



**Tax**  
147 Collins Street  
Melbourne Vic 3000  
  
GPO Box 2291U  
Melbourne Vic 3001  
Australia

ABN: 51 194 660 183  
Telephone: +61 3 9288 5555  
Facsimile: +61 3 9288 6666  
DX: 30824 Melbourne  
www.kpmg.com.au

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

Our ref ED Submission  
Letter\_10876001\_1(Admin) (2).DOC  
Contact David H Gelb (+61 (3) 9288 6160)

Email: rdtaxcredit@treasury.gov.au

5 February 2010

Dear Sir

## **The New Research and Development Tax Incentive - Exposure Draft Legislation and Explanatory Materials**

Please find enclosed KPMG's submission in respect of the Research and Development (R&D) Tax Incentive - Exposure Draft Legislation and Explanatory Materials released on 18 December 2009.

We welcome the opportunity to comment on the proposed legislation and endorse the policy vision announced with the release of the Exposure Draft that the R&D tax credit "is about boosting investment in research and development, supporting jobs and strengthening Australian companies as they continue to seize new opportunities during the economic recovery".

Unfortunately, we are concerned that the legislation, as drafted will not achieve this policy goal. In particular our submission considers the cumulative impact of the following key issues:

- Significant restrictions to the definition of R&D activities.
- The wholesale exclusion of computer software development activities and other activities
- The penalising of successful R&D with the introduction of new 'feedstock' rules and the expenditure 'not at risk' provision.
- The inability of Australian companies to access the R&D credit in respect of R&D activities undertaken for related foreign companies.

We also note that the proposed legislation is highly complex and will place an undue administrative burden on companies, particularly small and medium sized businesses.



***The Treasury***  
*The New Research and Development Tax Incentive -  
Exposure Draft Legislation and Explanatory Materials*  
5 February 2010

We would be pleased to work with you to redraft the legislation in a manner which will enable the Government's stated policy to be achieved.

Yours faithfully

A handwritten signature in black ink, appearing to read 'David H Gelb', written over a horizontal line.

David H Gelb  
Partner

cc:  
Tony Weber  
Martin Jacobs



# R&D Tax Credit Exposure Draft Legislation

KPMG submission

TAX

# Contents

Executive Summary	3
1 R&D Activities	6
1.1 “Core” R&D Activities	6
1.2 Supporting R&D Activities	7
1.3 Excluded Activities: Other than Computer Software	8
1.4 Excluded Activities: Computer Software	9
2 Entitlement to Tax Offset	13
2.1 “On own behalf” rules	13
2.2 On behalf of foreign residents	14
2.3 Reduction for ‘Feedstock’: Augmented feedstock rule	15
3 Integrity rules: Expenditure not at risk	17
4 Entities	19
4.1 Excluded “entities”	19
4.2 Corporate Trustees – Other than of Public Trading Trusts	19
4.3 Tax exempt entities	19
5 Other matters	20
5.1 Unlimited amendment	20
5.2 Imputation	20
5.3 Further clarification needed	20



# Executive Summary

## Policy Framework

The new Research and Development Tax Credit was part of a package of measures outlined by Government as its innovation agenda for Australia over the next decade in Powering Ideas: An Innovation Agenda for the 21st Century.

In heralding that document, the Minister for industry Innovation Science and Research, Senator the Hon Kim Carr acknowledged that:

*"Innovation is vital to accelerating economic recovery in the short term and opening up new pathways to prosperity in the long term."*

*Innovation can help us create a better Australia – a fairer, richer and greener nation that is equipped to meet the challenges and grasp the opportunities of the 21st century. It can give us new industries, high-wage jobs, safer communities, and a better quality of life."*

*Investing in innovation today is critical to addressing the collapse in productivity growth over the last decade, keeping our existing industries competitive and nurturing emerging industries based on new technologies"*

Moreover, that package of measures was expressly said to be designed "...to **boost business innovation**", purportedly, as part of:

***"...a vision for a national innovation system in 2020 in which...businesses of all sizes and in all sectors embrace innovation as the pathway to greater competitiveness, supported by government policies that minimize barriers and maximize opportunities for the commercialization of new ideas and new technologies."***

As a statement of "vision" and of the aspirations for Australia in moving into the next decade, it receives our strongest and most whole-hearted endorsement.

However, if the new Research and Development Tax Credit, as incorporated in the currently released Exposure Draft legislation ("ED") was intended to provide one of the cornerstones for promoting that vision and those aspirations, it will prove to be a major disappointment and a most regrettable lost opportunity.

The net impact of the package of new measures in fact represents a significant retrograde step in the promotion and encouragement of the nation's commercial and industrial R&D effort, where the greatest "spill-over" benefits from technological innovation have been and would have continued to emerge. Regrettably, it will therefore see the erosion of Australia's international competitiveness, as it starts to lag behind most countries in the developed and rapidly emerging markets of our region and globally.



## Legislation and policy contradiction on business R&D

### The policy focus

There are a number of key provisions which seem to be quite deliberately designed and very specifically targeted to deny the credit for commercial and industrial research and development in direct contrast to the Government's express policy focus of *"building innovation capacity and performance at the enterprise level"*.

It might also not be coincidental in this regard, that whilst this very same policy had been given specific statutory recognition in the current Act [section 73B(1AAA)] since at least 2001, referring as it does, for example, to: *"creating an environment that is conducive to increased commercialisation of new processes and product technologies developed by eligible companies"*, such expressions of policy are now notably excluded from the *"Object"* clause of the Exposure Draft legislation (section 355-5). If the ED is not a deliberate reversal of the Government's earlier espoused policy, it is difficult to reconcile some of its measures.

