



# Research & Development Tax Incentive Consultation Paper KPMG Submission

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# 1 Executive Summary

KPMG welcomes the government's initiative to make significant changes to Australia's Research and Development tax incentive following the findings of its review of the National Innovation System detailed in its *Venturous Australia* report of September 2008 and *Powering Ideas* of May 2009.

KPMG supports the reform objectives of making the new R&D tax incentive 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.

In particular, KPMG welcomes the proposals in the Consultation Paper as to:

- the introduction of a refundable tax credit available to small to medium-sized enterprises;
- the shift of focus from the location of intellectual property ownership to that of the location of R&D activities with regard to eligibility; and
- recognition of the currently outdated treatment of software development in R&D.

However, KPMG also has some concerns with the practical application of some of the principles and design features of the new R&D tax incentive as outlined in the Consultation Paper, in particular, with regard to:

- the practical application of the policy objectives of "additionality" and/or "spillover";
- the proposed changes to the definition of R&D activities;
- the proposed restriction on the incentive in respect of what would otherwise be genuine R&D activities
- the practical and policy issues surrounding restriction of eligibility for expenditure incurred in supporting activities; and
- the use of the "on own behalf", financial risk and beneficial ownership concepts.

These issues are "primary" to this submission insofar as they refer to what might be considered the key changes proposed in the Consultation Paper and we further address and make specific recommendations in relation to these issues below.

We also comment on the specific questions raised in the Consultation Paper, in addition to certain other issues which we consider pertinent to the current consultation process and therefore worthy of comment at this time.

## 2 Policy

### 2.1 Additionality and spillovers

The Consultation Paper states that “...an effective R&D incentive needs to result in firms conducting R&D that they would not otherwise perform...”

We submit that this principle, referred to as “additionality”, is erroneous and that companies do not make a decision to proceed with an R&D project solely as a result of a tax incentive.

Over the last 24 years the objective of R&D tax incentives has been to engender a culture of innovation and development in Australia and to create an environment that is conducive to increased commercialisation of new processes and product technologies. This should continue to be the driving principle behind the design rules for the new R&D tax incentive.

We do not necessarily disagree with ‘additionality and spillovers’ being adopted as general and overarching design objectives for the new system, but only from a macro economic and social perspective. In other words, the objective should be to create an overall environment which is conducive to greater, enhanced R&D activity. However, the policy driver should not be applied to disallow what would otherwise qualify as R&D activity of a given enterprise, merely because that enterprise was committed to that activity, regardless of the incentive.

There are other serious risks in believing that these principles should be applied at the activity or individual enterprise level. Such an approach would risk compromising the effectiveness of the whole scheme, it would be unworkable in practice and impossible to administer. Whilst, on one hand, this is effectively conceded in the Consultation Paper, we have serious reservations about other statements such as:

*“...the principle of additionality and spillovers will underpin the design of the rules for what activities will be eligible for the new R&D tax incentive.”*

Incorporating “additionality and spillovers” in the legislation, even within an objects clause, will lead to confusion as to its application at a company level. Spillover benefits are extremely difficult to quantify particularly at the commencement of R&D activities. Many of these benefits from both small step changes and radical new development, take many years to filter through the wider community. With the benefit of hindsight it is easier to determine if spillover has occurred. The ability of a company to determine potential broader benefits of its R&D program beyond the impact to its own business should not be a criterion for access to the R&D tax incentive.

The public Consultation Sessions conducted in October, indicated that the interpretation and application of these concepts are of significant concern to industry stakeholders. In particular the fact that if these concepts were included in the Objects clause of the new tax credit program, it could not be guaranteed that they would not be applied at a specific company level to disallow future R&D tax credit claims.

Productivity Commission Reviews have confirmed that the R&D tax concession has resulted in net economic and social benefits. Therefore, it does not appear that including the concepts of additionality and spillover within a legislative objects clause are necessary.

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. Having said that, we also agree that the definition of R&D should still conform to generally accepted international norms and conventions. In that regard, however, we accept the further rationalization that the proposed changes to the definition will bring the Australian definition more in line with International definition.

Modifying and narrowing the definition is likely to have an adverse impact on encouraging investment in R&D in Australia and in today's global community, companies can choose to undertake R&D under more advantageous regimes elsewhere.

## **2.2 “Above the line”**

Reporting of the R&D Credit “above the line” is absolutely critical if the Government's ambition is that the R&D Credit is to be a driving factor in a company's decision to undertake specific R&D projects. A company makes a decision on a pre-tax basis. As proposed in the Venturous Australia Report, consideration must be given to the design of the tax credit program so as to enable companies to treat the credit received as “above the line”.

## **2.3 Revenue neutrality**

In its Policy Statement, “Powering Ideas”, the Government acknowledged that *“Australia's recent innovation performance has been uneven and we have failed to keep pace with the rest of the world”*

Constricting the definition and reducing the level of support to essential activities will not improve Australia's innovation performance. However, the removal of complexity in accessing Government R&D incentives and the provision of more comprehensive guidance as to the interpretation of key definitions will enable Australians to focus on the primary goal of creating a better Australia that can meet the challenges and opportunities of the twenty-first century.

