under the new incentive.

The current definition of core R&D allows companies conducting activities that evidence *either* innovation or a high level of technical risk to claim the R&D tax concession. The requirement to evidence both these will preclude a significant number of projects from being claimed under the new research and development incentive. Activities having to satisfy both will significantly minimise the pool of eligible activities, meaning that for many firms, the administrative costs involved in claiming will far outweigh any tax saving provided.

There is no evidence or authority for the assertions made in paragraphs 52 to 54 of the paper that activities reflecting only innovation or high levels of technical risk have a lesser impact on either additionality or spillover benefits. This legislative amendment to the definition of “core” R&D activity has been put forward in the past and been the subject of considerable debate and analysis. In 2001, the Senate Economics Committee when considering this legislative amendment as part of the *Taxation Laws Amendment (research and Development) Bill 2001* failed to support this amendment on the basis that it would be unnecessarily restrictive. We submit that nothing has changed to make this option more valid as part of the new R&D tax incentive.

Deloitte recently polled 50 of our R&D clients, covering the spectrum from small private companies to top ASX listed companies, and representing a broad cross-section of industry, from major mining companies and construction and property firms through to biotechnology companies. We asked them a number of questions, the first being the likely impact on their entitlement to claim the concession if the current “or” test was replaced by “and” as set out in the paper.

The results were:



This result strongly confirms that current claimants of the R&D concession believe the proposed change will have a significant negative impact on the breadth of activities eligible for the concession.

Definition of core R&D in other jurisdictions

There is no international precedent for mandating both innovation and high levels of technical risk to satisfy the definition of eligible “core” R&D activities. The concept of innovation “and” technical risk is not part of the Frascati definition, as detailed in paragraphs 2.3.1 of the manual and alluded to in paragraph 55 of the paper.

The introduction of this dual requirement will result in the Australian definition of “core” R&D activities being one of the most stringent technical and effective definitions globally.

We have undertaken a review of the core definitions of R&D activity across a number of countries using Deloitte’s Global R&D tax and Incentives network, and refute the assertion in the white paper that adopting an “and” test is in accordance with the Frascati Manual and better aligns Australia with the rest of the world.

US definition of R&D

The US definition of eligibility of activities to qualify as R&D does not focus on ‘innovation and technical risk’ but requires that activities must be:

- Focused towards the development of a new or improved business component
- Technological in nature
- Address a technical uncertainty encountered at the outset of an endeavour and
- Involve a process of experimentation.

UK definition of R&D

The UK definition does not focus on ‘innovation and technical risk’ as such but requires there to be:

A “project”, that seeks to “achieve an advance in science or technology”, through the resolution of scientific or technological uncertainty.

Both of these definitions align closely with that in the Frascati Manual.

Asia-Pacific definitions of R&D

Throughout the Asia Pacific region, different countries have various definitions of R&D, including:

China

The definition of technical activities considered eligible for R&D tax incentives include those in certain high-technology areas as defined by the Government, and activities for the purposes of obtaining science and technical knowledge, application of new knowledge and substantial improvement of new technology, products and services.

Japan

Japan is currently reviewing its R&D incentives program, however under the existing incentives, R&D is taken to mean experimental and research work undertaken in order to manufacture products or improve, design/formulate, or invent techniques.

Singapore

Eligible R&D activity in Singapore is defined as “any systematic, investigative and experimental study that involves novelty *or* technical risk carried out in the field of science or technology with the object of acquiring new knowledge or using the results of the study for the production or improvement of materials, devices, products, produce, or processes”.

Malaysia

In Malaysia, eligible R&D activity is defined as “any systematic or intensive study carried out in the field of science or technology with the objective of using the results of the study for the production or improvement of materials, devices, products, produce or processes but does not include:

- Quality control of products or routine testing of materials, devices, products or produce
- Research in the social sciences or humanities
- Routine data collection
- Efficiency surveys or management studies
- Market research or sales promotion”.

Thailand

In Thailand eligible R&D activity qualifies if it exhibits the following characteristics:

- Basic industry research, which means a research or study to discover new knowledge to benefit the development of the new products, processes or services or to make progress to existing products, processes or services.
- Applied research, which means the change of outcomes of basic industry research into work plan in order to change, modify or create the products, processes or services either for sale or own use. It also includes model inventions that cannot be used for commercial purpose, conceptual formulation and design of products, processes or various forms of services, and the preliminary demonstration or pilot project in condition that such project cannot be modified or used for industrial or commercial purpose. However, applied research shall not include the ordinary change or change over period of time of the products, production system, production process, provision of services or other ongoing activities even if such changes may cause a process.

