

A decorative graphic on the left side of the page. It consists of a series of vertical lines of varying heights that form a triangular shape pointing to the right. From the tip of this line-based triangle, a solid yellow triangle extends diagonally upwards and to the right, filling the upper right portion of the page.

The New Research and Development Tax Incentive: Second Exposure Draft

Submission by Ernst & Young

19 April 2010

19 April 2010

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

Dear Sir/Madam

Response to “The New Research and Development Tax Incentive: Second Exposure Draft”

Ernst & Young is pleased to make this submission in response to “The New Research and Development Tax Incentive: Second Exposure Draft” regarding the proposed legislation for the new research and development (R&D) tax incentive to be introduced from 1 July 2010.

While it is pleasing to see that the second draft has addressed a number of industry concerns, there are still a number of problematic areas that are likely to lead to significant uncertainty, increased administrative burdens and a less robust system for supporting innovation.

We set out our reasoning for our submission further in the attached paper. If you would like to discuss this submission in more detail please contact me on 08 9429 2251.

Yours faithfully

A handwritten signature in black ink, appearing to read 'Rob Parsons'.

Robin Parsons
Partner

Contents

Introduction	3
<i>Object of the Division</i>	<i>3</i>
<i>Tax Incentive Should Encourage “Research AND Development”</i>	<i>3</i>
New Core R&D Activity Definition Creates Uncertainties	4
<i>Issues with the New Definition of Core R&D Activities</i>	<i>4</i>
<i>Technology Not Commercially Available – Clarification Required</i>	<i>8</i>
Dominant Purpose Test Too Restrictive	9
<i>Dominant Test Should Not Apply to Old Exclusion List</i>	<i>9</i>
<i>Alternative Approach</i>	<i>11</i>
<i>Production of Goods and Services Not Defined</i>	<i>11</i>
<i>Directly Related to Production – Examples Required</i>	<i>12</i>
Lack of Incentive for the Software Industry	13
<i>Software Core Activities R&D Exclusion</i>	<i>13</i>
<i>Developing and Primarily</i>	<i>14</i>
Administration of the R&D Tax Credit	16
<i>Enhanced Administrative Power of the Board</i>	<i>16</i>
<i>Registration Requirements – Core vs. Supporting</i>	<i>16</i>
<i>Registration Requirements – Single Entity</i>	<i>17</i>
<i>Documentation Requirements – Example of Planning Documentation and Registration Form</i>	<i>17</i>
Other Recommendations	18
<i>Grouping Provisions – 40% vs. 50%</i>	<i>18</i>
<i>Overseas Activity Cap</i>	<i>18</i>
<i>Depreciating Asset – Further clarity of key concepts needed in EM</i>	<i>19</i>
<i>Treatment of Corporate Limited Partnerships</i>	<i>19</i>
<i>Core Technology</i>	<i>19</i>
<i>More “Positive” Non-Production Resource Industry Examples</i>	<i>19</i>
<i>Other Areas to Clarify</i>	<i>20</i>
Conclusion	21

Introduction

Object of the Division

We note that the tone of the object as outlined in the second exposure draft (“ED”) at s 355-5(1) is still negative and seeks to overly restrict the purpose of the R&D tax incentive. The redrafted object does not specify support for R&D activities undertaken in Australia, and support provided to Australian businesses to achieve international competitiveness (for example by the timely conduct of their R&D projects).

The object of the existing system is written to clearly encourage and incentivise the development of innovative products, processes and services through a research and development endeavour undertaken by companies in Australia. Further to this, the existing object promotes an environment that is conducive to increased commercialisation of new processes and technologies.

The new object sets a tone of limitation through multiple layers of barriers rather than one of encouraging business to view the tax credit scheme as a mechanism that encourages business investment in innovation. It is our view that the existing R&D tax scheme’s object is better suited to match the policy and intent of the government to support innovation in Australia. To this end we would suggest that the proposed new object be reviewed and re-drafted, and should as a minimum, include references to Australia, and to the importance of international competitiveness, e.g.:

“The object of this Division is to encourage industry to **conduct R&D activities in Australia and enhance R&D activities in Australian businesses**, including activities that might not otherwise be conducted because of.....”

Tax Incentive Should Encourage “Research AND Development”

Further to our submission to the first ED and the corresponding explanatory material (“EM”), we continue to have concerns with regards to the revenue neutrality of the R&D Tax Credit incentive, and how the re-drafted legislation still fails to recognise the nexus between the nation’s productivity and business expenditure on Research and Development (“BERD”).

The new definition of “Core R&D Activities”, with strong emphasis on experimental activities, is increasingly focused on the “research” component of “R and D”. The new definition seems to leave out essential “development” activities, which bridge the gap between the research, and the application of the new knowledge generated in real-world situations.

Furthermore, the new definition creates disparities between different types of industries. It appears that the new legislation provides more support to businesses undertaking pure/basic research activities, and creates additional obstacles for particular industries (namely resources and manufacturing) to access the R&D Tax Credit incentive. This is further compounded by the application of the dominant purpose test on certain supporting activities, particularly on production and software development activities.