The concept of “revenue neutrality” of the R&D tax credit program would also appear to be at odds with improving Australia's innovative performance.

We acknowledge and welcome the fact that the R&D tax credits proposed will deliver a higher level of benefit than the base benefit of 125% deductions of the current R&D tax concession. We note that this may, at first glance, mean an increase in the total level of benefits provided. However, the abolition of the 175% premium deductions would provide a significant saving to revenue.

In 2008, Australian businesses reported \$14.4 billion of Business Expenditure on R&D activities<sup>1</sup>. Therefore the mere abolition of the 175% incremental premium deductions will be sufficient to achieve close to revenue neutrality.

The changes proposed to tighten the definition and limit the incentive to supporting activities are likely to result in a significant reduction in benefit paid by the Government to below the \$1.4 billion which would be inconsistent with the Government's intention. Additional guidance as to the scope of R&D activities which the Government considers eligible and/or ineligible would provide companies with more clarity and confidence in the tax incentive program.

## **2.4 Recommendations**

- Additionality and spillover can be appropriate policy drivers if considered in a macro-economic context but not at an enterprise or individual project basis. Therefore, these concepts should have no place in the legislation, even with an objects clause, as they are concepts which would be incapable of practical application.
- That the Government continue to endeavour to work with industry to develop a program design which will enable companies to treat the R&D credit as "above the line".
- Given the abolition of 175% incremental premium, no further legislative changes are necessary to achieve revenue neutrality through arbitrarily excluding activities which would otherwise qualify as "genuine" R&D activities. Properly considered and comprehensive guidance material, as proposed in the Consultation Paper, should help remedy perceived "over-claiming" of expenditure.

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<sup>1</sup> Australian Bureau of Statistics Report: 8104.0 - Research and Experimental Development, Businesses, Australia, 2007-08

## **3 Innovation and high levels of technical risk**

### **3.1 Definitional issues**

The proposed changes to the definition of core R&D activities will now require those activities to exhibit both innovation and high levels of technical risk where the threshold is currently for the activities to exhibit only one of these characteristics.

We note that such a change to require the satisfaction of both criteria was proposed in 2001 and widely rejected by both industry and practitioners<sup>2</sup> at the time for a number of reasons including:

- the increased complexity and attendant compliance burden for taxpayers in reviewing each activity for both criteria;
- its variance with the definition espoused in the Frascati Manual, being the definition broadly accepted by OECD member states;
- that the government had not been able to demonstrate that the interpretation of the existing definition by the courts and tribunals had expanded the breadth or quantum of claims beyond that of its policy intent;
- that the evidence the government had, provided for such a change to the definition referred to determinations relating to R&D activities undertaken prior to the raising of the threshold to “high levels” of technical risk in 1996 and that, since that time, the amended definition had proved sufficient to exclude ineligible activities from the benefit of the tax concession;
- the lack of government consultation or consideration as to the impact of a requirement to satisfy both criteria in a context of widely-differing interpretations of the definition of “innovation” between government and industry; and
- the government had not demonstrated that the original intention of the R&D tax concession was to allow tax relief to only those activities with both characteristics (and that therefore by reference, the R&D tax concession had been widely inappropriately claimed in the case of activities satisfying only one criterion since 1985).

In recognition of the persuasive weight of these arguments, the proposed change to require satisfaction of both criteria was never introduced by the government of the day.

KPMG would submit that these arguments remain equally valid in the context of current and future R&D activities and, accordingly, it is unclear as to the current government’s rationale for change in this regard.

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<sup>2</sup> Submissions made to the Senate Economics Committee in its consideration of legislation referred to it namely Taxation Laws Amendment (Research and Development) Bill 2001 and the Report issued by that Committee in September 2001.

It is also noted that the Venturous Australia Report recommended refinements, clarification and guidelines rather than a tightening of the definition. The Government's Policy Statement, Powering Ideas, stated that it accepted the Report's recommendation to tighten the definition. As discussed, we agree with the need for clarification and guidance but not with the need to tighten.

The proposed definition also changes from "activities" to "activity" and "for the purpose of producing new knowledge or improvements" instead of "new or improved materials, products, devices, processes or services" or "new knowledge". There is no discussion in the Consultation Paper as to the rationale for these changes, nor to their potential impact on what may be considered eligible R&D activities.

We will provide further comment on these aspects when more detail is provided or in response to the Exposure Draft of the proposed legislation.

### ***International comparison***

The Consultation Paper states that:

*"A definition which requires that core R&D activities involve both innovation and high levels of technical risk means that the new scheme will better align with the Frascati Manual and international practice. Currently Australia has one of the broadest definitions of R&D (when compared to the Frascati Manual). Many countries including the United Kingdom and the United States, take a narrower approach."*

In this regard, we note that the Frascati Manual does not make reference to any requirement for R&D activities to exhibit characteristics of both innovation and high levels of technical risk and, that the breadth of its definition of R&D is notably broader than that of the current Australian system:

*"Research and experimental development (R&D) comprise creative work undertaken on a systematic basis in order to increase the stock of knowledge, including knowledge of man, culture and society, and the use of this stock of knowledge to devise new applications."*

Further, we note that for the purposes of R&D expenditure qualifying for their respective systems' tax relief, the United Kingdom, Canada and Ireland all have sole requirements of characteristics of technical risk or technological advancement. The focus in these locations is on the end result or objective of the R&D activities, not on the requirement for innovation in the individual activity itself.