New Zealand

For the purposes of the New Zealand R&D Tax Credit, R&D activities must be systematic, investigative and experimental. They must either seek to resolve scientific or technological uncertainty *or* involve an appreciable element of novelty and be directed at acquiring new knowledge or creating new or improved products or processes.

From these definitions, we can see that the inclusion of an “and” test in the definition of core R&D for the purposes of the new R&D tax incentive would provide a much stricter eligibility threshold for companies conducting R&D in Australia and wishing to claim these as part of the program.

Our strong recommendation would be leave the current definition of “core R&D” as is, because it is clearly understood by industry, advisers, the administrators and regulators alike.

An adequate case for change has not been made by in the paper, and to do so as proposed will be unduly restrictive, be counter to the objective of the regime of supporting business expenditure in R&D and introduce uncertainty.

Supporting R&D

Principle 7 – Supporting R&D will continue to be recognised under the new R&D tax incentive but claims will be subject to new limitations.

It is welcomed that supporting R&D activities and expenditures will continue to be recognised under the new R&D tax incentive. Research and development activities that are undertaken in a commercial and/or industrial context are necessarily underpinned by a range of supporting activities that enable the core R&D activity to occur. The key is to ensure sufficient and commensurate connection with the core R&D activity, so that subsidy by the R&D tax incentive is warranted and appropriate. We have significant concerns, however, with the current proposals to provide for a framework of identifying and then limiting the eligibility of supporting activities in the consultation document.

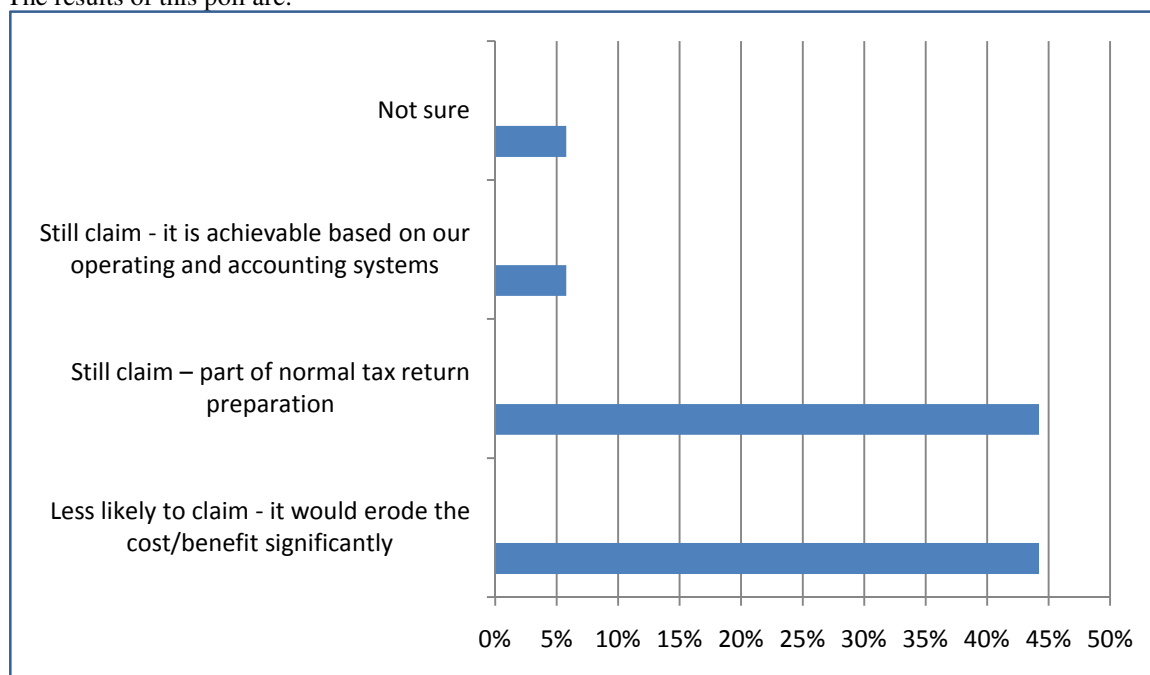
While the Government has indicated some concerns about “whole of mine” and “large scale engineering” claims being made (without pointing to specific examples of inappropriate activities or expenditures to validate these assertions), the current proposed measures to curb the inclusion of supporting activities and associated expenditure will dramatically affect the R&D claims made in all industries.