In the individual sections below we have highlighted fundamental issues in the second ED that should be addressed in order to alleviate potential negative impacts on BERD in Australia, and to ensure that the new R&D Tax Credit incentive fosters a culture of innovation, in line with the current government’s policy aim of increasing the number of businesses investing in R&D over time¹.

¹ Department of Innovation, Industry, Science and Research 2009 ‘Powering Ideas: An Innovation Agenda for the 21st Century’ p.6
Submission to Second Exposure Draft R&D Tax Incentive

New Core R&D Activity Definition Creates Uncertainties

Issues with the New Definition of Core R&D Activities

The Second ED has the following definition of Core R&D Activities:

“Core R&D activities are experimental activities:

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

The term “experimental activities” is a new concept that was introduced in the second draft, and it is a term that is **not** defined in the draft legislation.

Consulting the EM provides:

“The existence of core R&D depends first and foremost on establishing that an experiment (or set of related experiments) is taking place.

An experiment entails investigating causal relationship among relevant variables to test a hypothesis or determine the efficacy of something previously untried. Experiments take place in a range of settings, from a separate laboratory to an otherwise normal production run.”²

There are a number of issues associated with defining the existence of core R&D by establishing that “experimental activities” (or “an experiment” as provided by the EM) takes place.

Firstly, we would like to note that the EM’s focus on the requirement for “an experiment” with regards to the definition of core R&D activities is **inconsistent** with the ED and other parts of the EM, which use the term “experimental activities”.

Secondly, in addition to having to distinguish between core and supporting activities, the use of the term “experimental activities” (and interpretation of the term provided in the EM) requires companies to further dissect their R&D projects into a series of “experiments”. This is not in line with how businesses operate generally and will result in more inefficiency.

Thirdly, focusing on just the experimental activities deviates from the ordinary concept of R&D (currently utilised by the R&D Tax Concession scheme) that is well established and acknowledged internationally, creating uncertainties for companies currently claiming the R&D tax concession and putting Australia out of touch with the rest of the world.

² Paragraph 2.11 of the EM to the Second Exposure Draft

Lastly, limiting “core R&D activities” to only “experimental activities” may exclude activities that are the actual “core” of an R&D project: activities which are not **experimental** in nature but are crucial **development**. These activities often provide significant spill-over benefits to the greater Australian economy (for example concept design, prototype development, troubleshooting during commissioning, and feedback R&D). In doing so, the R&D Tax Credit has neglected the “development” part of “R and D”, and failed to support the R&D process as a whole - from conceptualisation to realisation.

The term “experimental activities” has been narrowly interpreted as “experiments”, as evidenced in the interpretation provided by the EM. In the past AusIndustry’s interpretation of “experimental” has deviated from experimentation as understood by industry.

Using the case studies below we will highlight how real-world small to medium businesses will be harmed by the proposed change to the definition of Core R&D Activities, specifically the emphasis on “experimental activities”.

Case Study A: Experiment vs. Experimental Activities - Example 2.4 in the EM

In relation to our first and second points above, we provide the following analysis of Example 2.4 in the EM. We believe this example, along with others in the EM, contradicts the overall thrust of the legislation and the provisions set down in the ED. In particular, paragraphs 2.12 and 2.22 of the EM states that:

“Experimental activities that qualify as core R&D will employ a systematic progression of work based on scientific principles and using an approach that proceeds from hypothesis to experiment, observation and evaluation and leads to logical conclusions. This approach is generally known as the scientific method” 2.12

“Core R&D activities will be activities that are part of the eligible experiment, rather than being merely related to it. Core R&D activities are those that lead, via the logical progression of work, to the experimental results.” 2.22

We believe there is a contradiction between these two paragraphs, which will lead to confusion for claimants. In particular, paragraph 2.12 appears to consider core R&D in the context of the whole scientific method, while paragraph 2.22 seems to indicate that only the experiment will be a core R&D activity and that the experiment can be broken into discrete activities or ‘parts’. This anomaly is central to our discussion below.

In Example 2.4, the experiment is focused on determining whether the addition of C23 can reduce greenhouse gas emissions, and if so, what proportion will give the best outcome.

The section discussing core activities does not describe/list the core activities, rather it largely provides more background information regarding C23 and K32 and makes brief statements about the presence of a knowledge gap, the need to apply the scientific method and discusses the purpose test.

In contrast, the section discussing supporting activities is very specific about the activities that are considered supporting activities. These are listed as:

- researching the properties and applications of C23 and K32;
- mixing and measuring the ingredients for the test batches;
- constructing apparatus to capture and record exhaust emissions; and
- developing a computer model to assist in interpreting the results.

When we measure this example against the words used in section 355-25 of the Bill, and paragraph 2.12 of the EM which discusses “experimental activities” that qualify as core R&D as “using an approach that proceeds from hypothesis to experiment, observation and evaluation and leads to logical conclusions”, some confusion arises.

If “experimental activities” are core R&D, by definition all stages of “experimental activities”, (i.e. hypothesis, experiment, observation, evaluation and logical conclusions) must be core R&D activities. It would appear that this example has focussed on the “experiment” step and neglected to discuss the other steps that make up “experimental activities”.