We are not aware of any significant problem with the application of these definitions in these jurisdictions giving rise to inappropriate claims. As such, it would seem that the proposed scheme, if enacted, would serve to distance Australia from international norms of R&D treatment. This would create a threat to Australia receiving its future share of global R&D spending in addition to placing Australian companies at a competitive disadvantage with their international counterparts.

### ***Practicalities of the definition***

KPMG believe that, whilst, of itself, such a requirement for satisfaction of dual criteria should not necessarily preclude the appropriate characterisation of the activities in question, in practice, this will largely depend on the definition of “innovation”, and how that definition is interpreted in practice by the Government authorities.

We would therefore stress the importance of the definition of innovation being commercially practicable with regard to the stated policy intention. Were “innovation” to be defined too narrowly, this could restrict the eligibility of the tax incentive beyond that intended by Government policy.

In particular, regard should be had to the nature of the practicality of commercial R&D activities, with the definition containing an appropriate level of tolerance for elements of existing technology through and upon which nevertheless eligible innovative R&D activities result in the creation of new technologies. The changes proposed are likely to lead to the support of “Basic Research” as defined by the Frascati Manual, rather than “Applied Research” or “Experimental Development” which are the types of R&D which result in useful, practical applications of technologies.

Given the complexities of each industry’s context, KPMG consider that the provision of industry-specific guidelines by AusIndustry would serve both to give effect to Government’s policy intention together with providing corporate taxpayers with an appropriate level of certainty as to their activities’ eligibility.

We also note that, were the definition of R&D activities to change, any new definition would need to continue to have regard to the project as a whole rather than to the discrete activities concerned in its execution. For example, design is innovative but the activity of brainstorming on a whiteboard is not. However the results of the brainstorming are creative and innovative ideas upon which later activities are built.

### ***Examples***

As far as we can understand, the rationale for making the change to the definition is, firstly, based upon a series of examples, such as the three provided in the Consultation Paper, purporting to demonstrate how, under the current definition, disproportionately large unjustifiable expenditures qualify for the concession. The assertion is that those expenditures relate to activities that, in substance, do not constitute “genuine” R&D, under more universally accepted norms and conventions and, therefore, for which “*there is not a strong rationale for public support.*”

It has not been demonstrated in the Consultation Paper as to how the change from “innovation or high levels of technical risk” to “innovation **and** high levels of technical risk” in the definition will impact on the three examples given. From the information provided in the Consultation Paper, the requirement for both innovation and high levels of technical risk would not change the determination of whether R&D activities were being undertaken in each of the 3 examples. It would appear that the examples are more concerned with claims for “supporting”

activities, extending beyond “genuine” R&D, than with whether the activities would satisfy the new definition of R&D activities.

## **3.2 Software**

We note that the paper has also expressed concern with respect to the application of the R&D definition to the development of software and welcome the invitation to provide specific comment as to alternative approaches in this regard.

KPMG concurs with the view expressed in the Consultation Paper as to both the multiple sale test’s irrelevance in today’s R&D context and the almost ubiquitous presence of software development in current economic endeavour given the world wide web.

Given its involvement across all industry sectors and the direct and indirect nexus to economic spillovers, we submit that software development should be afforded the same treatment as other core R&D activities. Accordingly, we submit that the optimal approach would be to avoid prescriptive rules for software-associated R&D activity wherever possible.

We also note that software development by its nature can be transformational, creating new industries without need for national expenditure on new infrastructure.

### ***International comparison***

With regard to the international treatment of software development in R&D, we note that whilst the Consultation Paper suggests that the United Kingdom system might be a useful starting point, it (in addition to the majority of OECD member states) does not differ in its treatment of software from that afforded to any other form of R&D activity.

In addition, we note that the examples given at paragraphs 76 and 77 appear to originate from industry-specific guidelines provided by HMRC rather than legislation and that, provided the R&D activity meets the requirements of the latter, the guidelines would in any case, be superseded.

For completeness, we also note that the definition of software in R&D at paragraphs 135-142 of the Frascati Manual is notable for both its breadth and lack of reference to any motive or purpose test as to future commercial exploitation.

### ***Examples***

Example 3, in the Consultation Paper again does not provide sufficient information about the relevant activities to make any proper determination. In addition, it is not clear how any proposed changes to the R&D definition would be intended to apply any differently to this type of R&D. For example, in relation to R&D associated with software development such as this, the respected Frascati Manual states:

*“For a software development project to be classified as R&D, its completion must be dependent on the development of a scientific and/or technological uncertainty on a*

*systematic basis...Therefore, an upgrade, addition or change to an existing program or system may be classified as R&D if it embodies scientific or technological advances which result in an increase in the stock of knowledge.*

That would appear to be the case under the current definition and we would hope that there is no intention to depart from this general approach. As for Example 3, the question is whether the claims made about the activities (that they “involved innovation and technical risk”) are founded in fact or not – or whether they involved no more than mere customisation or integration of existing systems, absent the necessary innovation or high levels of technical risk. If the activities satisfy the requirement for both innovation and high levels of technical risk then they should be supported and encouraged.