Each proposal for restricting the eligibility of supporting activities and expenditures in the paper assumes that claimants can readily identify and appropriately attribute expenditure to “core” and “supporting activity”. Our experience indicates that this is not the case. When such an exercise is required under audit activity, for example, given the limitation of financial systems, the necessary blending of activities and costs between supporting and “core”, this process is often very time consuming, costly, and subjective.

The proposed requirement to delineate between core and supporting activities will introduce an additional cost and administrative burden on all claimants, which we submit is unwarranted and will not deliver meaningful outcomes in program delivery and administration.

Deloitte polled our clients on the impact on their willingness to make a claim for the concession if they are required to split a project into core and supporting activities and attribute expenditure to this classification as part of the claim process.

The results of this poll are:



Our clients confirm our practical experience in this matter; that the imposition of a classification of core and supporting R&D activities is one that fails to reflect the reality of R&D undertaken in a commercial and industrial environment where project activities are necessarily blended, that supporting activities are key enablers of the overall project objective, accounting systems are not adequate to allocate or attribute cost on this basis, and most attribution will be subjective and be necessarily based on a range of assumptions.

Question 4 – 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 only a lower rate of assistance than core R&D?

(f) If so, what would the appropriate rate be?

- (a) We do not support the introduction of a cap on the level of supporting activity expenditure as a proportion of core R&D activity expenditure, as this is a very poor and simplistic policy option.

In keeping with the intent of the incentive, companies should be encouraged to spend increasing amounts on both core and supporting R&D, rather than being limited. The notion of capping, while one of the easiest methods of limiting supporting R&D expenditure, will have varying effects across different sectors, creating a skewing effect that goes against the broad-based equitable nature of an R&D incentive.

Any cap referenced to a fixed dollar amount, % of core R&D expenditure or direct R&D salary and wage expenditure is likely to introduce a range of unintended consequences, including industry bias, R&D life cycle bias and “safe harbour” behaviour.

- (b) It is usual for companies to undertake a range of R&D activities in production or commercial facilities. This is a practical necessity of commercial R&D and underpins the economic and commercial feasibility of many projects. For example, within the construction industry, companies will conduct R&D alongside general construction activities – it is simply not commercial to develop a pilot plant/building for the purposes of developing and validating a concept, when this work could instead be conducted as part of a broader project

A sole purpose test would preclude the majority of companies from claiming R&D expenditure incurred on activity that, while supporting, is intrinsically necessary to achieve a core technical objective. This method of defining supporting activity would favour start up companies, where a larger percentage of business focus may be on R&D compared with commercial production activity, while larger companies and industries such as property and construction or manufacturing for example, that use existing processes as a platform for development and validation would be severely limited in the supporting activities that could be claimed.

- (c) As above, the exclusion of dual role or production activities would preclude the eligibility of supporting activities and expenditure incurred in the course carrying out R&D activities in a commercial/industrial context. It is well understood that R&D is often undertaken by claimants in commercial or production facilities. A blanket exclusion of supporting activities for R&D undertaken in this context is a blunt policy response that will unfairly and disproportionately affect certain market sectors, such as the manufacturing sector and energy and resources sector, where much of the R&D is undertaken in developing new and improved products and processes.

We suggest that a better outcome may be achieved if a concept of “experimental production” or “experimental development” that is necessarily undertaken in a commercial or production environment set the basis for eligibility of directly related supporting R&D activities and expenditures.

Precedent for these concepts exists in the Canadian R&D tax credit and there is considerable guidance in Application Policy SR&ED 2002-02R2.

The Canadian system allows claimants to include activities and expenditures incurred in experimental production and/or experimental development that are undertaken in conjunction with or simultaneously with commercial production. The concept would be to allow those supporting activities that are directly related to and commensurate with supporting the experimental production or development. In this context it is up to the claimant to determine independently, based on the technical considerations and evidence relevant to the specific trial or activity. It allows for direct support work, labour of employees undertaking the activity, supervising or supporting the activity, specific engineering or design work, materials consumed or transformed in the process, operational research, data collection, and testing that is commensurate with the resolution of the stated technical objective.