It would seem that “researching the properties and applications of C23 and K32” and “mixing and measuring the ingredients for the test batches” must be classified as core activities as they are integral to both the forming of the hypothesis and the scope of the experiment; and are fundamental to the progression of the experiment. Activities to construct apparatus to capture and record exhaust emissions and develop a computer model to assist in interpreting the results, may not be part of the experiment, but these activities are necessary for the “observation” and “evaluation” steps of “experimental activities” per paragraph 2.12, and so could also be classified as core R&D.

The section discussing core activities in this example needs to be more specific about what the core activities actually are. As well as the abovementioned activities, in accordance with paragraph 2.12, other core R&D activities for the project would be gathering the necessary information to enable a robust hypothesis to be formed, running the various engines in various conditions, collecting results from the operation of the engines, analysis of results obtained and drawing conclusions, possibly via the production of reports and charts.

For commercially focussed environments conducting R&D, this example illustrates the somewhat artificial/unsatisfactory/illogical dissection of R&D activities that together are necessary for the conduct of an R&D project. It serves to illustrate that application of the proposed law will not be straightforward in a commercial setting.

Case Study B: New Core R&D Activity Definition

This case study is based on a real life example. It is a company based in Western Australia that, in late 2009, was visited under AusIndustry’s monitoring program and its R&D claim for 2007/08 reviewed.

The company is privately owned by a husband and wife who have invested heavily into the business. In each of 2007/08 and 2008/09 it had less than \$5m in turnover, spent less than \$1m on R&D and had sufficient tax losses to ‘cash out’ its R&D expenditure.

Its R&D program into the design and development of a Multi-Purpose, Light Weight Marine Vessel is based on the concept that the integration of new technology with the best production procedures will lead to significant improvements in the development of pleasure and commercial vessels, and result in the next generation of lighter, faster and much more fuel efficient vessels.

Various claims to both innovation and high levels of technical risk were made and detailed in the R&D Plan and Applications for Registration of R&D Activities made by the company in 2007/08 and 2008/09. These claims include the Integration of Vacuum Infusion Technology, Drive Systems not previously used in this size or class of vessel, unique Mould Designs and the potential to use the technology to manufacture production boats to Survey.

Evidence of experimental activities was demonstrated during the project via the use of modelling software, and various experimental moulds developed and tested to overcome the failures in the vacuum infusion and moulding processes. These failures were the result of a high level of technical risk inherent in the development of the moulding and vacuum infusion processes. The moulds trialled were designed and developed specifically for experimentation purposes.

Following this initial stage of experimentation, a prototype marine vessel was designed to incorporate the new Vacuum Infusion Technology, Drive Systems, and unique Mould Designs. Once built, the prototype vessel underwent an extensive trial phase to determine the success of the new design. Following this activity, the vessel was sold to a customer at a loss.

During the review, the Assessor indicated they were comfortable the concept and design of the vessel would meet the definition of experimentation, specifically because of the experimental approach undertaken by designing and developing the trial moulds specifically for experimental purposes.

The proposed R&D Tax Credit has a stronger emphasis on the “experimental” requirement for core activity eligibility. As a result, it is possible that an Assessor could interpret this as the core R&D activity being restricted to the design, development and experimentation of the experimental moulds, and exclude the design of the prototype vessel from being a core R&D activity (see “Tabby Marine” examples within the second R&D Tax Credit EM³).

The prototype vessel was developed with the intention of eventually being sold to a customer, which is commercially sensible when developing such a large and expensive prototype. As such, the prototype design was not developed for purely experimental purposes. However, its design integrated several experimental components, which involved a high level of technical risk.

The design of the prototype vessel should be considered a core R&D activity (in addition to the design of the individual experimental components) as the outcome of building the prototype vessel incorporating the experimental components could not have been known or determined in advance on the basis of current knowledge, information or experience, and the work involved a systematic progression of work that was based on principles of established science, proceeded from hypothesis to experiment, observation and evaluation, and lead to logical conclusions, and was conducted for the purpose of generating new knowledge.

As a result, the exclusion of this activity from being considered a core R&D activity could result in an R&D Tax Credit claim being limited to the experimental moulds under the proposed legislation, which is a relatively small activity within a much broader R&D project.

The removal of ‘experimental’ from the definition of core R&D activities removes the uncertainty that arises in relation to whether experimental activities either need to adopt the scientific method (per paragraph 2.12 of the EM), which proceeds from hypothesis to experiment, observation and evaluation, and leads to logical conclusions, or correspond to a single experiment within the overall context of the scientific method.

The recommended change means that any activities conducted as part of the scientific method and which are undertaken for the requisite purpose of generating new knowledge and, in doing so, achieving an unknown outcome will qualify as core R&D activities.

³ Paragraphs 2.64 to 2.67 of the EM to the Second Exposure Draft
Submission to Second Exposure Draft R&D Tax Incentive

In contrast, any activities conducted as part of the scientific method but which are not undertaken for the requisite purpose of generating new knowledge and, in doing so, achieving an unknown outcome will only qualify as supporting R&D activities.