### **3.3 Recommendations**

- That the definition of R&D activities retain the criteria of innovation **or** high levels of technical risk in the alternative. More extensive guidance material, as proposed in the Consultation Paper, would provide clarity to companies undertaking R&D activities and assist in remedying any deficiencies in claims.
- That the eligibility of “R&D activities” must continue to be assessed on a collective basis and not in relation to individual activities in isolation.
- That there are no additional criteria required for the development of software.
- The “multiple sale” test be abolished.

## 4 Supporting activities

### *General*

As an overarching comment, KPMG's view is that, from a policy perspective, the distinction between core and supporting activities is essentially artificial. That is, provided the activity is necessary for the successful pursuit of the R&D project and achievement of the objective of acquiring new knowledge and improvements, it should be supported by the tax concession.

This principle is recognised internationally by there being no differential treatment of expenditure incurred in core or supporting activities. As with the current Australian system, where there is no differential treatment, there is no tension as to characterisation of activities.

In practice, it appears that the changes proposed as options in the Consultation Paper do not represent the embodiment of any principle as to which activities should receive government support. Instead it appears to be a variety of means for the revenue cost of that support to be restricted.

It could also be argued that, 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 concession, 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.

To some extent, we believe that there is an overemphasis in the Paper on the distinction between so-called “core” and “support” R&D activities. Fundamentally, in our view, in order to be eligible, all relevant activities should be an integral part of an overall undertaking or project [or a more broadly defined activity] that meets the criteria of what is R&D, in the generally understood and defined sense. Therefore, the distinction between core and support can be somewhat artificial and might be largely dependent upon how broadly or narrowly an “activity” is defined.

For example, although challenged from time to time, it is clear that to qualify as “*research and development activities*” [i.e. core R&D, under paragraph (a) of the current definition], each and every activity, in isolation, does not need to exhibit every attribute contained within that definition, such as needing to be systematic, investigative and experimental and involving innovation or high technical risk in its own right. Any activities will qualify as “research and development activities” if, as one of a number of activities in combination, they meet that description. In other words if certain activities, in combination, satisfy the definition in *paragraph 73B(1)(a)*, each of those activities, individually, will meet the description of R&D activities.

Under the current definition, when properly interpreted and applied, if any individual activity is an integral and necessary part of:

- a systematic, investigative and experimental process (ie comprising multiple such “activities” in combination); and
- that process (collection of activities) incorporates innovation or high levels of technical risk; and

- that process is undertaken for the purpose of acquiring new knowledge or improved materials etc.,
- it should then qualify as “core” R&D in the strict and commonly understood sense.

Accordingly, if a prototype or production testing etc., is a necessary and integral part of proving-up a hypothesis and/or assessing or determining the viability of an innovative product or service, it is “core” and not support. If those things are unnecessary or superfluous to that process or to that end, then it is not properly R&D, under the current definition

When taken to its logical conclusion, the alternative interpretation has the potential to lead to fundamental uncertainty and absurd outcomes, as virtually all R&D, when broken down to the ultimate degree, is comprised of basic, conventional, pre-existing forms of individual activity. The experimentation, innovation, risk etc, is invariably in the unique and novel ways that those individual activities are undertaken in combination in order to acquire the new knowledge and or to create new and improved materials, products etc.

It should be noted that the definition of R&D activities needs to be evaluated in combination, as all R&D activities are interdependent. For example, an activity cannot be systematic unless it is part of a group of activities. Similarly the activity of (experimentation) testing may not involve innovation or high levels of technical risk but the results will demonstrate whether the innovative concept (hypothesis) is proven or not.

Therefore it is the combination of activities which involve innovation or high levels of technical risk and are undertaken in a systematic, investigative and experimental manner.

Examples provided by the Industry Research and Development Board in 2001 demonstrated that it distinguished testing and experimental activities as support activities. Many industry proponents would argue that experimental activities are in fact fundamental (core) to the R&D activity.

Within the examples provided in 2001, only 1 or 2 specific (simplified) activities such as concept design, were considered to be core activities, out of a total 7 activities in each project, whilst all other activities were considered to be supporting activities, including prototype construction and testing. This interpretation would naturally lead to a larger component of expenditure being incurred on supporting activities than on the single core activity.

However, many in industry would argue that prototype development and testing are investigative and experimental activities that endeavour to resolve technical uncertainty. However, the regulatory application has been to treat these activities generally as supporting activities. This difference of interpretation was previously manageable as it was accepted that both core and support activities were fundamentally R&D activities. This debate will be accentuated if a significant difference in treatment was applied to core and support activities as proposed.