- (d) The current feedstock provision is effective in dealing the direct activities, costs and revenues attributable to an R&D trial. The proposal to extend the basket of activities and costs to be included in this calculation and subject to recoupment as set out in paragraphs 67 to 69 of the paper needs to be very carefully considered.

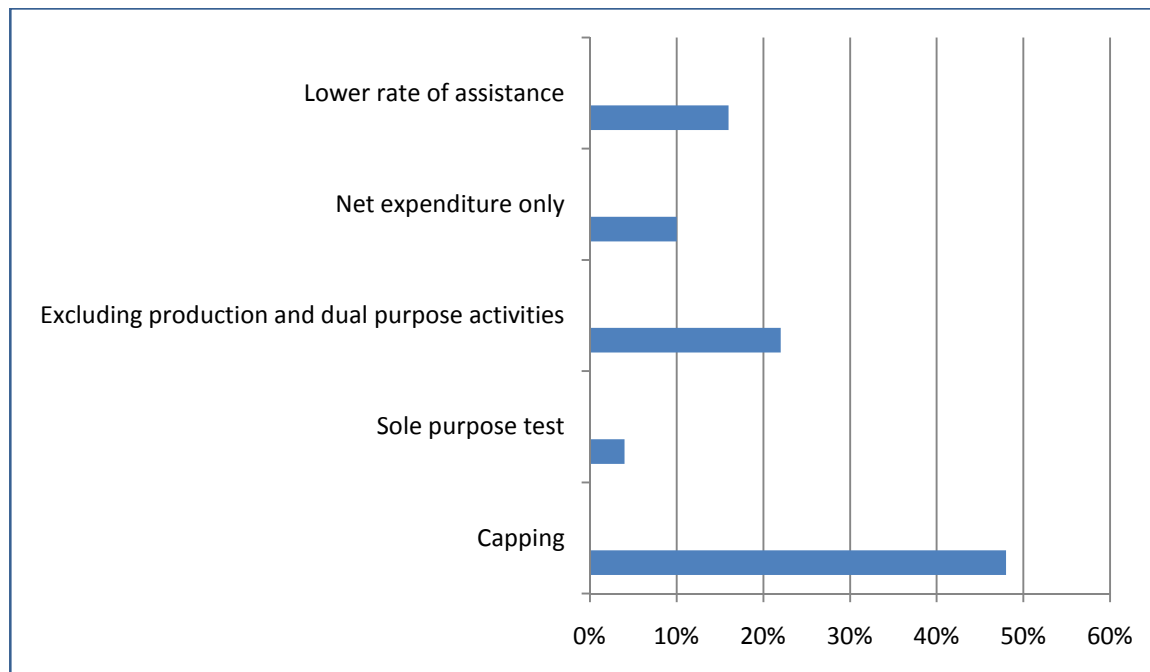
Recoupment rules do exist in other jurisdictions, however our review indicates that these rules to limit the recoupment do not extend to the costs of labour and other supporting expenditures incurred in the R&D activity. This current proposal would result in one of the most restrictive treatments internationally.

The ability to claim expenditure related to supporting activities on a net expenditure basis will introduce uncertainty and complexity for companies in the planning stages of R&D projects. As many companies hope to on-sell the results of R&D at a profit, this would obviate a large proportion of the expected incentive being received if a program of R&D activities was to prove successful, with companies only receiving the “full” incentive in the case of failure. This seems to be counterintuitive to the aims of the new incentive, particularly when looking at spillover benefits – all R&D, whether successful or not, should receive the same incentive for its conduct.

This proposal presents difficulties in calculation, as any revenue derived from the results of R&D may be received years after a claim is made and will require relevant claw back provisions to be drafted. Uncertainty also exists for many companies about whether they will in fact receive consideration for their R&D activities. This proposal also has a bias against contract-based firms, such as those in the property and construction sector, specialist manufacturing, food processing, energy and resources and engineering/technical consultancies that are developing R&D on their own behalf, but hope to eventually on-sell a developed asset or intellectual property.