### Some significant anomalies

#### Substantial narrowing of the definition of R&D activities

Whilst some tightening of the R&D definition was foreshadowed in *Powering Ideas*, industry was not expecting the wholesale changes made to the definition. This has resulted in a definition which is not focussed on industrial, experimental development but on academic research, and one which is not in line with accepted international definitions of R&D.

The exclusion of specific activities from both core and supporting R&D activities fails to clarify the new definition. The assumption these exclusions make is that R&D is undertaken in a laboratory in isolation from a company's operations. This could not be further from the truth. Experimental development requires vital input from the 'factory floor' if it is to be successful. If the definition of R&D activities is satisfied, then this should be sufficient.

#### Software development

In this modern technological age, one of the most significant of the measures proposed has to be the extensive carve-out from the credit for high risk and innovative applied software development.

Senator Kim Carr, Minister for Innovation, Industry, Science and Research, recently praised the Information and Communication Technology (ICT) industry, stating that "ICTs greatly enhance the productivity and innovative capacity of nearly all other industries, in particular those of financial services, resources, energy, manufacturing, health, education and entertainment. ICTs are continually transforming the way all industry sectors collect, analyse, distribute and exchange information"<sup>1</sup>.

It is not clear how any Government today could adopt a 'tax incentive', which excludes applied software development, as a cornerstone of an innovation policy for encouraging: *"businesses of all sizes and in all sectors embrace innovation as the pathway to greater competitiveness [and]...maximize opportunities for the commercialization of new ideas and new technologies"*.

The notion is simply paradoxical when applied developments in software are so endemic and absolutely integral to virtually all scientific, industrial and commercial advancements in today's society and are very often one of the most important technological keys to attaining competitive advantage.

Equally inexplicable then, is how a 20-year old statutory "multiple sale" pre-requisite, unique to Australia and widely acknowledged in the Government's own reviews as having totally outlived its relevance, is not only maintained but considerably strengthened and extended.

---

<sup>1</sup> ICT Industry Factsheet, 11 January 2010

### Anti-commercialisation provisions

The proposed “anti-commercialisation” provisions, inexplicably seek to deny the credit for successful R&D but would continue to reward failed R&D.

In this regard, there is the retention of a so-called integrity measure interpreted to deny the credit for R&D expenditure, where there might be reasonable prospects of later commercialisation. In addition, a new provision, under the guise of a ‘feedstock’ rule, then purports to clawback the credit, not just for the input cost of materials comprising part of the output of an R&D process (i.e. ‘feedstock’), but for the entire cost of the actual R&D activities themselves, but only if the success of those activities is reflected in the value created and not if the R&D is a commercial failure.

### Activities on behalf of related foreign residents

Whilst *Powering Ideas* indicated that international companies that hold their intellectual property offshore would be able to access the R&D tax credit, in reality the legislation, as drafted, will not allow such access. The cumulative effect of the ‘on own behalf’, ‘expenditure not at risk’ and ‘augmented feedstock’ rules will ensure that any Australian company undertaking R&D activities in Australia for a related foreign resident will be unable to claim the tax credit for those activities.

## A “less complex and more predictable R&D tax credit”?

Whilst there is no question that the removal of the incremental expenditure or ‘premium’ rules will materially reduce complexity and improve predictability (in addition to achieving a significant revenue cost saving for the Government), proposed changes to the definition of R&D activities, including 18 statutory exclusions, as well as the credit reduction provisions and some of the integrity rules, including those we alluded to, above will just create unwarranted new complexity and uncertainty.

Whilst the rate of benefit available has been increased, the cumulative impact of the proposed changes on genuine R&D activities is such that, based on our assessment, could lead to an overall reduction of more than 50% of claims.

We have no doubt that these measures will result in lost opportunities for investment in R&D in Australia.

# 1 R&D Activities

The definition for R&D activities, which has been in use in Australia since 1985, has been widely understood by industry and largely adopted in recent times by Singapore and New Zealand. Whilst the Government foreshadowed in *Powering Ideas* that there was a need to tighten this definition, particularly in light of the increase in the rate, the wholesale changes made have come as a surprise to industry.

Indeed, industry's clear preference would be for a lower rate and continuity of a well established R&D regime.

The modifications of every component of the definition of R&D activities will lead to increased uncertainty as to whether activities which currently satisfy the existing definition will continue to be eligible under the proposed criteria. Examples of the difficulties likely to arise in respect of the interpretation of the proposed definition are provided below.

## 1.1 "Core" R&D Activities

### 1.1.1 "Considerable novelty AND high levels of technical risk"

KPMG submit that the change to a cumulative test of "considerable novelty and high levels of technical risk":

- Is unwarranted and unnecessary;
- Has not been satisfactorily rationalized and, therefore, justified;
- Will create substantial practical uncertainty for innovative taxpayers in determining what activities will qualify for the credit; and
- Will leave Australia at odds with international practice and at a marked disadvantage at a time of increasing tax competition for highly mobile global R&D expenditure.

Practical uncertainty will come from including "considerable novelty" as a discrete and additional qualifying criterion because the requirement that the experimental activities must involve some degree of **novelty** is, by definition, already covered by those activities having to be "conducted for the purpose of acquiring **new** knowledge or information".