If examined in this light, the category of activities that would qualify as core R&D activities should generally be disproportionately larger than those that qualify as support activities, rather than the other way around, which seems to be one of the driving concerns underlying this aspect of the proposed reforms in the Paper.

## Examples

With regard to the examples given in the Consultation Paper at Attachment A, we note that these examples do not appear to exemplify or identify an in-principle distinction as to the core components of the R&D in question (innovation and high levels of technical risk). Rather, these examples express a concern with the *quantum* of associated expenditure.

Example 2 in particular would seem to highlight the primary concern with quantum. In that example, we submit that the key question should be as to how many trials were *necessary* for the success of the R&D project. If multiple trials resulted in new information as to improvements in the transportation models as to functionality, or production methods then the activity should be claimable.

It also appears to suggest that the sequence of activities is a concern where support activities take place after core activities have been completed. Again, we would submit that the question should be whether those activities were *necessary*, regardless of their timing or sequence with respect to the core activities. This is as espoused in the Explanatory Memorandum for the original R&D tax concession in 1986 which provided that activities which “are integral to and are undertaken in direct support of a research and development activity”.

In Example 1 there is no description of the particular relevant activities nor any other evidence as to how small or otherwise was the proportion of “core R&D” within the entire claim.

It should also be noted that when changes to the definition were espoused in 2001 the Industry Research and Development Board (now Innovation Australia) released examples as to how activities may meet the proposed definition. In those examples the R&D “projects” were broken down into broad categories of activities, with no more than 7 activities per project. These activities were then categorised into core and supporting activities. It is worth noting that each project as defined contained no more than 1 or 2 “core” activities. As a result of the interpretation provided in 2001, it should not be surprising that supporting activities make up a large quantum of the total R&D activity of a company.

However, the mere fact that the cost of these activities is high, does not make their contribution to the R&D activity any less valuable than “core” activities. Indeed they are likely to be fundamental to success or failure of the R&D project.

Whilst we comment below on each of the methodologies proposed in the Consultation Paper for the restriction of claims for supporting activities, from a practical legal and operational perspective, we nevertheless note that, of its nature, any such restriction places significant stress on the definitions of core and supporting activities with a characterisation of activities as core being preferable since there would be no such restriction.

## **4.1 Options proposed in the Consultation Paper**

### **4.1.1 Capped as a proportion of Core R&D**

We note the Consultation Paper suggests that capping eligible supporting activity at a percentage of core R&D expenditure would address concerns regarding the relative size of claims for supporting and core R&D activity.

However varying industries, R&D projects and indeed taxpayers will have differing ratios of expenditure with regard to core and supporting activities. This form of fixed cap would create an arbitrarily fixed relationship between core and supporting R&D claims, we consider it is likely to be inequitable in the majority of cases.

In addition, a question arises as to how the quantum of core R&D should be calculated for these purposes. For example, the quantum in question could be the current income year's core expenditure, the total expenditure over the life of the project, or actual or expected expenditure at a given time. Again, each approach is likely to affect taxpayers in a different way depending on their R&D cost profile and timing.

### **4.1.2 Sole purpose**

KPMG submits that a "sole purpose" test would not be practical, given that almost all bona fide supporting activities will have some element of incidental benefit for the claimant taxpayer. Accordingly, such an approach is likely to lead to the ineligibility of the majority of otherwise eligible expenditure incurred in supporting activities.

The suggested variation that the activity be "predominantly" for the purpose of supporting a core R&D activity may be a workable compromise. However, this option would require that practical, guidelines are given to both assessors and taxpayers to enable self assessment and equitable evaluation.

For completeness, we note that any approach based on a purpose test will, almost by definition, require an objective decision to be made as to the claimant's motive for such expenditure in addition to the assessment of value attributed to any incidental benefit. Accordingly, such an approach introduces not only uncertainty but also the potential for widely differing interpretation by assessors and claimants.

This is especially true given that industry R&D should focus on achieving a commercial outcome, albeit that this is achieved through the development of technology.

### **4.1.3 Exclude production / dual purpose activities**

With regard to the potential exclusion of activities with a purpose other than R&D, we would suggest that the key issue is that of whether the activities support or are needed to support the core R&D activities.

An approach based on exclusion of activities with a purpose other than R&D would seem to simply be a negative phrasing of the same question as that of sole purpose. However, we would submit that the key question should not be one of phrasing negative or positive limbs to the criteria but rather the recognition in legislation and practice of industry-specific norms as to at least some element of “dual purpose” or incidental benefit.

However, it should be noted that trials to prove whether a process or product is viable should continue to be eligible.

We would also submit that it is critical to the implementation of government policy that the development of prototypes remain eligible R&D expenditure as provided in the Explanatory Memorandum to the original legislation in 1986.

A variation on this option would be the inclusion of the concept of “Experimental Production” or Development as part of Commercial Production. This concept would be aligned with a number of international incentive programs such as Canada’s.

This concept acknowledges that experimental production activities can be necessary to verify whether the technological objectives have been met. This may be undertaken either as a separate experimental activity or where the development (trial) occurs in conjunction with commercial production. In these circumstances the expenditure incurred on the experimental production or development component of the commercial production would be an eligible R&D activity.