A remedy to the above issues would be to remove the word “experimental” from the definition of core R&D activities.

This would de-emphasise the requirement for a core activity to be experimental, and place more emphasis on whether the activity met the following criteria:

- The outcome could not have been known or determined in advance on the basis of current knowledge, information or experience;
- Followed a systematic progression of work based on principles of established science;
- Proceeded from hypothesis to experiment, observation and evaluation, and lead to logical conclusions; and
- Whether the activity was conducted for the purpose of generating new knowledge.

Technology Not Commercially Available – Clarification Required

The EM has not clarified eligibility of R&D activities to generate new knowledge or information where the technology to resolve the problem is not commercially available.

For example, competing companies may develop similar technologies but independently undertake their own set of experimental activities. Both parties have no intention of making the technology commercially available to the other, and the information is not obtainable from any other source.

Another example is where a solution to the technical problem has been developed but is not commercially available. The company conducts experimental activities in a scientific way to resolve the problem, and generates “new” knowledge in the process.

It is clear that in both of the above examples there are real benefits to the wider Australian economy in supporting this type of R&D. This includes improved productivity across the economy, capability building, enhanced competition and efficiency, and a recognition that it is experimentation activities that are the key and the development of scientific knowledge across the economy (and hence high spill-over benefits) and across multiple companies that goes hand in hand with this.

We suggest that an example is provided in the EM to clarify this situation.

Dominant Purpose Test Too Restrictive

Dominant Test Should Not Apply to Old Exclusion List

An unexpected outcome from both the exposure draft processes was the tightening of eligibility of support activities that are excluded as core R&D activity in the old law, namely, s 73B (2C) of the old legislation and s 355-30 of the current second ED. This is referred to as the excluded activities list.

We would argue that many of the activities listed in the excluded activities are an integral part of R&D experimentation, and we provide specific examples later. Further:

- Neither Dr Cutler or the Government highlighted the exclusions list as an area of concern or an area that would be reviewed;
- Although the regulator has been reluctant to provide specific examples of excessive claiming or “non-genuine” R&D, it has become apparent through the consultation process the concerns have mainly been around business as usual internal software development, production trials and the like. There has been no concerns raised with the exclusions list;
- At most of the public consultations last October, the exclusions list was highlighted as an area where genuine support was still required, due to the activities listed being an integral part of supporting R&D experimentation (such as data collection), and if anything, should be allowed to be considered in some form for core R&D activity eligibility; and
- The “directly related” test would continue to appear an appropriate threshold for this activity list.

There would appear no rationale to exclude the exclusions list from the “directly related” test, or put another way, to adjust the current law in this regard. Rather, by requiring these excluded activities to pass the much higher test of dominant purpose, the new legislation would exclude legitimate data collection, analysis and review work typically undertaken to support experimental activity.

The dominant test adversely affects this group of activities more than others, because many of these activities are undertaken in a dual setting by businesses being as efficient as possible.

Four exclusion examples are provided to illustrate this point below, demonstrating industry efficiently using the expense associated with one activity to achieve dual purposes.

Exclusion	Example Activity	Dual Purpose	
		Non-R&D Activity	R&D Activity
s 355-30(c) Obtaining a drilling sample to determine quality of deposit, and for R&D experimentation	A sub-economic nickel deposit has been discovered, but cannot be exploited with current technology. Subsequent phase 2 drilling occurs to both provide further geological / hydrological (sub-surface water) data and to obtain samples for metallurgical destructive testing to help develop a new metallurgical flowsheet to exploit this sub-economic resource.	The drilling data will enrich geological and hydrological understanding.	The drill samples will undergo metallurgical experimentation to build a new metallurgical processing solution to the sub-economic ore.
s 355-30(i) Routine collection of information and data for feedback R&D, except as part of another activity that is an R&D activity.	<p>A bauxite miner will routinely collect hydrological data relating to future mine operations, allowing mine planning to define mine design and extend mine life.</p> <p>Such data is beyond the prospecting, exploring or drilling stage of the bauxite operations (the extent of the resource is known) and not directly related to production of bauxite (which would be some 3 years away for the mine extension).</p> <p>The company is continually contaminating certain natural sub-surface aquifers and undertakes a series of experimental activities to explore sub-surface reverse osmosis (RO) solutions to the contamination.</p>	<p>The routine hydrogeological data will feed into the mine planning department.</p> <p>The non-R&D part of this activity will not pass the exception to this exclusion, and the interface with “dominant” will exclude this activity.</p>	The routine hydrogeological data provides feedback R&D to the RO solution, allowing for re-engineering and refinement of an effective solution.
s 355-30(l) Statutory compliance and data collection for fundamental analysis.	<p>A refinery emits sulphur dioxide as part of a chemically complex airborne emission from a production activity, and it is a statutory requirement to report such emissions. The operations have regularly breached guidelines, but this is allowed as long as they are reported.</p> <p>Notwithstanding this, the company undertakes experimentation on sulphur dioxide removal processes to develop new solutions, which is a world first for the industry.</p>	The data is collected and provided to the regulator as required under statute.	The data collected is further analysed to understand more fundamentally the chemical relationships of the complex emission, and relationships that could aid in the extraction of sulphur dioxide.