The word "novel" simply means "previously unknown" (Oxford Concise Australian Dictionary) and therefore "acquiring **new** knowledge or information" means acquiring 'previously unknown' knowledge or information (i.e. knowledge or information which is novel).

Moreover, the Explanatory Materials ("EM") appear to confirm that "novelty" and "technical risk" are also essentially interrelated concepts:

*"Technical risk exists when knowledge of whether something is scientifically possible or technologically feasible, or how to achieve it in practice, is not readily available or deducible by a competent professional working in the field"* [EM paragraph 2.25]



In addition, the incremental requirement for a “**considerable**” degree of novelty is also accommodated from the activities having to involve the requisite “**high levels** of technical risk”.

The EM, again, supports this view:

*“The degree of novelty needs to be considerable, rather than a mere logical progression from existing knowledge...Novel activities, therefore, go beyond something that can be readily implemented without significant risk.” [Paragraphs 2.22 & 2.23]*

Accordingly, it would follow that:

- experimental activities,
- conducted for the purpose of acquiring **new** knowledge or information AND
- involving high levels of technical risk,

will, by definition, involve “considerable novelty”.

Therefore, to insert “considerable novelty” as a discrete, incremental statutory requirement is not only unnecessary but, of more concern, fundamentally confusing for taxpayers to establish the eligibility of their R&D activities as ‘core’, despite having demonstrated pursuit of new knowledge or information and high technical risk in ESI activities.

Finally, we strongly believe that a cornerstone objective of Australia’s R&D incentive should be to encourage R&D activities within Australia in order to, amongst other things, make eligible enterprises internationally competitive.

Whilst it had been hoped that the modifications arising from the consultation process would have brought Australia more into line with international norms, it appears that the EDs modification and narrowing of the definition of R&D is likely to have an adverse impact on encouraging investment in R&D in Australia. In today’s global economy, companies can choose to undertake R&D under more advantageous regimes elsewhere and the ED, in its current form, would certainly appear to be a step in the wrong direction in this regard.

### 1.1.2 Purpose of knowledge and information (PKI) test

The modification of the purpose test from either acquiring new knowledge or creating new or improved materials, products, devices, processes or services to that solely of acquiring new knowledge appears to be a transition away from industrial, experimental development to academic research. This re-focus appears to be on the basis that greater ‘spillover’ results from the creation of knowledge than from the application of that knowledge. Evidence of this assertion has not been provided. Arguably, Australian society benefits from the successful application of knowledge by business through the creation of new or improved products or processes.

## 1.2 Supporting R&D Activities

### 1.2.1 Dominant purpose of supporting core R&D activities

The substitution of directly related with dominant purpose seeks to further narrow the definition of R&D activities. The EM specifically states that this removes the previously used criteria that supporting activities are necessary to conduct the core R&D activities.

The need to distinguish between core and supporting activities adds an unnecessary layer of complexity to the R&D tax credit. Where an activity is undertaken for both R&D and another purpose it will be difficult to differentiate. However, it is reasonably straightforward to determine if the activity was necessary for the conduct of the R&D, e.g. if it was required to enable testing activities to be conducted.

There is a commercial reality which is not contemplated with the concept of dominant purpose. With limited resources, businesses will often undertake tasks for more than one purpose to maximize their return. In particular, small and medium sized companies do not have the luxury to undertake R&D activities in isolation from their operational activities.

The dominant test focuses on pure research typically seen in a university setting, where production trials are far less common, and research is done in isolation. During the course of industrial R&D it is imperative to gauge the limitations

or needs of the production environment. The dominant purpose concept does not allow for the commercial and R&D realities that companies operate under and in fact, penalizes good business practice.

### 1.3 Excluded Activities: Other than Computer Software

KPMG submits that the specific statutory exclusions in sub-section 355-35(2) of the ED are unwarranted given that:

- a) a those activities qualifying as “core” activities under that definition are specifically calculated to promote the underlying policy of “spillover” and “additionality” benefits for the broader good of Australian society; and
- b) “supporting” activities have been properly circumscribed so as to promote core activities without, at the same time, opening the ‘floodgates’ to claims which would effectively “cross-subsidise normal production activities that would occur in the absence of the core R&D activities”.

In other words, if any of the specified activities in that subsection strictly qualified as core or supporting R&D activities in the circumstances of any given case, there would be very compelling policy grounds for them qualifying for the credit, in the absence of any overriding or overarching policy considerations to the contrary.

The fact is that no such overriding or overarching policy has been articulated as would justify any arbitrary and unprincipled exclusion of any of those activities, if they otherwise conformed to the strict definitional requirements of core or support activities.

Whilst the EM states that *“the list ... serves to simplify the R&D tax incentive by clarifying that certain activities would not meet the tests for R&D activities”*, this only begs the question as to why they do not meet the criteria for core or supporting activities – a question which is not addressed, leaving the exclusions without apparent justification.

If any or all of the listed activities fail to meet the strict definitional requirements of R&D activities, they will not qualify for the credit and the list is rendered entirely redundant. However, whether any or all of those activities do in fact meet those definitional requirements, should properly be left to be determined on the facts of any individual case, and not pre-empted in any arbitrary statutory list of exclusions.

That is, if the change to the definition of R&D to include innovation and high levels of technical risk represents the original policy intent of the tax credit, then this change alone should be sufficient to restrict government support to those eligible R&D activities. If so, all activity necessary to pursue those projects – supporting or core – should receive equal support.