#### 4.1.4 Net expenditure only

The Consultation Paper suggests that the net expenditure approach would “reduce leakage of support to activities that are profitable in their own right and so target activities more likely to be stimulated by the incentive”.

Under the current rules, any proceeds received arising from the results of R&D are included in the claimant’s assessable income under section 73B(27A) ITAA 1936. Were those proceeds to be netted off against associated R&D expenditure, this would of itself, reduce the effective tax concession available to “successful” R&D projects where proceeds exceeded costs. Furthermore, the effective tax concession would also be reduced where the claimant’s project made a net economic loss.

Under this approach, net qualifying expenditure (and therefore, any effective tax concession) would only arise where, and to the extent that, the R&D was “unsuccessful”.

KPMG is concerned by the assertion that such an approach would target support to activities more likely to be stimulated by the incentive. We would submit that the stimulus to future R&D activity is the prospect of a successful outcome. If the tax relief benefit is withdrawn, the tax concession will effectively only provide such a “stimulus” to projects which ultimately fail.

The fact that a company has sought to reduce its commercial risk of failure somewhat, by not commencing specific R&D activity until it has determined specific technical requirements with a potential customer for a product, does not eliminate the technical risk from the project and the

consequent financial risk attendant with that failure. It is important to note that having a commercial arrangement in place with a customer for the first (or only one of a kind) product does not mitigate the attendant technical risk under an arms length arrangement. The mere fact that a company has done so should not preclude them access to the R&D tax credit.

For completeness, we also note there appear to be significant practical difficulties with this approach including the valuation and timing of receipt and recoupment and the additional stress it would place on the nature of the nexus between proceeds and R&D results. The compliance and administrative burden could be prohibitive.

Section 73B(27A) ITAA 1936 currently limits this to instances of broadly “direct” access to R&D results. However it appears the proposed approach would broaden this to include proceeds or income received by the taxpayer with a tenuous or at least indirect nexus to the R&D project. For example, would such recoupment be proposed to apply where, as an indirect result of eligible R&D activities upon which it had claimed the tax concession, a claimant company realised an economic gain through reduced costs rather than receiving proceeds from direct sale of R&D results?

In addition, it is currently a requirement that the results of R&D activities be commercialised and exploited to the benefit of the Australian economy. As such, it would appear counter to this requirement if the expenditure incurred on the R&D activities was netted off against the income earned from the commercialisation of the results of those same activities.

#### 4.1.5 Lower rate of assistance

KPMG submit that the level of assistance granted to supporting activities should remain the same as that granted to core activities. As the supporting activity is required to properly enable the core activity, to the extent support was withdrawn from the former, it must of necessity indirectly reduce support for the latter.

In addition, as noted in our general comments above with regard to the introduction of differing treatment between supporting and core activities, such a differential will place significant stress on the interpretation of the associated definitions leading to greater uncertainty and complexity for taxpayers.

For completeness, we note that this is likely to be the case regardless of the nature of that differential treatment – that is, whether by characterisation or by rate of concession.

#### 4.1.6 Other

Should any of these options be adopted consideration will also need to be given to the tax treatment of expenditure above the relevant cap or otherwise excluded.

That is, any expenditure excluded from the tax credit regime should be deductible in the year in which it is incurred.

## **4.2 Recommendations**

- The R&D tax credit program should maintain an uncomplicated approach and therefore no distinction should be made between core and supporting activities particularly as to level of support.
- The definition of R&D activity should be read “in combination” or defined as a project. As an integrity measure a definition or guidance should be provided as to what constitutes the “end” of an R&D project.
- More extensive guidance material, as proposed in the Consultation Paper, would provide clarity to companies undertaking R&D activities and assist in remedying any deficiencies in claims.

## **5 Exclusion of nominated activities**

The current legislation contains some express exclusions from the definition of R&D activities contained in subsection 73B(2C) of the *Income Tax Assessment Act 1936* that we submit should be reconsidered from a policy viewpoint.

### **5.1 Pre-production**

We submit that activities such as demonstration of commercial viability, tooling up and trial runs are often ‘core’ R&D activities and not merely remote. Most often, they are integral and essential activities for successfully carrying out a broader R&D project. The greatest commercial risk is not laboratory R&D but rather, achieving a commercially viable outcome from the development of technology.

Accordingly, their exclusion appears to be arbitrary and would not seem to promote the policy intent of the new tax incentive and we would suggest that paragraph 73B(2C)(H) be repealed.

### **5.2 Compliance with statutory requirements**

We note that the full scope of this exclusion is as follows:

“Activities associated with complying with statutory requirements or standards, such as the maintenance of national standards, the calibration of secondary standards and routine testing and analysis of materials, components, products, processes, soils, atmospheres and other things.”

We submit that exclusion of these activities is difficult to rationalise, firstly, for most of the same reasons as outlined for pre-production activities above.