In all of the above examples, if the company was to undertake the R&D activity separately to the non-R&D activity, they would pass the dominant purpose test because the R&D activity would be the sole activity in question. It is only because the company undertakes their activities in an efficient and dual way, that the proposed provisions will limit their ability to claim R&D.

The above examples would pass the “directly related” test applied to other non-production supporting R&D activity.

In addition, the activities listed are typically modest in expenditure associated with them, generally being labour, consultant or minor consumables.

Finally, where these excluded activities are in relation to the production of goods or services, or directly related to such activities, they will be subject to the dominant purpose test anyway by way of ss 335-25(2)(b) - (c). As such, the below recommendation is in part removing “belts and braces” that exists with s 335-35(2)(a), and allowing meritorious, necessary and non-production R&D to gain assistance.

We would recommend the following change to s 355-35(2)(a), to ensure all exclusions do not need to overcome the dominant test:

***“355-35(2) However, if an activity:
(a) Is an activity referred to in section 355-30(o)”***

Alternative Approach

Although we prefer the above approach, an alternative would be to apportion access to the R&D credit based on the proportion of R&D activity for those activities on the exclusions list. This was a concept discussed at the 1 April meeting with Treasury. For example, where an activity had equally dual purpose, 50% of the expenditure would be allowed.

It is a concept used in other aspects of the R&D provisions, namely Para 3.84 of the EM, where the notional deduction is reduced to the extent that an asset is used for a purpose other than R&D activities, and it mirrors the current R&D treatment of depreciable assets.

The reason this is not our preferred approach is that there are some disadvantages with an apportionment method:

- Businesses do not generally allocated weighting to purpose in this manner and such a weighting provides little value to the enterprise;
- It is an added layer of complexity;
- The allocation could be practically difficult for most cases; and
- It diminishes the importance of these activities to fundamentally being able to execute the core R&D.

Production of Goods and Services Not Defined

The second draft legislation also introduces the terms “production of goods and services” and “directly related to production of goods or services” with regards to supporting activities. While we recognise that this is an attempt to address concerns that have been raised in relation to production type R&D claims, we never-the-less remain concerned at the potential breadth of these provisions, and do not agree with the proposed exclusion for production related activities, nor these rules as drafted. The term “production of goods and services” is also not defined in the legislation, and the examples provided in the EM are often inconclusive due to the layers of caveats and restrictions.

There is a practical business reality which is not respected with the concept of dominant purpose, particularly in a production environment. Where possible, businesses will undertake tasks for more than one purpose to maximise the return on limited resources. This is particularly applicable for small to medium size entities.

The dominant test is unsympathetic to R&D undertaken in a production setting. Rather, it favours the more pure research activities typically seen in a university or research body type environment, where production and production trials are far less common, and research is done in isolation. The second draft legislation still fails to recognise that production trials are important part of “Development” and complete the feedback R&D loop. The dominant purpose concept does not allow for the commercial reality that companies operate under, and ignores the fact that a range of high quality spill-over benefits are commonly generated from new knowledge gained during production.

Directly Related to Production – Examples Required

The use of the term “directly related” is subjective, and potentially creates an extensive nexus. Much of the (successful) R&D undertaken will eventually lead to a viable commercial outcome, most likely in the form of a good or service at one stage or another. Often this will not be readily discernable at the time the early stage R&D activity is undertaken. How direct the connection with the production needs to be, in both time and the nature of the activity, is unclear and needs more clarity.

For example, there is potential that the early stage research and experimentation of a biotechnology company into microorganisms which will eventually produce a chemical product, could be considered “directly related” to the future production of that good, even though this may be many years away from happening. This could potentially become an area of controversy and dispute with claimants, where the regulator seeks to establish a broad nexus with the relevant activity, even if the activity is at a very early stage. It also (as with the augmented feedstock rules previously proposed) could act as a type of “penalty” on successful, commercially-orientated R&D that leads to production.

We recommend that the terms “directly related” [to production of goods or services] are removed from s 355-35(2), or at the very least limited to production of goods/services in that year of income. This would provide greater clarity, while still achieving the aims of restricting the R&D claims in an immediate production environment.

Lack of Incentive for the Software Industry

Software Core Activities R&D Exclusion

As generally accepted, the current multiple sale test was originally intended to apply to a traditional software industry where licensing and shipping of physical software media was the norm. As such, the proposed removal of this test should allow support for new forms of software distribution such as hosted software, software as a service (SaaS) and various other distribution and software revenue models.

However, the addition of the following to the excluded activities list at s 355-30(o) may result in a number of genuine R&D activities being excluded as core, when they are currently supported under the current R&D Tax Concession:

“Developing, modifying or customising computer software solely or primarily for use by any of the following entities for their internal administration (including the internal administration of their business functions):

- *The entity (the developer) for which the software is developed, modified or customised;*
- *An entity connected with the developer;*
- *An affiliate of the developer, or an entity of which the developer is an affiliate.”⁴*

The following case study provides an example to demonstrate this point.