#### 1.3.1 Some specific exclusions

The following selection of exclusions from the statutory list in sub-section 335-35(2) are provided merely as examples of how further facts and circumstances in any given case could and should determine the eligibility of certain activities as core or supporting under a strict application of those definitions but which could, inappropriately, be denied the credit on a broad interpretation of the specific exclusionary provision if it was to be maintained without greater clarification.

Moreover, a blanket exclusion in this specific instance could be particularly damaging to the overall integrity of the credit, given that most R&D sought to be encouraged and promoted in order to achieve the requisite ‘spillover’ benefits is R&D in an applied commercial or industrial context.

##### **Exploration activities [paragraph {c}]**

Activities that could qualify as core or supporting R&D activities under the definitions may include the development of novel/experimental drilling techniques where it can be demonstrated that the dominant purpose of some exploration activities undertaken is to test that new technique.

##### **Pre-production activities [paragraph {h}]**

Demonstration of commercial viability, tooling up and trial runs can often be core or supporting R&D activities and not, predominantly, normal production-related. For example:

For mass produced items the creation of a single item or prototype is not sufficient to prove the technical viability of that item. In order for such items to be recognised as viable it is necessary to demonstrate that key performance criteria have been satisfied over the full extent of specified manufacturing conditions. These include but are not restricted to the following:

- Functional performance of the item
- Key technical attributes of the item remain within specified ranges (e.g. Dimensions, composition, rheological attributes, taste, texture)
- Wastage levels associated with the manufacture of those items remain within a pre-determined range
- Efficiency of manufacturing processes remain within pre-determined ranges

In order to determine that these key performance criteria have been satisfied, extended experimental runs are often required. Any commercial benefit derived from these experimental runs is accounted for via the existing feedstock rules.

### **Compliance with statutory requirements [paragraph {}]**

The development of technology to respond to the challenges of climate change, is just one example of critical technology which will be fundamentally developed and assessed against evolving standards and compliance benchmarks.

There are also a number of manufacturing industries that by their nature are highly regulated. This is often driven by concerns over public safety. An example of such an industry would be the electrical equipment industry. Equipment such as power transformers are a critical component of key infrastructure and therefore any improvements to their design or performance must be demonstrated to satisfy a number of standards, before they can be released into the market. Prototypes are constructed and then must be tested using a series of routine test procedures that have been specified within associated standards. Some tests require the destructive testing of the prototype or may lead to the destruction of the prototype if the prototype is inadequately designed for its intended purpose.

We would propose that whilst the test methods may be routine in nature and are prescribed via standards they are still a requirement of the research and development process and consequently should be considered an eligible experimental activity.

### **1.3.2 Recommendation**

That in order to really promote clarity in relation to the whole scheme and practical operation of the Division, sub-section 355-35(2) should be removed. Guidelines in respect of these types of activities which may ordinarily not satisfy the definition of R&D activities should be provided.

## **1.4 Excluded Activities: Computer Software**

KPMG submit that the commentary in the Consultation Paper as to the “outdated” nature of the multiple sale test led industry and practice alike to expect revised rules in keeping with the endemic nature of software development across all industry sectors. As a result, the further narrowing of eligibility for such expenditure in the ED was not only surprising but extremely disappointing.

This disappointment was compounded by a lack of any rationalisation for such tightening of the rules in the EM accompanying the ED or in any public commentary accompanying its release.

The key issues identified in the Government’s own Consultation Paper (“CP”) as demanding reform in this regard, included the need to:

- reduce the current level of legislative complexity and
- remove the anachronistic “multiple sale” test.

*“The Government acknowledges the treatment of software R&D is a complex area.” [CP paragraph 74] and*

*“The multiple sales test was intended to limit the government assistance for software R&D to claims where a firm sold the software that was produced, effectively excluding support for in-house software development.*

*However, it is important to note that when the multiple sale provisions were put into place some 20 years ago, the extent of development of e-commerce was not fully appreciated. The Government now considers that the current multiple sales test has become an outdated articulation of policy intent as it relates to software.” [CP paragraphs 75 & 76]*

In this regard, the Government will have received overwhelming support from stakeholders.

However, it would appear that in contrast to its previously stated position and at odds with the “stakeholder” submissions on this issue, in particular, in response to paragraph 74 of the Consultation Paper, the ED has not only retained but has materially strengthened the multiple sales test for eligible software development and, in doing so, has also considerably increased its complexity.

This, therefore, also calls into question the Government will meet it’s commitment to:

*“...[a] new R&D incentive [which] will be more effective in delivering support for business R&D and in targeting that support to where it is most likely to produce net-benefits for the Australian community.” [CP paragraph 8]*

It is also particularly noteworthy that, in its EM, the Government does not attempt to rationalize its position in relation to software R&D in terms of its overarching policy framework of *“delivering support for business R&D and in targeting that support to where it is most likely to produce net-benefits for the Australian community.”*

The absolutely endemic nature of software development in virtually all aspects of global scientific, technological, industrial and commercial endeavour, the fact that it is one of the single most important contributors to achieving competitive advantage in today’s open and global marketplace, and the fact that capital support for R&D in this strategically critical area is so internationally mobile, make these specific legislative proposals counterproductive to Australia’s national interest.