However, even more compelling in this case, would seem to be the particular relevance of this type of R&D activity to R&D projects related to the pre-eminent global innovation challenges of sustainability and environmental impact, including reductions in carbon emissions, “green” technologies etc. These activities will be fundamentally developed and assessed against evolving standards and compliance benchmarks. Therefore, this exclusion in particular, would represent a very notable shortcoming in the framework of an innovation incentive scheme at this time, and would appear contrary to Government policy for promoting lower emissions and environmentally sustainable technologies.

An incentive for these expenditures should be available to encourage sustainability.

### **5.3 Exploration activities**

The exclusion for prospecting, exploring and drilling (“exploration”) for minerals etc is only an exclusion when these activities are undertaken for the purpose of discovering deposits, determining more precisely the location of deposits or determining the size or quality of

deposits. We submit that this exclusion be amended such that exploration activities that are innovative and/or technically challenging be allowable under the new R&D tax credit.

Moreover, little guidance as to the extent of this existing exclusion has been provided. There is now a perception that the administrators of the tax concession program believe that all exploration activities cannot qualify as R&D activities. In this regard, industry would welcome guidance, as to the eligibility of activities such as, the development of new techniques of drilling which may require some exploration activities to be undertaken to prove the new technique.

## **5.4 Other excluded activities**

As noted above, with regard to other currently excluded activities such as quality control and data collection, KPMG submits that these activities are often necessary to the successful prosecution of the project in question and to the extent that they are, should be afforded the same level of support as other R&D activities.

## **5.5 Recommendation**

- Consideration should be given to allowing the activities listed above to either be eligible core or supporting activities (if a distinction is to be made).
- More extensive guidance material, as proposed in the Consultation Paper, would provide clarity to companies undertaking R&D activities and assist in remedying any deficiencies in claims.

## **6 “On own behalf”, IP ownership and financial risk**

### **6.1 “On own behalf” and IP ownership**

As the Consultation Paper notes, the purpose of the “on own behalf” rule was to prevent the duplication of claims where R&D was contracted out. However, this requires a complex consideration of the three criteria of financial risk, control and ownership of results which is often difficult to apply in practice.

The Consultation Paper, also states that the location of Intellectual Property (IP) will not be relevant in the R&D tax credit program.

We are unclear as to how the proposed system would operate in practice but would seek clarification as to our understanding that the “on own behalf” rule would still apply, albeit that a foreign resident grouped-company would satisfy this requirement.

If this is the case, we would also question why a non-grouped foreign resident company should not be able to access the new R&D tax incentive, given that the stated policy is to achieve spillover effects in Australia?

### **6.2 Financial risk and Section 73CA**

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. On the other hand, however, the Australian Taxation Office (“ATO”) is interpreting 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 concession, which expressly include “creating an environment that is conducive to increased commercialisation of new processes and product technologies...”

Accordingly, we would submit that section 73CA should be repealed.

### **6.3 Recommendations**

- Clarification of the interaction between IP ownership and the “on own behalf rules”.
- Removal of the Guaranteed Return concept as the arrangements it was intended to target will not be available under the proposed R&D tax credit program.

## **7 Eligible entities**

### **7.1 Form of eligible entities**

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.

Accordingly, we submit that the concession be extended to all forms of commercial enterprise structures, as applied in New Zealand.

### **7.2 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.

There may also be merit in extending this threshold to a higher level.

## **8 Other recommendations**

### **8.1 Overseas activities**

The present legislation, which extends the concession to 10 percent of project expenditure on overseas R&D activities is, in our view, soundly based in policy and is worthwhile retaining. That policy is to assist and encourage Australian enterprises to continue to invest in innovation for the benefit of the Australian economy, even if that investment has to be outside Australia, but only where the R&D cannot otherwise be accessed from within Australia.

However, having regard to that policy objective, we do not see that it is necessarily appropriate to limit the eligibility to overseas R&D only when forming part of a larger Australian R&D project, if the activities meet the other eligibility criteria.

An employee will often also undertake R&D activities overseas whilst remaining in the employ of an Australian company. The knowledge gained by this employee returns to Australia upon his/her repatriation and provides spillover benefits to both the company and Australia. Under the current rules such activity would not be eligible.

Also, accessing this concession is unnecessarily difficult and complex and is inconsistent with principles of self-assessment, involving pre-certifying expenditure and potentially having to pre-determine total final “project” expenditure in order to ascertain that the overseas expenditure incurred will be within 10 percent of that ultimate total project cost.

Accordingly, KPMG recommends that:

- the current approach for requiring prior certification of expenditure under the IR&D Act be replaced with self-assessment of such claims (perhaps with a cap, if regarded as necessary, to “protect the revenue”);
- the current 10 percent restriction for qualifying expenditure be applied to total R&D expenditure incurred in an income year rather than 10 percent of an Australian-based project;
- qualifying expenditure exceeding the 10 percent cap should be carried forward for credit in subsequent income years;
- if a company utilises only a portion of the 10% cap then it can carry forward the unused portion to future years;
- there should be some relaxation/exception to the general rule of the overseas R&D, in particular having regard to the contracting entity; and
- in circumstances of significant national benefit an amount greater than 10% could be approved by Innovation Australia.