Case Study C: Software

Company X is an established business in Australia, offering e-commerce services to approximately 5,000 Internet shops predominantly in Asia, the United States and Australia. The company is developing and patenting a new “Buy Now Button” for the Internet, which can also be used on TV and radio as well as in print media and on billboards. Their technology will allow companies to market products and services in the bricks and mortar world and make purchasing them via the Internet as easy as making a phone call.

Some of the main technical and commercial challenges and risks of Company X’s proprietary links are the speed of responding to the shoppers’ and merchants’ commands and requirements, and the time required in processing the extensive list of e-commerce functions.

These responses and processes take place in an environment with wide ranging levels of security and privacy depending on the content and intended audience in accordance to the various legislations and industry guidelines. For example, the major credit card issuers created payment card industry (PCI) compliance standards to protect personal information and ensure security when transactions are processed using a payment card. All PCI members (financial institutions, credit card companies and merchants) must comply with these standards if they want to accept credit cards.

Various technologies and solutions were researched and developed as no existing hardware or software solutions existed fulfilling these key requirements. A server and computing cloud environment was established as the basis of dealing with these various challenges and requirements, with the R&D then continuing and evolving in the cloud environment.

⁴ Section 355-30(1)(o) of Second Exposure Draft Legislation

Cloud computing is a new technology, and as such there are very few industry standards in regards to system architecture, and almost none in regards to achieving PCI compliance in the cloud. A different approach to achieving PCI compliance is required in the cloud largely due to not knowing which hardware the data resides on at any point in time.

In its efforts to help pioneer this industry, Company X has researched and tested many existing and emerging systems and techniques, but found they all needed to be managed and configured differently in the cloud. The new PCI server base that Company X has developed enables it to manage cloud infrastructure as if it were on a standard network, but still leverage the dynamic nature of the cloud.

Whilst the new cloud computing software technology was developed to support the core activity being undertaken, commercial imperatives dictated that the company leverage and benefit from its development programs. At the same time as it developed the new cloud computing software, the company also developed the ability to migrate several of their systems onto the new server base.

This project was recently reviewed by AusIndustry and rated as low risk.

The above case study describes a scenario in which the innovative technology and business model could only be supported via the use of cloud computing. The development of the new cloud computing software has posed significant technical challenges and required Company X to be innovative in its approach.

However, while the “Buy Now Button” technology was developed solely to provide a service to external clients, the new cloud computing software was not developed solely to support the “Buy Now Button”, and is not offered as an external service to clients.

As a result, it appears that the work undertaken by Company X to develop software to allow cloud computing technology to operate as if it were on a standard network, may be considered **developing** computer software **primarily** for use by Company X for their internal administration, and thus possibly fall within the proposed legislation’s core activity exclusion definition.

This is an example of where a highly innovative software technology has been developed and is eligible under the current legislation, but may not be eligible for R&D incentives under the proposed legislation.

“Developing” and “Primarily”

As highlighted in the above example, the controversial words within the proposed R&D Tax Credit legislation are “developing” and “primarily”.

A remedy that would enable this highly innovative and technically risky cloud computing software activity to be considered a core activity would be to remove the words “developing” and “primarily” from the internal computer software exclusion definition in s 355-30(1)(o).

The term “solely or primarily” is confusing, particularly where the software is used by both related and non-related parties and it is difficult to determine who the more relevant users are. This could lead to dispute and uncertainty for claimants. The use of the term “Primarily” would also suggest that businesses should quantify the usage of the software. The method of how this is determined can be very subjective and may become a contentious issue.

The word “primarily” has the effect of excluding internal R&D computer software activities where an activity has been undertaken for a dual purpose. The development of the cloud computing software to both enable PCI compliance (R&D activity) and provide benefits to internal systems (internal administration), is an example of good commercial sense. However, the word “primarily” may exclude this activity from being claimed as a core activity.

We recommend that the word “primarily” is removed from the proposed legislation. This would eliminate the potential exclusion of a highly innovative and technically risky activity from being claimed as a core activity, and remove an incentive for companies to undertake R&D activities solely for the purpose of undertaking R&D, which makes poor commercial sense, and is an inefficient use of resources.

Whilst the words “modifying” and “customising” relate to the adaptation of an existing technology, the word “developing” relates to a technology that did not exist previously, and thus has had to be developed. As a result, the inclusion of the word “developing” within the internal computer software exclusion definition has the effect of excluding the **development** of innovative internal computer software as a core activity.

The removal of “developing” from the internal computer software exclusion definition would remedy this issue whilst still excluding the modification and customisation of computer software for internal administration purposes.

We thus recommend the removal of the terms “primarily” and “developing” from the internal computer software exclusion definition in s 355-30(1)(o).

Administration of the R&D Tax Credit

Enhanced Administrative Power of the Board

The proposed R&D tax credit regime is to operate on a self assessment basis, however Innovation Australia has increased autonomy to reject applications for R&D Registration of core and/or supporting activities or change the classification between core and supporting following lodgement of the R&D applications.