New technological innovations have led to higher productivity and faster development of information and knowledge in Australia’s major industries, including:

<b>Automotive</b>	<ul style="list-style-type: none"> <li>• The high-performance computing (HPC) technologies developed by the ICT sector act as an invaluable tool in helping the automotive industry push the boundaries of automotive engineering, design and development. They are also helping reduce speed to market, predict and prevent defects, automate complex and arcane systems and gather real-time information from vehicles on the road.</li> <li>• Information technologies also play an increasing role in accelerating today's supply chains. Most legacy systems, such as homegrown material resource planning (MRP) systems, impede rapid material and information flow. Transaction-based, enterprise resource planning (ERP) systems have provided a step forward as they automate the principal functions of the manufacturing process.</li> </ul>
<b>Healthcare</b>	<ul style="list-style-type: none"> <li>• The adoption of technology in the health sector has been heavily embraced in the areas of investigations and surgery. According to data gathered for the World Health Organization, about 234 million major surgical operations are conducted every year<sup>2</sup>. That number includes over 63 million people who undergo surgery to treat traumatic injuries, 31 million for treating cancers, and another 10 million for pregnancy related complications. IT innovations have enabled us to be treated with the latest technology and most effective procedures, building on cutting edge science in physics, ICT, biotechnology and robotics, all working together.</li> <li>• The majority of the innovations currently being done in the field of ICT are focused on new imaging systems and virtual simulation.</li> </ul>

<sup>2</sup> Research & Innovation in Surgery – A Solution for European Health and Societal Challenges, pg 3

<b>Mining</b>	<ul style="list-style-type: none"> <li>• With the limited ability to influence prices, the Australian mining industry tends to concentrate on controlling its costs in order to remain competitive. As such, ICT providers assist the mining industry in improving productivity and cost reduction.</li> <li>• ICT works on product innovation and development for the mining industry in the areas of systems integration technologies, the web enablement of applications and the enrichment and quality improvement of graphical interfaces through 3D and other capabilities delivered over broadband communication systems.</li> <li>• Many small companies supplying specialised services to the mining industry are benefiting from export market opportunities for their products and services. Australia has established an international reputation in mining software and according to the Minerals Council of Australia and the Centre for International Economics (1999), supplied 60-70% of mining software worldwide.<sup>3</sup></li> </ul> <p>For example, in 2000, one of the more fascinating developments in the information technology field involved successful demonstrations by CSIRO Australia of mine modelling with Internet-based virtual reality tools. Interactive 4-D (place-time) virtual mine technologies are being developed to, inter alia, reduce mining risk in relation to both investment and safety, and win gains in productivity.</p>
<b>Banking &amp; Finance</b>	<ul style="list-style-type: none"> <li>• ICT is especially relevant in the financial industry in that it was one of the first sectors to use computer services on a large scale – taking off by about 1980 in using electronic transfer, ATMs, automatic accounting systems and other automated "back office" services to keep abreast of global markets and provide almost instantaneous services to customers. The latest contribution of ICT in this field has been internet banking and online shopping, providing superior encrypted technologies and security in place to protect transactions.</li> </ul>

We note:

1. the ED's acknowledgement that the degree of novelty and technical risk involved in software development is often "impossible to determine" (i.e. not stating that it would not otherwise meet the definition but simply stating the difficulty in its determination); and
2. the lack of any adequate rationalisation for its exclusion in the EM.

In this regard, we would submit that the government should not simply exclude software from core or supporting activities for reasons of complexity and resource requirements as the very quantum of software-related (core or supporting) R&D activity combined with Australia's divergence from international treatment would simply drive global R&D spend elsewhere.

The changes proposed are likely to result in reduced spend on cutting edge technology to enhance user experience and a reduction in technological expertise as it will be more cost effective to undertake development activities offshore.

### **"Commercial Return"**

In addition, the ED in its current form would appear to show a lack of perception as to the variety of ways in which businesses realise value from software development in R&D.

Many businesses invest heavily in software development which would otherwise be eligible for R&D but as a result of the nature of their market, provide access to the resulting intellectual property via means other than a direct licence to customers.

Overall, both large and small enterprises indicate that the business model in the ICT sector has permanently moved on from the business models applying in the recent past. The days of developing software and licensing it as a stand-alone product is very much in the minority. From SME's to the largest multinational, the paradigm is to work cooperatively with

<sup>3</sup> [http://www.dbcde.gov.au/\\_\\_data/assets/pdf\\_file/0015/20454/Mining\\_and\\_ICT.pdf](http://www.dbcde.gov.au/__data/assets/pdf_file/0015/20454/Mining_and_ICT.pdf), pg 17

customers, suppliers and subject matter experts to create innovative solutions. The rewards are more often indirect as evidenced by the variety of business models:

- Packaged software – eg single or multiple user licence, seat based licences. Sometimes the licence comes by buying the computer, other times it is provided through internet or cloud services.
- “Free-mium” business models where basic capability is provided for free but enhanced services are on a fee for service basis (eg classified advertising where the user pays for additional information or to be alerted by SMS for buying opportunities).
- Integrated software and services – the vendor provides software, support and or hardware to its customers. These are often multi-year deals where the vendor remuneration is based on formulae based on how they deliver savings in costs and performance improvements.
- Development of services where the revenue stream arises indirectly – eg the advertiser pays a fee to the developer based on the number of ‘hits’ to a website.
- Development of tools that improve the customer service experience – these are a growing source of internet enabled business opportunities – on-line health, education, product trouble-shooting etc. The provision of the internet service helps secure customer loyalty but does not give rise to direct revenue from the underlying development.