## **8.2 Transitional period**

We note that, under the present system, the treatment of core technology, plant and equipment and government grants is spread over more than one income year. Accordingly, with the advent of the new system, we also seek clarification as to transitional rules for treatment of these items.

## **8.3 Core technology**

With respect to “core technology” expenditure, we submit that the existing unduly complex rules should be scrapped and deductibility provided under the current capital allowance provisions, over the lesser of the “effective life” of that technology or, say, 3 or 5 years.

We also note that the current system appears to be inequitable as, in certain cases, successful R&D projects will suffer a permanent disallowance for a large portion of their core technology expenditure. That is, the undeducted expenditure carried forward will never be deductible if the project was successful in the first income year and there is no R&D expenditure in the following year.

## **8.4 Clawback of grants**

With respect to clawback of R&D expenditures, we believe that expenditure equal to the amount of any grant or subsidy should be subject to normal deductibility rules (the grant or subsidy being assessable income) and any excess be subject to the normal concessionary tax credit.

## **8.5 Plant and equipment deductions**

We assume that plant and equipment will continue to be entitled to concessional treatment under the new tax credit rules but would seek clarification in this regard.

We recommend that a company be able to elect whether the concessional treatment is to apply to its depreciable assets. An election was in place under the previous “exclusive use” concessional deductions for plant and equipment. A similar election should be incorporated into the design of the new R&D credit program.

## **8.6 Non-enhanced deductions**

KPMG submit that, where taxpayers have a turnover in excess of \$20m and are therefore ineligible for the refundable tax credit, such expenditure should be deductible under the general deduction provision. Where taxpayers are eligible for the refundable tax credit, relief could be given as a 30% tax credit.

The Consultation Paper states that it may be simpler to treat these expenditure items under normal tax rules. It should be noted that many of these items may not be elsewhere deductible because of their connection with R&D activities. As a result, companies will be adversely

impacted as a result of incurring this expenditure. A specific provision should be included to ensure that these items will be deductible at 100%.

## **8.7 Amendment period**

The Australian Tax Office (ATO) has currently an unlimited time, under subsection 170(10A) of the Income Tax Assessment Act 1936, to amend R&D tax concession claims.

This is at odds with the standard four year limitation for most other potential tax adjustments excepting for situations involving fraud or evasion or where Part IVA (the general anti-avoidance provision) applies.

There appears to be no justification for such an anomaly. Further, it imposes an unwarranted and onerous record-keeping compliance burden and increases the perceived risks for claimants, particularly with any substantial effluxion of time before a claim is reviewed. As such KPMG would recommend that subsection 170(10A) be repealed.

## **8.8 Impact on Franking Accounts**

The impact of the R&D Tax Credits on a company's franking account should also be incorporated into the design of the program. Under the current tax concession program, whilst a company receives a tax saving when dividends are paid to individual shareholders that shareholder must make up the shortfall of tax resulting from the concessional treatment received by the company.

The R&D tax credit should provide a permanent benefit to Australia and encourage investment in Australia.

Franking accounts should, therefore, reflect the notional tax paid prior to application of the R&D tax credit for both refundable and non-refundable categories. This would ensure that the cost of the benefit received by the company is not ultimately borne by shareholders on any future distributions paid by the company.

## **8.9 Plans and registration process**

As far as possible, we consider that compliance with the concessionary tax system should operate on the basis of self-assessment, consistently with the rest of the tax system. Compliance should be based upon sound risk management principles with a view to minimising unwarranted compliance costs for taxpayers.

Accordingly, we submit that:

- the registration process should be streamlined especially by further improving electronic lodgement systems currently in place; and

- the Australian Bureau of Statistics (“ABS”) information should accept any new R&D definitions. Whilst this might depart from currently accepted definitions, this would result in materially correct data.

Given the increased pace of change of technology, the definition in some sectors goes out of date. As a compromise, small companies should not need to lodge separately with the ABS.

We would also suggest that, in the context of tax consolidated groups, group companies should be able to register as a single consolidated entity, since the tax consolidation regime will account for the apportionment of claims through stub returns for periods within an income year spent inside / outside a tax consolidated group.

## **A Specific questions raised in the Consultation Paper**

### **Question 1**

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

KPMG comment: Refer section 8.1 in main body of submission.

### **Question 2**

How should the new R&D tax incentive treat R&D expenditure that is currently deductible at 100 per cent?

KPMG comment: Refer sections 8.3, 8.4 and 8.6 in main body of submission.

### **Question 3**

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

KPMG has no comment to make on this question at this time.

### **Question 4**

Should supporting activities:

- a) be capped as a proportion of expenditure on core R&D and if so, what would be the appropriate proportion?
- b) only be eligible where they are for the sole purpose of supporting core R&D activity?
- c) exclude production activities or dual role activities?
- d) only be eligible on a net expenditure basis?
- e) attract a lower rate of assistance than core R&D and if so, what would the appropriate rate be?

KPMG comment: Refer section 4 in main body of submission.

### **Question 5**

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

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

KPMG comment: Refer section 5 in main body of submission.

### **Question 6**

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

KPMG comment: Refer section 3.2 in main body of submission.