The Board may make findings about the R&D entity and the nature of the activities both before and after registration, and make these decisions without requesting further information from the claimant. These changes increase the uncertainty around self assessment as entities would have to wait until they are registered to be assured that no amendments have been made. This approach would be equivalent to a current 39L assessment from AusIndustry which is against the intended self assessment approach.

Additionally the draft legislation imposes no time limit upon Innovation Australia in regards to its findings about a particular registration. This further creates uncertainty for the claimant, and most importantly, **will cause delays and complications in completing the company's tax return.**

There also remains uncertainty in relation to the 10 month time limit exclusions and whether this would continue to run once an R&D registration had been refused by Innovation Australia. This could act as a significant penalty to those who validly contest a decision by Innovation Australia to refuse to register a claimant. In some circumstances (e.g. where the review goes past the 10 month registration deadline), this could indeed defeat the whole premise of making these decisions reviewable.

It is our recommendation in relation to enhanced administrative powers of Innovation Australia:

- a) Limitations on the powers, especially to refuse to register a company, should be imposed and better aligned with the nature of a self-assessment system and the existing powers;
- b) For the avoidance of doubt, that the requirement to register within 10 months of the year end apply to the date the R&D application is submitted and not the date of final acceptance by Innovation Australia. This could be achieved through the addition of an explicit statement at s 27A to this effect; and
- c) Specified time limits should apply for assessment decisions by Innovation Australia.

Registration Requirements – Core vs. Supporting

The new registration requirements call for the separation of core and supporting R&D activity within the R&D Application. Companies do not naturally dissect a project into these classifications, but rather look at all activities necessary to achieve an objective.

This requirement imposes a greater administration burden, particularly upon small to medium enterprises (SMEs), when completing the Registration form and may discourage companies from accessing the R&D tax credit.

Registration Requirements – Single Entity

With the move towards better aligning the tax and R&D registration treatment of tax consolidated entities, it is important to provide clarity on the treatment of entities that are entering and leaving a tax consolidated group. Under the proposed exposure draft rules, for tax consolidated companies a single (head) entity will be registered on behalf of the tax consolidated group made up of a number of subsidiary entities.

If one or more of these subsidiary entities leave the tax consolidated group (for example they are sold) part way through the tax year, then our understanding from the exposure draft and EM, is that two registrations will be required, one while the entity is part of the tax consolidated group and another while it is part of its own or a new tax consolidated group.

We seek clarification that this is the correct understanding, and would appreciate if an EM example could be provided in relation to this to provide clarity.

Documentation Requirements – Example of Planning Documentation and Registration Form

The draft R&D tax credit legislation has removed the requirement for a company to hold an R&D Plan in order to claim the R&D tax credit; however the EM requires that sufficient planning documentation be maintained. The EM should go further to state what would be considered sufficient documentation for a variety of different projects.

We also suggest that draft approved forms for registration of R&D activities should be made available for comments from the general public.

Other Recommendations

Grouping Provisions – 40% vs. 50%

The exposure draft provisions have now been aligned with the small business entity provisions under Division 328, requiring the aggregate turnover of 'connected' entities be included when considering eligibility for the refundable R&D tax credit.

This changes the grouping requirement from a control test exceeding 50% ownership of an entity to being 'connected' and therefore grouped at 40%. Not only will this change exclude more small to medium enterprises from access to the Refundable Tax Credit, opposing the guiding policy objective of redistributing benefit towards SME entities, it also adds complexity to the legislation and critically can result in a company being connected with two entities who each control 40% or more of the entity. This is also a significant departure from existing provisions under which many SMEs that currently claim the R&D Tax Rebate have been set-up, and could actually result in some SME claimants being significantly worse off under the new option.

In line with the policy objective of providing benefits to SMEs, we recommend that grouping or 'connected' rules apply at greater than 50%, consistent with the treatment under the R&D Tax Concession. This could be achieved though extending the wording used at item 2 of s 355-100(1) (for exempt entities) to item 1.

Overseas Activity Cap

Under the existing R&D system, it is possible for amounts spent on overseas R&D to qualify for the R&D tax benefit, provided pre-approval is obtained and certain other conditions are met. The overseas amounts are capped at 10% of the overall Australian R&D expenditure on the project (ie. the overseas component may exceed the 10% cap, but only amounts up to the 10% will be claimable). There are sound reasons why this exists- it is normally only applicable where the work done overseas is a critical part of the overall R&D effort, and that work (due to the expertise, equipment availability or otherwise) can only be conducted overseas.

The proposed new rules also recognise that in these limited circumstances overseas R&D activities should also be claimable. Sections 355-205(d) and (e) allow for these amounts to be claimed, provided that the new advance approval requirements under ss 28B and 28BA of the Industry Research & Development Act 1986, are met. These new provisions, provide a clear link to the R&D activity and the role that the overseas R&D must play in the R&D project.