- (e) We do not support the proposal to benefit supporting activities at a lower rate. A lower rate of assistance will increase the compliance and administrative burden for all claimants, in effect requiring two sets of eligible expenditure calculations to be undertaken for each claim. The provision of a lower rate of assistance would create a perverse incentive to claimants to categorise supporting activities as core to receive a greater tax benefit, ultimately increasing the compliance effort required to administer this aspect of the claim. It is poor policy.

We polled our Deloitte clients on this proposal, seeking input on the question that if a “limiting mechanism” on supporting activities was to be introduced, how it could be made straight forward to apply to their business. The following response was obtained:



This question is directed at the practical administration of the proposals, asking our clients to select the option that would be the easiest to implement within their existing claim processes. This is distinct from their selection of the preferred option with regards to the overall effectiveness of this aspect of the incentive by our sample group.

Excluded activities

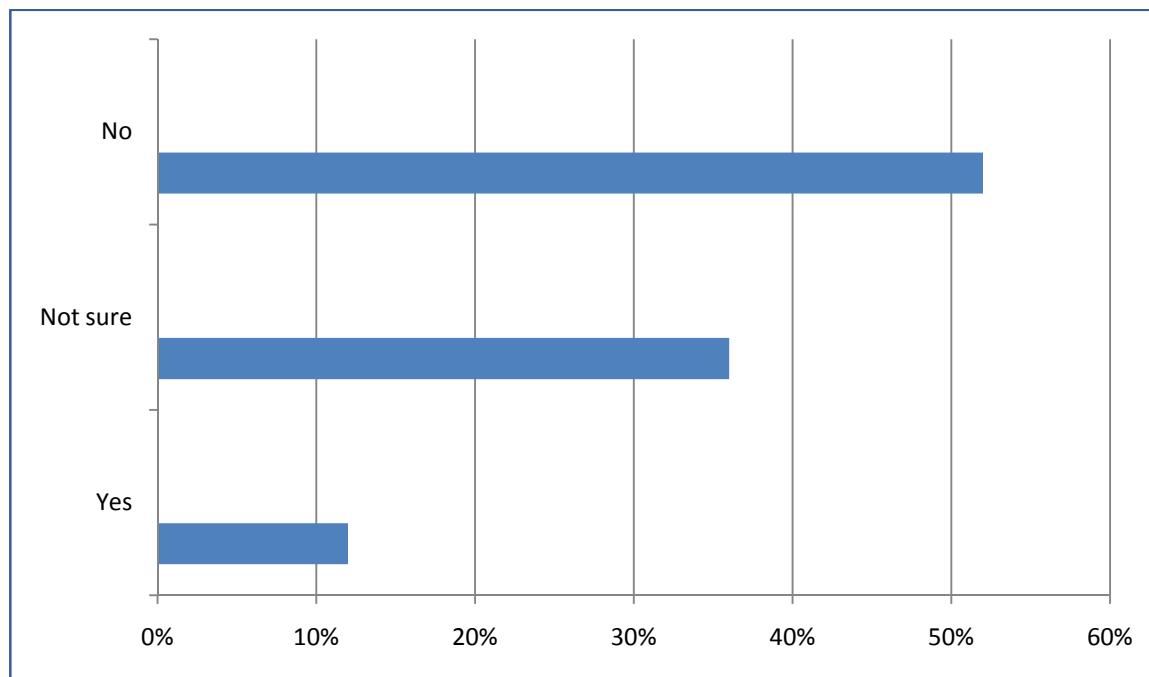
Question 5 – Should the current list of activities excluded from being considered core R&D be:

- (a) amended in any way?*
- (b) extended to exclude certain activities from being considered supporting activities?*

We strongly oppose any additions to the current list of activities excluded from being considered core R&D, and also oppose changing the current treatment of these activities from eligible supporting activities to ruling these out as eligible activities altogether.

The complete exclusion of certain activities listed in s73B(2C) of the ITAA 1936 from being considered eligible activity makes significant assumptions about the R&D activity being undertaken by industry, where certain activities simply must be undertaken to develop and validate a concept. These potential exclusions will not take into account the evolution of technology, and hence R&D over time – activities that may not be considered a necessary aspect of any R&D project now may become so as research and development activities change over time - as has happened with software R&D activities since the R&D tax concession was first legislated.