Value may just as easily be realised through reduced costs or via inclusion of the intellectual property in the provision of a fee-earning service or with the associated revenue parcelled into a differing pricing structure.



## 2 Entitlement to Tax Offset

### 2.1 “On own behalf” rules

As clarified in the EM, the requirement in the ED that:

*“Generally, an R&D entity is only entitled to a tax deduction in relation to R&D activities conducted for the entity (whether by the R&D entity for itself or by another entity for it). Also, an entity cannot deduct its expenditure on R&D activities if it conducts those activities to a significant extent for another... retains a key rule from the existing law commonly known as the ‘on own behalf’ rule.”*

The Consultation Paper correctly noted, that the purpose of the “on own behalf” rule was to prevent the duplication of claims where R&D was contracted out and this is again acknowledged in the current EM.

However, the EM, on this occasion, also raises as a further policy justification for the existing rule to continue, namely, the need to:

*“...limit eligibility for a notional deduction to where an R&D entity is the major benefactor from the expenditure it incurs on the R&D activities.”*

This policy rationale is seriously questionable. If the R&D expenditure sought to be encouraged such as would be incurred on activities within Australia and delivering all of the requisite “spillover” benefits to Australian society, why should it matter on whose behalf the expenditure is undertaken, provided there is no duplication of deductions.

We had understood this logic to extend to R&D undertaken on behalf of foreign residents (as appeared to be expressly intended in the Consultation paper), potentially obviating the additional requirements for establishing some sort of connection or affiliation with the Australian R&D entity.

Whilst the EM states that, under the new regime:

*“R&D entities will be able to claim the new R&D tax incentive for their expenditure on eligible R&D activities regardless of where the resulting intellectual property is held. ... [strengthening] the case for companies to conduct their R&D activities in Australia.”*

it is clear that, under the “on own behalf” rules, which R&D entity ends up owning the IP will remain a matter of significance, for no reason which is apparent or has been rationally explained in the EM.

## 2.2 On behalf of foreign residents

As foreshadowed in Powering Ideas, activities undertaken in Australia for a related foreign company will be eligible R&D activities. The criteria to qualify for this incentive essentially remain the same as those currently required for the International Premium Tax Concession.

However, unlike the current concession, if the Australian company is reimbursed for the R&D expenditure it incurs for the foreign related company, it may not be entitled to the R&D tax offset, due to the operation of the anti-commercialisation provisions, as the expenditure may be considered not at risk or clawed back under the augmented feedstock rule. As financial risk is a key criterion to determine if an R&D activity is undertaken for a particular company, it may be difficult to establish that the work is being undertaken for (or on behalf of) the foreign resident if that foreign resident is not bearing the cost of the R&D activities. It is not clear whether this is an intentional change or an error in drafting.

Furthermore, there may be other income tax consequences (such as transfer pricing) for Australian companies who do not price their R&D work for a related foreign party on normal commercial terms, so we cannot readily envisage circumstances where an Australian company undertaking R&D activities on behalf of a foreign related party will receive any meaningful benefit from this.

### 2.2.1 Clarification of eligibility criteria

The drafting of paragraph 355-215(e) (and the associated Note 2), should be reconsidered as to whether it achieves the intended objective.

The references to the “first entity” in sub-paragraph 355-215(e)(iii) should properly be a reference to the “other” R&D entity [the 3<sup>rd</sup> party sub-contractor referred to in sub-paragraph 355-215(d)(ii)]. This would then be consistent with paragraph 3.54 of the EM.

Similarly in Note 2, the R&D entity which has the agreement with the foreign resident cannot also conduct the R&D as a sub-contractor. That entity will be the principal contractor in any sub-contract.

In relation to R&D activities conducted for a foreign entity, the provision, generally, requires that the R&D activity be conducted in accordance with a written agreement (say, the “principal agreement”) binding on both “the” R&D entity and the foreign entity, whether the activities are ultimately conducted directly by “the” R&D entity or by a 3<sup>rd</sup> party under, effectively, a “sub-contract agreement”.

Paragraph 355-215(e) however, purports to deny the deduction, where the R&D is conducted in connection with an agreement:

- a) between “the” R&D entity (also referred to as the “first entity”) and a 3<sup>rd</sup> party (“another” R&D entity) connected or affiliated to “the” entity (therefore, necessarily a “sub-contract agreement” between the two R&D entities); and
- b) where that sub-contract agreement is for the R&D activity to be conducted either:
  - i. by “the first entity” or
  - ii. by a further entity under another agreement (a second sub-contract) to which “the first entity” is or will become a party.

However, the “first entity” will not be the party in either of those sub-contracts to conduct the activities because it is the “principal contractor” in the first of those sub-contracts. The reference to the “first entity” should be a reference to the other R&D entity (the 3<sup>rd</sup> party sub-contractor). This would then be consistent with paragraph 3.54 of the EM.

Similarly in Note 2, the R&D entity which has the agreement with the foreign resident cannot also conduct the R&D as a sub-contractor. It will be the principal contractor in any sub-contract.

## 2.3 Reduction for 'Feedstock': Augmented feedstock rule

KPMG submit that the '*augmented feedstock rule*' [EM page 19], by itself, has the potential to severely undermine or neutralize the effectiveness of the credit for all applied research and development.

The full extent to which the new feedstock rule does so, however, may yet possibly depend upon key aspects of the legislation, which remain unsettled, having yet to be finalized, including:

1. The scope of "quarantined expenditures", which will be those such as expenditure on conceptual design, considered likely to produce spillover benefits; and
2. Its application to R&D undertaken in order to enable the completion of contractual obligations (such as civil engineering projects).