However, the new provisions leave uncertainty in relation to the extent that the expenditure may be claimable, and the EM provides no further guidance. At s 28BA(5) it is stated the overseas expenditure must be less than the Australian expenditure, but it is unclear if this is a cap (like the existing provisions), or a requirement to qualify. That is, it is unclear whether only the amounts up to a cap of 50% of the total project costs are eligible, so that if, for example, the total overseas costs associated with the project were 51%, there is uncertainty as to whether the claim would be limited to the 50% of amount for overseas costs, or whether the entire overseas amount would not qualify. We would suggest that a cap approach is fairer, and consistent with the intent of the legislation in supporting R&D.

The legislation itself should be redrafted at s 28BA(5) to expressly state that the advance registration approval will be capped at 50% of the overall (overseas and Australian) R&D project expenditure (even where the total amounts spent might be higher).

Depreciating Asset – Further clarity of key concepts needed in EM

The existing R&D tax benefit recognises that there are a number of small, but significant variations that are required to the standard tax rules that apply to depreciating assets, in order to provide an incentive to companies when utilising an asset for R&D purposes. This includes allowing the depreciation to be claimed from the point of being “installed ready for R&D purposes”.

This is implied in the EM (e.g. at Para 3.83 and 3.84), but nowhere is it explicitly stated. It would be useful and provide certainty, if either the EM or the examples stated that the effective date to be used was the date it was “installed ready for R&D purposes” (or similar words).

Treatment of Corporate Limited Partnerships

The second exposure draft treats corporate limited partnerships differently from some other types of entities, and makes them ineligible to claim the R&D Tax Credit (refer to EM Para 3.20). We can see no reason why this should be the case, given that in all other respects under tax law this type of entity is treated as a company. Furthermore, many corporate limited partnerships contain partners that are only/ predominantly corporations (in contrast to the statement at 3.20). We suggest that this be changed accordingly to either allow these entities to claim, or allow corporate limited partnerships which have only/ predominantly corporate partners, to be treated as a company and hence be eligible.

Core Technology

Changes to the core technology provisions under the proposed R&D tax credit, will reduce the extent of allowable deductions claimable in each tax year, and potentially makes it less attractive for companies to develop new technologies in a strategic fashion using existing technology as a platform.

The current R&D provisions encourage technology transfer within Australia for the purpose of developing new technologies. The knowledge gained is likely to benefit the wider Australian economy, which is in line with the object of the second exposure draft. This is done through special allowances to deduct core technology at an accelerated rate.

By changing these provisions to align with the general tax provisions and remove the current accelerated core technology deductions, it will be less attractive for companies to invest in core technology as part of their R&D efforts. Australia may miss out on important spill-over benefits arising from strategic technology transfer which leads to the development of innovative new technologies.

More “Positive” Non-Production Resource Industry Examples

The case studies and examples provided in the EM in relation to the resources industry are mainly “negative”, where activities are determined to be ineligible R&D activities. Where there are “positive” examples, they are focused on activities undertaken in a production environment with various caveats/restrictions, limiting the eligibility of the activities.

We propose that the EM should contain more “positive” industry examples for eligible R&D activities. An example of this is where high-value/ spill-over “conceptual design activities” are undertaken before the Final Investment Decision (FID) where there is still significant technical uncertainty about whether production will even be possible. Similar wording was used to support these activities in the augmented feedstock provisions, to ensure that early stage R&D would still be supported.

Other Areas to Clarify

It would be useful to provide further clarification in the EM/ future guidance, including worked examples, in relation to the following areas:

1. The treatment of franking credits when a refundable tax offset is received- this is unclear from the existing information.
2. Further examples in relation to the disposal of assets and the impacts on the notional Div 40 deduction under s 355-310- especially where an asset is used for only part of the year and only in part for R&D.

Conclusion

The application of new concepts (namely “experimental activities” and “dominant”) to by-pass perceived shortcomings of the first ED is inadequate. The better approach in our opinion is to provide specific solutions to specific concerns.

Further to this overall concern, we highlight in this paper the main problems of the second ED namely:

- a) New definition for core R&D activities being too narrow and a potential source of uncertainties and dispute;

Key recommendation:

Remove the word “experimental” from the definition of core R&D activities.

- b) The tightening of certain categories of supporting R&D activities through the dominant purpose test limits the positive spill-over benefits that the R&D tax credit is seeking to support;

Key recommendation:

Change to s 355-35(2)(a), to ensure all exclusions do not need to overcome the dominant test:

“355-35(2) However, if an activity:

(a) Is an activity referred to in section 355-30(o)”...

- c) The introduction of the “primarily” and “developed” concepts on core and supporting software activities discourages competitiveness of the Australian software industry;

Key recommendation:

Removal of the terms “primarily” and “developing” from the internal computer software exclusion definition in s 355-30(1)(o).

- d) The additional administrative requirements and extended powers of the Board creating inefficiencies and uncertainties.

Key recommendation:

Limitations on the Board’s powers, especially to refuse to register a company, should be imposed and better aligned with the nature of a self-assessment system and the existing powers.

We welcome the opportunity to make this submission, and would be happy to provide any additional input should you wish to further discuss.