We asked our clients if the current treatment of excluded activities should be extended to cover supporting R&D activities. Their response was:



Software R&D

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

We recommend that software R&D should be subject to the same R&D definition as all other R&D activity.

We support the removal of the multiple sale criterion, as this does not reflect the evolution and role software R&D plays in a modern, open economy. We concur with the observation in the Frascati manual that software development has become a major intangible innovation activity with a high R&D content with advances in computing leading to innovation in service activities and products. The introduction of legislation specifically targeting software R&D would introduce unwarranted legislative distortion, greater complexity and additional administrative burden.

We recommend the guidance in the Frascati manual, together with industry consultation, set the framework for practical Innovation Australia guidelines on software R&D. Precedent can be drawn from both the UK and Canadian administrations.

The Frascati manual acknowledges that:

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

Furthermore, technological advances in software R&D are generally incremental rather than revolutionary, and as such the guidance should reflect this commercial reality.

More specifically, the manual provides the following examples that “illustrate what would be considered R&D in software:

- *R&D producing new theorems and algorithms in the field of theoretical computer science.*
- *Development of information technology at the level of operating systems, programming languages, data management, communications software and software development tools.*
- *Development of Internet technology.*
- *Research into methods of designing, developing, deploying or maintaining software.*
- *Software development that produces advances in generic approaches for capturing, transmitting, storing, retrieving, manipulating or displaying information.*
- *Experimental development aimed at filling technology knowledge gaps as necessary to develop a software programme or system.*
- *R&D on software tools or technologies in specialised areas of computing (image processing, geographic data presentation, character recognition, artificial intelligence and other areas)”.*¹

Other considerations

Unlimited review

Under section 170(10A) of the ITAA 1936, the ATO has an unlimited amendment period for R&D claims. For many companies, this ability for the ATO to amend their claims at any given point in the future presents substantial uncertainty for positions reflected in accounts, and means they lack security about having received the incentive for R&D performed.

We recommend that the amendment period for the purposes of the R&D tax credit aligns with the existing statutory amendment period for corporate tax.

“At risk” provisions (73CA)

By way of background, s73CA of the ITAA 1936 (Guaranteed returns to investors) was an amendment to the original R&D tax concession legislation to counter the basis for certain syndicated R&D arrangement contrary to the overall policy intent of the R&D tax concession.

It has recently been raised by the ATO that 73CA may also apply to more traditional R&D arrangements, such as the undertaking of R&D in contractual arrangements whereby the party conducting R&D may indeed be entitled to consideration for said R&D work indirectly, e.g. through the sale of a development, etc. This is despite the Explanatory Memorandum for the original legislation covering this section stating that companies should not be considered “not at risk” under the conduct of “normal commercial transactions”.

Should 73CA in its current or a modified form be included in the legislation implementing the new R&D tax credit, its inclusion would counter the overall intent of the scheme to support both R&D and its eventual commercialisation, through sale/licensing or otherwise, of its results, as companies that would receive consideration in return for the results may be precluded from claiming the credit on the relevant expenditure incurred.

Moreover, the inclusion of legislation with a similar intent to 73CA would create further confusion in allowing companies to self assess their eligibility to claim the R&D tax credit, depending on project arrangements.

We recommend that the redrafting and inclusion of the “on own behalf” rules, as per paragraph 31- 34 of the Paper, should provide certainty that the incentive is claimed by the company that bears the financial risk of the conduct of eligible R&D activities, with any further legislation which would instead unduly restrict successful companies from claiming where they may receive consideration for R&D undertaken at some time in the future.

¹ 2.4.1 Identifying R&D in software development – p.46 *OECD Frascati Manual 2002*

Accounting treatment of the new R&D tax credit

In drafting the new legislation to implement the R&D tax credit, we would propose that Treasury bears in mind the “above the line” impact of any tax credit, in accordance with broader accounting regulations. We support the current consultation with relevant stakeholders to determine if both the 40% R&D credit and 45% refundable credit can be designed to provide an above the line impact.

R&D plans

Currently, new claimants to the R&D tax concession may be precluded from claiming relevant R&D activity for a previous financial year due to the lack of R&D Plans being put in place prospectively, despite satisfying all other eligibility criteria, because of the retrospective nature of claim.

With the Government intending to increase the number of SME claimants under the new incentive, and in light of the resource constraints faced by many of these companies, we recommend transitional measures be introduced to provide for first year SME claimants, with an option to comply with the R&D plan requirements from the second year of registration.