We are not able to discern a rationale behind the new "feedstock" rule in the proposed legislation other than that of a cost savings measure and it would appear the measures cannot be justified with regard to other stated policies outlined in the EM.

The CP alluded to it solely as a possibility for limiting the claims for "supporting activities" [CP paragraphs 66-69]. This was supposedly because:

*"...a considerable portion of the current R&D tax concession subsidizes supporting rather than core activities"*  
[CP paragraph 57]

This was consistent with the view throughout the CP that:

*"[s]upporting activities are not the specific activities that the R&D tax incentive seeks to target. It is additional core R&D activity which is expected to provide the highest social benefit from the public investment."* [CP paragraph 70]

However, the ED makes no such distinction in relation to the augmented feedstock rule, which would extend its negative impact to core R&D activities as well, regardless of the admission in the EM that core R&D "is expected to provide the highest social benefit from the public investment". The EM expressly states that:

*"The feedstock rule applies in relation to **both** core and supporting activities."* [EM para2.55]

The only policy justification discernable from the EM, on the other hand, seems to be that this is simply a natural extension of the "feedstock" rule in the current legislation, which is said to be founded on a policy of extending the credit only for the net costs of R&D, after deducting the value of the outcomes of those activities ("outputs").

However, the current rule, as the term "feedstock" itself suggests, would negate the credit only in relation to and to the extent of the costs of any "raw material" inputs, which are processed or transformed by R&D activities and are embodied in any processed or transformed outputs of value. The current rules are limited to experimental/trial activities.

The fundamental difference, therefore, is that the current feedstock rule does not apply to the non-material costs of the actual *R&D activities*, themselves nor to the costs of laboratory development (if, for example, the output value happened to exceed the cost of those materials inputs). Whilst maintaining the term "feedstock" in relation to the new measure might be considered as cynical and calculating in order to rationalize what is now proposed, the terminology is at best misconceived and entirely inappropriate.

Accordingly, the deliberate effect of the new feedstock rule (based on this proposed new policy of qualifying "**net expenditure**") would be to deny the tax credit, not only for materials input costs but also for the costs of the actual qualifying R&D activities, themselves - core or supporting – potentially wiping out the credit for that R&D entirely, depending on the commercial value of the outputs (materials, products devices or services).

Therefore, counter-intuitively, this augmented feedstock rule will effectively 'penalize' successful R&D activities and 'reward' failed / unsuccessful R&D activities. For example, a full tax offset will be allowed for, say, the costs of developing a prototype boat, provided that the prototype doesn't work and is therefore valueless.

In essence, this measure will strike at the heart of any applied business (industrial, technological and commercial) research and development. It could be, as stated in the EM *[at paragraph 1.5]*, “the biggest reform to business innovation support for more than a decade” but for all the wrong reasons. Attempts to try to ameliorate its worst effects through specific statutory exclusions are likely to be arbitrary at best and, contrary to one of the main objects of the reform, will necessarily add unwarranted complexity for businesses wishing to avail themselves of the credit.

In relation to the illustrative examples in the EM on this point, reference is made only to “Boulevard Mining 1, as indicative of stakeholder concerns with these proposed feedstock rules. In this example, core R&D activities were identified as follows:

*“The experimental activities pertain to investigating how the truss functions as a tunnel support, rather than a cantilever roof support, in conjunction with various tunnel widths and shapes. The experiments are systematic and investigative ... [and] involve the requisite levels of novelty and technical risk. They are conducted for the purpose of acquiring new knowledge and/or improved processes and so satisfy the PKI test. They are not listed as excluded activities. Accordingly, the experimental activities constitute core R&D.”* [EM page 25]

Prima facie, therefore, according to the words of the EM, these “core R&D activities” are the very:

*“specific activities that the R&D tax incentive seeks to target. It is additional core R&D activity which is expected to provide the highest social benefit from the public investment.”* [CP paragraph 70]

However, such core R&D might still not attract all or any level of credit in this case, regardless of the high levels of risk to be assumed by the business in undertaking that particular course of experimentation and/or regardless of the intrinsic value and spillover benefits that may be associated with the new knowledge or information that could result from these same core R&D activities, no matter how “considerable”.

In some situations this rule may even result in a negative tax credit in some years where a tax credit is obtained in year one and final output is generated in year two. This proposed measure could require taxpayers to amend prior year’s returns – and would undoubtedly complicate the R&D calculation process. This appears inconsistent with the objective of simplifying and removing red tape from the R&D tax credit.

It must also be noted that the successful application of R&D generates additional taxable income and as a result the net level of offset received already reduced through the payment of tax on any income received.

The cumulative impact of the change in definition of both core and supporting R&D activities and the feedstock rule would appear to be heavy-handed. An activity must either be an experimental activity which satisfies the criteria of a core R&D activity or be undertaken for the dominant purpose of supporting core R&D activities. If, upon commencement, the activity satisfies these requirements, then its entitlement to the R&D tax credit should not be re-evaluated after completion.

# 3 Integrity rules: Expenditure not at risk

We submit that section 355-405 of the ED should be entirely removed from the final legislation as it is misconceived and is incapable of practical application without rendering the credit unworkable in most cases where R&D activities are undertaken in a commercial context.