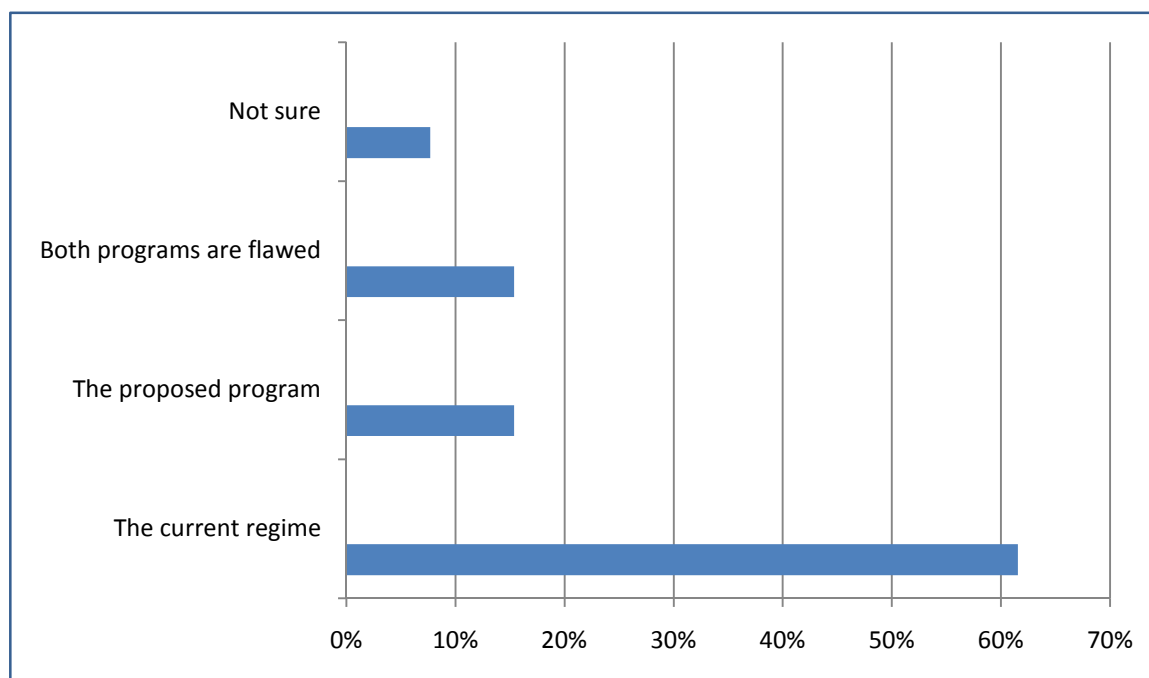
Conclusion

The proposed R&D tax credit should remain an incentive to Australian businesses to increase R&D spend, and provide ongoing support to those companies already seeking assistance under the R&D tax concession. The effectiveness and efficiency of this support would be significantly diminished if many of the proposed options are implemented, in particular the inclusion of the “and” core R&D test, as well as stated options for restricting supporting R&D activities.

We recommend that case for change to the definition of “core” R&D activities has not been made by the Paper, and we strongly suggest the current definition of core R&D activities remains unchanged.

The current definition of core R&D activities is well founded on the principles set out in the Frasacti manual, on which many of the other R&D tax incentives available globally are based. The definition is well known to industry, claimants, advisers and administrators, and has delivered substantial outcomes in supporting business expenditure in R&D in Australia.

For the new R&D tax credit to operate effectively and efficiently, the compliance burden on companies must be reduced, and the application and calculation process must reflect how companies operate, rather than imposing an extra level of burden to access what is ultimately a benefit provision. This is reflected in the response we received from our clients, when asked to decide, when comparing the existing R&D tax concession in its entirety, and the proposed new R&D tax credit in its entirety, about which scheme they would prefer. The response was overwhelming:



This result indicates, even with a possible increase in net tax benefit to companies (the implication of removing the 175% premium having to be taken into account), along with the option of cashing out credits for more companies, the majority of our clients polled would prefer that the existing incentive stay in place. This ultimately counters the Government’s intention, with the proposed new incentive, to encourage expenditure on R&D in Australia by offering a simplified, broad-based tax incentive.