In addition, it very specifically and directly undermines the intention to extend the credit to R&D undertaken on behalf of foreign residents, which is one instance where it is actually expected that there will be “guaranteed returns” to the R&D entity. Even the current legislation provides for a specific exclusion to the operation of section 73CA in respect of “foreign owned” R&D [see paragraph 73(14D)(a)].

Section 355-405 is effectively a regurgitation of the much criticised Section 73CA contained in the current legislation. That provision was the subject of an extensive consultative process with the ATO without stakeholders having received any response and so virtually those same submissions were also made in relation to this issue when it was again canvassed in the CP.

The fact that this provision has found itself in the latest ED, with two very short paragraphs in the EM which neither canvass any of the issues raised, nor seek to provide any policy rationale, nor offer any considered explanation or guidance as to how stakeholders might begin to apply this provision in practice on a day-to-day basis, is very disappointing. The current EM, in fact, provides less justification for this provision than the Explanatory Memorandum to the Bill which originally introduced section 73CA.

Again, for the record, section 73CA was introduced in 1990 specifically to deal with R&D claims made by companies taking advantage of the extension of the concession to “R&D syndicated arrangements” in a particular way to effectively remove all or most of the commercial risk to investors by guaranteeing them a minimum return on their expenditure.

Critically, the Explanatory Memorandum to the Bill introducing the section made it quite clear that it was **not** intended to apply to the “exploitation of the results of R&D activities on normal commercial terms”.

The relevant syndicated R&D provisions giving rise to the measure have since been repealed and therefore, this provision is now redundant. Furthermore, it is manifestly unclear as to how qualifying R&D which must inherently exhibit high levels of technical risk can involve effectively guaranteed returns, other than in clear reimbursement situations, where payment is not dependent upon the ultimate success of the R&D activity under the contract.

On the other hand, however, the Australian Taxation Office (“ATO”) has sought to interpret the section as extending to normal commercial arrangements for exploiting the R&D. Applying the section in this way risks undermining the very objectives of the credit, which expressly included “creating an environment that is conducive to increased commercialisation of new processes and product technologies...”

During 2009, the ATO released an Interpretative Decision 2009/107 (ID) which acknowledged that whilst section 73CA “could be read as extending to practically all matters, particularly given the references to any ‘circumstance’ that existed or was likely to exist”, the ATO did not take this view. If section 355-405 is retained, it should incorporate the views outlined in the abovementioned ATO ID.

Given the ‘on own behalf’ requirement has been maintained from the current concession, which includes a criterion that the claimant must bear requisite financial risk, the ‘expenditure not at risk’ provision is largely redundant.



# 4 Entities

## 4.1 Excluded “entities”

No explanation or policy rationale has been provided in response to submissions on the CP that the credit be extended beyond incorporated entities.

For example, based on the premise that innovative enterprises will benefit the Australian economy, it is difficult to rationalise a restriction of the R&D incentive to corporate entities only. Value-adding R&D is undertaken by all forms of the usual unincorporated business structures, from joint ventures to partnerships to trusts to branches.

Excluding listed property and infrastructure trusts, for example, disenfranchises the largest commercial property-owners in Australia who would be a crucial constituency to encourage to invest in R&D for the “greening” of buildings, structures and other major capital works.

## 4.2 Corporate Trustees – Other than of Public Trading Trusts

If it remains the intention to exclude corporate trustees, other than those acting as trustees of public trading trusts, we note that, as a matter of drafting, the ED legislation does not contain an excluding provision such as sub-section 73B(3) that operates currently for that purpose.

## 4.3 Tax exempt entities

KPMG welcomes the extension of the 25% ownership threshold to 50% for tax-exempt entities. This will be particularly beneficial in assisting university and other non-profit organisations’ spin-off opportunities that are limited by the current ownership caps.

# 5 Other matters

## 5.1 Unlimited amendment

KPMG welcomes the removal of the unlimited amendment of assessments in respect of the R&D tax credit and the introduction of a time limit of four years in respect of findings about a registration. We acknowledge that this will promote certainty for taxpayers in relation to their R&D activities.

## 5.2 Imputation

Unfortunately, the tax credit remains a timing benefit only to the ultimate shareholder. If a company pays less tax as a result of the R&D tax offset, it may not be able to provide fully franked dividends to its shareholders. The shortfall in tax would be borne by the shareholder.

In the case of the refundable tax credit, the debit to the franking account is merely deferred until the company commences paying income tax.

As a result the credit received, particularly by small and medium sized Australian companies, is merely a loan which will be repaid by the shareholders when profits are distributed.

## 5.3 Further clarification needed

We note that a number of areas have not been fully addressed in the ED or EM. These include:

- the clawback of Government grants;
- several aspects of the augmented feedstock provisions;
- whether R&D plans will continue to be required;
- whether overseas expenditure will be limited to a specific cap per project or company; and
- whether the R&D tax credit can be treated as 'above the line'.

Whilst many of the above relate to the administration of the program, industry would welcome guidance and clarification of these matters.



## Contact us

### **KPMG in Australia**

Melbourne  
147 Collins Street  
Melbourne Vic 3000  
Tel +61 (3) 9288 5555

Sydney  
10 Shelley Street  
Sydney NSW 2000  
Tel +61 (2) 9355 7000

[kpmg.com.au](http://kpmg.com.au)

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

© 2010 KPMG, an Australian partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. KPMG and the KPMG logo are registered trademarks of KPMG International. Liability limited by a scheme approved under Professional Standards Legislation.